

Guidance Note on Audit of Banks (2009 Edition)



Celebrating the 60th Year of Excellence



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

List of RBI Circulars in CD

S. No.	Date	Title of the Circular	Circular No.
Master Circulars:			
1	1-Jul-2008	Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances	DBOD.No.BP.BC.20/21.04.048/2008-09
2	1-Jul-2008	Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by Banks	DBOD No. BP. BC. 5 / 21.04.141 / 2008-09
3	1-Jul-2008	Loans and Advances – Statutory and Other Restrictions	DBOD No. Dir. BC. 17/13.03.00/2008-09
4	1-Jul-2008	Disclosure in Financial Statements - Notes to Accounts	DBOD.BP.BC No. 3 / 21.04.018/2008-09
5	1-Jul-2008	Exposure Norms	DBOD No. Dir. BC. 19/13.03.00/ 2008- 09
6	1-Jul-2008	Guarantees and Co-acceptances	DBOD. No. Dir. BC. 18/13.03.00/2008-09
7	1-Jul-2008	Lending to Micro, Small and Medium Enterprises (MSME)Sector	RPCD.SME&NFS. BC. No. 2 / 06.02.31/ 2008-09
8	1-Jul-2008	Lending to Priority Sector	RPCD. CO. Plan. BC. 9 /04.09.01/ 2008-09
9	1-Jul-2008	Micro Credit	RPCD. MFFI. BC.No.08 / 12.01.001/ 2008-09
10	1-Jul-2008	Para-banking Activities	DBOD. No.FSD.BC. 7/ 24.01.001/ 2008-09
11	1-Jul-2008	Prudential Norms on Capital Adequacy-Basel I Framework	DBOD.No.BP.BC. 2 /21.01.002/2008-09

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S. No.	Date	Title of the Circular	Circular No.
12	1-Jul-2008	Prudential Guidelines on Capital Adequacy and Market Discipline - Implementation of the New Capital Adequacy Framework (NCAF)	DBOD.No.BP.BC. 11 /21.06.001/2008-09
13	1-Jul-2008	Frauds – Classification and Reporting	DBS. CO.FrMC. BC. No. 15 /23.04.001/2008-09
14	1-Jul-2008	Call-Notice Money Market Operations	FMD. MSRG. No.22/02.08.003/2008-09
15	1-Jul-2008	Wilful Defaulters	DBOD No.DL.BC.1/20.16.003/2008-09
16	1-Jul-2008	Credit Card Operations of Banks	DBOD.FSD.BC.6/ 24.01.011/ 2008-09
17	1-Jul-2008	Housing Finance	DBOD. No.DIR. (HSG). BC.10 /08.12.01/2008--09
18	1-Jul-2008	Know Your Customer (KYC) norms/Anti-Money Laundering (AML) Standards/ Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002	DBOD. AML. BC. No. 12 /14 .01.001/2008-09
19	11-Oct-2006	Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)	DBOD.No. Ret.BC. 34/12.01.001/2006-07
General Circulars:			
1	2-Jan-2009	Prudential Guidelines on Restructuring of Advances by Banks	DBOD.BP.No.104/21.04.132/2008-09
2	31-Dec-2008	Internal assignments in banks by statutory auditors	Ref.DBS.ARS.No.BC. 02/ 08.91.001/ 2008-09

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S. No.	Date	Title of the Circular	Circular No.
3	11-Dec-2008	Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by Banks	DBOD.No.BP. 97 /21.04.158/2008-09
4	8-Dec-2008	Lending under Consortium Arrangement-Multiple Banking Arrangements	DBOD.No.BP.BC.94 /08.12.001/2008-09
5	8-Dec-2008	Prudential Guidelines on Restructuring of Advances by Banks	DBOD.No.BP.BC.93 /21.04.132/2008-09
6	4-Dec-2008	Implementation of the New Capital Adequacy Framework (NCAF) – Parallel run reporting format – Monitoring of Prudential Floor	DBOD.No.BP.BC.92 /21.06.001/2008-09
7	1-Dec-2008	Operations of Foreign Branches and Subsidiaries of the Indian banks- Compliance with statutory/regulatory/ administrative prohibitions/ restrictions	DBOD.No.BP.BC.89 /21.04.141/2008-09
8	15-Nov-2008	Review of Prudential Norms – Provisioning for Standard Assets and Risk Weights for Exposures to Corporates, Commercial Real Estate and NBFC- ND-SI	DBOD.BP.BC. 83 / 21.01.002/2008-09
9	3-Nov-2008	Prudential Guidelines on Restructuring of Advances by Banks	DBOD.No.BP.BC.76 /21.04.0132/2008-09

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10	29-Oct-2008	Prudential Norms for Off-balance Sheet Exposures of Banks	DBOD.BP.BC.No.69/21.03.009/2008-09
11	13-Oct-2008	Guidelines on Exchange Traded Interest Rate Derivatives	DBOD.BP.BC. No.56 /21.04.157/2008-09
12	13-Oct-2008	Prudential Norms for Off-balance Sheet Exposures of Banks	DBOD.No.BP.BC.57 / 21.04.157 / 2008 – 09
13	8-Oct-2008	Mobile Banking transactions in India - Operative Guidelines for Banks	DPSS.CO.No.619/02.23.02/ 2008-09
14	19-Sep-2008	Lending under Consortium Arrangement-Multiple Banking Arrangements	DBOD No. BP. BC.46/ 08.12.001/2008-09
15	27-Aug-2008	Prudential Guidelines on Restructuring of Advances by Banks	DBOD.No.BP.BC.No.37 /21.04.132/2008-09
16	22-Aug-2008	Unclaimed Deposits - Inoperative Accounts in banks	DBOD.No.Leg. BC. 34 /09.07.005/2008-09
17	8-Aug-2008	Prudential Norms for Off-Balance Sheet Exposures of Banks	DBOD.No.BP.BC. 31 /21.04.157/2008 – 09

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S. No.	Date	Title of the Circular	Circular No.
18	30-Jul-2008	Agricultural Debt Waiver and Debt Relief Scheme, 2008 – Prudential Norms on Income Recognition, Asset Classification and Provisioning, and Capital Adequacy	DBOD.No.BP.BC. 26 /21.04.048/2008-09
19	22-Jul-2008	Mobile Payments in India - Operating Guidelines for Banks	DPSS.CO.No.144/02.23.01/2008-2009
20	30-May-2008	Capital Adequacy Norms – Treatment of banks' investments in subsidiaries- associates and of the subsidiaries' -associates' investments in parent banks	DBOD No.BP.BC 88/ 21.06.001./ 2007-08
21	21-May-2008	Consolidated Financial Statement	DBOD.No.BP.BC.84/21.04.018/2007-08
22	9-Apr-2008	Guidelines on Asset-Liability Management (ALM) System	DBOD. No. BP. BC. 68 / 21.04.098/ 2007-08
23	3-Mar-2008	Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks	DBOD.NO.BP. 64 / 21.04.158/ 2007-08
24	13-Feb-2008	Section 24 of the Banking Regulation Act, 1949 Maintenance of Statutory Liquidity Ratio (SLR)	DBOD No.Ret.BC.62/12.02.001/2007-08
25	29-Oct-2007	Guidelines for issuing preference shares as part of regulatory capital	DBOD.BP.BC.42/21.01.002/2007-08
26	26-Jun-2007	Guidelines on Stress Testing	DBOD. No. BP. BC.101 / 21.04.103/ 2006-07

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S. No.	Date	Title of the Circular	Circular No.
27	20-Apr-2007	Compliance Function in Banks	DBS.CO.PP.BC.6/11.01.005/2006-07
28	20-Apr-2007	Comprehensive Guidelines on Derivatives	DBOD. No. BP.BC. 86/21.04.157/2006-07
29	6-Mar-2007	Prudential limits for Inter Bank Liabilities (IBL)	DBOD.BP.BC.66/21.01.002/2006-07
30	20-Sep-2006	Section 17 (2) Of Banking Regulation Act, 1949 Appropriation from Reserve Fund	DBOD.BP.BC.31/21.04.018/2006-07
31	5-Apr-2006	Guidelines on compliance with AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates'	DBOD.BP.BC.76/21.04.018/2005-06
32	15-Mar-2005	Guidelines on compliance with AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates'	DBOD.BP.BC.76/ 21.04.018/2004-05
33	8-Feb-1999	Framework on Analysis of Balance Sheets	DBOD No. BP.BC.3/21.04.109/99

RBI/2008-09/84

DBOD.No.BP.BC.20/21.04.048/2008-09

July 1, 2008

All Commercial Banks (excluding RRBs)

Dear Sir

Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances

Please refer to the Master Circular No. DBOD.BP.BC.12/21.04.048/2007-2008 dated July 2, 2007 consolidating instructions / guidelines issued to banks till June 30, 2007 on matters relating to prudential norms on income recognition, asset classification and provisioning pertaining to advances.

2. The Master Circular has now been suitably updated by incorporating instructions issued up to June 30, 2008 and is attached. It has also been placed on the RBI web-site (<http://www.rbi.org.in>). We advise that this revised Master Circular consolidates the instructions contained in the circulars mentioned in the Annex II.

Yours faithfully

(Prashant Saran)
Chief General Manager-in-Charge

MASTER CIRCULAR - PRUDENTIAL NORMS ON INCOME RECOGNITION, ASSET CLASSIFICATION AND PROVISIONING PERTAINING TO ADVANCES

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Master Circular - Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances

1. GENERAL

1.1 In line with the international practices and as per the recommendations made by the Committee on the Financial System (Chairman Shri M. Narasimham), the Reserve Bank of India has introduced, in a phased manner, prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the banks so as to move towards greater consistency and transparency in the published accounts.

1.2 The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets of banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms. Also, the provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained nonperforming and the availability of security and the realisable value thereof.

1.3 Banks are urged to ensure that while granting loans and advances, realistic repayment schedules may be fixed on the basis of cash flows with borrowers. This would go a long way to facilitate prompt repayment by the borrowers and thus improve the record of recovery in advances.

1.4 With the introduction of prudential norms, the Health Code-based system for classification of advances has ceased to be a subject of supervisory interest. As such, all related reporting requirements, etc. under the Health Code system also cease to be a supervisory requirement. Banks may, however, continue the system at their discretion as a management information tool.

2. DEFINITIONS

2.1 Non performing Assets

2.1.1 An asset, including a leased asset, becomes non performing when it ceases to generate income for the bank.

2.1.2 A non performing asset (NPA) is a loan or an advance where;

- i. interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,
- ii. the account remains 'out of order' as indicated at paragraph 2.2 below, in respect of an Overdraft/Cash Credit (OD/CC),

- iii. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- iv. the instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,
- v. the instalment of principal or interest thereon remains overdue for one crop season for long duration crops,
- vi. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

2.1.3 Banks should, classify an account as NPA only if the interest charged during any quarter is not serviced fully within 90 days from the end of the quarter.

2.2 'Out of Order' status

An account should be treated as '**out of order**' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as '**out of order**'.

2.3 'Overdue'

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

3. INCOME RECOGNITION

3.1 Income Recognition Policy

3.1.1 The policy of income recognition has to be objective and based on the record of recovery. Internationally income from nonperforming assets (NPA) is not recognised on accrual basis but is booked as income only when it is actually received. Therefore, the banks should not charge and take to income account interest on any NPA.

3.1.2 However, interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

3.1.3 Fees and commissions earned by the banks as a result of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis over

the period of time covered by the re- negotiated or rescheduled extension of credit.

3.1.4 If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

3.2 Reversal of income

3.2.1 If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. **This will apply to Government guaranteed accounts also.**

3.2.2 In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

3.2.3 Leased Assets

The *finance charge* component of finance income [as defined in 'AS 19 Leases' issued by the Council of the Institute of Chartered Accountants of India (ICAI)] on the leased asset which has accrued and was credited to income account before the asset became nonperforming, and remaining unrealised, should be reversed or provided for in the current accounting period.

3.3 Appropriation of recovery in NPAs

3.3.1 Interest realised on NPAs may be taken to income account provided the credits in the accounts towards interest are not out of fresh/ additional credit facilities sanctioned to the borrower concerned.

3.3.2 In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e. towards principal or interest due), banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner.

3.4 Interest Application

There is no objection to the banks using their own discretion in debiting interest to an NPA account taking the same to Interest Suspense Account or maintaining only a record of such interest in proforma accounts.

3.5 Computation of NPA levels

Banks should deduct the following items from the Gross Advances and Gross NPAs to arrive at the Net advances and Net NPAs respectively:

- i) Balance in Interest Suspense Account
- ii) DICGC/ECGC claims received and held, pending adjustment
- iii) Part payment received and kept in suspense account
- iv) Total provisions held (excluding amount of technical write off and provision on standard assets)

For the purpose, the amount of gross advances should exclude the amount of Technical Write off but would include all outstanding loans and advances; including the advances for which refinance has been availed but excluding the amount of rediscounted bills. The level of gross and net NPAs will be arrived at in percentage terms by dividing the amount of gross and net NPAs by gross and net advances, computed as above, respectively.

4. ASSET CLASSIFICATION

4.1 Categories of NPAs

Banks are required to classify nonperforming assets further into the following three categories based on the period for which the asset has remained nonperforming and the realisability of the dues:

- i. **Substandard Assets**
- ii. **Doubtful Assets**
- iii. **Loss Assets**

4.1.1 Substandard Assets

With effect from 31 March 2005, a substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. In such cases, the current net worth of the borrower/ guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

4.1.2 Doubtful Assets

With effect from March 31, 2005, an asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months. A loan classified

as doubtful has all the weaknesses inherent in assets that were classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

4.1.3 Loss Assets

A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

4.2 **Guidelines for classification of assets**

4.2.1 Broadly speaking, classification of assets into above categories should be done taking into account the degree of well-defined credit weaknesses and the extent of dependence on collateral security for realisation of dues.

4.2.2 Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts. The banks may fix a minimum cut off point to decide what would constitute a high value account depending upon their respective business levels. The cut off point should be valid for the entire accounting year. Responsibility and validation levels for ensuring proper asset classification may be fixed by the banks. The system should ensure that doubts in asset classification due to any reason are settled through specified internal channels within one month from the date on which the account would have been classified as NPA as per extant guidelines.

4.2.3 Availability of security / net worth of borrower/ guarantor

The availability of security or net worth of borrower/ guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, except to the extent provided in Para 4. 2.9, as income recognition is based on record of recovery.

4.2.4 Accounts with temporary deficiencies

The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance

outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. In the matter of classification of accounts with such deficiencies banks may follow the following guidelines:

i) Banks should ensure that drawings in the working capital accounts are covered by the adequacy of current assets, since current assets are first appropriated in times of distress. Drawing power is required to be arrived at based on the stock statement which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular.

A working capital borrowal account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

ii) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ ad hoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of ad hoc sanction will be treated as NPA.

4.2.5 Upgradation of loan accounts classified as NPAs

If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' accounts. With regard to upgradation of a restructured/ rescheduled account which is classified as NPA contents of paragraphs 4.2.15 and 4.2.16 will be applicable.

4.2.6 Accounts regularised near about the balance sheet date

The asset classification of borrowal accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors/Inspecting Officers about the manner of regularisation of the account to eliminate doubts on their performing status.

4.2.7 Asset Classification to be borrower-wise and not facility-wise

i) It is difficult to envisage a situation when only one facility to a borrower/one investment in any of the securities issued by the borrower becomes a problem credit/investment and not others. Therefore, all the facilities granted by a bank to a borrower and investment in all the securities issued by the borrower will have to be treated as NPA/NPI and not the particular facility/investment or part thereof which has become irregular.

ii) If the debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning.

4.2.8 Advances under consortium arrangements

Asset classification of accounts under consortium should be based on the **record of recovery of the individual member banks** and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account will be treated as not serviced in the books of the other member banks and therefore, be treated as NPA. The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

4.2.9 Accounts where there is erosion in the value of security/frauds committed by borrowers

In respect of accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers it will not be prudent that such accounts should go through various stages of asset classification. In cases of such serious credit impairment the asset should be straightaway classified as doubtful or loss asset as appropriate.

i. Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

ii. If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

4.2.10 Advances to PACS/FSS ceded to Commercial Banks

In respect of agricultural advances as well as advances for other purposes granted by banks to PACS/ FSS under the on-lending system, only that particular credit facility granted to PACS/ FSS which is in default for a period of two crop seasons in case of short duration crops and one crop season in case of long duration crops, as the case may be, after it has become due will be classified as NPA and not all the credit facilities sanctioned to a PACS/ FSS. The other direct loans & advances, if any, granted by the bank to the member borrower of a PACS/ FSS outside the on-lending arrangement will become NPA even if one of the credit facilities granted to the same borrower becomes NPA.

4.2.11 Advances against Term Deposits, NSCs, KVP/IVP, etc

Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs and life policies need not be treated as NPAs, provided adequate margin is available in the accounts. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.

4.2.12 Loans with moratorium for payment of interest

- i. In the case of bank finance given for industrial projects or for agricultural plantations etc. where moratorium is available for payment of interest, payment of interest becomes 'due' only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue and hence do not become NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected.
- ii. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates.

4.2.13 Agricultural advances

- i. A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops, would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.
The above norms should be made applicable to all direct agricultural advances as listed at items 1.1.1, 1.1.2, 1.1.3, 1.1.4, 1.1.5, 1.1.6 and 1.2.1, 1.2.2 and 1.2.3 of Master Circular on lending to priority sector. RPCD.

No.Plan. BC. 84 /04.09.01/ 2006-2007 dated 30 April 2007. An extract of the list of these items is furnished in the Annex I. In respect of agricultural loans, other than those specified in the Annex I and term loans given to non-agriculturists, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

ii. Where natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-schedulement of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines contained in RBI circular RPCD. No.PLFS.BC.6/ 05.04.02/ 2004-05 dated July 1, 2005.

iii. In such cases of conversion or re-schedulement, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms & conditions and would be treated as NPA if interest and/or instalment of principal remains overdue for two crop seasons for short duration crops and for one crop season for long duration crops. For the purpose of these guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not 'long duration' would be treated as "short duration" crops.

iv. The debts as on March 31, 2004 of farmers, who have suffered production and income losses on account of successive natural calamities, i.e., drought, flood, or other calamities which might have occurred in the districts for two or more successive years during the past five years may be rescheduled/ restructured by the banks, provided the State Government concerned has declared such districts as calamity affected. Accordingly, the interest outstanding/accrued in the accounts of such borrowers (crop loans and agriculture term loans) up to March 31, 2004 may be clubbed with the principal outstanding therein as on March 31, 2004, and the amount thus arrived at shall be repayable over a period of five years, at current interest rates, including an initial moratorium of two years. As regards the crop loans and agricultural term loans which have already been restructured on account of natural calamities as per the standing guidelines, only the overdue instalments including interest thereon as on March 31, 2004 may be taken into account for the proposed restructuring. On restructuring as above, the farmers concerned will become eligible for fresh loans. The rescheduled/restructured loans as also the fresh loans to be issued to the farmers may be treated as current dues and need not be classified as NPA. While the fresh loans would be governed by the NPA norms as applicable to agricultural loans, in case of rescheduled/restructured loans, the NPA norms would be applicable from the third year onwards, i.e., on expiry of the initial moratorium period of two years.

v. In case of Kharif crop loans in the districts affected by failure of the SouthWest monsoon as notified by the State Government, recovery of any amount either by way of principal or interest during the financial year 2002-03 need not be effected. Further, the principal amount of crop loans in such cases should be converted into term loans and will be recovered over a period of minimum 5 years in case of small and marginal farmers and 4 years in case of other farmers. Interest due in the financial year 2002-03 on crop loans should also be deferred and no interest should be charged on the deferred interest. In such cases of conversion or re-schedulement of crop loans into term loans, the term loans may be treated as current dues and need not be classified as NPA. The asset classification of these loans would

thereafter be governed by the revised terms and conditions and would be treated as NPA if interest and / or instalment of principal remain overdue for two crop seasons.

vi. While fixing the repayment schedule in case of rural housing advances granted to agriculturists under Indira Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/instalment payable on such advances are linked to crop cycles.

4.2.14 Government guaranteed advances

The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked. This exemption from classification of Government guaranteed advances as NPA is not for the purpose of recognition of income. The requirement of invocation of guarantee has been delinked for deciding the asset classification and provisioning requirements in respect of State Government guaranteed exposures. With effect from the year ending 31 March 2006 State Government guaranteed advances and investments in State Government guaranteed securities would attract asset classification and provisioning norms if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days.

4.2.15 Restructuring/ Rescheduling of Loans

- i. The stages, at which the restructuring/rescheduling/renegotiation of the terms of loan agreement could take place, can be identified as under:
 - a. before commencement of commercial production;
 - b. after commencement of commercial production but before the asset has been classified as sub standard,
 - c. after commencement of commercial production and after the asset has been classified as sub standard.

In each of the foregoing three stages, the rescheduling, etc., of principal and/or of interest could take place, with or without sacrifice, as part of the restructuring package evolved.

ii. Treatment of restructured standard accounts

- a. A rescheduling of the instalments of principal alone, at any of the aforesaid first two stages would not cause a standard asset to be classified in the sub standard category provided the loan/credit facility is fully secured.
- b. A rescheduling of interest element at any of the foregoing first two stages would not cause an asset to be downgraded to sub standard category subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved. For the purpose, the future interest due as per the original loan agreement in respect of an account should be discounted to the present value at a rate appropriate to

the risk category of the borrower (i.e., current PLR+ the appropriate credit risk premium for the borrower category) and compared with the present value of the dues expected to be received under the restructuring package, discounted on the same basis.

c. In case there is a sacrifice involved in the amount of interest in present value terms, as at (b) above, the amount of sacrifice should either be written off or provision made to the extent of the sacrifice involved.

iii. Treatment of restructured substandard accounts

a. A rescheduling of the instalments of principal alone, would render a sub-standard asset eligible to be continued in the substandard category for the specified period, provided the loan/credit facility is fully secured.

b. A rescheduling of interest element would render a substandard asset eligible to be continued to be classified in sub standard category for the specified period subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved. For the purpose, the future interest due as per the original loan agreement in respect of an account should be discounted to the present value at a rate appropriate to the risk category of the borrower (i.e., current PLR + the appropriate credit risk premium for the borrower-category) and compared with the present value of the dues expected to be received under the restructuring package, discounted on the same basis.

c. In case there is a sacrifice involved in the amount of interest in present value terms, as at (b) above, the amount of sacrifice should either be written off or provision made to the extent of the sacrifice involved. Even in cases where the sacrifice is by way of write off of the past interest dues, the asset should continue to be treated as substandard.

iv. Upgradation of restructured accounts

The substandard accounts which have been subjected to restructuring etc., whether in respect of principal instalment or interest amount, by whatever modality, would be eligible to be upgraded to the standard category only after the specified period i.e., a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due, subject to satisfactory performance during the period. The amount of provision made earlier, net of the amount provided for the sacrifice in the interest amount in present value terms as aforesaid, could also be reversed after the one year period. During this one year period, the substandard asset will not deteriorate in its classification if satisfactory performance of the account is demonstrated during the period. In case, however, the satisfactory performance during the one year period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

v. General

a. The instructions contained in sub-paras (i) to (iv) above would be applicable to all type of credit facilities including working capital limits, extended to industrial units, provided they are fully covered by tangible securities.

b. As trading involves only buying and selling of commodities and the problems associated with manufacturing units such as bottleneck in commercial production, time and cost escalation etc. are not applicable to them, the guidelines contained in subparas (i) to (iv) above should not be applied to restructuring/ rescheduling of credit facilities extended to traders.

c. While assessing the extent of security cover available to the credit facilities, which are being restructured/ rescheduled, collateral security would also be reckoned, provided such collateral is a tangible security properly charged to the bank and is not in the intangible form like guarantee etc. of the promoter/ others.

d. Banks can not reschedule /restructure /renegotiate borrowal accounts with retrospective effect. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring /rescheduling/renegotiation. In case there is undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would attract supervisory intervention.

e. Banks are not expected to repeatedly restructure/ reschedule the amounts due to them unless there are very strong and valid reasons which warrant such repeated restructuring/rescheduling. Restructuring in all cases should be based on viability parameters. Any restructuring done without looking into cash flows of the borrower would invite supervisory concerns. The special asset classification status in terms of paragraphs (ii) and (iii) above shall be available only when the account is restructured for the first time, as already prescribed for restructuring under CDR mechanism, vide para 4.2.16 (G) below.

f. Normally restructuring can not take place unless alteration/changes in the original loan agreement are made with the formal consent/application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.

g. As regards the regulatory treatment of 'funded interest' recognised as income and 'conversion into equity, debentures or any other instrument' banks should adopt the following:

- i. Funded Interest: Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/ rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.
- ii. Conversion into equity, debentures or any other instrument: The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition

to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the “available for sale” category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, ab initio, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realisation basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognised only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

h. Reversal of provision made for NPA is permitted when the account becomes a standard asset. The provision made in a restructured/rescheduled account towards interest sacrifice, may be reversed on satisfactory completion of all repayment obligations and the outstanding in the account is fully repaid. Banks should not re-compute the extent of sacrifice each year and make adjustments in the provisions made towards interest sacrifice.

i. While banks may consider accounts other than that of industrial units also for restructuring, such accounts would have to qualify the basic test of viability before it is considered for restructuring. However, these accounts would not qualify for the special asset classification status available to restructured ‘standard’ and restructured ‘substandard’ accounts as at sub-paras (ii) and (iii) above. The accounts which do not qualify for restructuring/rescheduling in terms of sub-paras (i) to (iii) above, will be subjected to the following prudential norms.

- i) These restructured/ rescheduled accounts would continue to age and migrate to the next asset classification status in the normal course. Banks should ensure that the amount of sacrifice, if any, in the element of interest both in term loans or working capital facilities, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved. For the purpose, the future interest due as per the original loan agreement in respect of an account should be discounted to the present value at a rate appropriate to the risk category of the borrower (i.e., current PLR + the appropriate credit risk premium for the borrower-category) and compared with the present value of the dues expected to be received under the restructuring package, discounted on the same basis.
- ii) These restructured/ rescheduled accounts, whether in respect of principal instalment or interest amount, by whatever modality, would be eligible to be upgraded to the standard category only after a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the revised terms, subject to satisfactory performance during the period. The amount of provision made earlier, net of the amount provided for the sacrifice in

the interest amount in present value terms as aforesaid, could also be reversed after the one year period.

j. Disclosures in the Notes on Account to the Balance Sheet pertaining to restructured/ rescheduled accounts apply to all accounts restructured/ rescheduled during the year. While banks should ensure that they comply with the minimum disclosures prescribed, they may make more disclosures than the minimum prescribed.

4.2.16 Revised Guidelines on Corporate Debt Restructuring (CDR) Mechanism

A. Background

i. Based on the experience in other countries like the U.K., Thailand, Korea, etc. of putting in place institutional mechanism for restructuring of corporate debt and need for a similar mechanism in India, a Corporate Debt Restructuring System was evolved, and detailed guidelines were issued vide circular DBOD No. BP.BC. 15/21.04.114/200001 dated August 23, 2001 for implementation by banks. Subsequently based on the recommendations made by the Working Group to make the operations of the CDR mechanism more efficient (Chairman: Shri Vepa Kamesam, Deputy Governor, RBI. The group was constituted pursuant to the announcement made by the Finance Minister in the Union Budget 2002-2003), and consultations with the Government, the guidelines on Corporate Debt Restructuring system were revised in terms of our circular DBOD No. BP.BC. 68/21.04.114/200203 dated February 5, 2003.

ii. A Special Group was constituted in September 2004 with Smt.S.Gopinath, Deputy Governor, RBI, as the Chairperson to review and suggest changes / improvements, if any, in the CDR mechanism. Based on the suggestions of the Special Group, and the feedback received on the draft guidelines, the CDR Guidelines have been further revised. The revised guidelines are in supersession of the extant guidelines outlined in the aforesaid circular dated February 5, 2003.

iii. One of the main features of the restructuring under CDR system is the provision of two categories of debt restructuring under the CDR system. Accounts, which are classified as 'standard' and 'substandard' in the books of the creditors, will be restructured under the first category (Category 1). Accounts which are classified as 'doubtful' in the books of the creditors would be restructured under the second category (Category 2).

The main features of the CDR mechanism are given below:

B. Objective

The objective of the Corporate Debt Restructuring (CDR) framework is to ensure timely and transparent mechanism for restructuring the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned. In particular, the framework will aim at preserving viable corporates that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

C. Structure

CDR system in the country will have a three tier structure:

- CDR Standing Forum and its Core Group
- CDR Empowered Group
- CDR Cell

i. CDR Standing Forum

a) The CDR Standing Forum would be the representative general body of all financial institutions and banks participating in CDR system. All financial institutions and banks should participate in the system in their own interest. CDR Standing Forum will be a self-empowered body, which will lay down policies and guidelines, and monitor the progress of corporate debt restructuring.

b) The Forum will also provide an official platform for both the creditors and borrowers (by consultation) to amicably and collectively evolve policies and guidelines for working out debt restructuring plans in the interests of all concerned.

c) The CDR Standing Forum shall comprise of Chairman & Managing Director, Industrial Development Bank of India Ltd; Chairman, State Bank of India; Managing Director & CEO, ICICI Bank Limited; Chairman, Indian Banks' Association as well as Chairmen and Managing Directors of all banks and financial institutions participating as permanent members in the system. Since institutions like Unit Trust of India, General Insurance Corporation, Life Insurance Corporation may have assumed exposures on certain borrowers, these institutions may participate in the CDR system. The Forum will elect its Chairman for a period of one year and the principle of rotation will be followed in the subsequent years. However, the Forum may decide to have a Working Chairman as a wholtime officer to guide and carry out the decisions of the CDR Standing Forum. The RBI would not be a member of the CDR Standing Forum and Core Group. Its role will be confined to providing broad guidelines.

d) The CDR Standing Forum shall meet at least once every six months and would review and monitor the progress of corporate debt restructuring system. The Forum would also lay down the policies and guidelines including those relating to the critical parameters for restructuring (for example, maximum period for a unit to become viable under a restructuring package, minimum level of promoters' sacrifice etc.) to be followed by the CDR Empowered Group and CDR Cell for debt restructuring and would ensure their smooth functioning and adherence to the prescribed time schedules for debt restructuring. It can also review any individual decisions of the CDR Empowered Group and CDR Cell. The CDR Standing Forum may also formulate guidelines for dispensing special treatment to those cases, which are complicated and are likely to be delayed beyond the time frame prescribed for processing.

e) A CDR Core Group will be carved out of the CDR Standing Forum to assist the Standing Forum in convening the meetings and taking decisions relating to policy, on behalf of the Standing Forum. The Core Group will consist of Chief Executives of Industrial Development Bank of India Ltd., State Bank of India, ICICI Bank Ltd, Bank of Baroda, Bank of India, Punjab National Bank, Indian Banks' Association and Deputy Chairman of Indian Banks' Association representing foreign banks in India.

f) The CDR Core Group would lay down the policies and guidelines to be followed by the CDR Empowered Group and CDR Cell for debt restructuring. These guidelines shall also suitably address the operational difficulties experienced in the functioning of the CDR Empowered Group. The CDR Core Group shall also prescribe the PERT chart for processing of cases referred to the CDR system and decide on the modalities for enforcement of the time frame. The CDR Core Group shall also lay down guidelines to ensure that overoptimistic projections are not assumed while preparing / approving restructuring proposals especially with regard to capacity utilization, price of products, profit margin, demand, availability of raw materials, input-output ratio and likely impact of imports / international cost competitiveness.

ii. CDR Empowered Group

a) The individual cases of corporate debt restructuring shall be decided by the CDR Empowered Group, consisting of ED level representatives of Industrial Development Bank of India Ltd., ICICI Bank Ltd. and State Bank of India as standing members, in addition to ED level representatives of financial institutions and banks who have an exposure to the concerned company. While the standing members will facilitate the conduct of the Group's meetings, voting will be in proportion to the exposure of the creditors only. In order to make the CDR Empowered Group effective and broad based and operate efficiently and smoothly, it would have to be ensured that participating institutions / banks approve a panel of senior officers to represent them in the CDR Empowered Group and ensure that they depute officials only from among the panel to attend the meetings of CDR Empowered Group. Further, nominees who attend the meeting pertaining to one account should invariably attend all the meetings pertaining to that account instead of deputing their representatives.

b) The level of representation of banks/ financial institutions on the CDR Empowered Group should be at a sufficiently senior level to ensure that concerned bank / FI abides by the necessary commitments including sacrifices, made towards debt restructuring. There should be a general authorisation by the respective Boards of the participating institutions / banks in favour of their representatives on the CDR Empowered Group, authorizing them to take decisions on behalf of their organization, regarding restructuring of debts of individual corporates.

c) The CDR Empowered Group will consider the preliminary report of all cases of requests of restructuring, submitted to it by the CDR Cell. After the Empowered Group decides that restructuring of the company is prima-facie feasible and the enterprise is potentially viable in terms of the policies and guidelines evolved by Standing Forum, the detailed restructuring package will be worked out by the CDR Cell in conjunction with the Lead Institution. However, if the lead institution faces difficulties in working out the detailed restructuring package, the participating banks / financial institutions should decide upon the alternate institution / bank which would work out the detailed restructuring package at the first meeting of the Empowered Group when the preliminary report of the CDR Cell comes up for consideration.

d) The CDR Empowered Group would be mandated to look into each case of debt restructuring, examine the viability and rehabilitation potential of the Company and approve the restructuring package within a specified time frame of 90 days, or at best within 180 days of reference to the Empowered

Group. The CDR Empowered Group shall decide on the acceptable viability benchmark levels on the following illustrative parameters, which may be applied on a case-by-case basis, based on the merits of each case:

- Return on Capital Employed (ROCE),
- Debt Service Coverage Ratio (DSCR),
- Gap between the Internal Rate of Return (IRR) and the Cost of Fund (CoF),
- Extent of sacrifice.

e) The Board of each bank / FI should authorise its Chief Executive Officer (CEO) and / or Executive Director (ED) to decide on the restructuring package in respect of cases referred to the CDR system, with the requisite requirements to meet the control needs. CDR Empowered Group will meet on two or three occasions in respect of each borrowal account. This will provide an opportunity to the participating members to seek proper authorisations from their CEO / ED, in case of need, in respect of those cases where the critical parameters of restructuring are beyond the authority delegated to him / her.

f) The decisions of the CDR Empowered Group shall be final. If restructuring of debt is found to be viable and feasible and approved by the Empowered Group, the company would be put on the restructuring mode. If restructuring is not found viable, the creditors would then be free to take necessary steps for immediate recovery of dues and / or liquidation or winding up of the company, collectively or individually.

iii) CDR Cell

a) The CDR Standing Forum and the CDR Empowered Group will be assisted by a CDR Cell in all their functions. The CDR Cell will make the initial scrutiny of the proposals received from borrowers / creditors, by calling for proposed rehabilitation plan and other information and put up the matter before the CDR Empowered Group, within one month to decide whether rehabilitation is prima facie feasible. If found feasible, the CDR Cell will proceed to prepare detailed Rehabilitation Plan with the help of creditors; and if necessary, experts to be engaged from outside. If not found prima facie feasible, the creditors may start action for recovery of their dues.

b) All references for corporate debt restructuring by creditors or borrowers will be made to the CDR Cell. It shall be the responsibility of the lead institution / major stakeholder to the corporate, to work out a preliminary restructuring plan in consultation with other stakeholders and submit to the CDR Cell within one month. The CDR Cell will prepare the restructuring plan in terms of the general policies and guidelines approved by the CDR Standing Forum and place for consideration of the Empowered Group within 30 days for decision. The Empowered Group can approve or suggest modifications but ensure that a final decision is taken within a total period of 90 days. However, for sufficient reasons the period can be extended up to a maximum of 180 days from the date of reference to the CDR Cell.

c) The CDR Standing Forum, the CDR Empowered Group and CDR Cell

is at present housed in Industrial Development Bank of India Ltd. However, it may be shifted to another place if considered necessary, as may be decided by the Standing Forum. The administrative and other costs shall be shared by all financial institutions and banks. The sharing pattern shall be as determined by the Standing Forum.

d) CDR Cell will have adequate members of staff deputed from banks and financial institutions. The CDR Cell may also take outside professional help. The cost in operating the CDR mechanism including CDR Cell will be met from contribution of the financial institutions and banks in the Core Group at the rate of Rs.50 lakh each and contribution from other institutions and banks at the rate of Rs.5 lakh each.

D. Other features

i. Eligibility criteria

a) The scheme will not apply to accounts involving only one financial institution or one bank. The CDR mechanism will cover only multiple banking accounts / syndication / consortium accounts of corporate borrowers with outstanding fundbased and non-fund based exposure of Rs.10 crore and above by banks and institutions.

b) The Category 1 CDR system will be applicable only to accounts classified as 'standard' and 'substandard'. There may be a situation where a small portion of debt by a bank might be classified as doubtful. In that situation, if the account has been classified as 'standard' / 'substandard' in the books of at least 90% of creditors (by value), the same would be treated as standard / substandard, only for the purpose of judging the account as eligible for CDR, in the books of the remaining 10% of creditors. There would be no requirement of the account / company being sick, NPA or being in default for a specified period before reference to the CDR system. However, potentially viable cases of NPAs will get priority. This approach would provide the necessary flexibility and facilitate timely intervention for debt restructuring. Prescribing any milestone(s) may not be necessary, since the debt restructuring exercise is being triggered by banks and financial institutions or with their consent.

c) While corporates indulging in frauds and malfeasance even in a single bank will continue to remain ineligible for restructuring under CDR mechanism as hitherto, the Core group may review the reasons for classification of the borrower as wilful defaulter specially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent and satisfy itself that the borrower is in a position to rectify the wilful default provided he is granted an opportunity under the CDR mechanism. Such exceptional cases may be admitted for restructuring with the approval of the Core Group only. The Core Group may ensure that cases involving frauds or diversion of funds with mala fide intent are not covered.

d) The accounts where recovery suits have been filed by the creditors against the company, may be eligible for consideration under the CDR system provided, the initiative to resolve the case under the CDR system is taken by at least 75% of the creditors (by value) and 60% of creditors (by number).

e) BIFR cases are not eligible for restructuring under the CDR system. However, large value BIFR cases, may be eligible for restructuring under the CDR system if specifically recommended by the CDR Core Group. The Core Group shall recommend exceptional BIFR cases on a case-to-case basis for consideration under the CDR system. It should be ensured that the lending institutions complete all the formalities in seeking the approval from BIFR before implementing the package.

ii. Reference to CDR system

a) Reference to Corporate Debt Restructuring System could be triggered by (i) any or more of the creditor who have minimum 20% share in either working capital or term finance, or (ii) by the concerned corporate, if supported by a bank or financial institution having stake as in (i) above.

b) Though flexibility is available whereby the creditors could either consider restructuring outside the purview of the CDR system or even initiate legal proceedings where warranted, banks / FIs should review all eligible cases where the exposure of the financial system is more than Rs.100 crore and decide about referring the case to CDR system or to proceed under the new Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 or to file a suit in DRT etc.

iii. Legal Basis

a) CDR is a non-statutory mechanism which is a voluntary system based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA). The Debtor-Creditor Agreement (DCA) and the Inter-Creditor Agreement (ICA) shall provide the legal basis to the CDR mechanism. The debtors shall have to accede to the DCA, either at the time of original loan documentation (for future cases) or at the time of reference to Corporate Debt Restructuring Cell. Similarly, all participants in the CDR mechanism through their membership of the Standing Forum shall have to enter into a legally binding agreement, with necessary enforcement and penal clauses, to operate the System through laid-down policies and guidelines. The ICA signed by the creditors will be initially valid for a period of 3 years and subject to renewal for further periods of 3 years thereafter. The lenders in foreign currency outside the country are not a part of CDR system. Such creditors and also creditors like GIC, LIC, UTI, etc., who have not joined the CDR system, could join CDR mechanism of a particular corporate by signing transaction to transaction ICA, wherever they have exposure to such corporate.

b) The Inter-Creditor Agreement would be a legally binding agreement amongst the creditors, with necessary enforcement and penal clauses, wherein the creditors would commit themselves to abide by the various elements of CDR system. Further, the creditors shall agree that if 75 per cent of creditors by value and 60 per cent of the creditors by number, agree to a restructuring package of an existing debt (i.e., debt outstanding), the same would be binding on the remaining creditors. Since Category 1 CDR Scheme covers only standard and substandard accounts, which in the opinion of 75 per cent of the creditors by value and 60 per cent of creditors by number, are likely to become performing after introduction of the CDR package, it is expected that all other creditors (i.e., those outside the minimum 75 per cent by value and 60 per cent by number) would be willing to participate in the entire CDR package, including the agreed additional financing.

Other Aspects

c) In order to improve effectiveness of the CDR mechanism a clause may be incorporated in the loan agreements involving consortium/syndicate accounts whereby all creditors, including those which are not members of the CDR mechanism, agree to be bound by the terms of the restructuring package that may be approved under the CDR mechanism, as and when restructuring may become necessary.

iv. Stand-Still Clause

a) One of the most important elements of Debtor-Creditor Agreement would be 'stand still' agreement binding for 90 days, or 180 days by both sides. Under this clause, both the debtor and creditor(s) shall agree to a legally binding 'standstill' whereby both the parties commit themselves not to take recourse to any other legal action during the 'standstill' period, this would be necessary for enabling the CDR System to undertake the necessary debt restructuring exercise without any outside intervention, judicial or otherwise. However, the standstill clause will be applicable only to any civil action either by the borrower or any lender against the other party and will not cover any criminal action. Further, during the standstill period, outstanding foreign exchange forward contracts, derivative products, etc., can be crystallised, provided the borrower is agreeable to such crystallisation. The borrower will additionally undertake that during the standstill period the documents will stand extended for the purpose of limitation and also that he will not approach any other authority for any relief and the directors of the borrowing company will not resign from the Board of Directors during the stand-still period.

b) During pendency of the case with the CDR system, the usual asset classification norms would continue to apply. The process of reclassification of an asset should not stop merely because the case is referred to the CDR Cell. However, if a restructuring package under the CDR system is approved by the Empowered Group, and the approved package is implemented within four months from the date of approval, the asset classification status may be restored to the position which existed when the reference to the Cell was made. Consequently, any additional provisions made by banks towards deterioration in the asset classification status during the pendency of the case with the CDR system may be reversed.

c) If an approved package is not implemented within four months after the date of approval by the Empowered Group, it would indicate that the success of the package is uncertain. In that case, the asset classification status of the account should not be restored to the position as on the date of reference to the CDR Cell.

v. Additional finance

a) Additional finance, if any, is to be provided by all creditors of a 'standard' or 'substandard account' irrespective of whether they are working capital or term creditors, on a pro-rata basis. In case for any internal reason, any creditor (outside the minimum 75 per cent and 60 per cent) does not wish to commit additional financing, that creditor will have an option in accordance with the provisions of para 4.2.16.D (vi).

b) The additional finance may be treated as 'standard asset', up to a period of one year after the first interest/ principal payment, whichever is earlier, falls due under the approved restructuring package. However, in the case of accounts where the existing facilities are classified as 'substandard' and 'doubtful', interest income on the additional finance should be recognised only on cash basis. If the restructured asset does not qualify for upgradation at the end of the above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

c) The providers of additional finance, whether existing creditors or new creditors, shall have a preferential claim, to be worked out under the restructuring package, over the providers of existing finance with respect to the cash flows out of recoveries, in respect of the additional exposure.

vi. Exit Option

a) As stated in para 4.2.16.D (v)(a) a creditor (outside the minimum 75 per cent and 60 per cent) who for any internal reason does not wish to commit additional finance will have an option. At the same time, in order to avoid the "free rider" problem, it is necessary to provide some disincentive to the creditor who wishes to exercise this option. Such creditors can either (a) arrange for its share of additional finance to be provided by a new or existing creditor, or (b) agree to the deferment of the first year's interest due to it after the CDR package becomes effective. The first year's deferred interest as mentioned above, without compounding, will be payable along with the last instalment of the principal due to the creditor.

b) In addition, the exit option will also be available to all lenders within the minimum 75 percent and 60 percent provided the purchaser agrees to abide by restructuring package approved by the Empowered Group. The exiting lenders may be allowed to continue with their existing level of exposure to the borrower provided they tie up with either the existing lenders or fresh lenders taking up their share of additional finance.

c) The lenders who wish to exit from the package would have the option to sell their existing share to either the existing lenders or fresh lenders, at an appropriate price, which would be decided mutually between the exiting lender and the taking over lender. The new lenders shall rank on par with the existing lenders for repayment and servicing of the dues since they have taken over the existing dues to the exiting lender.

d) In order to bring more flexibility in the exit option, One Time Settlement

can also be considered, wherever necessary, as a part of the restructuring package. If an account with any creditor is subjected to One Time Settlement (OTS) by a borrower before its reference to the CDR mechanism, any fulfilled commitments under such OTS may not be reversed under the restructured package. Further payment commitments of the borrower arising out of such OTS may be factored into the restructuring package.

vii. Conversion option

- a) The CDR Empowered Group, while deciding the restructuring package, should decide on the issue regarding convertibility (into equity) option as a part of restructuring exercise whereby the banks / financial institutions shall have the right to convert a portion of the restructured amount into equity, keeping in view the statutory requirement under Section 19 of the Banking Regulation Act, 1949, (in the case of banks) and relevant SEBI regulations.
- b) Equity acquired by way of conversion of debt / overdue interest under the CDR mechanism is allowed to be taken up without seeking prior approval from RBI, even if by such acquisition the prudential capital market exposure limit prescribed by the RBI is breached, subject to reporting such holdings to RBI, Department of Banking Supervision (DBS), every month along with the regular DSB Return on Asset Quality. However, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act 1949.
- c) Acquisition of non-SLR securities by way of conversion of debt is exempted from the mandatory rating requirement and the prudential limit on investment in unlisted non-SLR securities prescribed by the RBI, subject to periodical reporting to RBI in the aforesaid DSB return.
- d) The relaxations allowed under paras 4.2.16.D (vii)(b)&(c) would be reviewed after a year.

viii. Category 2 CDR System

- a) There have been instances where the projects have been found to be viable by the creditors but the accounts could not be taken up for restructuring under the CDR system as they fell under 'doubtful' category. Hence, a second category of CDR is introduced for cases where the accounts have been classified as 'doubtful' in the books of creditors, and if a minimum of 75% of creditors (by value) and 60% creditors (by number) satisfy themselves of the viability of the account and consent for such restructuring, subject to the following conditions:
 - i) It will not be binding on the creditors to take up additional financing worked out under the debt restructuring package and the decision to lend or not to lend will depend on each creditor bank / FI separately. In other words, under the proposed second category of the CDR mechanism, the existing loans will only be restructured and it would be up to the promoter to firm up additional financing arrangement with new or existing creditors individually.
 - ii) All other norms under the CDR mechanism such as the standstill clause, asset classification status during the pendency of

restructuring under CDR, etc., will continue to be applicable to this category also.

b) No individual case should be referred to RBI. CDR Core Group may take a final decision whether a particular case falls under the CDR guidelines or it does not.

c) All the other features of the CDR system as applicable to the First Category will also be applicable to cases restructured under the Second Category.

E. Creditors' Rights

All CDR approved packages must incorporate creditors' right to accelerate repayment and borrowers' right to prepay. The right of recompense should be based on certain performance criteria to be decided by the Standing Forum.

F. Prudential and Accounting Issues

i. Restructuring of corporate debts under CDR system could take place in the following stages:

a. before commencement of commercial production;

b. after commencement of commercial production but before the asset has been classified as 'substandard';

c. after commencement of commercial production and the asset has been classified as 'substandard' or 'doubtful'.

ii. Accounts restructured under CDR system, including accounts classified as 'doubtful' under Category 2 CDR, would be eligible for regulatory concession in asset classification and provisioning on writing off/providing for economic sacrifice stipulated in para 4.2.16.F(iii)(b) and 4.2.16.F(v)(b) below only if

a) Restructuring under CDR mechanism is done for the first time,

b) The unit becomes viable in 7 years and the repayment period for the restructured debts does not exceed 10 years,

c) Promoters' sacrifice and additional funds brought by them should be a minimum of 15% of creditors' sacrifice, and

d) Personal guarantee is offered by the promoter except when the unit is affected by external factors pertaining to the economy and industry.

iii. Treatment of 'standard' accounts restructured under CDR

a. A rescheduling of the instalments of principal alone, at any of the aforesaid first two stages [paragraph 4.2.16.F(i)(a) and (b) above] would not cause a standard asset to be classified in the substandard category, provided conditions (a) to (d) of Para 4.2.16.F(ii) are complied with and the loan / credit facility is fully secured.

b. A rescheduling of interest element at any of the foregoing first two stages provided conditions (i) to (iv) of Para 4.2.16.F(ii) are complied with would not cause an asset to be downgraded to substandard category on writing off/providing for the amount of sacrifice, if any, in the element of interest measured in present value terms. For this purpose, the sacrifice should be computed as the difference between the present value of future interest income reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring and the interest charged as per the restructuring package discounted by the current BPLR as on the date of restructuring plus appropriate term premium and credit risk premium as on the date of restructuring.

iv. Moratorium under Restructuring

If a standard asset is taken up for restructuring before commencement of production and the restructuring package provides a longer period of moratorium on interest payments beyond the expected date of commercial production / date of commercial production vis-à-vis the original moratorium period, the asset can no more be treated as standard asset. It may, therefore, be classified as substandard. The same regulatory treatment will apply if a standard asset is taken up for restructuring after commencement of production and the restructuring package provides for a longer period of moratorium on interest payments than the original moratorium period.

v. Treatment of 'substandard' / 'doubtful' accounts restructured under CDR

a. A rescheduling of the instalments of principal alone, would render a substandard / 'doubtful' asset eligible to be continued in the substandard / 'doubtful' category for the specified period, [defined in sub para (b) below] provided the conditions (a) to (d) of Para 4.2.16.F(ii) are complied with and the loan / credit facility is fully secured.

b. A rescheduling of interest element would render a substandard / 'doubtful' asset eligible to be continued to be classified in substandard / 'doubtful' category for the specified period, i.e., a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, provided the conditions (a) to (d) of Para 4.2.16.F(ii) are complied with and the amount of sacrifice, if any, in the element of interest, measured in present value terms computed as per the methodology described in Para 4.2.16.F(iii)(b) is either written off or provision is made to the extent of the sacrifice involved.

vi. Treatment of Provision

a) Interest sacrifice involved in the amount of interest should be written off or provided for necessarily by debit to Profit & Loss account and held in a distinct account.

b) Sacrifice may be recomputed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR, term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

c) The amount of provision made for NPA, may be reversed when the account is reclassified as a 'standard asset'.

d). In the event any security is taken against interest sacrifice, it should be valued at Re.1/till maturity of the security. This will ensure that the effect of charging off the economic sacrifice to the Profit & Loss account is not negated.

vii. Upgradation of restructured accounts

The substandard / doubtful accounts at Para 4.2.16.F(v) (a) & (b) above, which have been subjected to restructuring, etc. whether in respect of principal instalment or interest amount, by whatever modality, would be eligible to be upgraded to the standard category only after the specified period, i.e. a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period.

viii) Asset classification status of restructured accounts

During the specified one year period, the asset classification of substandard / doubtful status accounts will not deteriorate if satisfactory performance of the account is demonstrated during the specified period. In case, however, the satisfactory performance during the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre restructuring payment schedule. The asset classification would be bank specific based on record of recovery of each bank/FI, as per the existing prudential norms applicable to banks/FIs.

ix) Prudential norms on conversion

a) Where overdue interest is funded or outstanding principal and interest components are converted into equity, debentures, zero coupon bonds or other instruments and income is recognized in consequence, full provision should be made for the amount of income so recognized. Equity, debentures and other financial instruments acquired by way of conversion of outstanding principal and/ or interest should be classified in the AFS category and valued in accordance with the extant instructions on valuation of banks' investment portfolio except to the extent that (a) equity may be valued as per market value, if quoted (b) in cases where equity is not quoted, valuation may be at breakup value in respect of standard assets and in respect of substandard / doubtful assets, equity may be initially valued at Re1 and at breakup value after restoration / up gradation to standard category.

b) If the conversion of interest into equity, which is quoted, interest income can be recognized after the account is upgraded to the standard category at market value of equity, on the date of such up gradation, not exceeding the amount of interest converted into equity. If the conversion of interest is into equity, which is not quoted, interest income should not be recognized.

c) In case of conversion of principal and / or interest into equity, debentures, bonds, etc., such instruments should be treated as NPA *abinitio* in the same asset classification category as the loan if the loan's classification is substandard or doubtful on implementation of the restructuring package and provision should be made as per the norms. Consequently, income

should be recognized on these instruments only on realization basis. The income in respect of unrealised interest which is converted into debentures or any fixed maturity instruments, would be recognized only on redemption of such instruments.

d) Banks may reverse the provisions made towards income recognised at the time of conversion of accrued interest into equity, bonds, debentures etc. when the instrument goes out of balance sheet on sale/ realisation of value/maturity.

G. Asset classification of repeatedly restructured accounts

The regulatory concession in terms of paragraphs 4.2.16.F(iii) and 4.2.16.F(v) would not be available if the account is restructured for the second or more times. In case a restructured asset, which is a standard asset on restructuring, is subjected to restructuring on a subsequent occasion, it should be classified as substandard. If the restructured asset is a substandard or a doubtful asset and is subjected to restructuring, on a subsequent occasion its asset classification would be reckoned from the date when it became NPA on the previous occasion. However, such assets restructuring for the second or more time may be allowed to be upgraded to standard category after one year from the date of first payment of interest or repayment of principal whichever falls due earlier in terms of the current restructuring package subject to satisfactory performance.

H. Disclosure

Banks / FIs should also disclose in their published annual Balance Sheets, under "Notes on Accounts", the following information in respect of corporate debt restructuring undertaken during the year:

- a. Total number of accounts, total amount of loan assets and the amount of sacrifice in the restructuring cases under CDR.

$$[(a) = (b)+(c)+(d)]$$

- b. The number, amount and sacrifice in standard assets subjected to CDR.
- c. The number, amount and sacrifice in substandard assets subjected to CDR.
- d. The number, amount and sacrifice in doubtful assets subjected to CDR.

4.2.17 Debt restructuring mechanism for Small and Medium Enterprises (SMEs)

A. Eligibility criteria

- i. These guidelines would be applicable to the following entities, which are viable
or potentially viable :
 - a) All non-corporate SMEs irrespective of the level of dues to banks.
 - b) All corporate SMEs, which are enjoying banking facilities from a single bank, irrespective of the level of dues to the bank.
 - c) All corporate SMEs, which have funded and non-funded outstanding up to Rs.10 crore under multiple/ consortium banking arrangement
- ii. Accounts involving wilful default, fraud and malfeasance will not be eligible for restructuring under these guidelines. However banks may review the reasons for classification of the borrower as wilful defaulter specially in old cases where the manner of classification of a borrower as wilful defaulter was not transparent and satisfy themselves that the borrower is in a position to rectify the wilful default provided he is granted an opportunity under the Debt Restructuring Mechanism for SMEs. Such exceptional cases may be admitted for restructuring with the approval of the Board of Directors of the banks only.
- iii. Accounts classified by banks as “Loss Assets” will not be eligible for restructuring.
- iv. In respect of BIFR cases banks should ensure completion of all formalities in seeking approval from BIFR before implementing the package.

B. Viability criteria

Banks may decide on the acceptable viability benchmark, consistent with the unit becoming viable in 7 years and the repayment period for restructured debt not exceeding 10 years.

C. Prudential Norms for restructured accounts

- i. Treatment of 'standard' accounts subjected to restructuring
 - a) A rescheduling of the instalments of principal alone, would not cause a standard asset to be classified in the substandard category, provided the borrower's outstanding is fully covered by tangible security. However, the condition of tangible security may not be made applicable in cases where the outstanding is up to Rs.5 lakh, since the collateral requirement for loans up to Rs 5 lakh has been dispensed with for SSI / tiny sector.
 - b) A rescheduling of interest element would not cause an asset to be downgraded to substandard category subject to the condition that the

amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved.

c) In case there is a sacrifice involved in the amount of interest in present value terms, as at (b) above, the amount of sacrifice should either be written off or provision made to the extent of the sacrifice involved.

ii. Treatment of 'substandard' / 'doubtful' accounts subjected to restructuring

a) A rescheduling of the instalments of principal alone, would render a 'sub-standard' / 'doubtful' asset eligible to continue in the 'substandard' / 'doubtful' category for the specified period (as defined in paragraph 4.2.17 E below), provided the borrower's outstanding is fully covered by tangible security. However, the condition of tangible security may not be made applicable in cases where the outstanding is up to Rs.5 lakh, since the collateral requirement for loans up to Rs 5 lakh has been dispensed with for SSI / tiny sector.

b) A rescheduling of interest element would render a substandard / 'doubtful' asset eligible to be continued to be classified in substandard / 'doubtful' category for the specified period subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved.

c) Even in cases where the sacrifice is by way of write off of the past interest dues, the asset should continue to be treated as substandard / 'doubtful'.

iii. Treatment of Provision

a) Provision made towards interest sacrifice should be created by debit to Profit & Loss account and held in a distinct account. For this purpose, the future interest due as per the current BPLR in respect of an account should be discounted to the present value at a rate appropriate to the risk category of the borrower (i.e., current PLR + the appropriate term premium and credit risk premium for the borrower-category) and compared with the present value of the dues expected to be received under the restructuring package, discounted on the same basis.

b) Sacrifice may be recomputed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR, term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

c) The amount of provision made for NPA, may be reversed when the account is reclassified as a 'standard asset'.

D. Additional finance

Additional finance, if any, may be treated as 'standard asset' in all accounts viz; standard, substandard, and doubtful accounts, up to a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the approved restructuring package. If the restructured asset does not qualify for upgradation at the end of the above period, additional finance

shall be placed in the same asset classification category as the restructured debt.

E. Upgradation of restructured accounts

The substandard / doubtful accounts, at para 4.2.17.C (ii) (a) & (b) above, which have been subjected to restructuring, whether in respect of principal instalment or interest, by whatever modality, would be eligible to be upgraded to the standard category after the specified period, i.e., a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period.

F. Asset classification status

During the specified one year period, the asset classification status of rescheduled accounts will not deteriorate if satisfactory performance of the account is demonstrated during the period. In case, however, the satisfactory performance during the one year period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule. The asset classification would be bank specific, based on record of recovery of each bank, as per the existing prudential norms applicable to banks.

G. Repeated restructuring

The special dispensation for asset classification as available in terms of paragraphs 5, 6 and 7 above, shall be available only when the account is restructured for the first time.

H. Procedure

- i. Based on these guidelines, banks may formulate, with the approval of their Board of Directors, a debt restructuring scheme for SMEs. While framing the scheme, banks may ensure that the scheme is simple to comprehend and will, at the minimum, include parameters indicated in these guidelines.
- ii. The restructuring would follow a receipt of a request to that effect from the borrowing units.
- iii. In case of eligible SMEs which are under consortium/multiple banking arrangements, the bank with the maximum outstanding may work out the restructuring package, along with the bank having the second largest share.

I. Time frame

Banks should work out the restructuring package and implement the same within a maximum period of 60 days from date of receipt of requests.

J. Disclosure

The Debt Restructuring Scheme for SMEs should be displayed on the bank's website and also forwarded to SIDBI for placing on their web site.

Banks should also disclose in their published annual Balance Sheets, under "Notes on Accounts", the following information in respect of restructuring

undertaken during the year for SME accounts:

(a) Total amount of assets of SMEs subjected to restructuring.

$$[(a) = (b)+(c)+(d)]$$

(b) The amount of standard assets of SMEs subjected to restructuring.

(c) The amount of substandard assets of SMEs subjected to restructuring.

(d) The amount of doubtful assets of SMEs subjected to restructuring.

4.2.18 Projects under implementation

It was observed that there were instances, where despite substantial time overrun in the projects under implementation, the underlying loan assets remained classified in the standard category merely because the project continued to be under implementation. Recognising that unduly long time overrun in a project adversely affected its viability and the quality of the asset deteriorated, a need was felt to evolve an objective and definite timeframe for completion of projects so as to ensure that the loan assets relating to projects under implementation were appropriately classified and asset quality correctly reflected. In the light of the above background, it was decided to extend the norms detailed below on income recognition, asset classification and provisioning to banks with respect to industrial projects under implementation, which involve time overrun.

- i. The projects under implementation are grouped into three categories for the purpose of determining the date when the project ought to be completed:

Category I: Projects where financial closure had been achieved and formally documented.

Category II: Projects sanctioned before 1997 with original project cost of Rs.100 crore or more where financial closure was not formally documented.

Category III: Projects sanctioned before 1997 with original project cost of less than Rs.100 crore where financial closure was not formally documented.

Asset classification

- ii. In case of each of the three categories, the date when the project ought to be completed and the classification of the underlying loan asset should be determined in the following manner:

Category I (Projects where financial closure had been achieved and formally documented): In such cases the date of completion of the project should be as envisaged at the time of original financial closure. In all such cases, the asset may be treated as *standard asset for a period not*

exceeding two years beyond the date of completion of the project, as originally envisaged at the time of initial financial closure of the project.

In case, however, in respect of a project financed after 1997, the financial closure had not been formally documented, the norms enumerated for category III below, would apply.

Category II (Projects sanctioned before 1997 with original project cost of Rs.100 crore or more where financial closure was not formally documented): For such projects sanctioned prior to 1997, where the date of financial closure had not been formally documented, an independent Group was constituted with experts from the term lending institutions as well as outside experts in the field to decide on the deemed date of completion of projects. The Group, based on all material and relevant facts and circumstances, has decided the deemed date of completion of the project, on a project-by-project basis. In such cases, the asset may be treated as *standard asset for a period not exceeding two years beyond the deemed date of completion of the project, as decided by the Group*. Banks, which have extended finance towards such projects, may approach the lead financial institutions to which a copy of the independent Group's report has been furnished for obtaining the particulars relating to the deemed date of completion of project concerned.

Category III (Projects sanctioned before 1997 with original project cost of less than Rs.100 crore where financial closure was not formally documented): In these cases, sanctioned prior to 1997, where the financial closure was not formally documented, the date of completion of the project would be as originally envisaged at the time of sanction. In such cases, *the asset may be treated as standard asset only for a period not exceeding two years beyond the date of completion of the project as originally envisaged at the time of sanction.*

- iii. In all the three foregoing categories, in case of time overruns beyond the aforesaid period of two years, the asset should be classified as substandard regardless of the record of recovery and provided for accordingly.
- iv. As regards the projects financed by the FIs/ banks **after 28th May, 2002**, the date of completion of the project should be clearly spelt out at the time of financial closure of the project. In such cases, if the date of commencement of commercial production extends beyond a period of six months after the date of completion of the project, as originally envisaged at the time of initial financial closure of the project, the account should be treated as a sub-standard asset. However, for Infrastructure projects alone, w.e.f. March 31, 2008, 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 substandard.

Income recognition

- v. Banks may recognise income on accrual basis in respect of the above three categories of projects under implementation, which are classified as 'standard'.
- vi. Banks should not recognise income on accrual basis in respect of the above three categories of projects under implementation which are classified as a 'substandard' asset. Banks may recognise income in such accounts only on realisation on cash basis.

Consequently, banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s). As regards the regulatory treatment of 'funded interest' recognised as income and 'conversion into equity, debentures or any other instrument' banks should adopt the following:

a) Funded Interest: Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/ rescheduling/ renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realisation and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognised as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.

b) Conversion into equity, debentures or any other instrument: The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognised in consequence, full provision should be made for the amount of income so recognised to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognised at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the "available for sale" category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, ab initio, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognised only on realisation basis. The income in respect of unrealised interest which is converted into debentures or any other fixed maturity instrument should be recognised only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments.

Provisioning

- vii. While there will be no change in the extant norms on provisioning for NPAs, banks which are already holding provisions against some of the accounts, which may now be classified as 'standard', shall continue to hold the provisions and shall not reverse the same.

4.2.19 Takeout Finance

Takeout finance is the product emerging in the context of the funding of long-term infrastructure projects. Under this arrangement, the institution/the bank financing infrastructure projects will have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their

books on a predetermined basis. In view of the time-lag involved in taking-over, the possibility of a default in the meantime cannot be ruled out. The norms of asset classification will have to be followed by the concerned bank/financial institution in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution should not recognise income on accrual basis and account for the same only when it is paid by the borrower/ taking over institution (if the arrangement so provides). The lending institution should also make provisions against any asset turning into NPA pending its take over by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed. However, the taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA even though the account was not in its books as on that date.

4.2.20 Post-shipment Supplier's Credit

- i. In respect of post-shipment credit extended by the banks covering export of goods to countries for which the ECGC's cover is available, EXIM Bank has introduced a guarantee-cum-refinance programme whereby, in the event of default, EXIM Bank will pay the guaranteed amount to the bank within a period of 30 days from the day the bank invokes the guarantee after the exporter has filed claim with ECGC.
- ii. Accordingly, to the extent payment has been received from the EXIM Bank, the advance may not be treated as a nonperforming asset for asset classification and provisioning purposes.

4.2.21 Export Project Finance

- i. In respect of export project finance, there could be instances where the actual importer has paid the dues to the bank abroad but the bank in turn is unable to remit the amount due to political developments such as war, strife, UN embargo, etc.
- ii. In such cases, where the lending bank is able to establish through documentary evidence that the importer has cleared the dues in full by depositing the amount in the bank abroad before it turned into NPA in the books of the bank, but the importer's country is not allowing the funds to be remitted due to political or other reasons, the asset classification may be made after a period of one year from the date the amount was deposited by the importer in the bank abroad.

4.2.22 Advances under rehabilitation approved by BIFR/ TLI

Banks are not permitted to upgrade the classification of any advance in respect of which the terms have been renegotiated unless the package of renegotiated terms has worked satisfactorily for a period of one year. While the existing credit facilities sanctioned to a unit under rehabilitation packages approved by BIFR/term lending

institutions will continue to be classified as substandard or doubtful as the case may be, in respect of additional facilities sanctioned under the rehabilitation packages, the Income Recognition, Asset Classification norms will become applicable after a period of one year from the date of disbursement.

5 PROVISIONING NORMS

5.1 General

5.1.1 The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank managements and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines.

5.1.2 In conformity with the prudential norms, provisions should be made on the nonperforming assets on the basis of classification of assets into prescribed categories as detailed in paragraphs 4 supra. Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged to the bank, the banks should make provision against substandard assets, doubtful assets and loss assets as below:

5.2 Loss assets

Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

5.3 Doubtful assets

i. 100 percent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis.

ii. In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20 percent to 100 percent of the secured portion depending upon the period for which the asset has remained doubtful:

Period for which the advance has remained in 'doubtful' category	Provision requirement (%)
Up to one year	20
One to three years	30
More than three years	100

iii. Banks are permitted to phase the additional provisioning consequent upon the reduction in the transition period from substandard to doubtful asset from 18 to 12 months over a four year period commencing from the year ending March 31, 2005, with a minimum of 20 % each year.

Note: Valuation of Security for provisioning purposes

With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board would be mandatory in order to enhance the reliability on stock valuation. Collaterals such as immovable properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

5.4 Substandard assets

A general provision of 10 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and **securities available**.

The 'unsecured exposures' which are identified as 'substandard' would attract additional provision of 10 per cent, i.e., a total of 20 per cent on the outstanding balance. The provisioning requirement for unsecured 'doubtful' assets is 100 per cent. Unsecured exposure is defined as an exposure where the realisable value of the security, as assessed by the bank/approved valuers/Reserve Bank's inspecting officers, is not more than 10 percent, *ab-initio*, of the outstanding exposure. 'Exposure' shall include all funded and non-funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters etc.

5.5 Standard assets

(i) Banks should make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:

- (a) direct advances to agricultural and SME sectors at 0.25 per cent;
- (b) residential housing loans beyond Rs. 20 lakh at 1 per cent;
- (c) advances to specific sectors, i.e., personal loans (including credit card receivables), loans and advances qualifying as Capital Market exposures, Commercial Real Estate loans, and Loans and advances to Non-deposit taking Systemically Important NBFCs

- at 2 per cent
- (d) all other advances not included in (a), (b) and (c) above, at 0.40 per cent.

(ii) In order to ensure continued and adequate availability of credit to highly productive sectors of the economy, the provisioning requirement for loans and advances to Asset Finance Companies (as defined by DNBS, RBI from time to time), which are standard assets, shall remain unchanged at 0.40 %

(iii) The provisions on standard assets should not be reckoned for arriving at net NPAs.

(iv) The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions Others' in Schedule 5 of the balance sheet.

5.6 Prudential norms on creation and utilisation of floating provisions

5.6.1 Principle for creation of floating provisions by banks

The bank's board of directors should lay down approved policy regarding the level to which the floating provisions can be created. The bank should hold floating provisions for 'advances' and 'investments' separately and the guidelines prescribed will be applicable to floating provisions held for both 'advances' & 'investment' portfolios.

5.6.2 Principle for utilisation of floating provisions by banks

The floating provisions should not be used for making specific provisions as per the extant prudential guidelines in respect of nonperforming assets or for making regulatory provisions for standard assets. The floating provisions can be used only for contingencies under extraordinary circumstances for making specific provisions in impaired accounts after obtaining board's approval and with prior permission of RBI. The boards of the banks should lay down an approved policy as to what circumstances would be considered extraordinary.

To facilitate banks' boards to evolve suitable policies in this regard, it is clarified that the extra-ordinary circumstances refer to losses which do not arise in the normal course of business and are exceptional and non-recurring in nature. These extra-ordinary circumstances could broadly fall under three categories viz. General, Market and Credit. Under general category, there can be situations where bank is put unexpectedly to loss due to events such as civil unrest or collapse of currency in a country. Natural calamities and pandemics may also be included in the general category. Market category would include events such as a general melt down in the markets, which affects the entire financial system. Among the credit category, only exceptional credit losses would be considered as an extra-ordinary circumstance.

5.6.3 Accounting

Floating provisions cannot be reversed by credit to the profit and loss account. They can only be utilised for making specific provisions in extraordinary circumstances as mentioned above. Until such utilisation, these provisions can be netted off from gross NPAs to arrive at disclosure of net NPAs. Alternatively, they can be treated as part of Tier II capital within the overall ceiling of 1.25 % of total risk weighted assets.

5.6.4 Disclosures

Banks should make comprehensive disclosures on floating provisions in the “notes on accounts” to the balance sheet on (a) opening balance in the floating provisions account, (b) the quantum of floating provisions made in the accounting year, (c) purpose and amount of draw down made during the accounting year, and (d) closing balance in the floating provisions account.

5.6.5 Provisions for advances at higher than prescribed rates

A bank may voluntarily make specific provisions for advances at rates which are higher than the rates prescribed under existing regulations provided such higher rates are approved by the Board of Directors and consistently adopted from year to year. Such additional provisions are not to be considered as floating provisions.

5.7 **Provisions on Leased Assets**

i) Substandard assets

a) 10 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component. The terms ‘net investment in the lease’, ‘finance income’ and ‘finance charge’ are as defined in ‘AS 19 Leases’ issued by the ICAI.

b) Unsecured lease exposures, as defined in paragraph 5.4 above, which are identified as ‘substandard’ would attract additional provision of 10 per cent, i.e., a total of 20 per cent.

ii) Doubtful assets

100 percent of the extent to which, the finance is not secured by the realisable value of the leased asset. Realisable value is to be estimated on a realistic basis. In addition to the above provision, provision at the following rates should be made on the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component of the secured portion, depending upon the period for which asset has been doubtful:

Period for which the advance has remained in 'doubtful' category	Provision requirement (%)
Up to one year	20
One to three years	30
More than three years	100

iii) Loss assets

The entire asset should be written off. If for any reason, an asset is allowed to remain in books, 100 percent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component should be provided for.

5.8 Guidelines for Provisions under Special Circumstances

5.8.1 Advances granted under rehabilitation packages approved by BIFR/term lending institutions

(i) In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as substandard or doubtful asset.

(ii) As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement.

(iii) In respect of additional credit facilities granted to SSI units which are identified as sick [as defined in Section IV (Para 2.8) of RPCD circular RPCD.PLNFS.BC. No 83 /06.02.31/20042005 dated 1 March 2005] and where rehabilitation packages/nursing programmes have been drawn by the banks themselves or under consortium arrangements, no provision need be made for a period of one year.

5.8.2 Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs, gold ornaments, government & other securities and life insurance policies would attract provisioning requirements as applicable to their asset classification status.

5.8.3 Treatment of interest suspense account

Amounts held in Interest Suspense Account should not be reckoned as part of provisions. Amounts lying in the Interest Suspense Account should be deducted from the relative advances and thereafter, provisioning as per the norms, should be made on the balances after such deduction.

5.8.4 Advances covered by ECGC guarantee

In the case of advances classified as doubtful and guaranteed by ECGC, provision should be made only for the balance in excess of the amount guaranteed by the

Corporation. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by the Corporation and then provision made as illustrated hereunder:

Example

Outstanding Balance	Rs. 4 lakhs
ECGC Cover	50 percent
Period for which the advance has remained doubtful	More than 3 years remained doubtful (as on March 31, 2004)
Value of security held (excludes worth of Rs.)	Rs. 1.50 lakhs

Provision required to be made

Outstanding balance	Rs. 4.00 lakhs
Less: Value of security held	Rs. 1.50 lakhs
Unrealised balance	Rs. 2.50 lakhs
Less: ECGC Cover (50% of unrealisable balance)	Rs. 1.25 lakhs
Net unsecured balance	Rs. 1.25 lakhs
Provision for unsecured portion of advance	Rs. 1.25 lakhs (@ 100 percent of unsecured portion)
Provision for secured portion of advance (as on March 31, 2005)	Rs.0.90 lakhs (@ 60 per cent of the secured portion)
Total provision to be made	Rs.2.15 lakhs (as on March 31, 2005)

5.8.5 Advance covered by CGTSI guarantee

In case the advance covered by CGTSI guarantee becomes nonperforming, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for nonperforming advances. Two illustrative examples are given below:

Example I

Asset classification status:	Doubtful – More than 3 years (as on March 31, 2004)	
CGTSI Cover	75% of the amount outstanding or 75% of the unsecured amount or Rs.18.75 lakh, whichever is the least	
Realisable value of Security	Rs.1.50 lakh	
Balance outstanding	Rs.10.00 lakh	
<u>Less</u> Realisable value of security	Rs. 1.50 lakh	
Unsecured amount	Rs. 8.50 lakh	
<u>Less</u> CGTSI cover (75%)	Rs. 6.38 lakh	
Net unsecured and uncovered portion:	Rs. 2.12 lakh	
		<u>Provision Required</u> (as on March 31, 2005)
Secured portion	Rs.1.50 lakh	Rs. 0.90 lakh (@ 60%)
Unsecured & uncovered portion	Rs.2.12 lakh	Rs. 2.12 lakh (100%)
Total provision required		Rs. 3.02 lakh

Example II

Asset classification status	Doubtful – More than 3 years (as on March 31, 2005)	
CGTSI Cover	75% of the amount outstanding or 75% of the unsecured amount or Rs.18.75 lakh, whichever is the least	
Realisable value of Security	Rs.10.00 lakh	
Balance outstanding	Rs.40.00 lakh	
<u>Less</u> Realisable value of security	Rs. 10.00 lakh	
Unsecured amount	Rs. 30.00 lakh	
<u>Less</u> CGTSI cover (75%)	Rs. 18.75 lakh	
Net unsecured and uncovered portion:	Rs. 11.25 lakh	
		<u>Provision Required</u> (as on March 31, 2005)
Secured portion	Rs.10.00 lakh	Rs. 10.00 lakh (@ 100%)
Unsecured & uncovered portion	Rs.11.25 lakh	Rs.11.25 lakh (100%)
Total provision required		Rs. 21.25 lakh

5.8.6 Takeout finance

The lending institution should make provisions against a 'takeout finance' turning into NPA pending its takeover by the taking-over institution. As and when the asset is taken-over by the taking-over institution, the corresponding provisions could be reversed.

5.8.7 Reserve for Exchange Rate Fluctuations Account (RERFA)

When exchange rate movements of Indian rupee turn adverse, the outstanding amount of foreign currency denominated loans (where actual disbursement was made in Indian Rupee) which becomes overdue, goes up correspondingly, with its attendant implications of provisioning requirements. Such assets should not normally be revalued. In case such assets need to be revalued as per requirement of accounting practices or for any other requirement, the following procedure may be adopted:

- The loss on revaluation of assets has to be booked in the bank's Profit & Loss Account.
- Besides the provisioning requirement as per Asset Classification, banks should treat the full amount of the Revaluation Gain relating to the corresponding assets, if any, on account of Foreign Exchange Fluctuation as provision against the particular assets.

5.8.8 Provisioning for country risk

Banks shall make provisions, with effect from the year ending 31 March 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 percent according to the risk categories mentioned below. To begin with, banks shall make provisions as per the following schedule:

Risk category	ECGC Classification	Provisioning Requirement (per cent)
Insignificant	A1	0.25
Low	A2	0.25
Moderate	B1	5
High	B2	20
Very high	C1	25
Restricted	C2	100
Offcredit	D	100

Banks are required to make provision for country risk in respect of a country where its net funded exposure is one per cent or more of its total assets.

The provision for country risk shall be in addition to the provisions required to be held according to the asset classification status of the asset. In the case of 'loss assets' and 'doubtful assets', provision held, including provision held for country risk, may not exceed 100% of the outstanding.

Banks may not make any provision for 'home country' exposures i.e. exposure to India. The exposures of foreign branches of Indian banks to the host country should be included. Foreign banks shall compute the country exposures of their Indian branches and shall hold appropriate provisions in their Indian books. However, their exposures to India will be excluded.

Banks may make a lower level of provisioning (say 25% of the requirement) in respect of short-term exposures (i.e. exposures with contractual maturity of less than 180 days).

5.8.9 Provisioning norms for sale of financial assets to Securitisation Company (SC) / Reconstruction company (RC)

(i) If the sale of financial assets to SC/RC, is at a price below the net book value (NBV) (i.e. book value less provisions held), the shortfall should be debited to the profit and loss account of that year.

(ii) If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilized to meet the shortfall/loss on account of sale of other financial assets to SC/RC.

(iii) With a view to enabling banks to meet the shortfall, if any, banks are advised to build up provisions significantly above the minimum regulatory requirements for their NPAs, particularly for those assets which they propose to sell to securitisation/reconstruction companies.

5.8.10 Provisioning norms for Liquidity facility provided for Securitisation transactions

The amount of liquidity facility drawn and outstanding for more than 90 days, in respect of securitisation transactions undertaken in terms of our guidelines on securitisation dated February 1, 2006, should be fully provided for.

6. Guidelines on sale of financial assets to Securitisation Company (SC)/ Reconstruction Company (RC) (created under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002) and related issues

6.1 Scope

These guidelines would be applicable to sale of financial assets enumerated in paragraph 6.3 below, by banks/ FIs, for asset reconstruction/ securitisation under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

6.2 Structure

The guidelines to be followed by banks/ FIs while selling their financial assets to SC/RC under the Act *ibid* and investing in bonds/ debentures/ security receipts offered by the SC/RC are given below. The prudential guidelines have been grouped under the following headings:

- i) Financial assets which can be sold.
- ii) Procedure for sale of banks'/ FIs' financial assets to SC/ RC, including valuation and pricing aspects.
- iii) Prudential norms, in the following areas, for banks/ FIs for sale of their financial assets to SC/ RC and for investing in bonds/ debentures/ security receipts and any other securities offered by the SC/RC as compensation consequent upon sale of financial assets:
 - a) Provisioning / Valuation norms
 - b) Capital adequacy norms
 - c) Exposure norms
- iv) Disclosure requirements

6.3 Financial assets which can be sold

A financial asset may be sold to the SC/RC by any bank/ FI where the asset is:

- i) A NPA, including a non-performing bond/ debenture, and
- ii) A Standard Asset where:
 - (a) the asset is under consortium/ multiple banking arrangements,
 - (b) at least 75% by value of the asset is classified as non-performing asset in the books of other banks/FIs, and
 - (c) at least 75% (by value) of the banks / FIs who are under the consortium / multiple banking arrangements agree to the sale of the asset to SC/RC.

6.4. Procedure for sale of banks'/ FIs' financial assets to SC/ RC, including valuation and pricing aspects

(a) The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) allows acquisition of financial assets by SC/RC from any bank/ FI on such terms and conditions as may be agreed upon between them. This provides for sale of the financial assets on 'without recourse' basis, i.e., with the entire credit risk associated with the financial assets being transferred to SC/ RC, as well as on 'with recourse' basis, i.e., subject to unrealized part of the asset reverting to the seller bank/ FI. Banks/ FIs are, however, directed to ensure that the effect of the sale of the financial assets should be such that the asset is taken off the books of the bank/ FI and after the sale there should not be any known liability devolving on the banks/ FIs.

(b) Banks/ FIs, which propose to sell to SC/RC their financial assets should ensure that the sale is conducted in a prudent manner in accordance with a policy approved by the Board. The Board shall lay down policies and guidelines covering, *inter alia*,

- i. Financial assets to be sold;
- ii. Norms and procedure for sale of such financial assets;
- iii. Valuation procedure to be followed to ensure that the realisable value of financial assets is reasonably estimated;
- iv. Delegation of powers of various functionaries for taking decision on the sale of the financial assets; etc.

(c) Banks/ FIs should ensure that subsequent to sale of the financial assets to SC/RC, they do not assume any operational, legal or any other type of risks relating to the financial assets sold.

- (d) (i) Each bank / FI will make its own assessment of the value offered by the SC / RC for the financial asset and decide whether to accept or reject the offer.
- (ii) In the case of consortium / multiple banking arrangements, if 75% (by value) of the banks / FIs decide to accept the offer, the remaining banks / FIs will be obligated to accept the offer.
- (iii) Under no circumstances can a transfer to the SC/ RC be made at a contingent price whereby in the event of shortfall in the realization by the SC/RC, the banks/ FIs would have to bear a part of the shortfall.

(e) Banks/ FIs may receive cash or bonds or debentures as sale consideration for the financial assets sold to SC/RC.

(f) Bonds/ debentures received by banks/ FIs as sale consideration towards sale of financial assets to SC/RC will be classified as investments in the books of banks/ FIs.

(g) Banks may also invest in security receipts, Pass-through certificates (PTC), or other bonds/ debentures issued by SC/RC. These securities will also be classified as investments in the books of banks/ FIs.

(h) In cases of specific financial assets, where it is considered necessary, banks/ FIs may enter into agreement with SC/RC to share, in an agreed proportion, any surplus realised by SC/RC on the eventual realisation of the concerned asset. In such cases the terms of sale should provide for a report from the SC/RC to the bank/ FI on the value realised from the asset. No credit for the expected profit will be taken by banks/ FIs until the profit materializes on actual sale.

6.5. Prudential norms for banks/ FIs for the sale transactions

(A) Provisioning/ valuation norms

- (a)
 - (i) When a bank / FI sells its financial assets to SC/ RC, on transfer the same will be removed from its books.
 - (ii) If the sale to SC/ RC is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year.
 - (iii) If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilized to meet the shortfall/ loss on account of sale of other financial assets to SC/RC.
 - (iv) When banks/ FIs invest in the security receipts/ pass-through certificates issued by SC/RC in respect of the financial assets sold by them to the SC/RC, the sale shall be recognised in books of the banks / FIs at the lower of:
 - the redemption value of the security receipts/ pass-through certificates, and
 - the NBV of the financial asset.

The above investment should be carried in the books of the bank / FI at the price as determined above until its sale or realization, and on such sale or realization, the loss or gain must be dealt with in the same manner as at (ii) and (iii) above.

- (b) *The securities (bonds and debentures) offered by SC / RC should satisfy the following conditions:*

- (i) The securities must not have a term in excess of six years.

- (ii) The securities must carry a rate of interest which is not lower than 1.5% above the Bank Rate in force at the time of issue.
 - (iii) The securities must be secured by an appropriate charge on the assets transferred.
 - (iv) The securities must provide for part or full prepayment in the event the SC / RC sells the asset securing the security before the maturity date of the security.
 - (v) The commitment of the SC / RC to redeem the securities must be unconditional and not linked to the realization of the assets.
 - (vi) Whenever the security is transferred to any other party, notice of transfer should be issued to the SC/ RC.
- (c) *Investment in debentures/ bonds/ security receipts/ Pass-through certificates issued by SC/ RC*

All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/ RC in which banks/ FIs invest will be in the nature of non SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's/ FI's investment in debentures/ bonds/ security receipts/PTCs issued by SC/ RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank/ FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

(B) Capital Adequacy

For the purpose of capital adequacy, banks/ FIs should assign risk weights as under to the investments in debentures/ bonds/ security receipts/ PTCs issued by SC/ RC and held by banks/ FIs as investment:

- i) Risk weight for credit risk: 100%.
- ii) Risk weight for market risk: 2.5 %

$$\text{Applicable risk weight} = (i) + (ii)$$

(C) Exposure Norms

Banks'/ FIs' investments in debentures/ bonds/ security receipts/PTCs issued by a SC/RC will constitute exposure on the SC/RC. As only a few SC/RC are being set up now, banks'/ FIs' exposure on SC/RC through their investments in debentures/ bonds/security receipts/PTCs issued by the SC/ RC may go beyond their prudential exposure ceiling. In view of the extra ordinary nature of event, banks/ FIs will be allowed, in the initial years, to exceed prudential exposure ceiling on a case-to-case basis.

6.6. Disclosure Requirements

Banks/ FIs, which sell their financial assets to an SC/ RC, shall be required to make the following disclosures in the Notes on Accounts to their Balance sheets:

Details of financial assets sold during the year to SC/RC for Asset Reconstruction

- a. No. of accounts
- b. Aggregate value (net of provisions) of accounts sold to SC / RC
- c. Aggregate consideration
- d. Additional consideration realized in respect of accounts transferred in earlier years
- e. Aggregate gain / loss over net book value.

6.7. Related Issues

- (a) SC/ RC will also take over financial assets which cannot be revived and which, therefore, will have to be disposed of on a realisation basis. Normally the SC/ RC will not take over these assets but act as an agent for recovery for which it will charge a fee.
- (b) Where the assets fall in the above category, the assets will not be removed from the books of the bank/ FI but realisations as and when received will be credited to the asset account. Provisioning for the asset will continue to be made by the bank / FI in the normal course.

7. Guidelines on purchase/ sale of Non - Performing Financial Assets

In order to increase the options available to banks for resolving their non performing assets and to develop a healthy secondary market for nonperforming assets, where securitisation companies and reconstruction companies are not involved, guidelines have been issued to banks on purchase / sale of NonPerforming Assets. Since the sale/purchase of nonperforming financial assets under this option would be conducted within the financial system the whole process of resolving the non performing assets and matters related thereto has to be initiated with due diligence and care warranting the existence of a set of clear guidelines which shall be complied with by all entities so that the process of resolving nonperforming assets by sale and purchase of NPAs proceeds on smooth and sound lines. Accordingly guidelines on sale/purchase of nonperforming assets have been formulated and furnished below. The guidelines may be placed before the bank's /FI's /NBFC's Board and appropriate steps may be taken for their implementation.

Scope

7.1 These guidelines would be applicable to banks, FIs and NBFCs purchasing/ selling non performing financial assets, from/ to other banks/FIs/NBFCs (excluding securitisation companies/ reconstruction companies).

7.2 A financial asset, including assets under multiple/consortium banking arrangements, would be eligible for purchase/sale in terms of these guidelines if it is a nonperforming asset/non performing investment in the books of the selling bank.

7.3 The reference to 'bank' in the guidelines on purchase/sale of nonperforming financial assets would include financial institutions and NBFCs.

Structure

7.4 The guidelines to be followed by banks purchasing/ selling nonperforming financial assets from / to other banks are given below. The guidelines have been grouped under the following headings:

- i) Procedure for purchase/ sale of non performing financial assets by banks, including valuation and pricing aspects.
- ii) Prudential norms, in the following areas, for banks for purchase/ sale of non performing financial assets:
 - a) Asset classification norms
 - b) Provisioning norms
 - c) Accounting of recoveries
 - d) Capital adequacy norms
 - e) Exposure norms
- iii) Disclosure requirements

7.5 Procedure for purchase/ sale of non performing financial assets, including valuation and pricing aspects

- i) A bank which is purchasing/ selling nonperforming financial assets should ensure that the purchase/ sale is conducted in accordance with a policy approved by the Board. The Board shall lay down policies and guidelines covering, *inter alia*,
 - a) Non performing financial assets that may be purchased/ sold;
 - b) Norms and procedure for purchase/ sale of such financial assets;
 - c) Valuation procedure to be followed to ensure that the economic value of financial assets is reasonably estimated based on the estimated cash flows arising out of repayments and recovery prospects;
 - d) Delegation of powers of various functionaries for taking decision on the purchase/ sale of the financial assets; etc.
 - e) Accounting policy

ii) While laying down the policy, the Board shall satisfy itself that the bank has adequate skills to purchase non performing financial assets and deal with them in an efficient manner which will result in value addition to the bank. The Board should also ensure that appropriate systems and procedures are in place to effectively address the risks that a purchasing bank would assume while engaging in this activity.

iii) Banks should, while selling NPAs, work out the net present value of the estimated cash flows 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. (Same principle should be used in compromise settlements. As the payment of the compromise amount may be in instalments, 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 the realisable value of securities.)

iv) The estimated cash flows are normally expected to be realised within a period of three years and at least 10% of the estimated cash flows should be realized in the first year and at least 5% in each half year thereafter, subject to full recovery within three years.

v) A bank may purchase/sell nonperforming financial assets from/to other banks only on 'without recourse' basis, i.e., the entire credit risk associated with the nonperforming financial assets should be transferred to the purchasing bank. Selling bank shall ensure that the effect of the sale of the financial assets should be such that the asset is taken off the books of the bank and after the sale there should not be any known liability devolving on the selling bank.

vi) Banks should ensure that subsequent to sale of the non performing financial assets to other banks, they do not have any involvement with reference to assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold. Consequently, the specific financial asset should not enjoy the support of credit enhancements / liquidity facilities in any form or manner.

vii) Each bank will make its own assessment of the value offered by the purchasing bank for the financial asset and decide whether to accept or reject the offer.

viii) Under no circumstances can a sale to other banks be made at a contingent price whereby in the event of shortfall in the realization by the purchasing banks, the selling banks would have to bear a part of the shortfall.

ix) A nonperforming asset in the books of a bank shall be eligible for sale to other banks only if it has remained a nonperforming asset for at least two years in the books of the selling bank.

x) Banks shall sell nonperforming financial assets to other banks only on cash basis. The entire sale consideration should be received upfront and the asset can be taken out of the books of the selling bank only on receipt of the entire sale consideration.

xi) A nonperforming financial asset should be held by the purchasing bank in its books at least for a period of 15 months before it is sold to other banks. Banks should not sell such assets back to the bank, which had sold the NPFA.

(xii) Banks are also permitted to sell/buy homogeneous pool within retail non-performing financial assets, on a portfolio basis provided each of the nonperforming financial assets of the pool has remained as nonperforming financial asset for at least 2 years in the books of the selling bank. The pool of assets would be treated as a single asset in the books of the purchasing bank.

xiii) The selling bank shall pursue the staff accountability aspects as per the existing instructions in respect of the nonperforming assets sold to other banks.

7.6. Prudential norms for banks for the purchase/ sale transactions

(A) Asset classification norms

(i) The nonperforming financial asset purchased, may be classified as 'standard' in the books of the purchasing bank for a period of 90 days from the date of purchase. Thereafter, the asset classification status of the financial asset purchased, shall be determined by the record of recovery in the books of the purchasing bank with reference to cash flows estimated while purchasing the asset which should be in compliance with requirements in Para 7.5 (iii).

(ii) The asset classification status of an existing exposure (other than purchased financial asset) to the same obligor in the books of the purchasing bank will continue to be governed by the record of recovery of that exposure and hence may be different.

(iii) Where the purchase/sale does not satisfy any of the prudential requirements prescribed in these guidelines the asset classification status of the financial asset in the books of the purchasing bank at the time of purchase shall be the same as in the books of the selling bank. Thereafter, the asset classification status will continue to be determined with reference to the date of NPA in the selling bank.

(iv) Any restructure/reschedule/rephrase of the repayment schedule or the estimated cash flow of the nonperforming financial asset by the purchasing bank shall render the account as a nonperforming asset.

(B) Provisioning norms

Books of selling bank

i) When a bank sells its nonperforming financial assets to other banks, the same will be removed from its books on transfer.

ii) If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year.

iii) If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/ loss on account of sale of other nonperforming financial assets.

Books of purchasing bank

The asset shall attract provisioning requirement appropriate to its asset classification status in the books of the purchasing bank.

(C) Accounting of recoveries

Any recovery in respect of a nonperforming asset purchased from other banks should first be adjusted against its acquisition cost. Recoveries in excess of the acquisition cost can be recognised as profit.

(D) Capital Adequacy

For the purpose of capital adequacy, banks should assign 100% risk weights to the nonperforming financial assets purchased from other banks. In case the nonperforming asset purchased is an investment, then it would attract capital charge for market risks also. For NBFCs the relevant instructions on capital adequacy would be applicable.

(E) Exposure Norms

The purchasing bank will reckon exposure on the obligor of the specific financial asset. Hence these banks should ensure compliance with the prudential credit exposure ceilings (both single and group) after reckoning the exposures to the obligors arising on account of the purchase. For NBFCs the relevant instructions on exposure norms would be applicable.

7.7. Disclosure Requirements

Banks which purchase nonperforming financial assets from other banks shall be required to make the following disclosures in the Notes on Accounts to their Balance sheets:

A. Details of nonperforming financial assets purchased:

(Amounts in Rupees crore)

1. (a) No. of accounts purchased during the year
(b) Aggregate outstanding
2. (a) Of these, number of accounts restructured during the year
(b) Aggregate outstanding

B. Details of nonperforming financial assets sold:

(Amounts in Rupees crore)

1. No. of accounts sold
2. Aggregate outstanding
3. Aggregate consideration received

C. The purchasing bank shall furnish all relevant reports to RBI, CIBIL etc. in respect of the nonperforming financial assets purchased by it.

8. Writing off of NPAs

8.1 In terms of Section 43(D) of the Income Tax Act 1961, income by way of interest in relation to such categories of bad and doubtful debts as may be prescribed having regard to the guidelines issued by the RBI in relation to such debts, shall be chargeable to tax in the previous year in which it is credited to the bank's profit and loss account or received, whichever is earlier.

8.2 This stipulation is not applicable to provisioning required to be made as indicated above. In other words, amounts set aside for making provision for NPAs as above are not eligible for tax deductions.

8.3 Therefore, the banks should either make full provision as per the guidelines or write-off such advances and claim such tax benefits as are applicable, by evolving appropriate methodology in consultation with their auditors/tax consultants. Recoveries made in such accounts should be offered for tax purposes as per the rules.

8.4 Write-off at Head Office Level

Banks may write-off advances at Head Office level, even though the relative advances are still outstanding in the branch books. However, it is necessary that provision is made as per the classification accorded to the respective accounts. In other words, if an advance is a loss asset, 100 percent provision will have to be made therefor.

ANNEX - 1
(Cf. para 4.2.13)

**Relevant extract of the list of direct agricultural advances, from the Master Circular
on lending to priority sector - RPCD. No. Plan. BC. 84 /04.09.01/ 2006-07
dated 30 April 2007**

DIRECT FINANCE		
1.1	Finance to individual farmers [including Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual farmers, provided banks maintain disaggregated data on such finance] for Agriculture	
	1.1.1	Short-term loans for raising crops, i.e. for crop loans. This will include traditional / non-traditional plantations and horticulture.
	1.1.2	Advances up to Rs. 10 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months, irrespective of whether the farmers were given crop loans for raising the produce or not.
	1.1.3	Working capital and term loans for financing production and investment requirements for agriculture.
	1.1.4	Loans to small and marginal farmers for purchase of land for agricultural purposes.
	1.1.5	Loans to distressed farmers indebted to non-institutional lenders, against appropriate collateral or group security.
	1.1.6	Loans granted for pre-harvest and post-harvest activities such as spraying, weeding, harvesting, grading, sorting, processing and transporting undertaken by individuals, SHGs and cooperatives in rural areas.
1.2	Finance to others [such as corporates, partnership firms and institutions] for Agriculture	
	1.2.1	Loans granted for pre-harvest and post harvest activities such as spraying, weeding, harvesting, grading, sorting and transporting.
	1.2.2	Finance up to an aggregate amount of Rs. one crore per borrower for the purposes listed at 1.1.1, 1.1.2, 1.1.3 and 1.2.1 above.
	1.2.3	One-third of loans in excess of Rs. one crore in aggregate per borrower for agriculture.

ANNEX - 2
(Cf. para 2 of the covering circular)

List of Circulars consolidated by the Master Circular on IRAC Norms

Sl. No.	Circular No.	Date	Subject	Para No. of the MC
1	RBI/2007-08/316 DBOD.BP.BC.82/21.04.048/2007-08	08.05.2008	Prudential Norms on Asset Classification Pertaining to Advances - Infrastructure Projects under Implementation and Involving Time Overrun	4.2.18 (iv)
2	RBI/2007-2008/152 DBOD.No.BP.BC.34/21.04.048/2007-08	04.10.2007	Guidelines on Purchase / Sale of Non Performing Assets	7.5 (iii)
3	RBI/2006-2007/396 DBOD.No.BP.BC.97/21.04.048/2006-07	16.05.2007	Guidelines on Purchase / Sale of Non Performing Assets	7.5 (iii)
4	RBI/2006-2007/320 DBOD.No.BP.BC.76/21.04.048/2006-07	12.04.2007	Prudential Norms on Income Recognition, Asset Classification and Provisioning Pertaining to Advances - Projects Involving Time Overrun	4.2.18 (iv)
5	RBI/2006-07/287 DBOD.No.BP.BC.68/21.04.048/2006-07	13.03.2007	Prudential Norms on Creation and Utilisation of Floating Provisions	4.6.2
6	RBI/ 2006-2007/240 DBOD.No.BP.BC.53/21.04.048/2006-2007	31.01.2007	Third Quarter Review of the Annual Statement on Monetary Policy for the year 2006-07 - Provisioning Requirement for Standard Assets and Risk Weights for Capital Adequacy	5.5 (i)
7	RBI/2006-07/65 DBOD.No.BP.BC.21/21.04.048/2006-2007	12.07.2006	Annual Policy Statement for the year 2006-07 - Additional Provisioning Requirement for Standard Assets	5.5 (i)
8	RBI/200506/421 DBOD.NO.BP.BC.89/21.04.048/ 2005-06	22.06.2006	Prudential norms on creation and utilization of floating provisions	5.6

9	RBI/200506/394 DBOD.NO.BP.BC.85/ 21.04.048/ 2005-06	29.05.2006	Annual Policy Statement for the year 2006-07: Additional Provisioning Requirement for Standard Assets	5.5(i)
10	RBI/RRBI/200506/ DBOD.NO.BP.BC.45 /21.0421.04.048/2005 -06	10.11.2005	Revised Guidelines on Corporate Debt Restructuring(CDR) Mechanism	4.2.16
11	RBI/2005-06/ 206 DBOD.NO.BP.BC.46 /21.0421.04.048/2005-06	10.11.2005	Debt restructuring mechanism for Small and Medium Enterprises (SMEs)	4.2.17.A (ii)
12	RBI/200506/198 DBOD.NO.BP.BC.40/ 21.04.048/ 2005-06	04.11.2005	MidTerm Review of Annual Policy Statement for the year 200506: Additional Provisioning Requirement for Standard Assets	5.5(i)
13	RBI/200506/159 DBOD.NO.BP.BC. 34 /21.04.132/2005-06	08.09.2005	Debt restructuring mechanism for Small and Medium Enterprises (SMEs) - Announcement made by the Union Finance Minister	4.2.17
14	RBI/200506/54 DBOD.NO.BP.BC.16/ 21.04.048/ 2005-06	13.07.2005	Guidelines on purchase/sale of Non performing Assets	7
15	RBI No.200405/140 DBOD.BP.BC.34/21.0 4.048/2004-05	26.08.2004	Repayment schedule of rural housing loans	4.2.13(vi)
16	RBI No.200405/118 DBOD.BP.BC.29/21.04.048/ 2004-05	13.08.2004	Prudential norms –	4.2.14
			State Government	
			guaranteed exposures	
17	RBI/2004/266	24.06.2004	Flow of credit to	4.2.13 (iv)
	RPCD No. Plan.BC		Agriculture	
	92/04.09.01/2003-04			
18	RBI/2004/264	24.06.2004	Prudential Norms for	2.1.2(iv), (v)
	DBOD No. BP.BC		Agricultural Advances	4.2.10, 4.2.13(i)
	102/21.04.048/2003-04			
19	RBI/2004/261	21.06.2004	Additional Provisioning	5.3(ii), 5.7(ii),
	DBOD No. BP.BC		Requirement for NPAs	5.8.5, 5.8.6
	99/21.04.048/2003-04			

20	RBI/2004/254	17.06.2004	Prudential Guidelines on	5.4, 5.7(1)
	DBOD No. BP.BC		Unsecured Exposures	
	97/21.04.141/2003-04			
21	RBI/2004/253	17.06.2004	Country Risk	5.8.9
	DBOD No. BP.BC		Management Guidelines	
	96/21.04.103/2003-04			
22	DBOD No. BP.BC	23.04.2003	Guidelines on sale of financial assets to Securitisation / reconstruction company and related issues	5.8.10, 6
	96/21.04.048/2002-03			
23	DBOD BP.BC. NO.	27.02.2003	Projects under	4.2.18
	74/21.04.048/2002-2003		implementation	
			involving time overrun	
24	DBOD No. BP.BC. 71/21.04.103/2002-2003	19.02.2003	Risk Management Systems in Banks – Guidelines on Country Risk Management	5.8.9
25	DBOD BP.BC. No.	10.02.2003	Upgradation of loan accounts classified as NPAs	4.2.5
	69/21.04.048/2002-03			
26	DBOD. BP.BC No.	30.11.2002	Agricultural loans	4.2.13
	44/21.04.048/2002-03		affected by natural calamities	
27	DBOD No.BP.BC. 108/ 21.04.048/2001-2002	28.05.2002	Income recognition, asset classification and provisioning on advances - treatment of projects under implementation involving time overrun	4.2.18
28	DBOD No.BP.BC. 101/ 21.01.002/ 2001-02	09.05.2002	Corporate Debt Restructuring	4.2.16
29	DBOD No.BP.BC. 100/ 21.01.002/ 2001-02	09.05.2002	Prudential norms on asset classification	4.1.2
30	DBOD No.BP.BC. 59/ 21.04.048/2001-2002	22.01.2002	Prudential norms on income recognition, asset classification and	4.2.13(i)
			Provisioning agricultural advances	
31	DBOD No.BP.BC. 25/ 21.04.048/2000-2001	11.09.2001	Prudential norms on income recognition, asset classification and	4.2.15 (v)
			provisioning	

32	DBOD No.BP.BC. 15 / 21.04.114/2000-2001	23.08.2001	Corporate Debt Restructuring	4.2.16
33	DBOD No.BP.BC. 132/ 21.04.048/2000-2001	14.06.2001	Income Recognition, Asset Classification and Provisioning for Advances	4.2.2, 4.2.4, 4.2.6, 4.2.7(ii), 4.2.8, 4.2.9, 5.8.8
34	DBOD No. BP.BC. 128/ 21.04.048/2000-2001	07.06.2001	SSI Advances Guaranteed by CGTSI – Riskweight and provisioning norms	5.8.6
35	DBOD No. BP. BC. 116 /21.04.048/ 2000-2001	02.05.2001	Monetary & Credit Policy Measures 2001-02	2.1.2
36	DBOD No. BP. BC. 98/ 21.04.048/ 2000-2001	30.03.2001	Treatment of Restructured Accounts	4.2.15
37	DBOD No. BP. BC. 40 / 21.04.048/ 2000-2001	30.10.2000	Income Recognition, Asset Classification and Provisioning Reporting of NPAs to RBI	3.5
38	DBOD.No.BP.BC.161/21.04. 0 48/ 2000	24.04.2000	Prudential Norms on Capital Adequacy, Income Recognition, Asset Classification and Provisioning, etc.	5.5
39	DBOD.No.BP.BC.144/21.04. 0 48/ 2000	29.02.2000	Income Recognition, Asset Classification and Provisioning and Other Related Matters and Adequacy Standards - Takeout Finance	4.2.19, 5.8.7
40	DBOD.No.BP.BC.138/21.04. 0 48/ 2000	07.02.2000	Income Recognition, Asset Classification and Provisioning Export Project Finance	4.2.21
41	DBOD.No.BP.BC.103/21.04. 0 48/ 99	21.10.99	Income Recognition, Asset Classification and Provisioning Agricultural Finance by Commercial Banks through Primary Agricultural Credit Societies	4.2.10
42	DBOD.No.FSC.BC.70/24.01. 001/ 99	17.07.99	Equipment Leasing Activity Accounting/ Provisioning Norms	3.2.3, 5.7

43	DBOD.No.BP.BC.45/21.04.04 8/99	10.05.99	Income Recognition Asset Classification and Provisioning Concept of Commencement of Commercial Production	4.2.15
44	DBOD.No.BP.BC.120/21.04.04 8/ 98	29.12.98	Prudential norms on Income Recognition, Asset Classification and Provisioning Agricultural Loans Affected by Natural Calamities	4.2.13(ii) & (iii)
45	DBOD.No.BP.BC.103/21.01.02/ 98	31.10.98	Monetary & Credit Policy Measures	4.1.1, 4.1.2, 5.5
46	DBOD.No.BP.BC.17/21.04.04 8/98	04.03.98	Prudential Norms on Income Recognition, Asset Classification and Provisioning Agricultural Advances	4.2.13
47	DOS. No. CO.PP. BC.6/ 11.01.005/ 9697	15.05.97	Assessments relating to asset valuation and loan loss provisioning	5.1.1
48	DBOD.No.BP.BC.29/21.04.04 8/97	09.04.97	Income Recognition Asset Classification and Provisioning Agricultural Advances	4.2.13
49	DBOD.No.BP.BC.14/21.04.04 8/97	19.02.97	Income Recognition Asset Classification and Provisioning Agricultural Advances	4.2.13
50	DBOD.No.BP.BC.9/21.04.04 8 /97	29.01.97	Prudential Norms Capital Adequacy, Income Recognition Asset Classification and Provisioning	4.2.4, 4.2.5, 4.2.8, 4.2.9
51	DBOD.No.BP.BC.163/21.04.04 8/ 96	24.12.96	Classification of Advances with Balance less than Rs. 25,000/	4.1
52	DBOD.No.BP.BC.65/21.04.04 8/96	04.06.96	Income Recognition Asset Classification and Provisioning	4.2.8
53	DBOD.No.BP.BC.26/21.04.04 8/96	19.03.96	NonPerforming Advances Reporting to RBI	3.5

54	DBOD.No.BP.BC.25/21.04.0 48/96	19.03.96	Income Recognition Asset Classification and Provisioning	4.2.8, 4.2.14, 7.4
55	DBOD.No.BP.BC.134/21.04.0 48/ 95	20.11.95	EXIM Bank's New Lending Programme Extension of Guarantee cum Refinance to Commercial Bank in respect of Post shipment Supplier's Credit	4.2.20
56	DBOD.No.BP.BC.36/21.04.0 48/95	03.04.95	Income Recognition Asset Classification and Provisioning	3.2.2, 3.3, 4.2.20, 5.8.1(i)(ii)
57	DBOD.No.BP.BC.134/21.04.0 48/ 94	14.11.94	Income Recognition Asset Classification Provisioning and Other Related Matters	4.2.20, 5.8.1
58	DBOD.No.BP.BC.58/21.04.0 4 894	16.05.94	Income Recognition Asset Classification and Provisioning and Capital Adequacy Norms - Clarifications	5.8.5
59	DBOD.No.BP.BC.50/21.04.0 48/94	30.04.94	Income Recognition Asset Classification and Provisioning	5.8.5
60	DOS.BC.4/16.14.001/9394	19.03.94	Credit Monitoring System - Health Code System for Borrowal Accounts	1.3
61	DBOD.No.BP.BC.8/21.04.04 3 /94	04.02.94	Income Recognition, Provisioning and Other Related Matters	3.1.2, 3.4, 4.2.11, 4.2.22, 5.8.2, 5.8.3, 5.8.4
62	DBOD.No.BP.BC.195/21.04.0 48/ 93	24.11.93	Income Recognition, Asset Classification and Provisioning Clarifications	4.2.14
63	DBOD.No.BP.BC.95/21.04.0 48/93	23.03.93	Income Recognition, Asset Classification, Provisioning and Other Related Matters	3.2, 5, 7
64	DBOD.No.BP.BC.59/21.04.0 4 392	17.12.92	Income Recognition, Asset Classification and Provisioning Clarifications	3.2.1, 3.2.2, 4.2.7(i), 4.2.8, 4.2.9(ii), 4.2.12, 4.2.13, 4.2.14, 4.2.16

65	DBOD.No.BP.BC.129/21.04.0 4392	27.04.92	Income Recognition, Asset Classification,	1.1, 1.2, 2.1.1, 2.2,
			Provisioning and Other Related Matters	3.1.1,3.1.3, 4.1, 4.1.1,
				4.1.2, 4.1.3,
				4.2, 5.1, 5.2,
				5.3, 5.4
66	DBOD.No.BP.BC.42/C.469 (W)90	31.10.90	Classification of Non Performing Loans	3.1.1
67	DBOD.No.Fol.BC.136/C.249 85	07.11.85	Credit Monitoring System - Introduction of Health Code for Borrowal Accounts in Banks	1.3
68	DBOD.No.BP.BC.35/21.01.0 02/99	24.04.99	Monetary & Credit Policy Measures	4.2.11 4.2.15
69	DBOD.No.FSC.BC.18/24.01.001/ 9394	19.02.94	Equipment Leasing, Hire Purchase, Factoring, etc. Activities	2.1, 3.2.3

RBI/2008-09/ 34

DBOD No. BP. BC. 5 / 21.04.141 / 2008-09

July 1, 2008

**All Commercial Banks
(excluding Regional Rural Banks)**

Dear Sir,

**Master Circular – Prudential norms for classification,
valuation and operation of investment portfolio by banks**

Please refer to the Master Circular No. DBOD. BP. BC.15 / 21.04.141/ 2007-08 dated July 2, 2007, containing consolidated instructions/guidelines issued to banks till June 30, 2007, on matters relating to prudential norms for classification, valuation and operation of investment portfolio by banks. The above Master Circular has since been suitably updated by incorporating instructions/guidelines issued between July, 2007 and June 30, 2008, and furnished in the Annex. This updated version has also been placed on the RBI web-site (<http://www.rbi.org.in>).

2. An appendix containing a list of circulars referred for the purpose of the current Master circular is furnished at the end of the Annex.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

**MASTER CIRCULAR – PRUDENTIAL NORMS FOR CLASSIFICATION,
VALUATION AND OPERATION OF INVESTMENT PORTFOLIO BY BANKS**

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**MASTER CIRCULAR – PRUDENTIAL NORMS FOR CLASSIFICATION,
VALUATION AND OPERATION OF INVESTMENT PORTFOLIO BY BANKS**

1. Introduction

With the introduction of prudential norms on capital adequacy, income recognition, asset classification and provisioning requirements, the financial position of banks in India has improved in the last few years. Simultaneously, trading in securities market has improved in terms of turnover and the range of maturities dealt with. In view of these developments and taking into consideration the evolving international practices, Reserve Bank of India (RBI) has issued guidelines on classification, valuation and operation of investment portfolio by banks from time to time as detailed below:

1.1 Investment Policy

i) Banks should frame Internal Investments Policy Guidelines and obtain the Board's approval. The investment policy may be suitably framed/amended to include PD activities also. Within the overall framework of the investment policy, the PD business undertaken by the bank will be limited to dealing, underwriting and market –making in Government Securities. Investments in Corporate/ PSUs/ FIs bonds, Commercial Papers, Certificate of Deposits, debt mutual funds and other fixed income securities will not be deemed to be part of PD business. The investment policy guidelines should be implemented to ensure that operations in securities are conducted in accordance with sound and acceptable business practices. While framing the investment policy, the following guidelines are to be kept in view by the banks:

(a) Banks may sell a government security already contracted for purchase, provided:

(i) The purchase contract is confirmed prior to the sale,

(ii) The purchase contract is guaranteed by CCIL or the security is contracted for purchase from the Reserve Bank and,

(iii) the sale transaction will settle either in the same settlement cycle as the preceding purchase contract, or in a subsequent settlement cycle so that the delivery obligation under the sale contract is met by the securities acquired under the purchase contract (e.g. when a security is purchased on T+0 basis, it can be sold on either T+0 or T+1 basis on the day of the purchase; if however it is purchased on T+1 basis, it can be sold on T+1 basis on the day of purchase or on T+0 or T+1 basis on the next day).

For purchase of securities from RBI through Open Market Operations (OMO), no sale transactions should be contracted prior to receiving the confirmation of the deal/advice of allotment from the RBI.

- In addition to the above, the Scheduled Commercial Banks (other than RRBs and LABs) and Primary Dealers have been permitted to short sell Government securities in accordance with the requirements specified in **Annexure I - A**.

- Further, the NDS-OM members have been permitted to transact on 'When Issued' basis in Central Government dated securities, subject to the guidelines specified in **Annexure I-B**.

(b) Banks successful in the auction of primary issue of government may enter into contracts for sale of the allotted securities in accordance with the terms and conditions as per **Annexure I-C**.

(c) The settlement of all outright secondary market transactions in Government Securities will be done on a standardized T+1 basis effective May 24, 2005.

(d) All the transactions put through by a bank, either on outright basis or ready forward basis and whether through the mechanism of Subsidiary General Ledger (SGL) Account or Bank Receipt (BR), should be reflected on the same day in its investment account and, accordingly, for SLR purpose wherever applicable.

(e) The brokerage on the deal payable to the broker, if any, (if the deal was put through with the help of a broker) should be clearly indicated on the notes/ memoranda put up to the top management seeking approval for putting through the transaction and a separate account of brokerage paid, broker-wise, should be maintained.

(f) For issue of BRs, the banks should adopt the format prescribed by the Indian Banks' Association (IBA) and strictly follow the guidelines prescribed by them in this regard. The banks, subject to the above, could issue BRs covering their own sale transactions only and should not issue BRs on behalf of their constituents, including brokers.

(g) The banks should be circumspect while acting as agents of their broker clients for carrying out transactions in securities on behalf of brokers.

(h) Any instance of return of SGL form from the Public Debt Office of the Reserve Bank for want of sufficient balance in the account should be immediately brought to Reserve Bank's notice with the details of the transactions.

(i) Banks desirous of making investment in equity shares/ debentures should observe the following guidelines:

- (i)** Build up adequate expertise in equity research by establishing a dedicated equity research department, as warranted by their scale of operations;
- (ii)** Formulate a transparent policy and procedure for investment in shares, etc., with the approval of the Board.

(iii) The decision in regard to direct investment in shares, convertible bonds and debentures should be taken by the Investment Committee set up by the bank's Board. The Investment Committee should be held accountable for the investments made by the bank.

ii) With the approval of respective Boards, banks should clearly lay down the broad investment objectives to be followed while undertaking transactions in securities on their own investment account and on behalf of clients, clearly define the authority to put through deals, procedure to be followed for obtaining the sanction of the appropriate authority, procedure to be followed while putting through deals, various prudential exposure limits and the reporting system. While laying down such investment policy guidelines, banks should strictly observe Reserve Bank's detailed instructions on the following aspects:

(a) Ready Forward (buy back) deals	(Paragraph 1.1.1)
(b) Transactions through Subsidiary General Ledger A/c	(Paragraph 1.1.2)
(c) Use of Bank Receipts	(Paragraph 1.1.3)
(d) Retailing of Government securities	(Paragraph 1.1.4)
(e) Internal Control System	(Paragraph 1.1.5)
(f) Dealings through Brokers	(Paragraph 1.1.6)
(g) Audit, Review and Reporting	(Paragraph 1.1.7)
(h) Non- SLR investments	(Paragraph 1.1.8)

iii) The aforesaid instructions will be applicable mutatis mutandis, to the subsidiaries and mutual funds established by banks, except where they are contrary to or inconsistent with, specific regulations of Securities and Exchange Board of India (SEBI) and RBI governing their operations.

1.1.1 Ready Forward Contracts in Government Securities.

The terms and conditions subject to which ready forward contracts (including reverse ready forward contracts) may be entered into, are as under:

(a) Ready forward contracts may be undertaken only in (i) Dated Securities and Treasury Bills issued by Government of India and (ii) Dated Securities issued by State Governments.

(b) Ready forward contracts in the above-mentioned securities may be entered into by:

i) persons or entities maintaining a Subsidiary General Ledger (SGL) account with RBI, Mumbai and

ii) the following categories of entities who do not maintain SGL accounts with the RBI but maintain gilt accounts (i.e gilt account holders) with a bank or any other entity (i.e. the custodian) permitted by the RBI to maintain Constituent Subsidiary General Ledger (CSGL) account with its Public Debt Office, Mumbai:

- (a)** Any scheduled bank,
- (b)** Any primary dealer authorised by the RBI,
- (c)** Any non-banking financial company registered with the RBI, other than Government companies as defined in Section 617 of the Companies Act, 1956,
- (d)** Any mutual fund registered with the SEBI,
- (e)** Any housing finance company registered with the National Housing Bank, and
- (f)** Any insurance company registered with the Insurance Regulatory and Development Authority.
- (g)** Any non-scheduled Urban Co-operative bank,
- (h)** Any listed company, having a gilt account with a scheduled commercial bank, subject to the following conditions.

(1) The minimum period for Reverse Repo (lending of funds) by listed companies is seven days. However, listed companies can borrow funds through repo for shorter periods including overnight;

(2) Where the listed company is a 'buyer' of securities in the first leg of the repo contract (i.e. lender of funds), the custodian through which the repo transaction is settled should block these securities in the gilt account and ensure that these securities are not further sold or re-repoed during the repo period but are held for delivery under the second leg; and

(3) The counterparty to the listed companies for repo / reverse repo transactions should be either a bank or a Primary Dealer maintaining SGL Account with the RBI.

(c) All persons or entities specified at (ii) above can enter into ready forward transactions among themselves subject to the following restrictions:

i) An SGL account holder may not enter into a ready forward contract with its own constituent. That is, ready forward contracts should not be undertaken between a custodian and its gilt account holder.

ii) Any two gilt account holders maintaining their gilt accounts with the same custodian (i.e., the CSDL account holder) may not enter into ready forward contracts with each other,
and

iii) Cooperative banks may not enter into ready forward contracts with the non-banking financial companies. This restriction would not apply to repo transactions between Urban Co-operative banks and authorised Primary Dealers in Government Securities.

- (d) All ready forward contracts shall be reported on the Negotiated Dealing System (NDS). In respect of ready forward contracts involving gilt account holders, the custodian (i.e., the CSDL account holder) with whom the gilt accounts are maintained will be responsible for reporting the deals on the NDS on behalf of the constituents (i.e. the gilt account holders).
- (e) All ready forward contracts shall be settled through the SGL Account / CSDL Account maintained with the RBI, Mumbai, with the Clearing Corporation of India Ltd. (CCIL) acting as the central counter party for all such ready forward transactions.
- (f) The custodians should put in place an effective system of internal control and concurrent audit to ensure that:
 - i) ready forward transactions are undertaken only against the clear balance of securities in the gilt account,
 - ii) all such transactions are promptly reported on the NDS, and
 - iii) other terms and conditions referred to above have been complied with.
- (g) The RBI regulated entities can undertake ready forward transactions only in securities held in excess of the prescribed Statutory Liquidity Ratio (SLR) requirements.
- (h) No sale transaction shall be put through, in the first leg of a ready forward transaction by CSDL constituent entities, without actually holding the securities in the portfolio.
- (i) Securities purchased under the ready forward contracts shall not be sold during the period of the contract except by entities permitted to undertake short selling.
- (j) Double ready forward deals in any security are strictly prohibited
- (k) The guidelines for uniform accounting for Repo / Reverse Repo transactions are furnished in paragraph 4.

1.1.2 Transactions through SGL account

The following instructions should be followed by banks for purchase / sale of securities through SGL A/c, under the Delivery Versus Payment (DvP) System wherein the transfer of securities takes place simultaneously with the transfer of funds. It is, therefore, necessary for both the selling bank and the buying bank to maintain current account with the RBI. As no 'Overdraft facility' in the current account would be extended, adequate balance in current account should be maintained by banks for effecting any purchase transaction.

- i)** All transactions in Govt. securities for which SGL facility is available should be put through SGL A/Cs only.
- ii)** Under no circumstances, a SGL transfer form issued by a bank in favour of another bank should bounce for want of sufficient balance of securities in the SGL A/c of seller or for want of sufficient balance of funds in the current a/c of the buyer.
- iii)** The SGL transfer form received by purchasing banks should be deposited in their SGL A/Cs. immediately i.e. the date of lodgement of the SGL Form with RBI shall be within one working day after the date of signing of the Transfer Form. While in cases of OTC trades, the settlement has to be only on 'spot' delivery basis as per Section 2(i) of the Securities Contract Act, 1956, in cases of deals on the recognised Stock Exchanges; settlement should be within the delivery period as per their rules, bye laws and regulations. In all cases, participants must indicate the deal/trade/contract date in Part C of the SGL Form under 'Sale date'. Where this is not completed the SGL Form will not be accepted by the RBI.
- iv)** No sale should be effected by way of return of SGL form held by the bank.
- v)** SGL transfer forms should be signed by two authorised officials of the bank whose signatures should be recorded with the respective PDOs of the RBI and other banks.
- vi)** The SGL transfer forms should be in the standard format prescribed by the RBI and printed on semi-security paper of uniform size. They should be serially numbered and there should be a control system in place to account for each SGL form.
- vii)** If a SGL transfer form bounces for want of sufficient balance in the SGL A/c, the (selling) bank which has issued the form will be liable to the following penal action against it :

 - a)** The amount of the SGL form (cost of purchase paid by the purchaser of the security) would be debited immediately to the current account of the selling bank with the RBI.
 - b)** In the event of an overdraft arising in the current account following such a debit, penal interest would be charged by the RBI, on the amount of the overdraft, at a rate of 3 percentage points above the Discount and Finance House of India's (DFHI) call money lending rate on the day in question. However, if the DFHI's closing call money rate is lower than the prime lending rate of banks, as stipulated in the RBI's interest rate directive in force, the applicable penal rate to be charged will be 3 percentage points, above the prime lending rate of the bank concerned, and

c) If the bouncing of the SGL form occurs thrice, the bank will be debarred from trading with the use of the SGL facility for a period of 6 months from the occurrence of the third bouncing. If, after restoration of the facility, any SGL form of the concerned bank bounces again, the bank will be permanently debarred from the use of the SGL facility in all the PDOs of the RBI.

d) The bouncing on account of insufficient balance in the current account of the buying bank would be reckoned (against the buying bank concerned) for the purpose of debarment from the use of SGL facility on par with the bouncing on account of insufficient balance in SGL a/c. of the selling bank (against selling bank). Instances of bouncing in both the accounts (i.e SGL a/c and current a/c) will be reckoned together against the SGL account holder concerned for the purpose of debarment (i.e three in a half-year for temporary suspension and any bouncing after restoration of SGL facility, for permanent debarment.)

1.1.3 Use of Bank Receipt (BR)

The banks should follow the following instructions for issue of BRs:

- a)** No BR should be issued under any circumstances in respect of transactions in Govt. securities for which SGL facility is available.
- b)** Even in the case of other securities, BR may be issued for ready transactions only, under the following circumstances:
 - (i)** The scrips are yet to be issued by the issuer and the bank is holding the allotment advice.
 - (ii)** The security is physically held at a different centre and the bank is in a position to physically transfer the security and give delivery thereof within a short period.
 - (iii)** The security has been lodged for transfer / interest payment and the bank is holding necessary records of such lodgements and will be in a position to give physical delivery of the security within a short period.
- c)** No BR should be issued on the basis of a BR (of another bank) held by the bank and no transaction should take place on the basis of a mere exchange of BRs held by the bank.
- d)** BRs could be issued covering transactions relating to banks' own Investments Accounts only, and no BR should be issued by banks covering transactions relating to either the Accounts of Portfolio Management Scheme (PMS) Clients or Other Constituents' Accounts, including brokers.
- e)** No BR should remain outstanding for more than 15 days.

f) A BR should be redeemed only by actual delivery of scrips and not by cancellation of the transaction/set off against another transaction. If a BR is not redeemed by delivery of scrips within the validity period of 15 days, the BR should be deemed as dishonoured and the bank which has issued the BR should refer the case to the RBI, explaining the reasons under which the scrips could not be delivered within the stipulated period and the proposed manner of settlement of the transaction.

g) BRs should be issued on semi-security paper, in the standard format (prescribed by IBA), serially numbered and signed by two authorised officials of the bank, whose signatures are recorded with other banks. As in the case of SGL forms, there should be a control system in place to account for each BR form.

h) Separate registers of BRs issued and BRs received should be maintained and arrangements should be put in place to ensure that these are systematically followed up and liquidated within the stipulated time limit.

i) The banks should also have a proper system for the custody of unused B.R. Forms and their utilisation. The existence and operations of these controls at the concerned offices/ departments of the bank should be reviewed, among others, by the statutory auditors and a certificate to this effect may be forwarded every year to the Regional Office of Department of Banking Supervision (DBS), RBI, under whose jurisdiction the Head Office of the bank is located.

j) Any violation of the instructions relating to BRs would invite penal action, which could include raising of reserve requirements, withdrawals of refinance facility from the RBI and denial of access to money markets. The RBI may also levy such other penalty as it may deem fit in accordance with the provisions of the Banking Regulation Act, 1949.

1.1.4 Retailing of Government Securities

The banks may undertake retailing of Government securities with non-bank clients subject to the following conditions:

(i) Such retailing should be on outright basis and there is no restriction on the period between sale and purchase.

ii) The retailing of Government securities should be on the basis of ongoing market rates/ yield curve emerging out of secondary market transactions.

1.1.5 Internal Control System

The banks should observe the following guidelines for internal control system in respect of investment transactions:

- (a)** There should be a clear functional separation of (i) trading, (ii) settlement, monitoring and control and (iii) accounting. Similarly, there should be a functional separation of trading and back office functions relating to banks' own Investment Accounts, Portfolio Management Scheme (PMS) Clients' Accounts and other Constituents (including brokers') accounts. The Portfolio Management service may be provided to clients, subject to strictly following the guidelines in regard thereto (covered in paragraph 1.3.3). Further, PMS Clients Accounts should be subjected to a separate audit by external auditors.
- (b)** For every transaction entered into, the trading desk should prepare a deal slip which should contain data relating to nature of the deal, name of the counter-party, whether it is a direct deal or through a broker, and if through a broker, name of the broker, details of security, amount, price, contract date and time. The deal slips should be serially numbered and controlled separately to ensure that each deal slip has been properly accounted for. Once the deal is concluded, the dealer should immediately pass on the deal slip to the back office for recording and processing. For each deal there must be a system of issue of confirmation to the counterparty. The timely receipt of requisite written confirmation from the counterparty, which must include all essential details of the contract, should be monitored by the back office.
- (c)** With respect to transactions matched on the NDS-OM module, since CCIL is the central counterparty to all deals, exposure of any counterparty for a trade is only to CCIL and not to the entity with who a deal matches. Besides, details of all deals on NDS-OM are available to the counterparties as and when required by way of reports on NDS-OM itself. In view of the above, the need for counterparty confirmation of deals matched on NDS-OM does not arise. However, all government securities transactions, other than those matched on NDS-OM, will continue to be physically confirmed by the back offices of the counterparties, as hitherto.
- (d)** Once a deal has been concluded, there should not be any substitution of the counter party bank by another bank by the broker, through whom the deal has been entered into; likewise, the security sold/purchased in the deal should not be substituted by another security.
- (e)** On the basis of vouchers passed by the back office (which should be done after verification of actual contract notes received from the broker/ counterparty and confirmation of the deal by the counterparty), the Accounts Section should independently write the books of account.

(f) In the case of transaction relating to PMS Clients' Accounts (including brokers), all the relative records should give a clear indication that the transaction belongs to PMS Clients/ other constituents and does not belong to bank's own Investment Account and the bank is acting only in its fiduciary/ agency capacity.

(g) (i) Records of SGL transfer forms issued/ received, should be maintained.

(ii) Balances as per bank's books should be reconciled at quarterly intervals with the balances in the books of PDOs. If the number of transactions so warrant, the reconciliation should be undertaken more frequently, say on a monthly basis. This reconciliation should be periodically checked by the internal audit department.

(iii) Any bouncing of SGL transfer forms issued by selling banks in favour of the buying bank, should immediately be brought to the notice of the Regional Office of Department of Banking Supervision of RBI by the buying bank.

(iv) A record of BRs issued/ received should be maintained.

(v) A system for verification of the authenticity of the BRs and SGL transfer forms received from the other banks and confirmation of authorised signatories should be put in place.

(h) Banks should put in place a reporting system to report to the top management, on a weekly basis, the details of transactions in securities, details of bouncing of SGL transfer forms issued by other banks and BRs outstanding for more than one month and a review of investment transactions undertaken during the period.

(i) Banks should not draw cheques on their account with the RBI for third party transactions, including inter-bank transactions. For such transactions, bankers' cheques/ pay orders should be issued.

(j) In case of investment in shares, the surveillance and monitoring of investment should be done by the Audit Committee of the Board, which shall review in each of its meetings, the total exposure of the bank to capital market both fund based and non-fund based, in different forms as stated above and ensure that the guidelines issued by RBI are complied with and adequate risk management and internal control systems are in place;

(k) The Audit Committee should keep the Board informed about the overall exposure to capital market, the compliance with the RBI and Board guidelines, adequacy of risk management and internal control systems;

(l) In order to avoid any possible conflict of interest, it should be ensured that the stockbrokers as directors on the Boards of banks or in any other capacity, do not involve themselves in any manner with the Investment Committee or in the decisions in regard to making investments in shares, etc., or advances against shares.

(m) The internal audit department should audit the transactions in securities on an on going basis, monitor the compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of the bank.

(n) The banks' managements should ensure that there are adequate internal control and audit procedures for ensuring proper compliance of the instructions in regard to the conduct of the investment portfolio. The banks should institute a regular system of monitoring compliance with the prudential and other guidelines issued by the RBI. The banks should get compliance in key areas certified by their statutory auditors and furnish such audit certificate to the Regional Office of DBS, RBI under whose jurisdiction the HO of the bank falls.

1.1.6 Engagement of brokers

i) For engagement of brokers to deal in investment transactions, the banks should observe the following guidelines:

(a) Transactions between one bank and another bank should not be put through the brokers' accounts. The brokerage on the deal payable to the broker, if any (if the deal was put through with the help of a broker), should be clearly indicated on the notes/memorandum put up to the top management seeking approval for putting through the transaction and separate account of brokerage paid, broker-wise, should be maintained.

(b) If a deal is put through with the help of a broker, the role of the broker should be restricted to that of bringing the two parties to the deal together.

(c) While negotiating the deal, the broker is not obliged to disclose the identity of the counterparty to the deal. On conclusion of the deal, he should disclose the counterparty and his contract note should clearly indicate the name of the counterparty. It should also be ensured by the bank that the broker note contains the exact time of the deal. Their back offices may ensure that the deal time on the broker note and the deal ticket is the same. The bank should also ensure that their concurrent auditors audit this aspect.

(d) On the basis of the contract note disclosing the name of the counterparty, settlement of deals between banks, viz. both fund settlement and delivery of security should be directly between the banks and the broker should have no role to play in the process.

(e) With the approval of their top managements, banks should prepare a panel of approved brokers which should be reviewed annually or more often if so warranted. Clear-cut criteria should be laid down for empanelment of brokers, including verification of their creditworthiness, market reputation, etc. A record of broker-wise details of deals put through and brokerage paid, should be maintained.

(f) A disproportionate part of the business should not be transacted through only one or a few brokers. Banks should fix aggregate contract limits for each of the approved brokers. A limit of 5% of total transactions (both purchase and sales) entered into by a bank during a year should be treated as the aggregate upper contract limit for each of the approved brokers. This limit should cover both the business initiated by a bank and the business offered/ brought to the bank by a broker. Banks should ensure that the transactions entered into through individual brokers during a year normally did not exceed this limit. However, if for any reason it becomes necessary to exceed the aggregate limit for any broker, the specific reasons therefor should be recorded, in writing, by the authority empowered to put through the deals. Further, the board should be informed of this, post facto. However, the norm of 5% would not be applicable to banks' dealings through Primary Dealers.

(g) The concurrent auditors who audit the treasury operations should scrutinise the business done through brokers also and include it in their monthly report to the Chief Executive Officer of the bank. Besides, the business put through any individual broker or brokers in excess of the limit, with the reasons therefor, should be covered in the half-yearly review to the Board of Directors/ Local Advisory Board. These instructions also apply to subsidiaries and mutual funds of the banks.

[Certain clarifications on the instructions are furnished in the **Annexure II.**]

ii) Inter-bank securities transactions should be undertaken directly between banks and no bank should engage the services of any broker in such transactions.

Exceptions:

Note (i) Banks may undertake securities transactions among themselves or with non-bank clients through members of the National Stock Exchange (NSE), OTC Exchange of India (OTCEI) and the Stock Exchange, Mumbai (BSE). If such transactions are not undertaken on the NSE, OTCEI or BSE, the same should be undertaken by banks directly, without engaging brokers.

Note (ii) Although the Securities Contracts (Regulation) Act, 1956 defines the term 'securities' to mean corporate shares, debentures, Govt. securities and rights or interest in securities, the term 'securities' would exclude corporate shares. The Provident / Pension Funds and Trusts registered under the Indian Trusts Act, 1882, will be outside the purview of the expression 'non-bank clients' for the purpose of note (i) above.

1.1.7 Audit, review and reporting of investment transactions

The banks should follow the following instructions in regard to audit, review and reporting of investment transactions:

- a)** Banks should undertake a half-yearly review (as of 30 September and 31 March) of their investment portfolio, which should, apart from other operational aspects of investment portfolio, clearly indicate amendments made to the Investment Policy and certify adherence to laid down internal investment policy and procedures and RBI guidelines, and put up the same before their respective Boards within a month, i.e by end-April and end-October.
- b)** A copy of the review report put up to the Bank's Board, should be forwarded to the RBI (concerned Regional Office of DBS, RBI) by 15 May and 15 November respectively.
- c)** In view of the possibility of abuse, treasury transactions should be separately subjected to concurrent audit by internal auditors and the results of their audit should be placed before the CMD of the bank once every month. Banks need not forward copies of the above mentioned concurrent audit reports to RBI of India. However, the major irregularities observed in these reports and the position of compliance thereto may be incorporated in the half yearly review of the investment portfolio.

1.2 Non- SLR investments

1.2.1

(i) Appraisal

Banks have made significant investment in privately placed unrated bonds and, in certain cases, in bonds issued by corporates who are not their borrowers. While assessing such investment proposals on private placement basis, in the absence of standardised and mandated disclosures, including credit rating, banks may not be in a position to conduct proper due diligence to take an investment decision. Thus, there could be deficiencies in the appraisal of privately placed issues.

(ii) Disclosure requirements in offer documents

The risk arising from inadequate disclosure in offer documents should be recognised and banks should prescribe minimum disclosure standards as a policy with Board approval. In this connection, RBI had constituted a Technical Group comprising officials drawn from treasury departments of a few banks and experts on corporate finance to study, *inter alia*, the methods of acquiring, by banks, of non-SLR investments in general and private placement route, in particular, and to suggest measures for regulating these investments. The Group had designed a format containing the minimum disclosure requirements as well as certain conditionalities regarding documentation and creation of charge for private placement issues, which may serve as a 'best practice model' for the banks. The details of the Group's recommendations are given in the Annexure III and banks should have a suitable format of disclosure requirements on the lines of the recommendations of the Technical Group with the approval of their Board.

(iii) Internal assessment

With a view to ensuring that the investments by banks in issues through private placement, both of the borrower customers and non-borrower customers, do not give rise to systemic concerns, it is necessary that banks should ensure that their investment policies duly approved by the Board of Directors are formulated after taking into account the following aspects:

(a) The Boards of banks should lay down policy and prudential limits on investments in bonds and debentures including cap and on private placement basis, sub limits for PSU bonds, corporate bonds, guaranteed bonds, issuer ceiling, etc.

(b) Investment proposals should be subjected to the same degree of credit risk analysis as any loan proposal. Banks should make their own internal credit analysis and rating even in respect of rated issues and should not entirely rely on the ratings of external agencies. The appraisal should be more stringent in respect of investments in instruments issued by non-borrower customers.

(c) Strengthen their internal rating systems which should also include building up of a system of regular (quarterly or half-yearly) tracking of the financial position of the issuer with a view to ensuring continuous monitoring of the rating migration of the issuers/issues.

(d) As a matter of prudence, banks should stipulate entry-level minimum ratings/ quality standards and industry-wise, maturity-wise, duration-wise, issuer-wise etc. limits to mitigate the adverse impacts of concentration and the risk of illiquidity.

(e) The banks should put in place proper risk management systems for capturing and analysing the risk in respect of these investments and taking remedial measures in time.

(iv) Some banks / FIs have not exercised due precaution by reference to the list of defaulters circulated / published by RBI while investing in bonds, debentures, etc., of companies. Banks may, therefore, exercise due caution, while taking any investment decision to subscribe to bonds, debentures, shares etc., and refer to the 'Defaulters List' to ensure that investments are not made in companies / entities who are defaulters to banks / FIs. Some of the companies may be undergoing adverse financial position, turning their accounts to sub-standard category due to recession in their industry segment, like textiles. Despite restructuring facility provided under RBI guidelines, the banks have been reported to be reluctant to extend further finance, though considered warranted on merits of the case. Banks may not refuse proposals for such investments in companies whose director's name(s) find place in the 'Defaulter Companies List' circulated by RBI, at periodical intervals and particularly in respect of those loan accounts, which have been restructured under extant RBI guidelines, provided the proposal is viable and satisfies all parameters for such credit extension.

Prudential guidelines on investment in Non-SLR securities

1.2.2 Coverage

These guidelines cover banks' investments in non-SLR securities issued by corporates, banks, FIs and State and Central Government sponsored institutions, SPVs etc, including, capital gains bonds, bonds eligible for priority sector status. The guidelines will apply to investments both in the primary market as well as the secondary market.

1.2.3 The guidelines on listing and rating pertaining to non-SLR securities vide paragraphs 1.2.7 to 1.2.16 are not applicable to banks' investments in:

- (a) Securities directly issued by the Central and State Governments, which are not reckoned for SLR purposes.
- (b) Equity shares
- (c) Units of equity oriented mutual fund schemes, viz. those schemes where any part of the corpus can be invested in equity
- (d) Equity/debt instruments/Units issued by Venture capital funds
- (e) Commercial Paper
- (f) Certificates of Deposit

1.2.4 Definitions of a few terms used in these guidelines have been furnished in **Annexure IV** with a view to ensure uniformity in approach while implementing the guidelines.

Regulatory requirements

1.2.5 Banks should not invest in Non-SLR securities of original maturity of less than one-year, other than Commercial Paper and Certificates of Deposits, which are covered under RBI guidelines.

1.2.6 Banks should undertake usual due diligence in respect of investments in non-SLR securities. Present RBI regulations preclude banks from extending credit facilities for certain purposes. Banks should ensure that such activities are not financed by way of funds raised through the non-SLR securities.

Listing and rating requirements

1.2.7 Banks must not invest in unrated non-SLR securities. However, the banks may invest in unrated bonds of companies engaged in infrastructure activities, within the ceiling of 10 per cent for unlisted non-SLR securities as prescribed vide paragraph 1.2.10 below.¹

1.2.8 The Securities Exchange Board of India (SEBI) vide their circular dated September 30, 2003 have stipulated requirements that listed companies are required to comply with, for making issue of debt securities on a private placement basis and listed on a stock exchange. According to this circular, any listed company, making issue of debt securities on a private placement basis and listed on a stock exchange, has to make full disclosures (initial and continuing) in the manner prescribed in Schedule II of the Companies Act 1956, SEBI (Disclosure and Investor Protection) Guidelines, 2000 and the Listing Agreement with the exchanges. Furthermore, the debt securities shall carry a credit rating of not less than investment grade from a Credit Rating Agency registered with the SEBI.

1.2.9 Accordingly, while making fresh investments in non-SLR debt securities, banks should ensure that such investment are made only in listed debt securities of companies which comply with the requirements of the SEBI circular dated September 30, 2003, except to the extent indicated in paragraph 1.2.10 and 1.2.11 below.

¹ Please refer to circular DBOD.No.BP.BC.56/21.04.141/200708 dated Dec 6, 2007

Fixing of prudential limits

1.2.10 Bank's investment in unlisted non-SLR securities should not exceed 10 per cent of its total investment in non-SLR securities as on March 31, of the previous year, and such investment should comply with the disclosure requirements as prescribed by the SEBI for listed companies.

1.2.11 Bank's investment in unlisted non-SLR securities may exceed the limit of 10 per cent, by an additional 10 per cent, provided the investment is on account of investment in securitisation papers issued for infrastructure projects, and bonds/debentures issued by Securitisation Companies (SCs) and

Reconstruction Companies (RCs) set up under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFEASI Act) and registered with RBI. In other words, investments exclusively in securities specified in this paragraph could be up to the maximum permitted limit of 20 per cent of non-SLR investment.

1.2.12 Investment in the following will not be reckoned as 'unlisted non-SLR securities' for computing compliance with the prudential limits prescribed in the above guidelines:

(i) Security Receipts issued by SCs / RCs registered with RBI.

(ii) Investment in Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS), which are rated at or above the minimum investment grade. However, there will be close monitoring of exposures to ABS on a bank specific basis based on monthly reports to be submitted to RBI as per proforma being separately advised by the Department of Banking Supervision.

1.2.13 The investments in RIDF / SIDBI Deposits may not be reckoned as part of the numerator for computing compliance with the prudential limit of 10 per cent of its total non-SLR securities as on March 31, of the previous year.

1.2.14 With effect from January 1, 2005, only investment in units of such mutual fund schemes, which have an exposure to unlisted securities of less than 10 per cent of the corpus of the fund, will be treated on par with listed securities for the purpose of compliance with the prudential limits prescribed in the above guidelines. While computing the exposure to the unlisted securities for compliance with the norm of less than 10 percent of the corpus of the mutual fund scheme, Treasury Bills, Collateralised Borrowing and Lending Obligations (CBLO), Repo/Reverse Repo and Bank Fixed Deposits may not be included in the numerator.

1.2.15 For the purpose of the prudential limits prescribed in the guidelines, the denominator viz., 'non-SLR investments', would include investment under the following four categories in Schedule 8 to the balance sheet viz., 'shares', 'bonds & debentures', 'subsidiaries/joint ventures' and 'others'.

1.2.16 Banks whose investment in unlisted non-SLR securities are within the prudential limit of 10 per cent of its total non-SLR securities as on March 31, of the previous year may make fresh investment in such securities and up to the prudential limits.

Role of Boards

1.2.17 Banks should ensure that their investment policies duly approved by the Board of Directors are formulated after taking into account all the relevant issues specified in these guidelines on investment in non-SLR securities. Banks should put in place proper risk management systems for capturing and analysing the risk in respect of non-SLR investment and taking remedial measures in time.

Banks should also put in place appropriate systems to ensure that investment in privately placed instruments is made in accordance with the systems and procedures prescribed under respective bank's investment policy.

1.2.18 Boards of banks should review the following aspects of non-SLR investment at least at quarterly intervals:

- a) Total business (investment and divestment) during the reporting period.
- b) Compliance with the prudential limits prescribed by the Board for non-SLR investment.
- c) Compliance with the prudential guidelines issued by RBI on non-SLR securities.
- d) Rating migration of the issuers/ issues held in the bank's books and consequent diminution in the portfolio quality.
- e) Extent of non-performing investments in the non-SLR category.

Disclosures

1.2.19 In order to help in the creation of a central database on private placement of debt, a copy of all offer documents should be filed with the Credit Information Bureau (India) Ltd. (CIBIL) by the investing banks. Further, any default relating to interest/ instalment in respect of any privately placed debt should also be reported to CIBIL by the investing banks along with a copy of the offer document.

1.2.20 Banks should disclose the details of the issuer composition of non-SLR investments and the non-performing non-SLR investments in the 'Notes on Accounts' of the balance sheet, as indicated in **Annexure V**.

Trading and settlement in debt securities

1.2.21 As per the SEBI guidelines, all trades with the exception of the spot transactions, in a listed debt security, shall be executed only on the trading platform of a stock exchange. In addition to complying with the SEBI guidelines, banks should ensure that all spot transactions in listed and unlisted debt securities are reported on the NDS and settled through the CCIL from a date to be notified by RBI.

1.2.22 Limits on Banks' Exposure to Capital Markets

A. Solo Basis

The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) should not exceed 40 per cent of its net worth as on March 31 of the previous year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its net worth.

B Consolidated Basis

The aggregate exposure of a consolidated bank to capital markets (both fund based and non-fund based) should not exceed 40 per cent of its consolidated net worth as on March 31 of the previous year. Within this overall ceiling, the aggregate direct exposure by way of the consolidated bank's investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its consolidated net worth.

The above-mentioned ceilings are the maximum permissible and a bank's Board of Directors is free to adopt a lower ceiling for the bank, keeping in view its overall risk profile and corporate strategy.

1.3 General

1.3.1 Reconciliation of holdings of Govt. securities – Audit Certificate

Banks should furnish a 'Statement of the Reconciliation of Bank's Investments (held in own Investment account, as also under PMS)', as at the end of every accounting year duly certified by the bank's auditors. The statement should reach the Regional Office of the DBS, RBI, under whose jurisdiction the bank's head office is located within one month from the close of the accounting year. Banks in the letters of appointment, issued to their external auditors, may suitably include the aforementioned requirement of reconciliation. The format for the statement and the instructions for compiling thereto are given in **Annexure VI**.

1.3.2 Transactions in securities - Custodial functions

While exercising the custodial functions on behalf of their merchant banking subsidiaries, these functions should be subject to the same procedures and safeguards as would be applicable to other constituents. Accordingly, full particulars should be available with the subsidiaries of banks of the manner in which the transactions have been executed. Banks should also issue suitable instructions in this regard to the department/office undertaking the custodial functions on behalf of their subsidiaries.

1.3.3 Portfolio Management on behalf of clients

i) The general powers vested in banks to operate PMS and similar schemes have been withdrawn. No bank should, therefore, restart or introduce any new PMS or similar scheme in future without obtaining specific prior approval of the RBI. However, bank-sponsored NBFCs are allowed to offer discretionary PMS to their clients, on a case-to-case basis. Applications in this regard should be submitted to the Department of Banking Operations and Development (DBOD), RBI, World Trade Centre, Mumbai – 400 005.

ii) The following conditions are to be strictly observed by the banks operating PMS or similar scheme with the specific prior approval of RBI:

(a) PMS should be entirely at the customer's risk, without guaranteeing, either directly or indirectly, a pre-determined return.

(b) Funds should not be accepted for portfolio management for a period less than one year.

(c) Portfolio funds should not be deployed for lending in call/notice money; inter-bank term deposits and bills rediscounting markets and lending to/placement with corporate bodies.

(d) Banks should maintain client wise account/record of funds accepted for management and investments made there against and the portfolio clients should be entitled to get a statement of account.

(e) Bank's own investments and investments belonging to PMS clients should be kept distinct from each other, and any transactions between the bank's investment account and client's portfolio account should be strictly at market rates.

(f) There should be a clear functional separation of trading and back office functions relating to banks' own investment accounts and PMS clients' accounts.

iii) PMS clients' accounts should be subjected by banks to a separate audit by external auditors as covered in paragraph 1.2.5 (i) (a).

iv) Banks should note that violation of RBI's instructions will be viewed seriously and will invite deterrent action against the banks, which will include raising of reserve requirements, withdrawal of facility of refinance from the RBI and denial of access to money markets, apart from prohibition from undertaking PMS activity.

v) Further, the aforesaid instructions will apply, *mutatis mutandis*, to the subsidiaries of banks except where they are contrary to specific regulations of the RBI or SEBI, governing their operations.

vi) Banks / merchant banking subsidiaries of banks operating PMS or similar scheme with the specific prior approval of the RBI are also required to comply with the guidelines contained in the SEBI (Portfolio Managers) Rules and Regulations, 1993 and those issued from time to time.

1.3.4 Investment Portfolio of bank - transactions in Government Securities

In the light of fraudulent transactions in the guise of Government securities, transactions in physical format by a few co-operative banks with the help of some broker entities, it has been decided to accelerate the measures for further reducing the scope of trading in physical forms. These measures are as under:

- (i) For banks, which do not have SGL account with RBI, only one gilt account can be opened.
- (ii) In case the gilt accounts are opened with a scheduled commercial bank, the account holder has to open a designated funds account (for all gilt account related transactions) with the same bank.
- (iii) The entities maintaining the gilt / designated funds accounts will be required to ensure availability of clear funds in the designated funds accounts for purchases and of sufficient securities in the gilt account for sales before putting through the transactions.
- (iv) No transactions by the bank should be undertaken in physical form with any broker.
- (v) Banks should ensure that brokers approved for transacting in Government securities are registered with the debt market segment of NSE/BSE/OTCEI.

2. Classification

i) The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories

viz. 'Held to Maturity',
'Available for Sale' and
'Held for Trading'.

- However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications:

viz. a) Government securities,
b) Other approved securities,
c) Shares,
d) Debentures & Bonds,
e) Subsidiaries/ joint ventures and
f) Others (CP, Mutual Fund Units, etc.).

- ii) Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

2.1 Held to Maturity

- i) The securities acquired by the banks with the intention to hold them up to maturity will be classified under 'Held to Maturity (HTM)'.
- ii) Banks are allowed to include investments included under HTM category upto 25 per cent of their total investments

The following investments are required to be classified under HTM but are not counted for the purpose of ceiling of 25 per cent specified for this category;

- (a) Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio. This will not include re-capitalisation bonds of other banks acquired for investment purposes.
- (b) Investment in subsidiaries and joint ventures (A Joint Venture would be one in which the bank, along with its subsidiaries, holds more than 25 percent of the equity).
- (c) The investments in debentures/bonds, which are deemed to be in the nature of advance. [Refer sub-paragraph (vii) below]

- iii) Banks are, however, allowed since September 2, 2004 to exceed the limit of 25 percent of total investment under HTM category provided:

- (d) the excess comprises only of SLR securities, and
- (e) the total SLR securities held in the HTM is not more than 25 percent of their DTL as on the last Friday of the second preceding fortnight.

- ii) The non-SLR securities, held as part of HTM as on September 2, 2004 may remain in that category. No fresh non-SLR securities, are permitted to be included in HTM, except the following:

- (a) Fresh re-capitalisation bonds, received from the Government of India, towards their re-capitalisation requirement and held in their investment portfolio. This will not include re-capitalisation bonds of other banks acquired for investment purposes.
- (b) Fresh investment in the equity of subsidiaries and joint ventures.
- (c) RIDF / SIDBI deposits

iii) To sum up, banks may hold the following securities under HTM:

(a) SLR Securities upto 25 percent of their DTL as on the last Friday of the second preceding fortnight.

(b) Non-SLR securities included under HTM as on September 2, 2004.

(c) Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in Investment portfolio.

(d) Fresh investment in the equity of subsidiaries and joint ventures

(e) RIDF/SIDBI deposits.

(vi) Profit on sale of investments in this category should be first taken to the Profit & Loss Account, and thereafter be appropriated to the 'Capital Reserve Account'. Loss on sale will be recognised in the Profit & Loss Account.

(vii) The debentures/ bonds must be treated in the nature of an advance when:

- The debenture/bond is issued as part of the proposal for project finance and the tenure of the debenture is for a period of three years and above

Or

The debenture/bond is issued as part of the proposal for working capital finance and the tenure of the debenture/ bond is less than a period of one year

And

- the bank has a significant stake i.e.10% or more in the issue

And

- the issue is part of a private placement, i.e. the borrower has approached the bank/FI and not part of a public issue where the bank/FI has subscribed in response to an invitation.

Since, no fresh non-SLR securities are permitted to be included in the HTM, these investments should not be held under HTM category and they should be subjected to mark- to-market discipline. They would be subjected to prudential norms for identification of non-performing investment and provisioning as applicable to investments.

2.2 Available for Sale & Held for Trading

i) The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements will be classified under 'Held for Trading (HFT)'.

ii) The securities which do not fall within the above two categories will be classified under 'Available for Sale (AFS)'.

iii) The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position.

iv) The investments classified under HFT would be those from which the bank expects to make a gain by the movement in the interest rates/market rates. These securities are to be sold within 90 days.

v) Profit or loss on sale of investments in both the categories will be taken to the Profit & Loss Account.

2.3 Shifting among categories

i) Banks may shift investments to/from HMT with the approval of the Board of Directors once a year. Such shifting will normally be allowed at the beginning of the accounting year. No further shifting to/from HTM will be allowed during the remaining part of that accounting year.

ii) Banks may shift investments from AFS to HFT with the approval of their Board of Directors/ ALCO/ Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/Head of the ALCO, but should be ratified by the Board of Directors/ ALCO.

iii) Shifting of investments from HFT to AFS is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee.

iv) Transfer of scrips from one category to another, under all circumstances, should be done at the acquisition cost/ book value/ market value on the date of transfer, whichever is the least, and the depreciation, if any, on such transfer should be fully provided for. Banks may apply the values as on the date of transfer and in case, there are practical difficulties in applying the values as on the date of transfer, banks have the option of applying the values as on the previous working day, for arriving at the depreciation requirement on shifting of securities.

3. Valuation

3.1 Held to Maturity

i) Investments classified under HTM need not be marked to market and will be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity. The banks should reflect the amortised amount in 'Schedule 13 – Interest Earned : Item II – Income on Investments', as a deduction. However, the deduction need not be disclosed separately. The book value of the security should continue to be reduced to the extent of the amount amortised during the relevant accounting period. ²

ii) Banks should recognise any diminution, other than temporary, in the value of their investments in subsidiaries/ joint ventures, which are included under HTM and provide therefor. Such diminution should be determined and provided for each investment individually.

3.2 Available for Sale

The individual scrips in the Available for Sale category will be marked to market at quarterly or at more frequent intervals. Securities under this category shall be valued scrip-wise and depreciation/ appreciation shall be aggregated for each classification referred to in item 2(i) above. Net depreciation, if any, shall be provided for. Net appreciation, if any, should be ignored. Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification. The book value of the individual securities would not undergo any change after the marking of market.

3.3 Held for Trading

The individual scrips in the Held for Trading category will be marked to market at monthly or at more frequent intervals and provided for as in the case of those in the Available for Sale category. Consequently, the book value of the individual securities in this category would also not undergo any change after marking to market.

² Please refer to the Mailbox clarification dated July 11, 2007.

3.4 Investment Fluctuation Reserve

(i) With a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future due to unexpected developments, banks were advised to build up Investment Fluctuation Reserve (IFR) of a minimum 5 per cent of the investment portfolio within a period of 5 years.

(ii) To ensure smooth transition to Basel II norms, banks were advised in June 24, 2004 to maintain capital charge for market risk in a phased manner over a two year period, as under:

(a) In respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005, and

(b) In respect of securities included in the AFS category by March 31, 2006.

(iii) With a view to encourage banks for early compliance with the guidelines for maintenance of capital charge for market risks, it was advised in April 2005 that banks which have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (items as indicated at (a) above) and AFS category may treat the balance in excess of 5 per cent of securities included under HFT and AFS categories, in the IFR, as Tier I capital. Banks satisfying the above were allowed to transfer the amount in excess of the said 5 per cent in the IFR to Statutory Reserve.

(iv) Banks were advised in October 2005 that, if they have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (items as indicated at (a) above) and AFS category as on March 31, 2006, they would be permitted to treat the entire balance in the IFR as Tier I capital. For this purpose, banks may transfer the balance in the Investment Fluctuation Reserve 'below the line' in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve or balance of Profit & Loss Account.

Investment Reserve Account (IRA)

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

(vi) Banks may utilise IRA as follows:

The provisions required to be created on account of depreciation in the AFS and HFT categories should be debited to the P&L Account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to Statutory Reserve), may be transferred from the IRA to the P&L Account.

Illustratively, banks may draw down from the IRA to the extent of provision made during the year towards depreciation in investment in AFS and HFT categories (net of taxes, if any, and net of transfer to Statutory Reserves as applicable to such excess provision). In other words, a bank which pays a tax of 30% and should appropriate 25% of the net profits to Statutory Reserves, can draw down Rs.52.50 from the IRA, if the provision made for depreciation in investments included in the AFS and HFT categories is Rs.100.

(vii) The amounts debited to the P&L Account for provision should be debited under the head 'Expenditure - Provisions & Contingencies'. The amount transferred from the IRA to the P&L Account, should be shown as 'below the line' item in the Profit and Loss Appropriation Account, after determining the profit for the year. Provision towards any erosion in the value of an asset is an item of charge on the profit and loss account, and hence should appear in that account before arriving at the profit for the accounting period. Adoption of the following would not only be adoption of a wrong accounting principle but would, also result in a wrong statement of the profit for the accounting period:

(a) the provision is allowed to be adjusted directly against an item of Reserve without being shown in the profit and loss account, **OR**

(b) a bank is allowed to draw down from the IRA before arriving at the profit for the accounting period (i.e., above the line), **OR**

(c) a bank is allowed to make provisions for depreciation on investment as a below the line item, after arriving at the profit for the period,

Hence none of the above options are permissible.

(viii) In terms of our guidelines on payment of dividend by banks, dividends should be payable only out of current year's profit. The amount drawn down from the IRA will, therefore, not be available to a bank for payment of dividend among the shareholders. However, the balance in the IRA transferred 'below the line' in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve or balance of Profit & Loss Account would be eligible to be reckoned as Tier I capital.

3.5 Market value

The 'market value' for the purpose of periodical valuation of investments included in the AFS and HFT would be the market price of the scrip as available from the trades/ quotes on the stock exchanges, SGL account transactions, price list of RBI, prices declared by Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association of India (FIMMDA) periodically. In respect of unquoted securities, the procedure as detailed below should be adopted.

3.6 Unquoted SLR securities

3.6.1 Central Government Securities

i) Banks should value the unquoted Central Government securities on the basis of the prices/ YTM rates put out by the PDAI/ FIMMDA at periodical intervals.

ii) The 6.00 per cent Capital Indexed Bonds may be valued at “cost”, as defined in circular DBOD.No.BC.8/12.02.001/ 97-98 dated January 22, 1998 and BC.18/12.02.001/ 2000-2001 dated August 16, 2000.

iii) Treasury Bills should be valued at carrying cost.

3.6.2 State Government Securities

State Government securities will be valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.

3.6.3 Other ‘approved’ Securities

Other approved securities will be valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.

3.7 Unquoted Non-SLR securities

3.7.1 Debentures/ Bonds

All debentures/ bonds other than debentures/bonds, which are in the nature of advance, should be valued on the YTM basis. Such debentures/ bonds may be of different companies having different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government securities as put out by PDAI/ FIMMDA periodically. The mark-up will be graded according to the ratings assigned to the debentures/ bonds by the rating agencies subject to the following: -

(a) The rate used for the YTM for rated debentures/ bonds should be at least 50 basis points above the rate applicable to a Government of India loan of equivalent maturity.

NOTE:

The special securities, which are directly issued by Government of India to the beneficiary entities, which do not carry SLR status, may be valued at a spread of 25 basis points above the corresponding yield on Government of India securities, with effect from the financial year 2008 - 09. At present, such special securities comprise: Oil Bonds, Fertiliser Bonds, bonds issued to the State Bank of India (during the recent rights issue), Unit Trust of India, Industrial Finance Corporation of India Ltd., Food Corporation of India, Industrial Investment Bank of India Ltd., the erstwhile Industrial Development Bank of India and the erstwhile Shipping Development Finance Corporation.³

(b) The rate used for the YTM for unrated debentures/ bonds should not be less than the rate applicable to rated debentures/ bonds of equivalent maturity. The mark-up for the unrated debentures/ bonds should appropriately reflect the credit risk borne by the bank.

(c) Where the debenture/ bonds is quoted and there have been transactions within 15 days prior to the valuation date, the value adopted should not be higher than the rate at which the transaction is recorded on the stock exchange.

³ Please refer to circular DBOD.No.BP.BC.86/21.04.141/200708 dated May 22, 2008

3.7.2 Zero coupon bonds (ZCBs)

ZCBs should be shown in the books at carrying cost, i.e., acquisition cost plus discount accrued at the rate prevailing at the time of acquisition, which may be marked to market with reference to the market value. In the absence of market value, the ZCBs may be marked to market with reference to the present value of the ZCB. The present value of the ZCBs may be calculated by discounting the face value using the 'Zero Coupon Yield Curve', with appropriate mark up as per the zero coupon spreads put out by FIMMDA periodically. In case the bank is still carrying the ZCBs at acquisition cost, the discount accrued on the instrument should be notionally added to the book value of the scrip, before marking it to market.

3.7.3 Preference Shares

The valuation of preference shares should be on YTM basis. The preference shares will be issued by companies with different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government securities put out by the PDAI/FIMMDA periodically. The mark-up will be graded according to the ratings assigned to the preference shares by the rating agencies subject to the following:

- a)** The YTM rate should not be lower than the coupon rate/ YTM for a GOI loan of equivalent maturity.
- b)** The rate used for the YTM for unrated preference shares should not be less than the rate applicable to rated preference shares of equivalent maturity. The mark-up for the unrated preference shares should appropriately reflect the credit risk borne by the bank.
- c)** Investments in preference shares as part of the project finance may be valued at par for a period of two years after commencement of production or five years after subscription whichever is earlier.
- d)** Where investment in preference shares is as part of rehabilitation, the YTM rate should not be lower than 1.5% above the coupon rate/ YTM for GOI loan of equivalent maturity.

- e) Where preference dividends are in arrears, no credit should be taken for accrued dividends and the value determined on YTM should be discounted by at least 15% if arrears are for one year, and more if arrears are for more than one year. The depreciation/provision requirement arrived at in the above manner in respect of non-performing shares where dividends are in arrears shall not be allowed to be set-off against appreciation on other performing preference shares.
- f) The preference share should not be valued above its redemption value.
- g) When a preference share has been traded on stock exchange within 15 days prior to the valuation date, the value should not be higher than the price at which the share was traded.

3.7.4 Equity Shares

The equity shares in the bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis. Equity shares for which current quotations are not available or where the shares are not quoted on the stock exchanges, should be valued at break-up value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's latest balance sheet (which should not be more than one year prior to the date of valuation). In case the latest balance sheet is not available the shares are to be valued at Re.1 per company.

3.7.5 Mutual Funds Units (MF Units)

Investment in quoted MF Units should be valued as per Stock Exchange quotations. Investment in unquoted MF Units is to be valued on the basis of the latest re-purchase price declared by the MF in respect of each particular Scheme. In case of funds with a lock-in period, where repurchase price/market quote is not available, Units could be valued at Net Asset Value (NAV). If NAV is not available, then these could be valued at cost, till the end of the lock-in period. Wherever the re-purchase price is not available, the Units could be valued at the NAV of the respective scheme.

3.7.6 Commercial Paper

Commercial paper should be valued at the carrying cost.

3.7.7 Investments in Regional Rural Banks (RRBs)

Investment in RRBs is to be valued at carrying cost (i.e. book value) on a consistent basis.

3.8. Investment in securities issued by SC/RC

When banks / FIs invest in the SRs / Pass-Through Certificates (PTCs) issued by SCs / RCs, in respect of the financial assets sold by them to the SCs / RCs, the sale shall be recognised in books of the banks / FIs at the lower of:

- the redemption value of the SRs /PTCs, and
- the net book value (NBV) (i.e. Book value less provisions held), of the financial asset.

The above investment should be carried in the books of the bank / FI at the price as determined above until its sale or realisation, and on such sale or realisation, the loss or gain must be dealt with as under:

(i) if the sale to SC /RC is at a price below the NBV, the shortfall should be debited to the profit and loss account of that year.

(ii) If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilised to meet the shortfall / loss on account of sale of other financial assets to SC / RC. All instruments received by banks / FIs from SC / RC as sale consideration for financial assets sold to them and also other instruments issued by SC / RC in which banks / FIs invest will be in the nature of non-SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by RBI from time to time would be applicable to bank's / FI's investment in debentures / bonds / security receipts / PTCs issued by SC / RC. However, if any of the above instruments issued by SC / RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank / FI shall reckon the Net Asset Value (NAV), obtained from SC / RC from time to time, for valuation of such investments.

3.9. Valuation and classification of banks' investment in VCFs

3.9.1 The quoted equity shares / bonds/ units of VCFs in the bank's portfolio should be held under AFS and marked to market preferably on a daily basis, but at least on a weekly basis, in line with valuation norms for other equity shares as per existing instructions.

3.9.2 Banks' investments in unquoted shares/bonds/units of VCFs made after August 23, 2006 (i.e. issuance of guidelines on valuation, classification of investments in VCFs) will be classified under HTM for initial period of three years and will be valued at cost during this period. For the investments made before issuance of these guidelines, the classification would be done as per the existing norms.

3.9.3 For this purpose, the period of three years will be reckoned separately for each disbursement made by the bank to VCF as and when the committed capital is called up. However, to ensure conformity with the existing norms for transferring securities from HTM, transfer of all securities which have completed three years as mentioned above will be effected at the beginning of the next accounting year in one lot to coincide with the annual transfer of investments from HTM category.

3.9.4 After three years, the unquoted units/shares/bonds should be transferred to AFS category and valued as under:

i) Units: In the case of investments in the form of units, the valuation will be done at the NAV shown by the VCF in its financial statements. Depreciation, if any, on the units based on NAV has to be provided at the time of shifting the investments to AFS category from HTM category as also on subsequent valuations which should be done at quarterly or more frequent intervals based on the financial statements received from the VCF. At least once in a year, the units should be valued based on the audited results. However, if the audited balance sheet/ financial statements showing NAV figures are not available continuously for more than 18 months as on the date of valuation, the investments are to be valued at Rupee 1.00 per VCF.

ii) Equity: In the case of investments in the form of shares, the valuation can be done at the required frequency based on the break-up value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's (VCF's) latest balance sheet (which should not be more than 18 months prior to the date of valuation). Depreciation, if any on the shares has to be provided at the time of shifting the investments to AFS category as also on subsequent valuations which should be done at quarterly or more frequent intervals. If the latest balance sheet available is more than 18 months old, the shares are to be valued at Rupee.1.00 per company.

(iii) Bonds: The investment in the bonds of VCFs, if any, should be valued as per prudential norms for classification, valuation and operation of investment portfolio by banks issued by RBI from time to time.

3.9.5 Valuation norms on conversion of outstanding

(a) Equity, debentures and other financial instruments acquired by way of conversion of outstanding principal and / or interest should be classified in the AFS category, and valued in accordance with the extant instructions on valuation of banks' investment portfolio, except to the extent that (a) equity may be valued as per market value, if quoted, (b) in cases, where equity is not quoted, valuation may be at breakup value in respect of standard assets and in respect of substandard / doubtful assets, equity may be initially valued at Re1 and at breakup value after restoration / up gradation to standard category.

3.10 Non-Performing Investments (NPI)

3.10.1 In respect of securities included in any of the three categories where interest/ principal is in arrears, the banks should not reckon income on the securities and should also make appropriate provisions for the depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

3.10.2 An NPI, similar to a non performing advance (NPA), is one where :

(i) Interest/ instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.

(ii) The above would apply mutatis-mutandis to preference shares where the fixed dividend is not paid.

(iii) In the case of equity shares, in the event the investment in the shares of any company is valued at Re.1 per company on account of the non availability of the latest balance sheet in accordance with the instructions contained in paragraph 28 of the Annex to the circular DBOD.BP.BC.32/ 21.04.048/ 2000-01 dated October 16, 2000, those equity shares would also be reckoned as NPI.

(iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities, including preference shares issued by the same issuer would also be treated as NPI and vice versa. However, if only the preference shares are classified as NPI, the investment in any of the other performing securities issued by the same issuer may not be classified as NPI and any performing credit facilities granted to that borrower need not be treated as NPA.

(v) The investments in debentures / bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

(vi) In case of conversion of principal and / or interest into equity, debentures, bonds, etc., such instruments should be treated as NPA abinitio in the same asset classification category as the loan if the loan's classification is substandard or doubtful on implementation of the restructuring package and provision should be made as per the norms.

3.10.3 State Government guaranteed investments

For the year ending March 31, 2005, investment in State Government guaranteed securities would attract prudential norms for identification of NPI and provisioning, if interest and/or principal or any other amount due to the bank remains overdue for more than 180 days. With effect from the year ending March 31, 2006, investment in State Government guaranteed securities, including those in the nature of 'deemed advance', will attract prudential norms for identification of non- performing investments and provisioning, when interest/ instalment of principal (including maturity proceeds) or any other amount due to the bank remains unpaid for more than 90 days.

4. Uniform accounting for Repo / Reverse Repo transactions.

4.1 In order to ensure uniform accounting treatment for accounting repo /reverse repo transactions and to impart an element of transparency, uniform accounting principles, have been laid down for repo / reverse repo transactions undertaken by all the regulated entities. However, for the present, these norms would not apply to repo / reverse repo transactions under the Liquidity Adjustment Facility (LAF) with RBI.

4.2 The uniform accounting principles were made applicable from the financial year 2003-04. The market participants may undertake repos from any of the three categories of investments, viz., Held for Trading, Available For Sale and Held to Maturity.

4.3 The securities sold under repo (the entity selling referred to as “seller”) are excluded from the Investment Account of the seller of securities and the securities bought under reverse repo (the entity buying referred to as “buyer”) are included in the Investment Account of the buyer of securities. Further, the buyer can reckon the approved securities acquired under reverse repo transaction for the purpose of Statutory Liquidity Ratio (SLR) during the period of the repo.

4.4 At present repo transactions are permitted in Central Government securities including Treasury Bills and dated State Government securities. Since the buyer of the securities will not hold it till maturity, the securities purchased under reverse repo by banks should not be classified under Held to Maturity category. The first leg of the repo should be contracted at prevailing market rates. Further, the accrued interest received / paid in a repo / reverse repo transaction and the clean price (i.e. total cash consideration less accrued interest) should be accounted for separately and distinctly.

4.5 The other accounting principles to be followed while accounting for repos / reverse repos will be as under:

4.5.1 Coupon

In case the interest payment date of the security offered under repo falls within the repo period, the coupons received by the buyer of the security should be passed on to the seller on the date of receipt as the cash consideration payable by the seller in the second leg does not include any intervening cash flows. While the buyer will book the coupon during the period of the repo, the seller will not accrue the coupon during the period of the repo. In the case of discounted instruments like Treasury Bills, since there is no coupon, the seller will continue to accrue the discount at the original discount rate during the period of the repo. The buyer will not therefore accrue the discount during the period of the repo.

4.5.2 Repo Interest Income / Expenditure

After the second leg of the repo / reverse repo transaction is over,

- (a) the difference in the clean price of the security between the first leg and the second leg should be reckoned as Repo Interest Income / Expenditure in the books of the buyer / seller respectively;
- (b) the difference between the accrued interest paid between the two legs of the transaction should be shown as Repo Interest Income/ Expenditure account, as the case may be; and
- (c) the balance outstanding in the Repo interest Income / Expenditure account should be transferred to the Profit and Loss account as an income or an expenditure.

As regards repo / reverse repo transactions outstanding on the balance sheet date, only the accrued income / expenditure till the balance sheet date should be taken to the Profit and Loss account. Any repo income / expenditure for the subsequent period in respect of the outstanding transactions should be reckoned for the next accounting period.

4.5.3 Marking to Market

The buyer will mark to market the securities acquired under reverse repo transactions as per the investment classification of the security. To illustrate, for banks, in case the securities acquired under reverse repo transactions have been classified under Available for Sale category, then the mark to market valuation for such securities should be done at least once a quarter. For entities that do not follow any investment classification norms, the valuation for securities acquired under reverse repo transactions may be in accordance with the valuation norms followed by them in respect of securities of similar nature.

In respect of the repo transactions outstanding as on the balance sheet date

- (a) the buyer will mark to market the securities on the balance sheet date and will account for the same as laid down in the extant valuation guidelines issued by the respective regulatory departments of RBI.
- (b) the seller will provide for the price difference in the Profit & Loss account and show this difference under "Other Assets" in the balance sheet if the sale price of the security offered under repo is lower than the book value.
- (c) the seller will ignore the price difference for the purpose of Profit & Loss account but show the difference under "Other Liabilities" in the Balance Sheet, if the sale price of the security offered under repo is higher than the book value; and
- (d) similarly the accrued interest paid / received in the repo / reverse repo transactions outstanding on balance sheet dates should be shown as "Other Assets" or "Other Liabilities" in the balance sheet.

4.5.4 Book value on re-purchase

The seller shall debit the repo account with the original book value (as existing in the books on the date of the first leg) on buying back the securities in the second leg.

4.5.5 Disclosure

The disclosures to be made by banks in the “Notes on Accounts” to the Balance Sheet is given in **Annexure VII**.

4.5.6 Accounting methodology

The accounting methodology to be followed is given below and illustrations are furnished in **Annexure VIII**. While market participants, having different accounting systems, may use accounting heads different from those used in the illustration, there should not be any deviation from the accounting principles enunciated above. Further, to obviate disputes arising out of repo transactions, the participants may consider entering into bilateral Master Repo Agreement as per the documentation finalized by FIMMDA.

4.5.7 Recommended Accounting Methodology for Uniform Accounting of Repo / Reverse Repo transactions

- a)** The following accounts may be opened, viz. (i) Repo Account, (ii) Repo Price Adjustment Account, (iii) Repo Interest Adjustment Account, (iv) Repo Interest Expenditure Account, (v) Repo Interest Income Account, (vi) Reverse Repo Account, (vii) Reverse Repo Price Adjustment Account, and (viii) Reverse Repo Interest Adjustment Account.
- b)** The securities sold/ purchased under repo should be accounted for as an outright sale / purchase.
- c)** The securities should enter and exit the books at the same book value. For operational ease, the weighted average cost method whereby the investment is carried in the books at their weighted average cost, may be adopted.

Repo

- d)** In a repo transaction, the securities should be sold in the first leg at market related prices and re-purchased in the second leg at the derived price. The sale and repurchase should be accounted in the Repo Account.
- e)** The balances in the Repo Account should be netted from the bank's Investment Account for balance sheet purposes.

f) The difference between the market price and the book value in the first leg of the repo should be booked in Repo Price Adjustment Account. Similarly the difference between the derived price and the book value in the second leg of the repo should be booked in the Repo Price Adjustment Account.

Reverse repo

g) In a reverse repo transaction, the securities should be purchased in the first leg at prevailing market prices and sold in the second leg at the derived price. The purchase and sale should be accounted for in the Reverse Repo Account.

h) The balances in the Reverse Repo Account should be part of the Investment Account for balance sheet purposes and can be reckoned for SLR purposes if the securities acquired under reverse repo transactions are approved securities.

i) The security purchased in a reverse repo will enter the books at the market price (excluding broken period interest). The difference between the derived price and the book value in the second leg of the reverse repo should be booked in the Reverse Repo Price Adjustment Account.

Other aspects relating to Repo / Reverse Repo

j) In case the interest payment date of the security offered under repo falls within the repo period, the coupons received by the buyer of the security should be passed on to the seller on the date of receipt as the cash consideration payable by the seller in the second leg does not include any intervening cash flows.

k) The difference between the amounts booked in the first and second legs in the Repo / Reverse Repo Price Adjustment Account should be transferred to the Repo Interest Expenditure Account or Repo Interest Income Account, as the case may be.

l) The broken period interest accrued in the first and second legs will be booked in Repo Interest Adjustment Account or Reverse Repo Interest Adjustment Account, as the case may be. Consequently the difference between the amounts booked in this account in the first and second legs should be transferred to the Repo Interest Expenditure Account or Repo Interest Income Account, as the case may be.

m) At the end of the accounting period the, for outstanding repos, the balances in the Repo / Reverse Repo Price Adjustment Account and Repo / Reverse repo Interest Adjustment account should be reflected either under item VI - 'Others' under Schedule 11 - 'Other Assets' or under item IV 'Others (including Provisions)' under Schedule 5 - 'Other Liabilities and Provisions' in the Balance Sheet, as the case may be.

n) Since the debit balances in the Repo Price Adjustment Account at the end of the accounting period represent losses not provided for in respect of securities offered in outstanding repo transactions, it will be necessary to make a provision therefor in the Profit & Loss Account.

o) To reflect the accrual of interest in respect of the outstanding repo/ reverse repo transactions at the end of the accounting period, appropriate entries should be passed in the Profit and Loss account to reflect Repo Interest Income / Expenditure in the books of the buyer / seller respectively and the same should be debited / credited as an income / expenditure accrued but not due. Such entries passed should be reversed on the first working day of the next accounting period.

p) In respect of repos in interest bearing (coupon) instruments, the buyer would accrue interest during the period of repo. In respect of repos in discount instruments like Treasury Bills, the seller would accrue discount during the period of repo based on the original yield at the time of acquisition.

q) At the end of the accounting period the debit balances (excluding balances for repos which are still outstanding) in the Repo Interest Adjustment Account and Reverse Repo Interest Adjustment Account should be transferred to the Repo Interest Expenditure Account and the credit balances (excluding balances for repos which are still outstanding) in the Repo Interest Adjustment Account and Reverse Repo Interest Adjustment Account should be transferred to the Repo Interest Income Account.

r) Similarly, at the end of accounting period, the debit balances (excluding balances for repos which are still outstanding) in the Repo / Reverse Repo Price Adjustment Account should be transferred to the Repo Interest Expenditure Account and the credit balances (excluding balances for repos which are still outstanding) in the Repo / Reverse Repo Price Adjustment Account should be transferred to the Repo Interest Income Account.

5. General

5.1 Income recognition

i) Banks may book income on accrual basis on securities of corporate bodies/ public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.

ii) Banks may book income from dividend on shares of corporate bodies on accrual basis provided dividend on the shares has been declared by the corporate body in its Annual General Meeting and the owner's right to receive payment is established.

iii) Banks may book income from Government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are pre-determined and provided interest is serviced regularly and is not in arrears.

iv) Banks should book income from units of mutual funds on cash basis.

5.2 Broken Period Interest

Banks should not capitalise the Broken Period Interest paid to seller as part of cost, but treat it as an item of expenditure under Profit and Loss Account in respect of investments in Government and other approved securities. It is to be noted that the above accounting treatment does not take into account taxation implications and hence the banks should comply with the requirements of Income Tax Authorities in the manner prescribed by them.

5.3 Dematerialised Holding

Banks should settle the transactions in securities as notified by SEBI only through depositories. After the commencement of mandatory trading in demat form, banks would not be able to sell the shares of listed companies if they were held in physical form. In order to extend the demat form of holding to other instruments like bonds, debentures and equities, it was decided that, with effect from October 31, 2001, banks, FIs, PDs and SDs would be permitted to make fresh investments and hold bonds and debentures, privately placed or otherwise, only in dematerialised form. Outstanding investments in scrip forms would have to be converted into dematerialised form by June 30, 2002. As regards equity instruments, banks were required to convert all their equity holding in scrip form into dematerialised form by December 31, 2004.

Short sale in Government Securities

Banks may undertake short sale of Central Government dated securities, subject to the short position being covered within a maximum period of five trading days, including the day of trade. In other words, the short sale position initiated today (trade date, T+0) will have to be covered on or before close of T+4 day. Such short positions shall be covered only by outright purchase of an equivalent amount of the same security. The short positions may be reflected in 'Securities Short Sold (SSS) A/c', specifically created for this purpose. For the purposes of this circular short sale and notional short sale are defined as under:

'Short Sale' is defined as sale of securities one does not own. A bank can also undertake 'notional' short sale where it can sell a security short from HFT even if the security is held under its AFS/HTM book. The resultant 'notional' short position would be subject to the same regulatory requirements as in the case of a short sale. For the purpose of these guidelines, short sale would include 'notional' short sale as well. The short sale by banks and the cover transaction shall not affect the holdings and valuation of the same security in AFS/HTM categories in any way.

Short sale transactions can be undertaken by banks, subject to the following conditions:

Minimum requirements:

In respect of short sales, banks shall ensure adherence to the following conditions:

- a) The sale leg of the transaction should be executed only on the Negotiated Dealing System – Order Matching (NDS-OM) platform. The cover leg of the short sale transaction can, however, be executed either on or outside the NDS-OM platform.
- b) The sale leg as well as the cover leg of the transaction should be accounted in the HFT category.
- c) Under no circumstances, should participants fail to deliver, on settlement date, the securities sold short. Failures to deliver securities short sold shall be treated as an instance of 'SGL bouncing' and the concerned banks will be liable to disciplinary action prescribed in respect of SGL bouncing, besides attracting such further regulatory action as may be considered necessary.
- d) At no point of time should a bank accumulate a short position (face value) in any security in the HFT category in excess of the following limits:
 - i) 0.25% of the total outstanding stock issued of each security in case of securities other than liquid securities.

ii) 0.50% of the total outstanding stock issued of each security in case of liquid securities.

e) Banks shall be entirely responsible for ensuring strict compliance with the above prudential limits on real time basis for which they may put in place appropriate systems and internal controls. The controls provided in the trading platform (NDS-OM) are merely in the nature of additional tools and should not be cited as a reason for any breach of internal or regulatory limits. The information regarding the outstanding stock of each Government of India dated security is being made available on the RBI website (URL: <http://rbi.org.in/Scripts/NDSUserXsl.aspx>). The list of liquid securities for compliance with the limits shall be provided by FIMMDA from time to time.

f) Banks which undertake short sale transactions shall mark-to-market their entire HFT portfolio, including the short positions, **on a daily basis** and account for the resultant mark-to-market gains / losses as per the relevant guidelines for marking-to-market of the HFT portfolio.

g) Gilt Accounts Holders (GAHs), under CSGL facility, are not permitted to undertake short sales. Entities maintaining CSGL Accounts are required to ensure that no short sale is undertaken by the GAHs.

Borrowing security (through the repo market) to meet delivery obligations:

Since securities that are short sold are to be **invariably** delivered on the settlement date, participants are permitted to meet their delivery obligations by acquiring securities in the repo market. Accordingly, with a view to enable participants to run short positions across settlement cycles, banks have been permitted to use the securities acquired under a reverse repo to meet the delivery obligation of the short sale transaction. While the reverse repos can be rolled over, it is emphasised that the delivery obligations under the successive reverse repo contracts are also to be invariably met, failing which the concerned banks shall attract the regulatory action as specified above. It may, however, be noted that the permission to use securities acquired under reverse repo as above applies only to securities acquired under market repo and **not** to securities acquired under RBI's Liquidity Adjustment Facility.

Policy and internal control mechanisms:

Before actually undertaking transactions in terms of this circular, banks shall put in place a written policy on short sale, which should be approved by their respective Boards of Directors. The policy should lay down the internal guidelines which should include, *inter alia*, risk limits on short position, an aggregate nominal short sale limit (in terms of Face Value) across all eligible securities, stop loss limits, the internal control systems to ensure adherence to regulatory and internal guidelines, reporting of short selling activity to the Board and the RBI, procedure to deal with violations, etc. Banks shall also put in place a system to detect violations if any, immediately, certainly within the same trading day.

In addition to the internal control mechanisms, the concurrent auditors should specifically verify compliance with these instructions, as well as with internal guidelines and report violations, if any, within a reasonably short time, to the appropriate internal authority. As part of their monthly reporting, concurrent auditors may verify whether the independent back/mid office has taken cognizance of lapses, if any, and whether they have reported the same within the required time frame to the appropriate internal authority. Any violation of regulatory guidelines noticed in this regard should immediately be reported to the respective Public Debt Office (PDO) where the SGL account is maintained and Internal Debt Management Department, Reserve Bank of India, Mumbai.

When Issued Market - Guidelines

Definition

‘When, as and if issued’ (commonly known as ‘when-issued’ (WI)) security refers to a security that has been authorized for issuance but not yet actually issued. ‘WI’ trading takes place between the time a new issue is announced and the time it is actually issued. All ‘when issued’ transactions are on an ‘if’ basis, to be settled if and when the actual security is issued.

Mechanics of Operation

Transactions in a security on a ‘When Issued’ basis shall be undertaken in the following manner:

- a) ‘WI’ transactions can be undertaken in the case of securities that are being reissued as well as newly issued, on a selective basis.
- b) ‘WI’ transactions would commence on the issue notification date and it would cease on the working day immediately preceding the date of issue.
- c) All ‘WI’ transactions for all trade dates will be contracted for settlement on the date of issue.
- d) At the time of settlement on the date of issue, trades in the ‘WI’ security will be netted off with trades in the existing security, in the case of reissued securities.
- e) The originating transactions (sale or purchase of ‘WI’ securities) shall be undertaken only on NDS-OM. Any reversal of a When Issued transaction can, however, be undertaken on or outside the NDS-OM platform.
- f) Only PDs can take a short position in the ‘WI’ market. In other words, non-PD entities can sell the ‘WI’ security to any counterparty only if they have a preceding purchase contract for equivalent or higher amount.
- g) Open Positions in the ‘WI’ market are subject to the following limits:

Category	Reissued security	Newly issued security
Non-PDs	Long Position, not exceeding 5 per cent of the notified amount.	Long Position, not exceeding 5 per cent of the notified amount.
PDs	Long or Short Position, not exceeding 10 per cent of the notified amount	Short Position, not exceeding 6 per cent and Long Position, not exceeding 10 per cent of the notified amount.

- h) In the event of cancellation of the auction for whatever reason, all ‘WI’ trades will be deemed null and void *ab initio* on grounds of force majeure.

Internal Control

All banks participating in the 'WI' market are required to have in place a written policy on 'WI' trading which should be approved by the Board of Directors. The policy should lay down the internal guidelines which should include, inter alia, risk limits on 'WI' position (including, in the case of reissued securities, overall position in the security, i.e., 'WI' plus the existing security), an aggregate nominal limit (in terms of Face Value) for 'WI' and in the case of reissued securities, 'WI' plus the existing security, the internal control arrangements to ensure adherence to regulatory and internal guidelines, reporting of 'WI' activity to the top management, procedure to deal with violations, etc. A system should be in place to detect violations immediately, certainly within the trading day.

The concurrent auditors should specifically verify compliance with these instructions and report violations on the date of trade itself, within a reasonably short time, to the appropriate internal authority. As part of their monthly reporting, concurrent auditors may verify whether the independent back/mid office has taken cognizance of all such lapses and reported the same within the required time frame. Any violation of regulatory guidelines noticed in this regard should immediately be reported to the Public Debt Office (PDO), Mumbai and IDMD, Reserve Bank of India.

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**Investment portfolio of banks – Transactions in securities –
Conditions subject to which securities allotted in the auctions for primary issues can be sold**

- (i) The contract for sale can be entered into only once by the allottee bank on the basis of an authenticated allotment advice issued by Reserve Bank of India. The selling bank should make suitable noting/stamping on the allotment advice indicating the sale contract number etc., the details of which should be intimated to the buying entity. The buying entity should not enter into a contract to further resell the securities until it actually holds the securities in its investment account. Any sale of securities should be only on a T + 0 or T + 1 settlement basis.
- (ii) The contract for sale of allotted securities can be entered into by banks with entities maintaining SGL Account with RBI as well as with and between CSGL account holders for delivery and settlement on the next working day through the Delivery versus Payment (DvP) system.
- (iii) The face value of securities sold should not exceed the face value of securities indicated in the allotment advice.
- (iv) The sale deal should be entered into directly without the involvement of broker/s.
- (v) Separate record of such sale deals should be maintained containing details such as number and date of allotment advice, description and the face value of securities allotted, the purchase consideration, the number, date of delivery and face value of securities sold, sale consideration, the date and details of actual delivery i.e. SGL Form No., etc. This record should be made available to RBI for verification. Banks should immediately report any cases of failure to maintain such records.
- (vi) Such type of sale transactions of Government securities allotted in the auctions for primary issues on the same day and based on authenticated allotment advice should be subjected to concurrent audit and the relative audit report should be placed before the Executive Director or the Chairman and Managing Director of the Bank once every month. A copy thereof should also be sent to the Department of Banking Supervision, RBI, Central Office, Mumbai.
- (vii) Banks will be solely responsible for any failure of the contracts due to the securities not being credited to their SGL account on account of non-payment / bouncing of cheque etc.

Annexure – II
Para 1.1.6 (i) (g)

**Investment portfolio of banks - Transactions in securities -
Aggregate contract limit for individual brokers**

Sr. No.	Issue Raised	Response
1.	The year should be calendar year or financial year?	Since banks close their accounts at the end of March, it may be more convenient to follow the financial year. However, the banks may follow calendar year or any other period of 12 months provided, it is consistently, followed in future.
2.	Whether the limit is to be observed with reference to total transactions of the previous year as the total transactions of the current year should be known only at the end of the year?	The limit has to be observed with reference to the year under review. While operating the limit, the bank should keep in view the expected turnover of the current year which may be based on turnover of the previous year and anticipated rise or fall in the volume of business in the current year.
3.	Whether to arrive at the total transactions of the year, transactions entered into directly with counter-parties i.e. where no brokers are involved would also be taken into account	Not necessary. However, if there are any direct deals with the brokers as purchasers or sellers the same would have to be included in the total transactions to arrive at the limit of transactions to be done through an individual broker.
4.	Whether in case of ready forward deals both the legs of the deals i.e. purchase as well as sale will be included to arrive at the volume of total transactions?	Yes. This is however only theoretical as R/F transactions in Govt. security now prohibited except in Treasury Bills and the 3 year dated securities issued by conversion of Treasury Bills recently
5.	Whether central loan /state loan /treasury bills etc. purchased subscriptions/ auction will be, included in the volume of total transactions?	No, as brokers are not involved as intermediaries.
6.	It is possible that even though bank considers that a particular broker has touched the prescribed limit of 5% he may come with an offer during the remaining period of the year which the bank may find it to its advantage as compared to offers received from the other brokers who have not yet done business upto the prescribed limit.	If the offer received is more advantageous the limit for the broker may be exceeded the reasons therefor recorded and approval of the competent authority / Board obtained post facto.
7.	Whether the transactions conducted on behalf of the clients would also be included in the total transactions of the year?	Yes. If they are conducted through the brokers.

8.	For a bank which rarely deals through brokers and consequently the volume of business is small maintaining the broker-wise limit of 5% may mean splitting the orders in small values amongst different brokers and there may also arise price differential.	There may be no need to split an order. If any deal causes the particular broker's share to exceed 5% limit, our circular provides the necessary flexibility in as much as Board's post facto approval can be obtained.
9.	During the course of the year it may not be possible to reasonably predict what will be the total quantum of transactions through brokers as a result of which there could be deviation in complying with the norm of 5% .	The bank may get post facto approval from the Board after explaining to it the circumstances in which the limit was exceeded.
10.	Some of the small private sector banks have mentioned that where the volume of business particularly the transactions done through brokers is small the observance of 5% limit may be difficult. A suggestion has therefore been made that the limit may be required to be observed if the business done through a broker exceeds a cut-off point of say Rs.10 crores	As already observed the limit of 5% can be exceeded subject to reporting the transactions to the competent authority post facto. Hence, no change in our instructions is considered necessary.

Recommendations of the Group on Non-SLR Investments of Banks**Pro-forma of minimum disclosure requirements in respect of private placement issues - Model Offer Document**

All issuers must issue an offer document with terms of issue, authorised by Board Resolution not older than 6 months from the date of issue. The offer document should specifically mention the Board Resolution authorising the issue and designations of the officials who are authorised to issue the offer document. The offer document may be printed or typed "For Private Circulation Only". The 'Offer Document' should be signed by the authorised signatory. The offer document should contain the following minimum information:

I. General Information

1. Name and address of registered office of the company
2. Full names (expanded initials), addresses of Directors and the names of companies where they are Directors.
3. Listing of the issue (If listed, name of the Exchange)
4. Date of opening of the issue

Date of closing of the issue

Date of earliest closing of the issue.
5. Name and addresses of auditors and Lead Managers / arrangers
6. Name address of the trustee - consent letter to be produced (in case of debenture issue)
7. Rating from any Rating Agency and / or copy of the rationale of latest rating.

II. Particulars of the issue

- (a) Objects
- (b) Project cost and means of financing (including contribution of promoters) in case of new projects.

III. The model offer document should also contain the following information:

- (1) Interest rate payable on application money till the date of allotment.
- (2) Security: If it is a secured issue, the issue is to be secured, the offer documents should mention description of security, type of security, type of charge, Trustees, private charge-holders, if any, and likely date of creation of security, minimum security cover, revaluation, if any.
- (3) If the security is collateralised by a guarantee, a copy of the guarantee or principal terms of the guarantee are to be included in the offer document.

- (4) Interim Accounts, if any.
- (5) Summary of last audited Balance Sheet and Profit & Loss Account with qualifications by Auditors, if any.
- (6) Last two published Balance Sheet may be enclosed.
- (7) Any conditions relating to tax exemption, capital adequacy etc. are to be brought out fully in the documents.
- (8) The following details in case of companies undertaking major expansion or new projects :- (copy of project appraisal may be made available on request)
 - (a) Cost of the project, with sources and uses of funds
 - (b) Date of commencement with projected cash flows
 - (c) Date of financial closure (details of commitments by other institutions to be provided)
 - (d) Profile of the project (technology, market etc)
 - (e) Risk factors
- (9) If the instrument is of tenor of 5 years or more, projected cash flows.

IV. Banks may agree to insist upon the following conditionalities for issues under private placements

All the issuers in particular private sector corporates, should be willing to execute a subscription agreement in case of all secured debt issues, pending the execution of Trust Deed and charge documents. A standardised subscription agreement may be used by the banks, inter-alia, with the following important provisions:

- (a) Letter of Allotment should be made within 30 days of allotment. Execution of Trust Deed and charge documents will be completed and debentures certificates will be dispatched within the time limit laid down in the Companies Act but not exceeding in any case, 6 months from the date of the subscription agreement.
- (b) In case of delay in complying with the above, the company will refund the amount of subscription with agreed rate of interest, or, will pay penal interest of 2% over the coupon rate till the above conditions are complied with, at the option of the bank.
- (c) Pending creation of security, during the period of 6 months (or extended period), the principal Directors of the company should agree to indemnify the bank for any loss that may be suffered by the bank on account of the subscription to their debt issue. (This condition will not apply to PSUs).
- (d) It will be the company's responsibility to obtain consent of the prior charge-holders for creation of security within the stipulated period. Individual banks may insist upon execution of subscription agreement or a suitable letter to comply with the terms of offer such as appointment of trustee, creation of security etc. on the above lines.
- (e) Rating: The Group recommends that the extant regulations of SEBI in regard to rating of all debt instruments in public offers would be made applicable to private placement also. This stipulation will also apply to preference shares, which are redeemable after 18 months.

(f) Listing: Currently, there is a lot of flexibility regarding listing required by banks in private placement issues. However, the Group recommends that listing of companies should be insisted upon, (exceptions, if any, to this rule shall be provided in the Investment Policy of the banks) which would in due course help develop secondary market. The advantage of listing would be that the listed companies would be required to disclose information periodically to the Stock Exchanges which would also help develop the secondary markets by way of investor information. In fact, SEBI has advised all the Stock Exchanges that all listed companies should publish unaudited financial results on a quarterly basis and that they should inform the Stock Exchanges immediately of all events which would have a bearing on the performance / operations of the company as well as price sensitive information.

(g) Security / documentation: To ensure that the documentation is completed and security is created in time, the Group has made recommendations, which is contained in this model offer document. It may be noted that in case of delay in execution of Trust Deed and Charge documents, the company will refund the subscription with agreed rate of interest or will pay penal interest of 2% over the coupon rate till these conditions are complied with at the option of the bank. Moreover, Principal Directors of the company will have to agree to indemnify the bank for any loss that may be suffered by the bank on account of the subscription to the debt issue during the period of 6 months (or extended period) pending creation of security.

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Annexure - IV
Para 1.2.4

Guidelines on Investments by Banks in Non-SLR Investment Portfolio by Banks - Definitions

1. With a view to imparting clarity and to ensure that there is no divergence in the implementation of the guidelines, some of the terms used in the guidelines on non-SLR investments are defined below.
 2. A security will be treated as rated if it is subjected to a detailed rating exercise by an external rating agency in India, which is registered with SEBI and is carrying a current or valid rating. The rating relied upon will be deemed to be current or valid if
 - (i) The credit rating letter relied upon is not more than one month old on the date of opening of the issue, and
 - (ii) The rating rationale from the rating agency is not more than one year old on the date of opening of the issue, and
 - (iii) The rating letter and the rating rationale is a part of the offer document.
 - (iv) In the case of secondary market acquisition, the credit rating of the issue should be in force and confirmed from the monthly bulletin published by the respective rating agency.Securities, which do not have a current or valid rating by an external rating agency, would be deemed as unrated securities.
 3. The investment grade ratings awarded by each of the external rating agencies operating in India would be identified by the IBA / FIMMDA. These would also be reviewed by IBA / FIMMDA at least once a year.
 4. A 'listed' security is a security which is listed in a stock exchange. If not so, it is an 'unlisted' security.
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**Prudential Guidelines on Management of the Non-SLR Investment Portfolio by Banks -
Disclosures Requirements**

Banks should make the following disclosures in the 'Notes on Accounts' of the balance sheet in respect of their non-SLR investment portfolio, with effect from the financial year ending 31 March 2004.

(i) **Issuer composition of Non SLR investments**

(Rs. in crore)						
Sl. No	Issuer	Amount	Extent of private placement	Extent of 'below investment grade' securities	Extent of 'unrated' securities	Extent of 'unlisted' securities
1	2	3	4	5	6	7
1.	PSUs					
2.	FIs					
3.	Banks					
4.	Private Corporates					
5.	Subsidiaries / Joint ventures					
6.	Others					
7.	Provision held towards depreciation		XXX	XXX	XXX	XXX
	Total *					

Note: 1. * Total under column 3 should tally with the total of investments included under the following categories in Schedule 8 to the balance sheet:

- (a) Shares
- (b) Debentures & Bonds
- (c) Subsidiaries / joint ventures
- (d) Others

- 2. Amounts reported under columns 4, 5, 6 and 7 above may not be mutually exclusive.

(ii) **Non-performing Non-SLR investments**

Particulars	Amount (Rs. Crore)
Opening balance	
Additions during the year since 1st April	
Reductions during the above period	
Closing balance	
Total provisions held	

RETURN/STATEMENT NO. 9

Proforma Statement showing the position of Reconciliation of Investment Account as on 31st March

Name of the bank/ Institution: _____

(Face value Rs. in crore)

Particulars of securities	General Ledger Balance	SGL Balance		BRs held	SGL Forms held	Actual Scrips Held	Outstanding deliveries
		As per PDO Books	As per bank's / institution's books				
1	2	3	4	5	6	7	8
Central Govt							
State Government							
Other approved securities							
Public Sector Bonds							
Units of UTI (1964)							
Others (Shares & Debenture etc)							
TOTAL							

Signature of the Authorised Official
with the Name and Designation

Note : Similar statements may be furnished in respect of PMS client's Accounts and other constituents' Accounts (including Brokers). In the case of PMS/other constituents' accounts, the face value and book value of securities appearing in the relevant registers of the bank should be mentioned under Column 2.

General instructions for compiling reconciliation statement

a) Column - 2 (GL balances)

It is not necessary to give complete details of securities in the format. Only aggregate amount of face value against each category may be mentioned. The corresponding book value of securities may be indicated in bracket under the amount of face value of securities under each category.

b) Column - 3 and 4 (SGL balances)

In the normal course balances indicated against item three and four should agree with each other. In case of any difference on account of any transaction not being recorded either in PDO or in the books of the bank this should be explained giving full details of each transaction.

c) Column - 5 (BRs held)

If the bank is holding any BRs for purchases for more than 30 days from the date of its issue, particulars of such BRs should be given in a separate statement.

d) Column - 6 (SGL forms held)

Aggregate amount of SGL forms received for purchases, which have not been tendered with PDO, should be given here.

e) Column - 7

Aggregate amount of all scrips held in the form of bonds, letters of allotments, subscription receipts as also certificates of entries in the books of accounts of the issuer (for other than government securities), etc. including securities which have been sold but physical delivery has not been given should be mentioned.

f) Column - 8 (outstanding deliveries)

This relates to BRs issued by the bank, where the physicals/scrips have not been delivered but the balance in General Ledger has been reduced. If any BR issued is outstanding for more than thirty days the particulars of such BRs may be given in a separate list indicating reasons for not affecting the delivery of scrips.

g) General

Face value of securities indicated against each item in column two should be accounted for under any one of the columns from four to seven. Similarly, amount of outstanding deliveries (BRs issued) which has been indicated in column eight will have to be accounted for under one of the columns four to seven. Thus the total of columns two and eight should tally with total of columns four to seven.

**Annexure - VII
Para 4.5.5****Disclosures**

The following disclosures should be made by banks in the 'Notes on Accounts' to the Balance Sheet.

(Rs. in crore)				
	Minimum outstanding during the year	Maximum outstanding during the year	Daily Average outstanding during the year	As on March 31
Securities sold under repos				
Securities purchased under reverse repos				

Annexure - VIII
Para 4.5.6

**Illustrative examples for uniform accounting of
Repo / Reverse repo transactions**

A. Repo / Reverse Repo of Coupon bearing security

1. Details of Repo in a coupon bearing security:

Security offered under Repo	11.43% 2015	
Coupon payment dates	7 August and 7 February	
Market Price of the security offered under Repo (i.e. price of the security in the first leg)	Rs.113.00	(1)
Date of the Repo	19 January, 2003	
Repo interest rate	7.75%	
Tenor of the repo	3 days	
Broken period interest for the first leg*	$11.43\% \times 162/360 \times 100 = 5.1435$	(2)
Cash consideration for the first leg	$(1) + (2) = 118.1435$	(3)
Repo interest**	$118.1435 \times 3/365 \times 7.75\% = 0.0753$	(4)
Broken period interest for the second leg	$11.43\% \times 165/360 \times 100 = 5.2388$	(5)
Price for the second leg	$(3) + (4) - (5) = 118.1435 + 0.0753 - 5.2388 = 112.98$	(6)
Cash consideration for the second leg	$(5) + (6) = 112.98 + 5.2388 = 118.2188$	(7)

* Computation of days based on 30 / 360 day count convention

** Computation of days based on Actual / 365 day count convention applicable to money market instruments

2. Accounting for seller of the security

We assume that the security was held by the seller at the book value (BV) of Rs.120.0000

First leg Accounting

	Debit	Credit
Cash Repo Account	118.1435	120.0000 (Book value)
Repo Price Adjustment account	7.0000 (Difference between BV & repo price)	
Repo Interest Adjustment account		5.1435

Second Leg Accounting

	Debit	Credit
Repo Account Repo Price Adjustment account	120.0000	7.02 (the difference between the BV and 2nd leg price)
Repo Interest Adjustment account Cash account	5.2388	118.2188

The balances in respect of the Repo Price Adjustment Account and Repo Interest Adjustment Account at the end of the second leg of repo transaction are transferred to Repo Interest Expenditure Account. In order to analyse the balances in these accounts, the ledger entries are shown below :

Repo Price Adjustment account

Debit		Credit	
Difference in price for the 1st leg	7.00	Difference in price for the 2nd leg	7.02
Balance carried forward to Repo Interest Expenditure account	0.02		
Total	7.02	Total	7.02

Repo Interest Adjustment account

Debit		Credit	
Broken period interest for the 2nd leg	5.2388	Broken period interest for the 1st leg	5.1435
		Balance carried forward to Repo Interest Expenditure account	0.0953
Total	5.2388	Total	5.2388

Repo Interest Expenditure Account

Debit		Credit	
Balance from Repo Interest Adjustment account	0.0953	Balance from Repo Price Adjustment account	0.0200
		Balance carried forward to P & L a/c.	0.0753
Total	0.0953	Total	0.0953

3. Accounting for buyer of the security

When the security is bought, it will bring its book value with it. Hence market value is the book value of the security.

First leg Accounting

	Debit	Credit
Reverse Repo Account	113.0000	
Reverse Repo Interest Adjustment account	5.1435	
Cash account		118.1435

Second Leg Accounting

	Debit	Credit
Cash account	118.2188	
Reverse Repo Price Adjustment account (Difference between the 1st and 2 nd leg prices)	0.0200	
Reverse Repo account		113.0000
Reverse Repo Interest Adjustment account		5.2388

The balances in respect of the Reverse Repo Interest Adjustment Account and Reverse Repo Price adjustment account at the end of the second leg of reverse repo in these accounts are transferred to Repo Interest Income Account. In order to analyse the balances in these two accounts, the ledger entries are shown below:

Reverse Repo Price Adjustment Account

Debit		Credit	
Difference in price of 1st & 2nd leg	0.0200	Balance to Repo Interest Income a/c.	0.0200
Total	0.0200	Total	0.0200

Reverse Repo Interest Adjustment Account

Debit		Credit	
Broken period interest for the 1st leg	5.1435	Broken period interest for the 2nd leg	5.2388
Balance carried forward to Repo Interest Income Account	0.0953		
Total	5.2388	Total	5.2388

Reverse Repo Interest Income Account

Debit		Credit	
Difference between the 1st & 2nd leg prices	0.0200	Balance from Reverse Repo Interest Adjustment account	0.0953
Balance carried forward to P & L account	0.0753		
Total	0.0953	Total	0.0953

4. Additional accounting entries to be passed on a Repo / Reverse Repo transaction on a coupon bearing security, when the accounting period is ending on an intervening day

Transaction Leg --- >	1st leg	End of accounting period	2nd leg
Dates --- >	19 Jan 03	21 Jan 03*	22 Jan 03

The difference in the clean price of the security between the first leg and the second leg should be apportioned upto the Balance Sheet date and should be shown as Repo Interest Income / Expenditure in the books of the seller / buyer respectively and should be debited / credited as an income / expenditure accrued but not due. The balances under Income / expenditure accrued but not due should be taken to the balance sheet

The coupon accrued by the buyer should also be credited to the Repo Interest Income account. No entries need to be passed on "Repo / Reverse Repo price adjustment account and Repo / Reverse repo interest adjustment account". The illustrative accounting entries are shown below:

a) **Entries in Seller's books on January 21, 2003**

Account Head	Debit	Credit
Repo Interest Income account [Balances under the account to be transferred to P & L]		0.0133 (Notional credit balance 0.0133 in the Repo Price Adjustment Account by way of apportionment of price difference for two days i.e. upto the balance sheet day)
Repo interest Income accrued but not due	0.0133	

* January 21, 2003 is assumed to be the balance sheet date

b) **Entries in Seller's books on January 21, 2003**

Account Head	Debit	Credit
Repo interest income	0.0133	
P & L a/c		0.0133

(c) **Entries in Buyer's Books on January 21, 2003**

Account Head	Debit	Credit
Repo interest income accrued but not due	0.0502	
Repo Interest Income account [Balances under the account to be transferred to P & L]		0.0502 (Interest accrued for 3 days of Rs. 0.0635* - Apportionment of the difference in the clean price of Rs. 0.0133)

* For the sake of simplicity the interest accrual has been considered for 2 days.

(d) **Entries in Buyer's Books on January 21, 2003**

Account Head	Debit	Credit
Repo interest income account	0.0502	
P& L a/c		0.0502

The difference between the repo interest accrued by the seller and the buyer is on account of the accrued interest forgone by the seller on the security offered for repo.

B. Repo / Reverse Repo of Treasury Bill

1. Details of Repo on a Treasury Bill

Security offered under Repo	GOI 91 day Treasury Bill maturing on 28 February, 2003	
Price of the security offered under Repo	Rs.96.0000	(1)
Date of the Repo	19 January, 2003	
Repo interest rate	7.75%	
Tenor of the repo	3 days	
Total cash consideration for the first leg	96.0000	(2)
Repo interest	0.0612	(3)
Price for the second leg	(2)+(3) = 96.0000 + 0.0612 = 96.0612	
Cash consideration for the 2nd leg	96.0612	

2. Accounting for seller of the security

We assume that the security was held by the seller at the book value (BV) of Rs.95.0000

First leg Accounting

	Debit	Credit
Cash Repo Account	96.0000	95.0000 (Book value)
Repo Price adjustment account		1.0000 (Difference between BV & repo price)

Second Leg Accounting

Repo Account Repo Price adjustment account	95.0000 1.0612 (the difference between the BV and 2nd leg price)	
Cash account		96.0612

The balances in respect of the Repo Price Adjustment Account at the end of the second leg of repo transaction are transferred to Repo Interest Expenditure Account. In order to analyse the balances in this account, the ledger entries are shown:

Repo Price Adjustment account

Debit		Credit	
Difference in price for the 2nd leg	1.0612	Difference in price for the 1st leg	1.0000
		Balance carried forward to Repo Interest Expenditure account	0.0612
Total	1.0612	Total	1.0612

Repo Interest Expenditure Account

Debit		Credit	
Balance from Repo Price Adjustment account	0.0612	Balance carried forward to P & L a/c.	0.0612
Total	0.0612	Total	0.0612

The Seller will continue to accrue the discount at the original discount rate during the period of the repo.

3. Accounting for buyer of the security

When the security is bought, it will bring its book value with it. Hence market value is the book value of the security.

First leg Accounting:

	Debit	Credit
Reverse Repo Account	96.0000	
Cash account		96.0000

Second Leg Accounting

	Debit	Credit
Cash account	96.0612	
Repo Interest Income account (Difference between the 1st and 2nd leg prices)		0.0612
Reverse Repo account		96.0000

The Buyer will not accrue for the discount during the period of the repo.

4. Additional accounting entries to be passed on a Repo / Reverse Repo transaction on a Treasury Bill, when the accounting period is ending on an intervening day

Transaction Leg ->	1st leg	B/S date	2 nd leg
Date ->	19 Jan.03	21 Jan.03*	22 Jan.03

* 21 January, 2003 is assumed to be the balance sheet date

(a) Entries in Seller's books on January 21, 2003

Account Head	Debit	Credit
Repo Interest Expenditure account (after apportionment of repo interest for two days) [Balances under the account to be transferred to P & L]	0.0408	
Repo interest expenditure accrued but not due		0.0408

(b) Entries in Seller's books on January 21, 2003

Account Head	Debit	Credit
Repo interest expenditure account		0.0408
P & L a/c	0.0408	

(c) Entries in Buyer's Books on January 21, 2003

Account Head	Debit	Credit
Repo interest income accrued but not due	0.0408	
Repo Interest Income account [Balances under the account to be transferred to P & L]		0.0408

(d) Entries in Buyer's Books on January 21, 2003

Account Head	Debit	Credit
Repo interest income account	0.0408	
P & L a/c		0.0408

Appendix

List of Circulars consolidated by the Master Circular

No.	Circular No.	Date	Relevant para no. of the circular	Subject	Para no. of the master circular
1.	<u>DBOD.No.FSC.BC.69/C.469- 90/91</u>	Jan 18, 1991	1,2,4	Portfolio Management on behalf of clients	1.3. 3
2.	<u>DO.DBOD.No.FSC.46/C.469- 91/92</u>	July 26, 1991	4(i), (ii), (iii), (iv), (v), (iv)	Investment portfolio of banks- Transaction in securities	1.2 (i)
3.	<u>DBOD.No.FSC.BC.143A/24.48. 001/ 91-92</u>	June 20, 1992	3(I), 3(I)- (ii)- (iii)- (iv)- (v)- (xi)- (xii)- (xvi)- (xvii), 3(II), 3(III), 3(V)- (i)- (ii)- (iii), (3) & (4)	Investment portfolio of banks- Transaction in securities	1.2 (ii), (iii) & (iv), 1.2.2, 1.2.3, 1.2.5, 1.2.6, 1.2.7
4.	<u>DBOD.No.FSC.BC.11/24.01.009/ 92-93</u>	July 30, 1992	3,4,5,6	Portfolio Management on behalf of clients	1.3.3
5.	<u>DBOD.No.FMC/BC/17/24.48.001. 92/93</u>	Aug 19, 1992	2	Investment portfolio of banks- Transaction in securities	1.3.2
6.	<u>DBOD.FMC.BC.62/27.02.001/ 92-93</u>	Dec 31, 1992	1	Investment portfolio of banks-	1.2.6

				Transaction in securities	
7.	<u>DBOD.No.FMC.1095/27.01.002/93</u>	April 15, 1993	1 & enclosed format	Investment portfolio of banks- Reconciliation of holdings	1.3.1 & Anne- xure VI
8.	<u>DBOD.No.FMC.BC.141/27.02.006/ 93/94</u>	July 19, 1993	Annex	Investment portfolio of banks- Transaction in securities- Aggregate contract limit for individual brokers- Clarifications	Anne- xure II
9	<u>DBOD.No.FMC.BC.1/27.02.001/ 93-94</u>	Jan 10, 1994	1	Investment portfolio of banks- Transaction in securities- Bouncing of SGL transfer forms- Penalties to be imposed.	1.2.2
10	<u>DBOD.No.FMC.73/27.07.001/ 94-95</u>	June 7, 1994	1,2	Acceptance of deposits under Portfolio Management Scheme	1.3.3
11.	<u>DBOD.No.FSC.BC.130/24.76.002/ 94-95</u>	Nov 15, 1994	1	Investment portfolio of banks- Transaction in securities-Bank Receipts (BRs)	1.2.3
12.	<u>DBOD.No.FSC.BC.129/24.76.002/ 94-95</u>	Nov 16, 1994	2 & 3	Investment portfolio of banks- Transaction in securities-Role of brokers	1.2.6
13.	<u>DBOD.No.FSC.BC.142/24.76.002/ 94-95</u>	Dec 9, 1994	1& 2	Do	1.2.6
14.	<u>DBOD.No.FSC.BC.70/24.76.002/ 95-96</u>	June 8, 1996	2	Retailing of Government Securities	1.2.4
15.	<u>DBOD.No.FSC.BC.71/24.76.001/ 96</u>	June 11, 1996	1	Investment portfolio of banks- Transaction in securities	1.2.2
16.	<u>DBOD.No.BC.153/24.76.002/96</u>	Nov 29, 1996	1	Do	1.2.6
17.	<u>DBOD.BP.BC.9/21.04.048/98</u>	29 Jan 1997	3	Prudential norms - capital adequacy, income recognition, asset classification and provisioning.	5.1 (iii) & (iv)
18.	<u>DBOD.BP.BC.32/21.04.048/97</u>	April 12.	1&2	Do	5.1 (i) &(ii)

		1997			
19.	<u>DBOD.FSC.BC.129/24.76.002-97</u>	Oct 22, 1997	1	Retailing of Government Securities	1.2.4
20.	<u>DBOD.No.BC.112/24.76.002/1997</u>	Oct 14, 1997	1	Investment portfolio of banks- Transaction in securities-Role of brokers	1.2.6
21.	<u>DBOD.BP.BC.75/21.04.048/98</u>	4 Aug 1998	All	Acquisition of Government and other approved securities - Broken Period Interest, - Accounting Procedure	5.2
22.	<u>DBS.CO.FMC.BC.1/22.53.014/98-99</u>	July 7, 1999	1	Investment portfolio of banks – Transactions in securities	1.3.1(i)
23.	<u>DBS.CO.FMC.BC.18/22.53.014/ 99-2000</u>	Oct 28, 1999	2, 3, 4 & 5	Do	1.2.2
24.	<u>DBOD.No.FSC.BC.26/24.76.002/ 2000</u>	Oct 6, 2000	2	Sale of Government securities allotted in the auctions for Primary issues	1.2(i)(b)
25.	<u>DBOD.BP.BC.32/21.04.048/ 2000-01</u>	Oct 16, 2000	All	Guidelines on classification and valuation of investments.	2 & 3
26.	<u>DBOD.FSC.BC.No.39/24.76.002/ 2000</u>	Oct 25, 2000	1	Investment portfolio of banks- Transaction in securities-Role of brokers	1.2.6
27.	<u>Dir.BC.107/13.03.00/2000-01</u>	April 19, 2001	6	Monetary and Credit Policy for the year 2000-2002 - Interest Rate Policy	5.3
28.	<u>DBOD.BP.BC.119/21.04.137/ 2000-2001</u>	May 11, 2001	Annex - 5 & 12	Bank financing of equities and investments in shares - Revised guidelines	1.2, 1.2.5 1.3, 1.3.1
29.	<u>DBOD.BP.BC.127/21.04.048/ 2000- 01</u>	June 7, 2001	All	Non- SLR Investments of Banks	1.2.8 Anne- xure III
30.	<u>DBOD.BP.BC.61/21.04.048/ 2001-02</u>	Jan 25, 2002	All	Guidelines for investments by banks/Fis and Guidelines for financing of restructured	1.2.8 (iv)

				accounts by banks/FIs	
31.	<u>DBOD.No.FSC.BC.113/24.76.002/ 2001-02</u>	June 7 2002	All	On Investment Portfolio of Banks Transaction in Govt. Securities	1.3.4
32.	<u>DBS.CO.FMC.BC.7/22.53.014/ 2002-03</u>	Nov 7, 2002	Para 2	Operation of investment portfolio by banks- submission of concurrent audit reports by banks	1.2.7(c)
33.	<u>DBOD.No.FSC.BC.90/24.76.002/ 2002-03</u>	March 31 2003	All	Ready Forward Contracts	1.2.1(i), (ii) and (iii)
34.	<u>IDMC.3810/11.08.10/2002-03</u>	March 24 2003	All	Guidelines for uniform accounting for Repo / Reverse Repo transactions	4, Anne- xure VII & Anne- xure VIII
35.	DBOD.BP.BC.44/21.04.141/03-04	Nov 12, 2003	All	Prudential guidelines on banks' investment in non- SLR securities	1.2.8 Annexure IV, V
36.	DBOD.BP.BC.53/21.04.141/03-04	Dec 10, 2003	All	do	1.2.8
37.	<u>DBOD.FSC.BC.59/24.76.002 /03-04</u>	Dec 26, 2003	All	Sale of Government securities allotted in the auctions for primary issues on the same day	Anne- xure I C
38	<u>IDMD.PDRS.05/10.02.01/ 2003-04</u>	Mar 29, 2004	3, 4, 6 & 7	Transactions in Government Securities	1.2(i) (a)
39.	<u>IDMD.PDRS/4777/10.02.01/ 2004-05</u>	May 11, 2005	3	Sale of securities allotted in primary issues	1.2(i) (b)
40.	<u>IDMD.PDRS/4779/10.02.01/ 2004-05</u>	May 11, 2005	2,3,4,5	Ready forward contracts	1.2.1 (b), 1.2.1 (c)
41.	<u>IDMD.PDRS/4783/10.02.01/ 2004-05</u>	May 11, 2005	3	Government securities transactions - T+1 settlement	1.2(i) (c)
42.	<u>DBOD.FSC.BC.28/24.76.002/ 2004-05</u>	Aug 12, 2004	2	Transactions in Government securities	1.2(i)(a)
43.	DBOD.BP.BC. 29/21.04.141/ 2004-05	Aug 13, 2004	2(b) of Annex	Prudential norms - State Government guaranteed exposures	3.5.2
44.	<u>DBOD.Dir.BC.32/13.07.05/ 2004-05</u>	Aug 17, 2004	2	Dematerialisation of banks' investment in	5.3

				equity	
45.	<u>DBOD.BP.BC.37/21.04.141/ 2004-05</u>	Sep 2, 2004	1(i) & (ii)	Prudential norms on classification of investment portfolio of banks	2.1 (ii) & (iii)
46.	<u>DBOD.FSD.BC.No.31/24.76.002/ 2005-06</u>	Sep 1, 2005	2, 3	NDS-OM - Counterparty Confirmation	1.2.5 (i) (c)
47.	<u>DBOD.BP.BC.38/21.04.141/ 2005-06</u>	Oct 10, 2005	All	Capital Adequacy - Investment Fluctuation Reserve	3.4
48.	<u>IDMD.No.03/11.01.01(B)/2005-06</u>	Feb 28, 2006	2,3,4,5	Secondary Market transactions in Government Securities- Intra day short selling	1.2 (i) (a)
49.	<u>IDMD.No.3426 /11.01.01 (D)/ 2005-06</u>	May 3, 2006	All	'When Issued' transactions in Central Government Securities'	1.2 (i) (a)
50	<u>DBOD.No.BP.BC.27/21.01.002/2006-07</u>	Aug 23, 2006	2, 4	Prudential guidelines – Bank's investments in VCF	3.9
51	<u>IDMD.No.2130/11.01.01(D)/2006-07</u>	Nov 16, 2006	All	When Issued transactions in Central Government Securities	1.2(i)(a)
52	<u>DBOD.No.FSD.BC.46/24.01.028/2006-07</u>	Dec 12, 2006	16B(ii)	Financial Regulation of Systemically Important NBFCs and Bank's Relationship with them	1.3.3(i)
53	<u>IDMD.No. /11.01.01(B)/2006-07</u>	Jan 31, 2007	All	Secondary Market transactions in Government Securities- Short selling	1.2.(i)a
54	<u>Mailbox Clarification</u>	July 11, 2007	All	HTM Securities	3.1.(i)
55	<u>DBOD.No.BP.BC.56/21.04.141/2007-08</u>	December 6, 2007	All	Limits on investment in unrated Non-SLR securities- infrastructure bonds	1.2.7
56.	<u>DBOD.No.BP.BC.86/21.04.141/200708</u>	May 22, 2008	All	Valuation of securities	3.7.1

RBI/2008-09/78
DBOD No. Dir. BC. 17/13.03.00/2008-09

July 1, 2008
Ashadha 10, 1930(Saka)

All Scheduled Commercial Banks
(excluding RRBs)

Dear Sir

Master Circular- Loans and Advances – Statutory and Other Restrictions

Please refer to the Master Circular DBOD. No. Dir. BC. 9/13.03.00/2006-07 dated July 2, 2007 consolidating the instructions/guidelines issued to banks till June 30, 2007 relating to statutory and other restrictions on Loans and Advances. The Master Circular has been suitably updated by incorporating the instructions issued up to June 30, 2008 and has been placed on the RBI website (<http://www.rbi.org.in>). A copy of the Master Circular is enclosed.

Yours faithfully

(P. Vijaya Bhaskar)
Chief General Manager

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Master Circular on Loans and Advances - Statutory and Other Restrictions

A. Purpose

This Master Circular consolidates the instructions issued by the Reserve Bank of India to banks on statutory and other restrictions on loans and advances.

B. Classification

A statutory guideline issued by the Reserve Bank in exercise of the powers conferred by the Banking Regulation Act, 1949.

C. Previous instructions

This Master Circular consolidates and updates the instructions on the above subject contained in the circulars listed in **Annex 5**.

D. Application

To all Scheduled Commercial Banks, excluding Regional Rural Banks.

Structure

1. INTRODUCTION

2. GUIDELINES

- 2.1 Statutory Restrictions
- 2.2 Regulatory Restrictions
- 2.3 Restrictions on other loans and advances
- 2.4 Guidelines on Fair Practices Code for Lenders

3. ANNEX

- Annex 1 - List of Controlled Substances
- Annex 2 - List of Controlled Substances
- Annex 3 - Selective Credit Control - Other operational stipulations
- Annex 4 - List of banks nominated to import Gold
- Annex 5 - List of circulars consolidated

1. INTRODUCTION

This Master Circular provides a framework of the rules/regulations/instructions issued to Scheduled Commercial Banks on statutory and other restrictions on loans and advances.

Banks should implement these instructions and adopt adequate safeguards in order to ensure that the banking activities undertaken by them are run on sound, prudent and profitable lines.

2. GUIDELINES

2.1 Statutory Restrictions

2.1.1 Advances against bank's own shares

In terms of Section 20(1) of the Banking Regulation Act, 1949, a bank cannot grant any loans and advances on the security of its own shares.

2.1.2 Advances to bank's Directors

2.1.2.1 Section 20(1) of the Banking Regulation Act, 1949 also lays down the restrictions on loans and advances to the directors and the firms in which they hold substantial interest.

2.1.2.2 Banks are prohibited from entering into any commitment for granting any loans or advances to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor, or any company (not being a subsidiary of the banking company or a company registered under Section 25 of the Companies Act, 1956, or a Government company) of which, or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or any individual in respect of whom any of its directors is a partner or guarantor.

2.1.2.3 There are certain exemptions in this regard. In terms of the explanation to the Section, 'loans or advances' shall not include any transaction which the Reserve Bank may specify by general or special order as not being a loan or advance for the purpose of this Section. While doing so the RBI shall, keep in view the nature of the transaction, the period within which, and the manner and circumstances in which, any amount due on account of the transaction is likely to be realised, the interest of the depositors and other relevant considerations.

2.1.2.4 2.1.2.4 If any question arises whether any transaction is a loan or advance for the purpose of this Section, it shall be referred to RBI, whose decision thereon shall be final.

2.1.2.5 For the above purpose, the term 'loans and advances' shall not include the following:

(a) loans or advances against Government securities, life insurance policies or fixed deposit;

(b) loans or advances to the Agricultural Finance Corporation Ltd;

(c) such loans or advances as can be made by a banking company to any of its directors (who immediately prior to becoming a director, was an employee of the banking company) in his capacity as an employee of that banking company and on the same terms and conditions as would have been applicable to him as an employee of that banking company, if he had not become a director of the banking company. The banking company includes every bank to which the provisions of Section 20 of the Banking Regulation Act, 1949 apply;

(d) such loans or advances as are granted by the banking company to its Chairman and Chief Executive Officer, who was not an employee of the banking company immediately prior to his appointment as Chairman/ Managing Director/CEO, for the purpose of purchasing a car, personal computer, furniture or constructing/ acquiring a house for his personal use and Festival Advance, with the prior approval of the RBI and on such terms and conditions as may be stipulated by it;

(e) such loans or advances as are granted by a banking company to its whole-time director for the purpose of purchasing furniture, car, Personal Computer or constructing/acquiring house for personal use, Festival advance with the prior approval of RBI and on such terms & conditions as may be stipulated by it;

(f) call loans made by banking companies to one another;

(f) facilities like bills purchased/discounted (whether documentary or clean and sight or usance and whether on D/A basis or D/P basis), purchase of cheques, other non-fund based facilities like acceptance/co-acceptance of bills, opening of L/Cs and issue of guarantees, purchase of debentures from third parties, etc.;

(h) line of credit/overdraft facility extended by settlement bankers to National Securities Clearing Corporation Ltd.(NSCCL) / Clearing Corporation of India Ltd. (CCIL) to facilitate smooth settlement; and

(i) a credit limit granted under credit card facility provided by a bank to its directors to the extent the credit limit so granted is determined by the bank by applying the same criteria as applied by it in the normal conduct of the credit card business.

Note: For obtaining the prior approval of the Reserve Bank as stipulated in clauses (d) and (e) above, the bank should make an application to the Department of Banking Operations, Central Office, Mumbai.

2.1.2.6 Purchase of or discount of bills from directors and their concerns, which is in the nature of clean accommodation, is reckoned as 'loans and advances' for the purpose of Section 20 of the Banking Regulation Act, 1949.

2.1.2.7 As regards giving guarantees and opening of L/Cs on behalf of the bank's directors, it is pertinent to note that in the event of the principal debtor committing default in discharging his liability and the bank being called upon to honour its obligations under the guarantee or L/C, the relationship between the bank and the director could become one of the creditor and debtor. Further, it is possible for the directors to evade the provisions of Section 20 by borrowing from a third party against the guarantee given by the bank. Such transactions may defeat the very purpose of restrictions imposed under Section 20, if the bank does not take appropriate steps to ensure that the liabilities thereunder do not devolve on them.

2.1.2.8 In view of the above, while extending non-fund based facilities such as guarantees, L/Cs, acceptance on behalf of directors and the companies/firms in which the directors are interested; it should be ensured that -

(a) adequate and effective arrangements have been made to the satisfaction of the bank that the commitments would be met by the openers of L/Cs, or acceptors, or guarantors out of their own resources,

(b) the bank will not be called upon to grant any loan or advance to meet the liability consequent upon the invocation of guarantee, and

(c) no liability would devolve on the bank on account of L/Cs/ acceptances.

2.1.2.9 In case, such contingencies arise as at (b) & (c) above, the bank will be deemed to be a party to the violation of the provisions of Section 20 of the Banking Regulation Act, 1949.

2.1.2.10 Restrictions on Power to Remit Debts

Section 20A of the Banking Regulation Act, 1949 stipulates that notwithstanding anything to the contrary contained in Section 293 of the Companies Act, 1956, a banking company shall not, except with the prior approval of the Reserve Bank, remit in whole or in part any debt due to it by –

- (a) any of its directors, or
- (b) any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor, or
- (c) any individual, if any of its directors is his partner or guarantor.

Any remission made in contravention of the provisions stated above shall be void and have no effect.

2.1.3 Restrictions on Holding Shares in Companies

2.1.3.1 In terms of Section 19(2) of the Banking Regulation Act, 1949, banks should not hold shares in any company except as provided in sub-section (1) whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less.

2.1.3.2 Further, in terms of Section 19(3) of the Banking Regulation Act, 1949, the banks should not hold shares whether as pledgee, mortgagee or absolute owner, in any company in the management of which any managing director or manager of the bank is in any manner concerned or interested.

2.1.3.4 Accordingly, while granting loans and advances against shares, statutory provisions contained in Sections 19(2) and 19(3) should be strictly observed.

2.1.4 Restrictions on Credit to Companies for Buy-back of their Securities

In terms of Section 77A(1) of the Companies Act, 1956, companies are permitted to purchase their own shares or other specified securities out of their

- free reserves, or
- securities premium account, or
- the proceeds of any shares or other specified securities,

subject to compliance of various conditions specified in the Companies (Amendment) Act, 1999. Therefore, banks should not provide loans to companies for buy-back of shares/securities.

2.1 Regulatory Restrictions

2.2.1 Granting loans and advances to relatives of Directors

Without prior approval of the Board or without the knowledge of the Board, no loans and advances should be granted to relatives of the bank's Chairman/Managing Director or other Directors, Directors (including Chairman/Managing Director) of other banks and their relatives, Directors of Scheduled Co-operative Banks and their relatives, Directors of Subsidiaries/Trustees of Mutual Funds/Venture Capital Funds set up by the financing banks or other banks, as per details given below.

2.2.1.1 Lending to directors and their relatives on reciprocal basis

There have been instances where certain banks have developed an informal understanding or mutual/reciprocal arrangement among themselves for extending credit facilities to each other's directors, their relatives, etc. By and large, they did not follow the usual procedures and norms in sanctioning credit limits to the borrowers, particularly those belonging to certain groups or directors, their relatives, etc. Facilities far in excess of the sanctioned limits and concessions were allowed in the course of operation of individual accounts of the parties. Although, there is no legal prohibition on a bank from giving credit facilities to a director of some other banks or his relatives, serious concern was expressed in Parliament that such *quid pro quo* arrangements are not considered to be ethical. The banks should, therefore, follow the guidelines indicated below in regard to grant of loans and advances and award of contracts to the relatives of their directors and directors of other banks and their relatives:

2.2.1.2 Unless sanctioned by the Board of Directors/Management Committee, banks should not grant loans and advances aggregating Rs. 25 lakhs and above to -

- (a) directors (including the Chairman/Managing Director) of other banks *;
- (b) any firm in which any of the directors of other banks * is interested as a partner or guarantor; and
- (c) any company in which any of the directors of other banks * holds substantial interest or is interested as a director or as a guarantor.

2.2.1.3 Unless sanctioned by the Board of Directors/Management Committee, banks should also not grant loans and advances aggregating Rs.25 lakhs and above to -

- (a) any relatives of their own Chairmen/Managing Directors or other Directors;
- (b) any relatives of the Chairman/Managing Director or other directors of other banks *;
- (c) any firm in which any of the relatives as mentioned in (a) & (b) above is interested as a partner or guarantor; and
- (d) any company in which any of the relatives as mentioned in (a) & (b) above hold substantial interest or is interested as a director or as a guarantor.

* including directors of Scheduled Co-operative Banks, directors of subsidiaries/trustees of mutual funds/venture capital funds.

2.2.1.4 The proposals for credit facilities of an amount less than Rs.25 lakh to these borrowers may be sanctioned by the appropriate authority in the financing bank under powers vested in such authority, but the matter should be reported to the Board.

2.2.1.5 The Chairman/Managing Director or other director who is directly or indirectly concerned or interested in any proposal should disclose the nature of his interest to the Board when any such proposal is discussed. He should not be present in the meeting unless his presence is required by the other directors for the purpose of eliciting information and the director so required to be present shall not vote on any such proposal.

2.2.1.6 The above norms relating to grant of loans and advances will equally apply to awarding of contracts.

2.2.1.7 The scope of the term 'relative' will be as under:

- Spouse
- Father
- Mother (including step-mother)
- Son (including step-son)
- Son's Wife
- Daughter (including step-daughter)
- Daughter's Husband

- Brother (including step-brother)
- Brother's wife
- Sister (including step-sister)
- Sister's husband
- Brother (including step-brother) of the spouse
- Sister (including step-sister) of the spouse

2.2.1.8 The term 'loans and advances' will not include loans or advances against -

- Government securities
- Life insurance policies
- Fixed or other deposits
- Stocks and shares
- Temporary overdrafts for small amounts, i.e. upto Rs. 25,000/-
- Casual purchase of cheques up to Rs. 5,000 at a time
- Housing loans, car advances, etc. granted to an employee of the bank under any scheme applicable generally to employees.

2.2.1.9 The term 'substantial interest' shall have the same meaning as assigned to it in Section 5(ne) of the Banking Regulation Act, 1949.

2.2.1.10 Banks should evolve, inter alia, the following procedure for ascertaining the interest of a director of a financing bank or of another bank, or his relatives, in credit proposals/award of contracts placed before the Board/Committee or other appropriate authority of the financing banks.

(i) Every borrower should furnish a declaration to the bank to the effect that -

- (a) (where the borrower is an individual) he is not a director or specified near relation of a director of a banking company;
- (b) (where the borrower is a partnership firm) none of the partners is a director or specified near relation of a director of a banking company; and
- (c) (where the borrower is a joint stock company) none of its directors, is a director or specified near relation of a director of a banking company.

(ii) The declaration should also give details of the relationship of the borrower to the director of the bank.

2.2.1.11 In order to ensure compliance with the instructions, banks should forthwith recall the loan when it transpires that the borrower has given a false declaration.

2.2.1.12 The above guidelines should also be followed while granting loans/ advances or awarding contracts to directors of scheduled co-operative banks or their relatives.

2.2.1.13 These guidelines should also be followed by banks when granting loans and advances and awarding of contracts to directors of subsidiaries/trustees of mutual funds/venture capital funds set up by them as also other banks.

2.2.1.14 These guidelines should be duly brought to the notice of all directors and also placed before the bank's Board of Directors.

2.2.2 Restrictions on Grant of Loans & Advances to Officers and Relatives of Senior Officers of Banks

2.2.2.1 The statutory regulations and/or the rules and conditions of service applicable to officers or employees of public sector banks indicate, to a certain extent, the precautions to be observed while sanctioning credit facilities to such officers and employees and their relatives. In addition, the following guidelines should be followed by all the banks with reference to the extension of credit facilities to officers and the relatives of senior officers:

(a) Loans & advances to officers of the bank

No officer or any Committee comprising, inter alia, an officer as member, shall, while exercising powers of sanction of any credit facility, sanction any credit facility to his/her relative. Such a facility shall ordinarily be sanctioned only by the next higher sanctioning authority. Credit facilities sanctioned to senior officers of the financing bank should be reported to the Board.

(ii) Loans and advances and award of contracts to relatives of senior officers of the bank

Proposals for credit facilities to the relatives of senior officers of the bank sanctioned by the appropriate authority should be reported to the Board. Further, when a credit facility is sanctioned by an authority, other than the Board to -

- any firm in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a partner or guarantor; or
- any company in which any of the relatives of any senior officer of the financing bank holds substantial interest, or is interested as a director or as a guarantor,

such transaction should also be reported to the Board.

2.2.2.2 The above norms relating to grant of credit facility will equally apply to the awarding of contracts.

2.2.2.3 Application of the Guidelines in case of Consortium Arrangements

In the case of consortium arrangements, the above norms relating to grant of credit facilities to relatives of senior officers of the bank will apply to the relatives of senior officers of all the participating banks.

2.2.2.4 Scope of certain expressions

(i) The scope of the term 'relative' is the same as mentioned at paragraph 2.2.1.7.

(ii) The term 'Senior Officer' will refer to -

- a) any officer in senior management level in Grade IV and above in a nationalised bank, and
- b) any officer in equivalent scale
 - in the State Bank of India and associate banks, and
 - in any banking company incorporated in India.

(iii) The term 'credit facility' will not include loans or advances against -

- a) Government securities
- b) Life Insurance policies
- c) Fixed or other deposits
- d) Temporary overdrafts for small amount i.e. upto Rs. 25,000/-, and
- e) Casual purchase of cheques up to Rs. 5,000/- at a time.

(iv) Credit facility will also not include loans and advances such as housing loans, car advances, consumption loans, etc. granted to an officer of the bank under any scheme applicable generally to officers.

(v) The term 'substantial interest' shall have the same meaning assigned to it in Section 5(ne) of the Banking Regulation Act, 1949.

2.2.2.5 In this context, banks may, *inter alia*,

- (i) (i) evolve a procedure to ascertain the interest of the relatives of a senior officer of the bank in any credit proposal/award of contract placed before the Board Committee or other appropriate authority of the financing bank;
- (ii) (ii) obtain a declaration from every borrower to the effect that -
 - (a) if he is an individual, that he is not a specified, near relation to any senior officer of the bank,
 - (b) if it is a partnership or HUF firm, that none of the partners, or none of the members of the HUF, is a near, specified relation of any senior officer of the bank, and
 - (c) if it is a joint stock company, that none of its directors, is a relative of any senior officer of the bank.
- (iii) ensure that the declaration gives details of the relationship, if any, of the borrower to any senior officer of the financing bank.
- (iv) make a condition for the grant of any credit facility that if the declaration made by a borrower with reference to the above is found to be false, then the bank will be entitled to revoke and/or recall the credit facility.
- (v) consider in consultation with their legal advisers, amendments, if any, required to any applicable regulations or rules, *inter alia*, dealing with the service conditions of officers of the bank to give effect to these guidelines.

2.2.3 **Restrictions on Grant of Financial Assistance to Industries Producing / Consuming Ozone Depleting Substances (ODS)**

2.2.3.1 Government of India has advised that as per the Montreal Protocol, to which India is a party, Ozone Depleting Substances (ODS) are required to be phased out as per schedule prescribed therein. The list of chemicals given in **Annex 1& 2** to the Montreal Protocol is annexed for ready reference. The Protocol has identified the main ODS and set a time limit on phasing out their production/consumption in future, leading to a complete phase out eventually. Projects for phasing out ODS in India are eligible for grants from the Multilateral Fund. The sectors covered in the phase out programme are given below.

Sector	Type of substance
Foam products	Chlorofluorocarbon - 11 (CFC - 11)
Refrigerators and Air-conditioners	CFC – 12
Aerosol products	Mixtures of CFC - 11 and CFC – 12
Solvents in cleaning applications	CFC - 113 Carbon Tetrachloride, Methyl Chloroform
Fire extinguishers	Halons - 1211, 1301, 2402

2.2.3.2 Banks should not extend finance for setting up of new units consuming/producing the above ODS. In terms of circular No. FI/12/96-97 dated February 16, 1996 issued by the erstwhile Industrial Development Bank of India no financial assistance should be extended to small/medium scale units engaged in the manufacture of the aerosol units using CFC and no refinance would be extended to any project assisted in this sector.

2.2.4 Restrictions on Advances against Sensitive Commodities under Selective Credit Control (SCC)

2.2.4.1 Issue of Directives

- (i) With a view to preventing speculative holding of essential commodities with the help of bank credit and the resultant rise in their prices, in exercise of powers conferred by Section 21 & 35A of the Banking Regulation Act, 1949, the Reserve Bank of India, being satisfied that it is necessary and expedient in the public interest to do so, issues, from time to time, directives to all commercial banks, stipulating specific restrictions on bank advances against specified sensitive commodities.
- (ii) The commodities, generally treated as sensitive commodities are the following:
 - (a) food grains i.e. cereals and pulses,
 - (b) selected major oil seeds indigenously grown, viz. groundnut, rapeseed/mustard, cottonseed, linseed and castorseed, oils thereof, vanaspati and all imported oils and vegetable oils,
 - (c) raw cotton and kapas,
 - (d) sugar/gur/khandsari,
 - (e) cotton textiles which include cotton yarn, man-made fibres and yarn and fabrics made out of man-made fibres and partly out of cotton yarn and partly out of man-made fibres.

2.2.4.2 Commodities currently exempted from Selective Credit Control

- (i) Presently the following commodities are exempted from all the stipulations of Selective Credit Controls:

Sr. No.	Commodity	Exemption w.e.f.
1.	Pulses	21.10.1996
2.	Other food grains (viz. coarse grains)	21.10.1996
3.	Oilseeds (viz. groundnut, rapeseed/mustard, cotton seed, linseed, castorseed)	21.10.1996
4.	Oils (viz. groundnut oil, rapeseed oil, mustard oil, cottonseed oil, linseed oil, castor oil) including vanaspati	21.10.1996
5.	All imported oil seeds and oils	21.10.1996
6.	Sugar, including imported sugar, excepting buffer stocks and unreleased stock of sugar with Sugar Mills	21.10.1996
7.	Gur and Khandsari	21.10.1996
8.	Cotton and Kapas	21.10.1996
9.	Paddy/Rice	18.10.1994
10.	Wheat *	12.10.1993
* Temporarily covered under SCC w.e.f. 8.4.97 to 7.7.97.		

Banks are free to fix prudential margins on advances against these sensitive commodities.

2.2.4.3 Commodities covered under Selective Credit Control

(i) Presently, the following commodities are covered under stipulations of Selective Credit Control:

- (a) Buffer stock of sugar with Sugar Mills
- (b) Unreleased stocks of sugar with Sugar Mills representing
 - levy sugar, and
 - free sale sugar

2.2.4.4 Stipulations of Selective Credit Control

(i) Margin on sugar

Commodity	Minimum Margin	With effect from
(a) Buffer stocks of sugar	0%	01.04.1987
(b) Unreleased stocks of sugar with Sugar Mills representing - • levy sugar • free sale sugar	10% @	22.10.1997 10.10.2000

@ Margins on credit for free sale sugar will be decided by banks including RRBs and LABs based on their commercial judgement.

(ii) Valuation of sugar stocks

- (a) The unreleased stocks of the levy sugar charged to banks as security by the sugar mills shall be valued at levy price fixed by Government.
- (b) The unreleased stocks of free sale sugar including buffer stocks of sugar charged to the bank as security by sugar mills, shall be valued at the average of the price realised in the preceding three months (moving average) or the current market price, whichever is lower; the prices for this purpose shall be exclusive of excise duty.

(iii) Interest rates

Banks have the freedom to fix lending rates for the commodities coming within the purview of Selective Credit Control.

(iv) Other operational stipulations

- (a) The other operational stipulations vary with the commodities. These stipulations are advised whenever Selective Credit Controls are reintroduced for any specific sensitive commodities.
- (b) Although, none of the earlier stipulations are currently applicable to the only sensitive commodity covered under Selective Credit Control viz. buffer stocks and unreleased stocks of levy/free sale sugar with Sugar Mills, yet these are reproduced in **Annex 3** for understanding therefrom the underlying objectives of Selective Credit Control so that banks do not allow the customers dealing in Selective Credit Control commodities any credit facilities which would directly or indirectly defeat the purpose of the directives.

(v) Delegation of powers

(a) The matter relating to delegation of powers with regard to approval of credit proposals relating to sensitive commodities coming under Selective Credit Control was reviewed and it was decided that the existing practice of banks' submitting credit proposals above Rs.1 crore to Reserve Bank of India for its prior approval under Selective Credit Control shall be discontinued and banks will have the freedom to sanction such credit proposals in terms of their individual loan policies. Accordingly, banks need not forward the credit proposals above Rs.1 crore in respect of borrowers dealing in sensitive commodities to Reserve Bank of India for its prior approval.

(b) Banks are also advised to circulate these instructions among their controlling offices/branches and take all necessary steps to ensure that the powers delegated at various levels are exercised with utmost caution without sacrificing the broad objectives of the Selective Credit Control concept.

2.2.5 Restriction on payment of commission to staff members including officers

Section 10(1)(b)(ii) of Banking Regulation Act, 1934, stipulates that a banking company shall not employ or continue the employment of any person whose remuneration or part of whose remuneration takes the form of commission or a share in the profits of the company. Further, clause (b) of Section 10(1)(b)(ii) permits payment of commission to any person who is employed only otherwise than as a regular staff. Therefore, banks should not pay commission to staff members and officers for recovery of loans.

2.3 Restrictions on other loans and advances

2.3.1 Loans and Advances against Shares, Debentures and Bonds

Banks are required to strictly observe regulatory restrictions on grant of loans and advances against shares, debentures and bonds which are detailed in the Master Circular on 'Bank Finance Against Shares and Debentures' dated August 28, 1998 and the Circular on Financing of acquisition of equity in overseas companies dated June 7, 2005. The restrictions, inter alia, on loans and advances against shares and debentures, are-

- No loans to be granted against partly paid shares.
- No loans to be granted to partnership/proprietorship concerns against the primary security of shares and debentures.

2.3.2 Money Market Mutual Funds

All the guidelines issued by the Reserve Bank of India on Money Market Mutual Funds (MMMF) have been withdrawn and the banks are to be guided by the SEBI Regulations in this regard. However the banks/ FIs which are desirous of setting up MMMFs would have to take necessary clearance from the RBI for undertaking this additional activity before approaching SEBI for registration.

2.3.3 Advances against Fixed Deposit Receipts (FDRs) Issued by Other Banks

There have been instances where fake term deposit receipts, purported to have been issued by some banks, were used for obtaining advances from other banks. In the light of these happenings, the banks should desist from sanctioning advances against FDRs, or other term deposits of other banks.

2.3.4 Advances to Agents/Intermediaries based on Consideration of Deposit Mobilisation

Banks should desist from being party to unethical practices of raising of resources through agents/intermediaries to meet the credit needs of the existing/prospective borrowers or from granting loans to intermediaries, based on the consideration of deposit mobilisation, who may not require the funds for their genuine business requirements.

2.3.5 Loans against Certificate of Deposits (CDs)

Banks cannot grant loans against CDs.

2.3.6 Bank Finance to Non-Banking Financial Companies (NBFCs)

2.3.6.1 The following activities undertaken by NBFCs, are not eligible for bank credit:

- (i) Bills discounted/rediscounted by NBFCs, except for rediscounting of bills discounted by NBFCs arising from the sale of –
 - (a) commercial vehicles (including light commercial vehicles), and
 - (b) two-wheeler and three-wheeler vehicles, subject to the following conditions:
 - the bills should have been drawn by the manufacturers on dealers only
 - the bills should represent genuine sale transactions as may be ascertained from the chassis/engine numbers and
 - before rediscounting the bills, banks should satisfy themselves about the bona fides and track record of NBFCs which have discounted the bills.
- (ii) Investments of NBFCs both of current and long term nature, in any company/entity by way of shares, debentures, etc. However, Stock Broking Companies may be provided need-based credit against shares and debentures held by them as stock-in-trade.
- (iii) Unsecured loans/inter-corporate deposits by NBFCs to/in any company.
- (iv) All types of loans/advances by NBFCs to their subsidiaries, group companies/entities.
- (v) Finance to NBFCs for further lending to individuals for subscribing to Initial Public Offerings (IPOs).

2.3.6.2 Banks should not grant bridge loans of any nature, or interim finance against capital/debenture issues and/or in the form of loans of a bridging nature pending raising of long-term funds from the market by way of capital, deposits, etc. to all categories of Non-Banking Financial Companies, i.e. equipment leasing and hire-purchase finance companies, loan and investment companies, Residuary Non-Banking Companies (RNBCs) and Venture Capital Funds (VCFs).

2.3.7 Bank Finance to Equipment Leasing Companies

(i) Banks should not enter into lease agreements departmentally with equipment leasing companies as well as other Non-Banking Financial Companies engaged in equipment leasing.

(ii) As banks can only support lease rental receivables arising out of lease of equipment/machinery owned by the borrowers, lease rentals receivables arising out of sub-lease of an asset by a Non-Banking Non Financial Company (undertaking nominal leasing activity) or by a Non-Banking Financial Company should be excluded for the purpose of computation of bank finance for such company.

2.3.7.1 Bank Finance to Factoring Companies

As regards bank finance to factoring companies, banks may be guided by the instructions contained in circular No. DBOD.BP. BC. No. /60/08.12.01/2007-08 dated February 12, 2008

2.3.8 Financing Infrastructure/ Housing Projects

2.3.8.1 Housing Finance

Banks may refer to the Master Circular on Housing Finance dated July 1, 2008 in this regard.

2.3.8.2 Guidelines for Financing of Infrastructure Projects

In view of the critical importance of the infrastructure sector and high priority being accorded for development of various infrastructure services, the matter has been reviewed in consultation with Government of India and the revised guidelines on financing of infrastructure projects are set out as under.

2.3.8.3 Definition of 'infrastructure lending'

Any credit facility in whatever form extended by lenders (i.e. banks, FIs or NBFCs) to an infrastructure facility as specified below falls within the definition of "infrastructure lending". In other words, a credit facility provided to a borrower company engaged in

- developing or
- operating and maintaining, or
- developing, operating and maintaining any infrastructure facility that is a project in any of the following sectors, or any infrastructure facility of a similar nature :

i. a road, including toll road, a bridge or a rail system;

ii. a highway project including other activities being an integral part of the highway project;

iii. a port, airport, inland waterway or inland port;

iv. a water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system;

v. telecommunication services whether basic or cellular, including radio paging, domestic satellite service (i.e., a satellite owned and operated by an Indian company for providing telecommunication service), network of trunking, broadband network and internet services;

- vi. an industrial park or special economic zone ;
- vii. generation or generation and distribution of power;
- viii. transmission or distribution of power by laying a network of new transmission or distribution lines;
- ix. construction relating to projects involving agro-processing and supply of inputs to agriculture;
- x. construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality;
- ix. construction of educational institutions and hospitals;
- xii. any other infrastructure facility of similar nature.

2.3.8.4 Criteria for Financing

Banks/FIs are free to finance technically feasible, financially viable and bankable projects undertaken by both public sector and private sector undertakings subject to the following conditions:

- (i) The amount sanctioned should be within the overall ceiling of the prudential exposure norms prescribed by RBI for infrastructure financing.
- (ii) Banks/ FIs should have the requisite expertise for appraising technical feasibility, financial viability and bankability of projects, with particular reference to the risk analysis and sensitivity analysis.
- (iii) In respect of projects undertaken by public sector units, term loans may be sanctioned only for corporate entities (i.e. public sector undertakings registered under Companies Act or a Corporation established under the relevant statute). Further, such term loans should not be in lieu of or to substitute budgetary resources envisaged for the project. The term loan could supplement the budgetary resources if such supplementing was contemplated in the project design. While such public sector units may include Special Purpose Vehicles (SPVs) registered under the Companies Act set up for financing infrastructure projects, it should be ensured by banks and financial institutions that these loans/investments are not used for financing the budget of the State Governments. Whether such financing is done by way of extending loans or investing in bonds, banks and financial institutions should undertake due diligence on the viability and bankability of such projects to ensure that revenue stream from the project is sufficient to take care of the debt servicing obligations and that the repayment/servicing of debt is not out of budgetary resources. Further, in the case of financing SPVs, banks and financial institutions should ensure that the funding proposals are for specific monitorable projects.
- (iv) Banks may also lend to SPVs in the private sector, registered under the Companies Act for directly undertaking infrastructure projects which are financially viable and not for acting as mere financial intermediaries. Banks may ensure that the bankruptcy or financial difficulties of the parent/ sponsor should not affect the financial health of the SPV.

2.3.8.5 Types of Financing by Banks

- (i) In order to meet financial requirements of infrastructure projects, banks may extend credit facility by way of working capital finance, term loan, project loan, subscription to bonds and debentures/ preference shares/ equity shares acquired as a part of the project finance package which is treated as "deemed advance" and any other form of funded or non-funded facility.

(ii) Take-out Financing

Banks may enter into take-out financing arrangement with IDFC/ other financial institutions or avail of liquidity support from IDFC/ other FIs. A brief write-up on some of the important features of the arrangement is given in paragraph 2.3.8.8(i). Banks may also be guided by the instructions regarding take-out finance contained in Circular No. DBOD. BP. BC. 144/ 21.04.048/ 2000 dated February 29, 2000.

(iii) Inter-institutional Guarantees

Banks are permitted to issue guarantees favouring other lending institutions in respect of infrastructure projects, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 per cent of the project cost and undertakes normal credit appraisal, monitoring and follow-up of the project. For detailed instructions on inter-institutional guarantee, please see paragraph 2.3.9.

(iv) Financing promoter's equity

In terms of Circular No. DBOD. Dir. BC. 90/ 13.07.05/ 98 dated August 28, 1998, banks were advised that the promoter's contribution towards the equity capital of a company should come from their own resources and the bank should not normally grant advances to take up shares of other companies. In view of the importance attached to the infrastructure sector, it has been decided that, under certain circumstances, an exception may be made to this policy for financing the acquisition of the promoter's shares in an existing company, which is engaged in implementing or operating an infrastructure project in India. The conditions, subject to which an exception may be made, are as follows:

(i) The bank finance would be only for acquisition of shares of existing companies providing infrastructure facilities as defined in paragraph (a) above. Further, acquisition of such shares should be in respect of companies where the existing foreign promoters (and/ or domestic joint promoters) voluntarily propose to disinvest their majority shares in compliance with SEBI guidelines, where applicable.

(ii) The companies to which loans are extended should, inter alia, have a satisfactory net worth.

(iii) The company financed and the promoters/ directors of such companies should not be a defaulter to banks/ FIs.

(iv) In order to ensure that the borrower has a substantial stake in the infrastructure company, bank finance should be restricted to 50% of the finance required for acquiring the promoter's stake in the company being acquired.

(v) Finance extended should be against the security of the assets of the borrowing company or the assets of the company acquired and not against the shares of that company or the company being acquired. The shares of the borrower company / company being acquired may be accepted as additional security and not as primary security. The security charged to the banks should be marketable.

(vi) Banks should ensure maintenance of stipulated margins at all times.

(vii) The tenor of the bank loans may not be longer than seven years. However, the Boards of banks can make an exception in specific cases, where necessary, for financial viability of the project.

(viii) This financing would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.

(ix) The banks financing acquisition of equity shares by promoters should be within the regulatory ceiling of 40 per cent of their net worth as on March 31 of the previous year for the aggregate exposure of the banks to the capital markets in all forms (both fund based and non-fund based).

(x) The proposal for bank finance should have the approval of the Board.

2.3.8.6 Appraisal

- (i) In respect of financing of infrastructure projects undertaken by Government owned entities, banks/Financial Institutions should undertake due diligence on the viability of the projects. Banks should ensure that the individual components of financing and returns on the project are well defined and assessed. State Government guarantees may not be taken as a substitute for satisfactory credit appraisal and such appraisal requirements should not be diluted on the basis of any reported arrangement with the Reserve Bank of India or any bank for regular standing instructions/periodic payment instructions for servicing the loans/bonds.
- (ii) Infrastructure projects are often financed through Special Purpose Vehicles. Financing of these projects would, therefore, call for special appraisal skills on the part of lending agencies. Identification of various project risks, evaluation of risk mitigation through appraisal of project contracts and evaluation of creditworthiness of the contracting entities and their abilities to fulfill contractual obligations will be an integral part of the appraisal exercise. In this connection, banks/FIs may consider constituting appropriate screening committees/special cells for appraisal of credit proposals and monitoring the progress/performance of the projects. Often, the size of the funding requirement would necessitate joint financing by banks/FIs or financing by more than one bank under consortium or syndication arrangements. In such cases, participating banks/ FIs may, for the purpose of their own assessment, refer to the appraisal report prepared by the lead bank/FI or have the project appraised jointly.

2.3.8.7 Prudential requirements

- (i) Prudential credit exposure limits

Credit exposure to borrowers belonging to a group may exceed the exposure norm of 40 per cent of the bank's capital funds by an additional 10 per cent (i.e. up to 50 per cent), provided the additional credit exposure is on account of extension of credit to infrastructure projects. Credit exposure to single borrower may exceed the exposure norm of 15 per cent of the bank's capital funds by an additional 5 per cent (i.e. up to 20 per cent) provided the additional credit exposure is on account of infrastructure as defined in paragraph (a) above. In addition to the exposure permitted above, banks may, in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to a borrower up to a further 5 per cent of capital funds. The bank should make appropriate disclosures in the 'Notes on account' to the annual financial statements in respect of the exposures where the bank had exceeded the prudential exposure limits during the year.

(ii) Assignment of risk weight for capital adequacy purposes

Banks may assign a concessional risk weight of 50 per cent for capital adequacy purposes, on investment in securitised paper pertaining to an infrastructure facility subject to compliance with the following:

- The infrastructure facility should satisfy the conditions stipulated in paragraph (a) above.
- The infrastructure facility should be generating income/ cash flows which would ensure servicing/ repayment of the securitised paper.
- The securitised paper should be rated at least 'AAA' by the rating agencies and the rating should be current and valid. The rating relied upon will be deemed to be current and valid if-
 - (i) The rating is not more than one month old on the date of opening of the issue, and the rating rationale from the rating agency is not more than one year old on the date of opening of the issue, and the rating letter and the rating rationale is a part of the offer document.
 - (ii) In the case of secondary market acquisition, the 'AAA' rating of the issue should be in force and confirmed from the monthly bulletin published by the respective rating agency.
 - (iii) The securitised paper should be a performing asset on the books of the investing/ lending institution.

(iii) Asset-Liability Management

The long-term financing of infrastructure projects may lead to asset – liability mismatches, particularly when such financing is not in conformity with the maturity profile of a bank's liabilities. Banks would, therefore, need to exercise due vigil on their asset-liability position to ensure that they do not run into liquidity mismatches on account of lending to such projects.

(iv) Administrative arrangements

Timely and adequate availability of credit is the pre-requisite for successful implementation of infrastructure projects. Banks/ FIs should, therefore, clearly delineate the procedure for approval of loan proposals and institute a suitable monitoring mechanism for reviewing applications pending beyond the specified period. Multiplicity of appraisals by every institution involved in financing, leading to delays, has to be avoided and banks should be prepared to broadly accept technical parameters laid down by leading public financial institutions. Also, setting up a mechanism for an ongoing monitoring of the project implementation will ensure that the credit disbursed is utilised for the purpose for which it was sanctioned.

2.3.8.8 Take-out financing/liquidity support

(i) Take-out financing arrangement

Take-out financing structure is essentially a mechanism designed to enable banks to avoid asset-liability maturity mismatches that may arise out of extending long tenor loans to infrastructure projects. Under the arrangements, banks financing the infrastructure projects will have an arrangement with IDFC or any other financial institution for transferring to the latter the outstandings in their books on a pre-determined basis. IDFC and SBI have devised different take-out financing structures to suit the requirements of various banks, addressing issues such as liquidity, asset-liability mismatches, limited availability of project appraisal skills, etc. They have also developed a Model Agreement that can be considered for use as a document for specific projects in conjunction with other project loan documents. The agreement between SBI and IDFC could provide a reference point for other banks to enter into somewhat similar arrangements with IDFC or other financial institutions.

(ii) Liquidity support from IDFC

As an alternative to take-out financing structure, IDFC and SBI have devised a product, providing liquidity support to banks. Under the scheme, IDFC would commit, at the point of sanction, to refinance the entire outstanding loan (principal+ unrecovered interest) or part of the loan, to the bank after an agreed period, say, five years. The credit risk on the project will be taken by the bank concerned and not by IDFC. The bank would repay the amount to IDFC with interest as per the terms agreed upon. Since IDFC would be taking a credit risk on the bank, the interest rate to be charged by it on the amount refinanced would depend on the IDFC's risk perception of the bank (in most of the cases, it may be close to IDFC's PLR). The refinance support from IDFC would particularly benefit the banks which have the requisite appraisal skills and the initial liquidity to fund the project.

2.3.9 Issue of Bank Guarantees in favour of Financial Institutions

2.3.9.1 Banks may issue guarantees favouring other banks/FIs/other lending agencies for the loans extended by the latter, subject to strict compliance with the following conditions.

- (i) The Board of Directors should reckon the integrity/robustness of the bank's risk management systems and, accordingly, put in place a well-laid out policy in this regard.

The Board approved policy should, among others, address the following issues:

- (a) Prudential limits, linked to bank's Tier I capital, up to which guarantees favouring other banks/FIs/other lending agencies may be issued.
- (b) Nature and extent of security and margins
- (c) Delegation of powers
- (d) Reporting system
- (e) Periodical reviews

- (i) The guarantee shall be extended only in respect of borrower constituents and to enable them to avail of additional credit facility from other banks/FIs/lending agencies

(ii) The guaranteeing bank shall assume a funded exposure of at least 10% of the exposure guaranteed.

(iii) Banks should not extend guarantees or letters of comfort in favour of overseas lenders including those assignable to overseas lenders, except for the relaxations permitted under FEMA.

(iv) guarantee issued by the bank will be an exposure on the borrowing entity on whose behalf the guarantee has been issued and will attract appropriate risk weight as per the extant guidelines.

(vi) Banks should ensure compliance with the recommendations of the Ghosh Committee and other internal requirements relating to issue of guarantees to obviate the possibility of frauds in this area.

2.3.9.2 Lending banks

A. Banks extending credit facilities against the guarantees issued by other banks/FIs should ensure strict compliance with the following conditions:

(i) The exposure assumed by the bank against the guarantee of another bank/FI will be deemed as an exposure on the guaranteeing bank/FI and will attract appropriate risk weight as per the extant guidelines.

(ii) Exposures assumed by way of credit facilities extended against the guarantees issued by other banks should be reckoned within the inter bank exposure limits prescribed by the Board of Directors. Since the exposure assumed by the bank against the guarantee of another bank/FI will be for a fairly longer term than those assumed on account of inter bank dealings in the money market, foreign exchange market and securities market, the Board of Directors should fix an appropriate sub-limit for the longer term exposures since these exposures attract greater risk.

(iii) Banks should monitor the exposure assumed on the guaranteeing bank/FI, on a continuous basis and ensure strict compliance with the prudential limits/sub limits prescribed by the Board for banks and the prudential single borrower limits prescribed by RBI for FIs.

(iv) Banks should comply with the recommendations of the Ghosh Committee and other internal requirements relating to acceptance of guarantees of other banks to obviate the possibility of frauds in this area.

B. However, the above conditions will not be applicable in the following cases:

(a) In respect of infrastructure projects, banks may issue guarantees favouring other lending institutions, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 percent of the project cost and undertakes normal credit appraisal, monitoring and follow up of the project.

(b) Issuance of guarantees in favour of various Development Agencies/Boards, like Indian Renewable Energy Development Agency, National Horticulture Board, etc. for obtaining soft loans and/or other forms of development assistance from such Agencies/Boards with the objective of improving efficiency, productivity, etc., subject to the following conditions:

- Banks should satisfy themselves, on the basis of credit appraisal, regarding the technical feasibility, financial viability and bankability of individual projects and/or loan proposals i.e. the standard of such appraisal should be the same, as is done in the case of a loan proposal seeking sanction of term finance/loan.
- Banks should conform to the prudential exposure norms prescribed from time to time for an individual borrower/group of borrowers.

- Banks should suitably secure themselves before extending such guarantees.
- (c) Issue of guarantees favouring HUDCO/State Housing Boards and similar bodies for loans granted by them to private borrowers who are unable to offer clean or marketable title to property, provided banks are otherwise satisfied about the capacity of borrowers to adequately service such loans.
- d) Issuance of guarantees by consortium member banks unable to participate in rehabilitation packages on account of temporary liquidity constraints, in favour of the banks which take up their share of the limit.
- C. Banks should not grant co-acceptance/guarantee facilities under Buyers Lines of Credit Schemes introduced by IDBI, SIDBI, Exim Bank, Power Finance Corporation (PFC) or any other financial institution, unless specifically permitted by the RBI.

2.3.10 Discounting/Rediscounting of Bills by Banks

Banks may adhere to the following guidelines while purchasing / discounting / negotiating / rediscounting of genuine commercial / trade bills:

- (i) Since banks have already been given freedom to decide their own guidelines for assessing / sanctioning working capital limits of borrowers, they may sanction working capital limits as also bills limit to borrowers after proper appraisal of their credit needs and in accordance with the loan policy as approved by their Board of Directors.
- (ii) Banks should clearly lay down a bills discounting policy approved by their Board of Directors, which should be consistent with their policy of sanctioning of working capital limits. In this case, the procedure for Board approval should include banks' core operating process from the time the bills are tendered till these are realised. Banks may review their core operating processes and simplify the procedure in respect of bills financing. In order to address the often-cited problem of delay in realisation of bills, banks may take advantage of improved computer / communication networks like the Structured Financial Messaging system (SFMS) and adopt the system of 'value dating' of their clients' accounts.
- (iii) Banks should open letters of credit (LCs) and purchase / discount / negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks. Banks should not, therefore, extend fund-based (including bills financing) or non-fund based facilities like opening of LCs, providing guarantees and acceptances to non-constituent borrower or / and non-constituent member of a consortium / multiple banking arrangement.
- (iv) Sometimes, a beneficiary of the LC may want to discount the bills with the LC issuing bank itself. In such cases, banks may discount bills drawn by beneficiary only if the bank has sanctioned regular fund-based credit facilities to the beneficiary. With a view to ensuring that the beneficiary's bank is not deprived of cash flows into its account, the beneficiary should get the bills discounted / negotiated through the bank with whom he is enjoying sanctioned credit facilities.
- (v) Bills purchased / discounted / negotiated under LC (where the payment to the beneficiary is not made 'under reserve') will be treated as an exposure on the LC issuing bank and not on the borrower. All clean negotiations as indicated above will be assigned the risk weight as is normally applicable to inter-bank exposures, for capital adequacy purposes. In the case of negotiations 'under reserve', the exposure should be treated as on the borrower and risk weight assigned accordingly.
- (vi) While purchasing / discounting / negotiating bills under LCs or otherwise, banks should establish genuineness of underlying transactions / documents.
- (vii) Banks should ensure that blank LC forms are kept in safe custody as in case of security items like blank cheques, demand drafts etc. and verified / balanced on daily

basis. LC forms should be issued to customers under joint signatures of the bank's authorised officials.

(viii) The practice of drawing bills of exchange claused 'without recourse' and issuing letters of credit bearing the legend 'without recourse' should be discouraged because such notations deprive the negotiating bank of the right of recourse it has against the drawer under the Negotiable Instruments Act. Banks should not therefore open LCs and purchase / discount / negotiate bills bearing the 'without recourse' clause.

(ix) Accommodation bills should not be purchased / discounted / negotiated by banks. The underlying trade transactions should be clearly identified and a proper record thereof maintained at the branches conducting the bills business.

(x) Banks should be circumspect while discounting bills drawn by front finance companies set up by large industrial groups on other group companies.

(xi) Bills rediscounts should be restricted to usance bills held by other banks. Banks should not rediscount bills earlier discounted by non-bank financial companies (NBFCs) except in respect of bills arising from sale of light commercial vehicles and two / three wheelers.

(xii) Banks may exercise their commercial judgment in discounting of bills of the services sector. However, while discounting such bills, banks should ensure that actual services are rendered and accommodation bills are not discounted. Services sector bills should not be eligible for rediscounting. Further, providing finance against discounting of services sector bills may be treated as unsecured advance and, therefore, should be within the norm prescribed by the Board of the bank for unsecured exposure limit.

(xiii) In order to promote payment discipline which would, to a certain extent, encourage acceptance of bills, all corporates and other constituent borrowers having turnover above threshold level as fixed by the bank's Board of Directors should be mandated to disclose 'aging schedule' of their overdue payables in their periodical returns submitted to banks.

(xiv) Banks should not enter into Repo transactions using bills discounted / rediscounted as collateral.

2.3.11 Advances against Bullion/Primary gold

- (a) Banks should not grant any advance against bullion/ Primary gold.
- (b) Banks should desist from granting advances to the silver bullion dealers which are likely to be utilised for speculative purposes.

2.3.12 Advances against Gold Ornaments & Jewellery

Hallmarking of gold jewellery ensures the quality of gold used in the jewellery as to caratage, fineness and purity. Therefore, banks would find granting of advances against the security of such hallmarked jewellery safer and easier. Preferential treatment of hallmarked jewellery is likely to encourage practice of hallmarking which will be in the long-term interest of consumer, lenders and the industry. Therefore, banks while considering granting advances against jewellery may keep in view the advantages of hallmarked jewellery and decide on the margin and rates of interest thereon.

2.3.13 Gold (Metal) Loans

2.3.13.1 Banks nominated to import gold (list of banks as per **Annex 4**) as per extant instructions may extend Gold (Metal) Loans to domestic jewellery manufacturers, who are not exporters of jewellery, subject to the condition that any gold loan borrowing or other non-funded commitments taken by them for the purpose of providing gold loans to domestic jewellery manufacturers will be taken into account for the purpose of the overall ceiling (presently 25 % of Tier I capital) in respect of aggregate borrowing for non-export purposes. The Gold Loans extended to exporters of jewellery would continue to be out of the 25% ceiling. The Gold (Metal) Loans provided by banks will be subject to the following conditions:

- (i) The tenor of the Gold (Metal) Loans, which nominated banks are permitted to extend to domestic jewellery manufacturers who are not exporters of jewellery, may be decided by the nominated banks themselves provided the tenor does not exceed 180 days and the banks' policy with regard to tenor and monitoring of end use of gold loan is documented in the banks' loan policy and strictly adhered to by the banks. The above guidelines will be reviewed in the light of experience gained, and the performance of the banks in regard to monitoring the end-use of gold loans will be an important factor in deciding upon their future requests for annual renewal of authorization to import gold / silver.
- (ii) Interest charged to the borrowers should be linked to the international gold interest rate.
- (iii) The gold borrowings will be subject to normal reserve requirements.
- (iv) The loan will be subject to capital adequacy and other prudential requirements.
- (v) Banks should ensure end-use of gold loans to jewellery manufacturers and adhere to KYC guidelines.
- (vi) Any mismatch arising out of the gold borrowings and lendings should be within the prudential risk limits approved by the nominated bank's Board.
- (vii) The banks should carefully assess the overall risks on granting gold loans and lay down a detailed lending policy with the approval of the Board.

2.3.13.2 Presently, nominated banks can extend Gold (Metal) Loans to exporters of jewellery who are customers of other scheduled commercial banks, by accepting stand-by letter of credit or bank guarantee issued by their bankers in favour of the nominated banks subject to authorised banks' own norms for lending and other conditions stipulated by RBI. Banks may also extend the facility to domestic jewellery manufacturers, subject to the following conditions:

- (i) The stand-by LC / BG shall be extended only on behalf of domestic jewellery manufacturers and shall cover at all times the full value of the quantity of gold borrowed by these entities. The stand-by LC / BG shall be issued by scheduled commercial banks in favour of a nominated bank (list appended) only and not to any other entity which may otherwise be having permission to import gold.
- (ii) The bank issuing the stand-by LC / BG (only inland letter of credit / bank guarantee) should do so only after carrying out proper credit appraisal. The bank should ensure that adequate margin is available to it at all times consistent with the volatility of the gold prices.
- (iii) The stand-by LC / BG facilities will be denominated in Indian Rupees and not in foreign currency.

(iv) Stand-by LC / BG issued by the non-nominated banks will be subject to extant capital adequacy and prudential norms.

(v) The banks issuing stand-by LC / BG should also carefully assess the overall risks on granting these facilities and lay down a detailed lending policy with the approval of their Board.

2.3.13.3 The nominated banks may continue to extend Gold (Metal) Loans to jewellery exporters subject to the following conditions:

- The exposure assumed by the nominated bank extending the Gold (Metal) Loan against the stand-by LC / BG of another bank will be deemed as an exposure on the guaranteeing bank and attract appropriate risk weight as per the extant guidelines.
- The transaction should be purely on back-to-back basis i.e. the nominated banks should extend Gold (Metal) Loan directly to the customer of a non-nominated bank, against the stand-by LC / BG issued by the latter.
- Gold (Metal) Loans should not involve any direct or indirect liability of the borrowing entity towards foreign suppliers of gold.
- The banks may calculate their exposure and compliance with prudential norms daily by converting into Rupee the gold quantity by crossing London AM fixing for Gold / US Dollar rate with the rupee-dollar reference rate announced by RBI.

2.3.13.4 There will be no change in the existing policy on lending against bullion. Banks should recognise the overall risks in extending Gold (Metal) Loans as also in extending SBLC / BG. Banks should lay down an appropriate risk management / lending policy in this regard and comply with the recommendations of the Ghosh Committee and other internal requirements relating to acceptance of guarantees of other banks to obviate the possibility of frauds in this area.

2.3.13.5 Nominated banks are not permitted to enter into any tie up arrangements for retailing of gold / gold coins with any other entity including non-banking financial companies / co-operative banks / non-nominated banks.

2.3.14 Loans and advances to Real Estate Sector

While appraising loan proposals involving real estate, banks should ensure that the borrowers have obtained prior permission from government / local governments / other statutory authorities for the project, wherever required. In order that the loan approval process is not hampered on account of this, while the proposals could be sanctioned in normal course, the disbursements should be made only after the borrower has obtained requisite clearances from the government authorities.

2.3.15 Loans and advances to Small Scale Industries

SSI units having working capital limits of up to Rs. 5 crore from the banking system are to be provided working capital finance computed on the basis of 20 percent of their projected annual turnover. The banks should adopt the simplified procedure in respect of all SSI units (new as well as existing).

2.3.16 Loan system for delivery of bank credit

(a) In the case of borrowers enjoying working capital credit limits of Rs. 10 crore and above from the banking system, the loan component should normally be 80 percent. Banks, however, have the freedom to change the composition of working capital by increasing the cash credit component beyond 20 percent or to increase the 'Loan Component' beyond 80 percent, as the case may be, if they so desire. Banks are expected to appropriately price each of the two components of working capital finance, taking into account the impact of such decisions on their cash and liquidity management.

(b) In the case of borrowers enjoying working capital credit limit of less than Rs. 10 crore, banks may persuade them to go in for the 'Loan System' by offering an incentive in the form of lower rate of interest on the loan component, as compared to the cash credit component. The actual percentage of 'loan component' in these cases may be settled by the bank with its borrower clients.

(c) In respect of certain business activities, which are cyclical and seasonal in nature or have inherent volatility, the strict application of loan system may create difficulties for the borrowers. Banks may, with the approval of their respective Boards, identify such business activities, which may be exempted from the loan system of delivery.

2.3.17 Working Capital Finance to Information Technology and Software Industry

Following the recommendations of the "National Task force on Information Technology and Software development", Reserve Bank has framed guidelines for extending working capital to the said industry. Banks are however free to modify the guidelines based on their own experience without reference to the Reserve Bank of India to achieve the purpose of the guidelines in letter and spirit. The salient features of these guidelines are set forth below:

- Banks may consider sanction of working capital limits based on the track record of the promoters group affiliation, composition of the management team and their work experience as well as the infrastructure.
- In the case of the borrowers with working capital limits of up to Rs 2 crore, assessment may be made at 20 percent of the projected turnover. However, in other cases, the banks may consider assessment of MPBF on the basis of the monthly cash budget system. For the borrowers enjoying working capital limits of Rs 10 crore and above from the banking system the guidelines regarding the loan system would be applicable.
- Banks can stipulate reasonable amount as promoters' contribution towards margin.
- Banks may obtain collateral security wherever available. First/ second charge on current assets, if available, may be obtained.
- The rate of interest as prescribed for general category of borrowers may be levied. Concessional rate of interest as applicable to pre-shipment/post-shipment credit may be levied.
- Banks may evolve tailor-made follow up system for such advances. The banks could obtain quarterly statements of cash flows to monitor the operations. In case the sanction was not made on the basis of the cash budgets, they can devise a reporting system, as they deem fit.

2.3.18 Guidelines for bank finance for PSU disinvestments of Government of India

2.3.18.1 In terms of RBI circular DBOD No. Dir. BC .90/13.07.05/98 dated August 28, 1998, banks have been advised that the promoters' contribution towards the equity capital of a

company should come from their own resources and the bank should not normally grant advances to take up shares of other companies. Banks were also advised to ensure that advances against shares were not used to enable the borrower to acquire or retain a controlling interest in the company/companies or to facilitate or retain inter-corporate investment. It is clarified that the aforesaid instructions of the 1998 circular would not apply in the case of bank finance to the successful bidders under the PSU disinvestment programme of the Government, subject to the following:

- Banks' proposals for financing the successful bidders in the PSU disinvestment programme should be approved by their Board of Directors.
- Bank finance should be for acquisition of shares of PSU under a disinvestment programme approved by Government of India, including the secondary stage mandatory open offer, wherever applicable and not for subsequent acquisition of the PSU shares. Bank finance should be made available only for prospective disinvestments by Government of India.
- The companies, including the promoters, to which bank finance is to be extended should have adequate net worth and an excellent track record of servicing loans availed from the banking system.
- The amount of bank finance thus provided should be reasonable with reference to the banks' size, its net worth and business and risk profile.

2.3.18.2 In case the advances against the PSU disinvestment is secured by the shares of the disinvested PSUs or any other shares, banks should follow RBI's extant guidelines on capital market exposures on margin, ceiling on overall exposure to the capital market, risk management and internal control systems, surveillance and monitoring by the Audit Committee of the Board, valuation and disclosure, etc. (cf. RBI circular No. DBOD.BP.BC.119/ 21.04.137 /2000-01 dated May 11, 2001).

2.3.18.3 Stipulation of lock-in period for shares

- (i) Banks should, while deciding to extend finance to the borrowers who participate in the PSU disinvestment programme, advise such borrowers to execute an agreement whereby they undertake to:
 - (a) Produce the letter of waiver by the Government for disposal of shares acquired under PSU disinvestment programme during the lock-in period, or
 - (b) Include a specific provision in the documentation with the Government permitting the pledgee to liquidate the shares during the lock-in period, in case of shortfall in margin requirement or default by the borrower.
- (ii) Banks may extend finance to the successful bidders even though the shares of the disinvested company acquired/ to be acquired by the successful bidder are subjected to a lock-in period/ other such restrictions which affect their liquidity, subject to fulfillment of following conditions:
 - (a) The documentation between the Government of India and the successful bidder should contain a specific provision permitting the pledgee to liquidate the shares even during lock-in period that may be prescribed in respect of such disinvestments, in case of shortfall in margin requirements or default by the borrower.
 - (b) If the documentation does not contain such a specific provision, the borrower (successful bidder) should obtain waiver from the Government for disposal of shares acquired under PSU disinvestment programme during the lock-in period.

2.3.18.4As per the terms and conditions of the PSU disinvestments by the Government of India, the pledgee bank will not be allowed to invoke the pledge during the first year of the lock-in period. During the second and third year of the lock-in period, in case of inability of the borrower to restore the margin prescribed for the purpose by way of additional security or non-performance of the payment obligations as per the repayment schedule agreed upon between the bank and the borrower, the bank would have the right to invoke the pledge. The pledgee bank's right to invoke the pledge during the second and third years of the lock-in period, would be subject to the terms and conditions of the documentation between Government and the successful bidder, which might also cast certain responsibilities on the pledgee banks.

2.3.18.5It is clarified that the concerned bank must make a proper appraisal and exercise due caution about creditworthiness of the borrower and the financial viability of the proposal. The bank must also satisfy itself that the proposed documentation, relating to the disposal of shares pledged with the bank, are fully acceptable to the bank and do not involve unacceptable risks on the part of the bank.

2.3.18.6In terms of IECD Circular No. 10/ 08.12.01/ 2000- 2001 dated 8 January 2001, banks are precluded from financing investments of NBFCs in other companies and inter-corporate loans / deposits to/ in other companies. The position has been reviewed and banks are advised that SPVs which comply with the following conditions would not be treated as investment companies and therefore would not be considered as NBFCs:

- o They function as holding companies, special purpose vehicles, etc. with not less than 90 per cent of their total assets as investment in securities held for the purpose of holding ownership stake,
- o They do not trade in these securities except for block sale,
- o They do not undertake any other financial activities, and
- o They do not hold/accept public deposits

2.3.18.7SPVs, which satisfy the above conditions, would be eligible for bank finance for PSU disinvestments of Government of India.

2.3.18.8In this context, it may be mentioned that Government of India, Ministry of Finance (DEA), Investment Division, vide its Press Note dated July 8, 2002, on guidelines for Euro issues, has permitted an Indian company utilizing ADR/GDR/ECB proceeds for financing disinvestment programme of the Government of India, including the subsequent open offer. Banks may, therefore, take into account proceeds from such ADR/GDR/ECB issues, for extending bank finance to successful bidders of the PSU disinvestment programme.

2.3.19 Grant of Loans for acquisition of Kisan Vikas Patras (KVPs)

(i) Certain instances have come to notice where banks have sanctioned loans to individuals (mostly High Networth Individuals-HNIs) for acquisition of Kisan Vikas Patras (KVPs). The HNIs were first required to bring in 10% of the total face value of the proposed investment in the KVPs as margin and the remaining 90% of the investment was treated as loan and funded by the bank for acquisition of the KVPs. Once the KVPs were acquired in the borrower's name, the same were pledged thereafter to the bank.

(ii) The sanction of loans as described above is not in conformity with the objectives of small savings schemes. The basic objective of small savings schemes is to provide a secure avenue of savings for small savers and promote savings, as well as to inculcate the habit of thrift among the people. The grant of loans for acquiring/investing in KVPs does not promote fresh savings and, rather, channelises the existing savings in the form of bank deposits to small savings instruments and thereby defeats the very purpose of such schemes. Banks should therefore ensure that no loans are sanctioned for acquisition of/investing in Small Savings Instruments including Kisan Vikas Patras.

2.3.20 Guidelines on Settlement of Non Performing Assets- Obtaining Consent Decree from Court

The Debt Recovery Tribunal, Ernakulam has observed in a case that although the bank and the defendant borrowers had reached a settlement under the compromise Settlement Scheme, the bank had not only failed to obtain the consent decree from the DRT, but had also suppressed from the DRT the fact of settlement for more than two and half years thereby violating the aforesaid RBI guidelines and causing the Tribunal to unnecessarily waste its valuable time. Banks are, therefore, advised to invariably ensure that once a case is filed before a Court / DRT / BIFR, any settlement arrived at with the borrower is subject to obtaining a consent decree from the Court / DRT / BIFR concerned.

2.3.21 Project Finance Portfolio of Banks

2.3.21.1 At the time of financing projects banks generally adopt one of the following methodologies as far as determining the level of promoters' equity is concerned.

- 1) Promoters bring their entire contribution upfront before the bank starts disbursing its commitment.
- 2) Promoters bring certain percentage of their equity (40% – 50%) upfront and balance is brought in stages.
- 3) Promoters agree, ab initio, that they will bring in equity funds proportionately as the banks finance the debt portion.

2.3.21.2 While it is appreciated that such decisions are to be taken by the boards of the respective banks, it has been observed that the last method has greater equity funding risk. In order to contain this risk, banks are advised in their own interest to have a clear policy regarding the Debt Equity Ratio (DER) and to ensure that the infusion of equity/fund by promoters should be such that the stipulated level of DER is maintained at all times. Further they may adopt funding sequences so that possibility of equity funding by banks is obviated.

2.4. Guidelines on Fair Practices Code for Lenders

2.4.1. On the basis of the recommendations of the Working Group on Lenders' Liability Laws constituted by the Government of India, the feasibility of introducing the Fair Practices Code for Lenders was examined in consultation with Government, select banks and financial institutions. The guidelines have since been finalised and banks/ all India Financial Institutions are advised to adopt the following broad guidelines and frame the Fair Practices Code duly approved by their Board of Directors.

2.4.2 Guidelines

(i) Applications for loans and their processing

(a) Loan application forms in respect of all categories of loans irrespective of the amount of loan sought by the borrower should be comprehensive. It should include information about the fees/charges, if any, payable for processing, the amount of such fees refundable in the case of non acceptance of application, pre-payment options and any other matter which affects the interest of the borrower, so that a meaningful comparison with that of other banks can be made and informed decision can be taken by the borrower.

(b) Banks and financial institutions should devise a system of giving acknowledgement for receipt of all loan applications. Time frame within which loan applications up to Rs.2 lakhs will be disposed of should also be indicated in acknowledgement of such applications.

(c) Banks / financial institutions should verify the loan applications within a reasonable period of time. If additional details / documents are required, they should intimate the borrowers immediately.

(d) In case of all categories of loans irrespective of any threshold limits, including credit card applications, the lenders should convey in writing, the main reason/reasons which, in the opinion of the bank after due consideration, have led to rejection of the loan applications within stipulated time.

(ii) Loan appraisal and terms/conditions

(a) Lenders should ensure that there is proper assessment of credit application by borrowers. They should not use margin and security stipulation as a substitute for due diligence on credit worthiness of the borrower.

(b) The lender should convey to the borrower the credit limit along with the terms and conditions thereof and keep the borrower's acceptance of these terms and conditions given with his full knowledge on record.

(c) Terms and conditions and other caveats governing credit facilities given by banks/ financial institutions arrived at after negotiation by lending institution and the borrower should be reduced in writing and duly certified by the authorised official. A copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement should be furnished to the borrower. It is reiterated that banks should invariably 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.

(d) As far as possible, the loan agreement should clearly stipulate credit facilities that are solely at the discretion of lenders. These may include approval or disallowance of facilities, such as, drawings beyond the sanctioned limits, honouring cheques issued for the purpose other than specifically agreed to in the credit sanction, and disallowing drawing on a borrowal account on its classification as a non-performing asset or on account of non-compliance with the terms of sanction. It may also be specifically stated that the lender does not have an obligation to meet further requirements of the borrowers on account of growth in business etc. without proper review of credit limits.

(e) In the case of lending under consortium arrangement, the participating lenders should evolve procedures to complete appraisal of proposals in the time bound manner to the extent feasible, and communicate their decisions on financing or otherwise within a reasonable time.

(iii) Disbursement of loans including changes in terms and conditions

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

(iv) Post disbursement supervision

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

(v) General

- Lenders should restrain from interference in the affairs of the borrowers except for what is provided in the terms and conditions of the loan sanction documents (unless new information, not earlier disclosed by the borrower, has come to the notice of the lender).
- Lenders must not discriminate on grounds of sex, caste and religion in the matter of lending. However, this does not preclude lenders from participating in credit-linked schemes framed for weaker sections of the society.
- In the matter of recovery of loans, the lenders should not resort to undue harassment viz. persistently bothering the borrowers at odd hours, use of muscle power for recovery of loans, etc.
- In case of receipt of request for transfer of borrowal account, either from the borrower or from a bank/financial institution, which proposes to take- over the account, the consent or otherwise i.e, objection of the lender, if any, should be conveyed within 21 days from the date of receipt of request.

2.4.3. Fair Practices Code based on the guidelines outlined in the paragraph 2.4.2 above should be put in place in respect of all lending. Banks and financial institutions will have the freedom of drafting the Fair Practices Code, enhancing the scope of the guidelines but in no way sacrificing the spirit underlying the above guidelines. For this purpose, the Boards of banks and financial institutions should lay down a clear policy.

- 2.4.4 The Board of Directors should also lay down the appropriate grievance redressal mechanism within the organization to resolve disputes arising in this regard. Such a mechanism should ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level. The Board of Directors should also provide for periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels of controlling offices. A consolidated report of such reviews may be submitted to the Board at regular intervals, as may be prescribed by it.
- 2.4.5. The adoption of the Code, printing of necessary loan application forms and circulation thereof among the branches and controlling offices should also be duly completed. The Fair Practices Code, which may be adopted by banks and financial institutions, should also be put on their website and given wide publicity. A copy may also be forwarded to the Reserve Bank of India.

ANNEX 1

List of Controlled Substances (paragraph 2.2.3.1)

Group	Substance	Ozone Depleting Potential *
Group I		
CFCl ₃	(CFC-11)	1.0
CF ₂ Cl ₂	(CFC-12)	1.0
C ₂ F ₃ Cl ₃	(CFC-113)	0.8
C ₂ F ₄ Cl ₂	(CFC-114)	1.0
Cl	(CFC-115)	0.6
Group II		
CF ₂ BrCl	(halon-1211)	3.0
CF ₃ Br	(halon-1301)	10.0
C ₂ F ₄ Br ₂	(halon-2402)	6.0
* These ozone depleting potentials are estimated based on existing knowledge and will be reviewed and revised periodically.		

ANNEX 2

**List of Controlled Substances
(paragraph 2.2.3.1)**

Group	Substance	Ozone Depleting Potential
Group I		
CF ₃ Cl	(CFC-13)	1.0
CF ₂ Cl ₅	(CFC-111)	1.0
C ₂ F ₂ Cl ₄	(CFC-112)	1.0
C ₂ FCI ₇	(CFC-211)	1.0
C ₂ F ₂ Cl ₆	(CFC-212)	1.0
C ₃ F ₃ Cl ₅	(CFC-213)	1.0
C ₃ F ₄ Cl ₄	(CFC-214)	1.0
C ₃ F ₅ Cl ₃	(CFC-215)	1.0
C ₃ F ₆ Cl ₂	(CFC-216)	1.0
C ₃ F ₇ Cl	(CFC-217)	1.0
Group II		
CCl ₄	Carbon Tetrachloride	1.1
Group III		
C ₂ H ₃ Cl ₃ *	1,1,1 - trichloroethane (methyl chloroform)	0.1
* This formula does not refer to 1,1,2 - trichloroethane.		

**Selective Credit Control
Other Operational Stipulations**

[paragraph 2.2.4.4 (iv)]

1. Banks should not allow the customers dealing in Selective Credit Control commodities any credit facilities which would directly or indirectly defeat the purpose of the directive. Advances against book debts/receivables and collateral securities like LIC policies, shares and stocks and real estate should not be considered in favour of such borrowers.
2. Although advances against security of or by way of purchase of demand documentary bills drawn in connection with the movement of the Selective Credit Control commodities are exempted, the bank should ensure that the bills offered have arisen out of actual movement of goods by verifying the relative invoices as also the receipts issued by transport operators, etc.
3. Usance bills arising out of sale of Selective Credit Control commodities should not be discounted except to the extent specifically permitted in the directives issued.
4. Clean Telegraphic Transfer Purchase facility may be allowed to a reasonable extent on certain conditions specified in the directives.
5. Priority sector advances are also covered by/under Selective Credit Control directives.
6. Where credit limits have been sanctioned against the security of more than one commodity and/or any other type of security, the credit limits against each commodity should be segregated and the restrictions contained in the directives made applicable to each of such segregated limit.
7. Banks are free to determine the rate of interest in respect of advances covered under Selective Credit Control directives.
8. Banks could grant loans to borrowers dealing in Selective Credit Control commodities, provided the term loans are used for the purpose of acquiring block assets like plant & machinery and normal appraisal and other criteria are followed by the banks.
9. Reserve Bank of India authorises limits to the Food Corporation of India and State Governments for procurement of foodgrains; at prices fixed by the Government of India, for the Central Pool and for the distribution of the same under the Public Distribution System (PDS). As the limits are authorised without margin, credit cannot be drawn against credit sales, book debts, Government subsidies, etc.
10. Banks should refer to the directives on Selective Credit Control measures issued by RBI from time to time.

ANNEX 4**List of banks nominated to import Gold
(paragraph 2.3.13.1)**

1.	Allahabad Bank
2.	Axis Bank Ltd
3.	Bank of Baroda
4.	Bank of India
5.	Bank of Nova Scotia
6.	Canara Bank
7.	Corporation Bank
8.	Dena Bank
9.	Federal Bank Ltd.
10.	ICICI Bank Ltd.
11.	Indian Overseas Bank
12.	IndusInd Bank Ltd.
13.	Kotak Mahindra Bank Ltd
14.	HDFC Bank Ltd.
15.	Indian Bank
16.	Oriental Bank of Commerce
17.	Punjab National Bank
18.	State Bank of India
19.	Syndicate Bank
20.	Union Bank of India

ANNEX 5

**List of Circulars consolidated in the Master Circular on
'Loans and Advances - Statutory and other Restrictions'**

1.	DBOD.No.Leg.BC.	28.09.07.005/2007-08	22.08.2007
2.	DBOD. BP.BC.	55/21.04.117/2007-08	30.11.2007
3.	DBOD.BP.	48/21.04.048/2007-08	06.11.2007
4.	DBOD. Dir. BC.	9/13.03.00/2007-08	02.07.2007
5.	DBOD.No.Leg.BC.	65/09.07.005/2006-07	06.03.2007
6.	DBOD.Leg.No. BC.	104/09.07.007/2002-03	05.05.2003

RBI/2008-09/32
DBOD.BP.BC No. 3 / 21.04.018/2008-09

July 1, 2008

The Chairmen/Chief Executives of
All Commercial Banks
(excluding RRBs)

Dear Sir,

Master Circular - Disclosure in Financial Statements - Notes to Accounts

Please refer to the master circular DBOD.BP.BC.No.14/21.04.018/2007-08 dated July 2, 2007 consolidating all operative instructions issued to banks till June 30, 2007 on matters relating to disclosures in the 'Notes to Accounts'. The Master Circular has now been suitably updated by incorporating instructions issued upto June 30, 2008. The Master Circular has also been placed on the RBI web-site (<http://www.rbi.org.in>).

2. It may be noted that all relevant instructions on the above subject contained in the circulars listed in the Annex 2 have been consolidated. In addition, disclosure requirements contained in our circular DBOD.No.BP.BC.90/20.06.001/ 2006-07 dated April 27, 2007 on "Implementation of the New Capital Adequacy Framework" will be applicable.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

Purpose

To provide a detailed guidance to banks in the matter of disclosures in the 'Notes to Accounts' to the Financial Statements.

Classification

Master Circular. A statutory guideline issued by the Reserve Bank of India under Section 35A of the Banking Regulation Act 1949.

Previous Guidelines superseded

Master Circular on 'Disclosure in Balance Sheets' issued vide DBOD.BP.BC No.14/21.04.018/2007-08 dated July 2, 2007

Scope of application

To all commercial banks (except RRBs and LABs)

Structure

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4.7	Accounting Standard 22 – Accounting for Taxes on Income
4.8	Accounting Standard 23 – Accounting for Investments in Associates in Consolidated Financial Statements
4.9	Accounting Standard 24 – Discontinuing Operations
4.10	Accounting Standard 25 – Interim Financial Reporting
4.11	Other Accounting Standards
4.12	Additional Disclosures
4.12.1	Provisions and contingencies
4.12.2	Floating Provisions
4.12.3	Draw Down from Reserves:
4.12.4	Disclosure of Complaints
4.12.5	Disclosure of Letter of Comforts (LOCs) issued by banks
Annex 1	List of Disclosure Items
Annex 2	List of Circulars consolidated by the Master Circular

1. Introduction

The users of the financial statements need information about the financial position and performance of the bank in making economic decisions. They are interested in its liquidity and solvency and the risks related to the assets and liabilities recognised on its balance sheet and to its off balance sheet items. In the interest of full and complete disclosure, some very useful information is better provided, or can only be provided, by notes to the financial statements. The use of notes and supplementary information provides the means to explain and document certain items, which are either presented in the financial statements or otherwise affect the financial position and performance of the reporting enterprise. Recently, a lot of attention has been paid to the issue of market discipline in the banking sector. Market discipline, however, works only if market participants have access to timely and reliable information, which enables them to assess banks' activities and the risks inherent in these activities. Enabling market discipline may have several benefits. Market discipline has been given due importance under Basel II by recognizing it as one of its three Pillars.

2.1 Presentation

'Summary of Significant Accounting Policies' and 'Notes to Accounts' may be shown under Schedule 17 and Schedule 18 respectively, to maintain uniformity.

2.2 Minimum Disclosures

At a minimum, the items listed in the circular should be disclosed in the 'Notes to Accounts'. Banks are also encouraged to make more comprehensive disclosures than the minimum required under the circular if they become significant and aid in the understanding of the financial position and performance of the bank. The disclosure listed is intended only to supplement, and not to replace, other disclosure requirements under relevant legislation or accounting and financial reporting standards. Where relevant, a bank should comply with such other disclosure requirements as applicable.

2.3 Summary of Significant Accounting Policies

Banks should disclose the accounting policies regarding key areas of operations at one place (under Schedule 17) along with notes to accounts in their financial statements. A suggestive list includes - Basis of Accounting, Transactions involving foreign exchange, Investments – classification, valuation, etc, Advances and Provisions thereon, Fixed

Assets and Depreciation, Revenue Recognition, Employee Benefits, Provision for Taxation, Net Profit, etc, etc.

2.4 Disclosure Requirements

In order to encourage market discipline, Reserve Bank has over the years developed a set of disclosure requirements which allow the market participants to assess key pieces of information on capital adequacy, risk exposures, risk assessment processes and key business parameters which provide a consistent and understandable disclosure framework that enhances comparability. Banks are also required to comply with the Accounting Standard 1 (AS I) on Disclosure of Accounting Policies issued by the Institute of Chartered Accountants of India (ICAI). The enhanced disclosures have been achieved through revision of Balance Sheet and Profit & Loss Account of banks and enlarging the scope of disclosures to be made in “Notes to Accounts”. In addition to the 16 detailed prescribed schedules to the balance sheet, banks are required to furnish the following information in the “Notes to Accounts”:

3.1 Capital

<i>Particulars</i>	<i>Current Year</i>	<i>Previous Year</i>
i) CRAR (%)		
ii) CRAR - Tier I capital (%)		
iii) CRAR - Tier II Capital (%)		
iv) Percentage of the shareholding of the Government of India in nationalized banks		
v) Amount of subordinated debt raised as Tier-II capital *		

*The total amount of subordinated debt through borrowings from Head Office for inclusion in Tier II capital may be disclosed in the balance sheet under the head 'Subordinated loan in the nature of long term borrowings in foreign currency from Head Office'.

3.2 Investments

(Rs. In crore)		
<i>Particulars</i>	<i>Current Year</i>	<i>Previous Year</i>
(1) Value of Investments		
(i) Gross Value of Investments		
(a) In India		

(b) Outside India, (ii) Provisions for Depreciation (a) In India (b) Outside India, (iii) Net Value of Investments (a) In India (b) Outside India. (2) Movement of provisions held towards depreciation on investments. (i) Opening balance (ii) Add: Provisions made during the year (iii) Less: Write-off/ write-back of excess provisions during the year (iv) Closing balance		

3.2.1 Repo Transactions

(Rs. in crore)

	<i>Minimum outstanding during the year</i>	<i>Maximum outstanding during the year</i>	<i>Daily Average outstanding during the year</i>	<i>As on March 31</i>
Securities sold under repos				
Securities purchased under reverse repos				

3.2.2. Non-SLR Investment Portfolio

i) Issuer composition of Non SLR investments

(Rs. in crore)

No.	Issuer	Amount	Extent of Private Placement	Extent of 'Below Investment Grade' Securities	Extent of 'Unrated' Securities	Extent of 'Unlisted' Securities
(1)	(2)	(3)	(4)	(5)	(6)	(7)
(i)	PSUs					
(ii).	FIs					
(iii).	Banks					
(iv).	Private Corporate					
(v).	Subsidiaries/ Joint Ventures					

(vi).	Others					
(vii).	Provision held towards depreciation		X X X	X X X	X X X	X X X
	Total *					

Note: (1) *Total under column 3 should tally with the total of Investments included under the following categories in Schedule 8 to the balance sheet:

- a) Shares
- b) Debentures & Bonds
- c) Subsidiaries/joint ventures
- d) Others

(2) Amounts reported under columns 4, 5, 6 and 7 above may not be mutually exclusive.

ii) Non performing Non-SLR investments

(Rs. in crore)	
<i>Particulars</i>	<i>Amount</i>
Opening balance	
Additions during the year since 1st April	
Reductions during the above period	
Closing balance	
Total provisions held	

3.3 Derivatives

3.3.1 Forward Rate Agreement/ Interest Rate Swap

(Rs. in crore)		
<i>Particulars</i>	<i>Current year</i>	<i>Previous year</i>
i) The notional principal of swap agreements		
ii) Losses which would be incurred if counterparties failed to fulfill their obligations under the agreements		
iii) Collateral required by the bank upon entering into swaps		
iv) Concentration of credit risk arising from the swaps \$		
v) The fair value of the swap book @		

Note: Nature and terms of the swaps including information on credit and market risk and the accounting policies adopted for recording the swaps should also be disclosed.

\$ Examples of concentration could be exposures to particular industries or swaps with highly geared companies

@ If the swaps are linked to specific assets, liabilities, or commitments, the fair value would be the estimated amount that the bank would receive or pay to terminate the swap agreements as on the balance sheet date. For a trading swap the fair value would be its mark to market value.

3.3.2 Exchange Traded Interest Rate Derivatives

(Rs. in crore)

S.No.	Particulars	Amount
(i)	Notional principal amount of exchange traded interest rate derivatives undertaken during the year (instrument-wise) a) b) c)	
(ii)	Notional principal amount of exchange traded interest rate derivatives outstanding as on 31st March (instrument-wise) a) b) c)	
(iii)	Notional principal amount of exchange traded interest rate derivatives outstanding and not "highly effective" (instrument-wise) a) b) c)	
(iv)	Mark-to-market value of exchange traded interest rate derivatives outstanding and not "highly effective" (instrument-wise) a) b) c)	

3.3.3 Disclosures on risk exposure in derivatives

Qualitative Disclosure

Banks shall discuss their risk management policies pertaining to derivatives with particular reference to the extent to which derivatives are used, the associated risks and business purposes served. The discussion shall also include:

- the structure and organization for management of risk in derivatives trading,
- the scope and nature of risk measurement, risk reporting and risk monitoring systems,
- policies for hedging and / or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges / mitigants, and

- d) accounting policy for recording hedge and non-hedge transactions; recognition of income, premiums and discounts; valuation of outstanding contracts; provisioning, collateral and credit risk mitigation.

Quantitative Disclosures

(Rs. in crore)

Sl.No	Particular	Currency Derivatives	Interest rate derivatives
(i)	Derivatives (Notional Principal Amount)		
	a) For hedging		
	b) For trading		
(ii)	Marked to Market Positions [1]		
	a) Asset (+)		
	b) Liability (-)		
(iii)	Credit Exposure [2]		
(iv)	Likely impact of one percentage change in interest rate (100*PV01)		
	a) on hedging derivatives		
	b) on trading derivatives		
(v)	Maximum and Minimum of 100*PV01 observed during the year		
	a) on hedging		
	b) on trading		

3.4 Asset Quality

3.4.1 Non-Performing Asset

(Rs. in crore)

Particulars	Current Year	Previous Year
(i) Net NPAs to Net Advances (%)		
(ii) Movement of NPAs (Gross)		
(a) Opening balance		
(b) Additions during the year		
(c) Reductions during the year		
(d) Closing balance		
(iii) Movement of Net NPAs		
(a) Opening balance		
(b) Additions during the year		
(c) Reductions during the year		
(d) Closing balance		
(iv) Movement of provisions for NPAs (excluding provisions on standard assets)		
(a) Opening balance		
(b) Provisions made during the year		

(c) Write-off/ write-back of excess provisions		
(d) Closing balance		

3.4.2 Details of Loan Assets subjected to Restructuring

(Rs. in crore)

<i>Particulars</i>	<i>Current year</i>	<i>Previous Year</i>
(i) Total amount of loan assets subjected to restructuring, rescheduling, renegotiation; - of which under CDR		
(ii) The amount of Standard assets subjected to restructuring, rescheduling, renegotiation; - of which under CDR		
(iii) The amount of Sub-Standard assets subjected to restructuring, rescheduling, renegotiation; - of which under CDR		
(iv) The amount of Doubtful assets subjected to restructuring, rescheduling, renegotiation; - of which under CDR		
Note: [(i) = (ii)+(iii)+(iv)]		

3.4.3 Details of financial assets sold to Securitisation/Reconstruction Company for Asset Reconstruction

<i>Particulars</i>	<i>Current year</i>	<i>Previous Year</i>
(i) No. of accounts		
(ii) Aggregate value (net of provisions) of accounts sold to SC/RC		
(iii) Aggregate consideration		
(iv) Additional consideration realized in respect of accounts transferred in earlier years		
(v) Aggregate gain/loss over net book value.		

3.4.4 Details of non-performing financial assets purchased/sold

Banks which purchase non-performing financial assets from other banks shall be required to make the following disclosures in the Notes on Accounts to their Balance sheets:

A. Details of non-performing financial assets purchased:

<i>Particulars</i>	(Rs. in crore)	
	<i>Current year</i>	<i>Previous Year</i>
1. (a) No. of accounts purchased during the year		
(b) Aggregate outstanding		
2. (a) Of these, number of accounts restructured during the year		
(b) Aggregate outstanding		

B. Details of non-performing financial assets sold:

<i>Particulars</i>	(Rs. in crore)	
	<i>Current year</i>	<i>Previous Year</i>
1. No. of accounts sold		
2. Aggregate outstanding		
3. Aggregate consideration received		

3.4.5 Provisions on Standard Asset

<i>Particulars</i>	<i>Current year</i>	<i>Previous Year</i>
Provisions towards Standard Assets		

Note: Provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets', under 'Other Liabilities and Provisions - Others' in Schedule No. 5 of the balance sheet.

3.5. Business Ratio

<i>Particulars</i>	<i>Current year</i>	<i>Previous Year</i>
(i) Interest Income as a percentage to Working Funds \$		
(ii) Non-interest income as a percentage to Working Funds		
(iii) Operating Profit as a percentage to Working Funds \$		
(iv) Return on Assets@		
(v) Business (Deposits plus advances) per employee #		
(vi) Profit per employee		

\$ Working funds to be reckoned as average of total assets (excluding accumulated losses, if any) as reported to Reserve Bank of India in Form X under Section 27 of the Banking Regulation Act, 1949, during the 12 months of the financial year.

@ 'Return on Assets would be with reference to average working funds (i.e. total of assets excluding accumulated losses, if any).

For the purpose of computation of business per employee (deposits plus advances) inter bank deposits may be excluded.

3.6 Asset Liability Management

Maturity pattern of certain items of assets and liabilities

(Rs. in crore)

	1 to 14 days	15 to 28 days	29 days to 3 month s	Over 3 month s & up to 6 month s	Over 6 month s & up to 1 year	Over 1 year & up to 3 years	Over 3 years & up to 5 years	Over 5 years	Total
Deposits									
Advances									
Investments									
Borrowings									
Foreign Currency assets									
Foreign Currency liabilities									

3.7 Exposures

3.7.1 Exposure to Real Estate Sector

Category	Current year	Previous Year
a) <i>Direct exposure</i> (i) Residential Mortgages – Lending fully secured by mortgages on residential property that is or will be occupied by the borrower or that is rented; (Individual housing loans eligible for inclusion in priority sector advances may be shown separately) (ii) Commercial Real Estate – Lending secured by mortgages on commercial real estates (office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction, etc.).		

Exposure would also include non-fund based (NFB) limits; (iii) Investments in Mortgage Backed Securities (MBS) and other securitised exposures – a. Residential, b. Commercial Real Estate. <i>b) Indirect Exposure</i> Fund based and non-fund based exposures on National Housing Bank (NHB) and Housing Finance Companies (HFCs).		

3.7.2 Exposure to Capital Market

<i>Particulars</i>	<i>Current year</i>	<i>Previous Year</i>

(i) direct investment in equity shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds the corpus of which is not exclusively invested in corporate debt; (ii) advances against shares/bonds/ debentures or other securities or on clean basis to individuals for investment in shares (including IPOs/ESOPs), convertible bonds, convertible debentures, and units of equity-oriented mutual funds; (iii) advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are taken as primary security; (iv) advances for any other purposes to the extent secured by the collateral security of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds i.e. where the primary security other than shares/convertible bonds/convertible debentures/units of equity oriented mutual funds `does not fully cover the advances; (v) secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers; (vi) loans sanctioned to corporates against the security of shares / bonds/debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources; (vii) bridge loans to companies against expected equity flows/issues; (viii) underwriting commitments taken up by the banks in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds; (ix) financing to stockbrokers for margin trading; (x) all exposures to Venture Capital Funds (both registered and unregistered) will be deemed to be on par with equity and hence will be reckoned for compliance with the capital market exposure ceilings (both direct and indirect) Total Exposure to Capital Market		

3.7.3 Risk Category wise Country Exposure

<i>Risk Category*</i>	<i>Exposure (net) as at March... (Current Year)</i>	<i>Provision held as at March... (Current Year)</i>	<i>Exposure (net) as at March... (Previous Year)</i>	<i>Provision held as at March... (Previous Year)</i>
Insignificant				
Low				
Moderate				
High				
Very High				
Restricted				
Off-credit				
Total				

Till such time, as banks move over to internal rating systems, banks may use the seven category classification followed by Export Credit Guarantee Corporation of India Ltd. (ECGC) for the purpose of classification and making provisions for country risk exposures. ECGC shall provide to banks, on request, quarterly updates of their country classifications and shall also inform all banks in case of any sudden major changes in country classification in the interim period.

3.7.4 Details of Single Borrower Limit (SGL), Group Borrower Limit (GBL) exceeded by the bank.

The bank should make appropriate disclosure in the 'Notes on account' to the annual financial statements in respect of the exposures where the bank had exceeded the prudential exposure limits during the year. The sanctioned limit or entire outstanding, whichever is high, shall be reckoned for arriving at exposure limit and for disclosure purpose.

3.8 Miscellaneous

3.8.1 Amount of Provisions made for Income-tax during the year;

<i>Particulars</i>	<i>Current year</i>	<i>Previous year</i>
Provision for Income Tax		

3.8.2 Disclosure of Penalties imposed by RBI

At present, Reserve Bank is empowered to impose penalties on a commercial bank under the provision of Section 46 (4) of the Banking Regulation Act, 1949, for contraventions of any of the provisions of the Act or non-compliance with any other requirements of the Banking Regulation Act, 1949; order, rule or condition specified by

Reserve Bank under the Act. Consistent with the international best practices in disclosure of penalties imposed by the regulator, it has been decided that the details of the levy of penalty on a bank in public domain will be in the interests of the investors and depositors. It has also been decided that strictures or directions on the basis of inspection reports or other adverse findings should be placed in the public domain. The penalty should also be disclosed in the "Notes on Accounts" to the Balance Sheet.

4. Disclosure Requirements as per Accounting Standards where RBI has issued guidelines in respect of disclosure items for 'Notes to Accounts':

4.1 Accounting Standard 5 – Net Profit or Loss for the period, prior period items and changes in accounting policies.

Since the format of the profit and loss account of banks prescribed in Form B under Third Schedule to the Banking Regulation Act 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be made in the Notes on Accounts to the balance sheet of banks.

4.2 Accounting Standard 9 – Revenue Recognition

This Standard requires that in addition to the disclosures required by Accounting Standard 1 on 'Disclosure of Accounting Policies' (AS 1), an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

4.3 Accounting Standard 15 – Employee Benefits

Banks may disclose the change in accounting policy in the appropriate schedule relating to 'Significant changes in Accounting Policies' / 'Principal Accounting Policies'. The Board of Directors of a bank must disclose the accounting policies followed in respect of VRS expenditure. If VRS applications were accepted subsequent to the closure of the accounting year, the Board of Directors would be required to make a disclosure in the Board Report of that fact and of the likely impact of the VRS.

4.4 Accounting Standard 17 – Segment Reporting

While complying with the Accounting Standard, banks are required to adopt the following:

- a) The business segment should ordinarily be considered as the primary reporting format and geographical segment would be the secondary reporting format.

- b) The business segments will be 'Treasury', 'Corporate/Wholesale Banking', 'Retail Banking' and 'Other banking operations'.
- c) 'Domestic' and 'International' segments will be the geographic segments for disclosure.
- d) Banks may adopt their own methods, on a reasonable and consistent basis, for allocation of expenditure among the segments.

Accounting Standard 17 - Format for disclosure under segment reporting

Part A: Business segments

(Rs. in crore)

<i>Business Segments</i> →	<i>Treasury</i>		<i>Corporate/ Wholesale Banking</i>		<i>Retail Banking</i>		<i>Other Banking Operations</i>		<i>Total</i>	
<i>Particulars</i> ↓	<i>Current Year</i>	<i>Previous Year</i>	<i>Current Year</i>	<i>Previous Year</i>	<i>Current Year</i>	<i>Previous Year</i>	<i>Current Year</i>	<i>Previous Year</i>	<i>Current Year</i>	<i>Previous Year</i>
Revenue										
Result										
Unallocated expenses										
Operating profit										
Income taxes										
Extraordinary profit/ loss										
Net profit										
Other Information:										
Segment assets										
Unallocated assets										
Total assets										
Segment liabilities										
Unallocated liabilities										
Total liabilities										

Note: No disclosure need be made in the shaded portion

Part B: Geographic segments

(Rs. in crore)

	<i>Domestic</i>		<i>International</i>		<i>Total</i>	
	<i>Current Year</i>	<i>Previous Year</i>	<i>Current Year</i>	<i>Previous Year</i>	<i>Current Year</i>	<i>Previous Year</i>
Revenue						
Assets						

4.5 Accounting Standard 18 – Related Party Disclosures

This Standard is applied in reporting related party relationships and transactions between a reporting enterprise and its related parties. The illustrative disclosure format recommended by the ICAI as a part of General Clarification (GC) 2/2002 has been suitably modified to suit banks. The illustrative format of disclosure by banks for the AS 18 is furnished below.

Accounting Standard 18 - Format for Related Party Disclosures

The manner of disclosures required by paragraphs 23 and 26 of AS 18 is illustrated below. It may be noted that the format is merely illustrative and is not exhaustive.

(Rs. in crore)

<i>Items/Related Party</i>	<i>Parent (as per ownership or control)</i>	<i>Subsidiaries</i>	<i>Associate s/ Joint ventures</i>	<i>Key Management Personnel @</i>	<i>Relatives of Key Management Personnel</i>	<i>Total</i>
Borrowings #						
Deposit#						
Placement of deposits #						
Advances #						
Investments#						
Non-funded commitments#						
Leasing/HP arrangements availed #						
Leasing/HP arrangements provided #						
Purchase of fixed assets						
Sale of fixed assets						
Interest paid						
Interest received						
Rendering of services *						
Receiving of services *						
Management contracts						

Note: Where there is only one entity in any category of related party, banks need not disclose any details pertaining to that related party other than the relationship with that related party [c.f. Para 8.3.1 of the Guidelines]

- * Contract services etc. and not services like remittance facilities, locker facilities etc.
 @ Whole time directors of the Board and CEOs of the branches of foreign banks in India.
 # The outstanding at the year-end and the maximum during the year are to be disclosed.

Illustrative disclosure of names of the related parties and their relationship with the bank

1. Parent	A Ltd
2. Subsidiaries	B Ltd and C Ltd
4. Associates	P Ltd, Q Ltd and R Ltd
5. Jointly controlled entity	L Ltd
6. Key Management Personnel	Mr.M and Mr.N
7. Relatives of Key Management Personnel	Mr.D and Mr.E

4.6 Accounting Standard 21 – Consolidated Financial Statements (CFS)

As regards disclosures in the 'Notes on Accounts' to the Consolidated Financial Statements, banks may be guided by general clarifications issued by Institute of Chartered Accountants of India from time to time.

A parent company, presenting the CFS, should consolidate the financial statements of all subsidiaries - domestic as well as foreign, except those specifically permitted to be excluded under the AS-21. The reasons for not consolidating a subsidiary should be disclosed in the CFS. The responsibility of determining whether a particular entity should be included or not for consolidation would be that of the Management of the parent entity. In case, its Statutory Auditors are of the opinion that an entity, which ought to have been consolidated, has been omitted, they should incorporate their comments in this regard in the "Auditors Report".

4.7 Accounting Standard 22 – Accounting for Taxes on Income

This Standard is applied in accounting for taxes on income. This includes the determination of the amount of the expense or saving related to taxes on income in respect of an accounting period and the disclosure of such an amount in the financial statements. Adoption of AS 22 may give rise to creation of either a deferred tax asset (DTA) or a deferred tax liability (DTL) in the books of accounts of banks and creation of DTA or DTL would give rise to certain issues which have a bearing on the computation of capital adequacy ratio and banks' ability to declare dividends. In this regard it is clarified as under:

- DTL created by debit to opening balance of Revenue Reserves on the first day of application of the Accounting Standards 22 or to Profit and Loss account for the current year should be included under item (vi) 'others (including provisions)' of

Schedule 5 - 'Other Liabilities and Provisions' in the balance sheet. The balance in DTL account will not be eligible for inclusion in Tier I or Tier II capital for capital adequacy purpose as it is not an eligible item of capital.

- DTA created by credit to opening balance of Revenue Reserves on the first day of application of Accounting Standards 22 or to Profit and Loss account for the current year should be included under item (vi) 'others' of Schedule 11 'Other Assets' in the balance sheet.
- Creation of DTA results in an increase in Tier I capital of a bank without any tangible asset being added to the banks' balance sheet. Therefore, in terms of the extant instructions on capital adequacy, DTA, which is an intangible asset, should be deducted from Tier I Capital.

4.8 Accounting Standard 23 – Accounting for Investments in Associates in Consolidated Financial Statements

This Accounting Standard sets out principles and procedures for recognising, in the consolidated financial statements, the effects of the investments in associates on the financial position and operating results of a group. A bank may acquire more than 20% of voting power in the borrower entity in satisfaction of its advances and it may be able to demonstrate that it does not have the power to exercise significant influence since the rights exercised by it are protective in nature and not participative. In such a circumstance, such investment may not be treated as investment in associate under this Accounting Standard. Hence the test should not be merely the proportion of investment but the intention to acquire the power to exercise significant influence.

4.9 Accounting Standard 24 – Discontinuing Operations

Merger/ closure of branches of banks by transferring the assets/ liabilities to the other branches of the same bank may not be deemed as a discontinuing operation and hence this Accounting Standard will not be applicable to merger / closure of branches of banks by transferring the assets/ liabilities to the other branches of the same bank.

Disclosures would be required under the Standard only when:

- a) discontinuing of the operation has resulted in shedding of liability and realisation of the assets by the bank or
decision to discontinue an operation which will have the above effect has been finalised by the bank and
- b) the discontinued operation is substantial in its entirety.

4.10 Accounting Standard 25 – Interim Financial Reporting

The half yearly review prescribed by RBI for public sector banks, in consultation with SEBI, vide circular DBS. ARS. No. BC 13/ 08.91.001/ 2000-01 dated 17th May 2001 is extended to all banks (both listed and unlisted) with a view to ensure uniformity in disclosures. Banks may adopt the format prescribed by the RBI for the purpose.

4.11 Other Accounting Standards

Banks are required to comply with the disclosure norms stipulated under the various Accounting Standards issued by the Institute of Chartered Accountants of India.

4.12 Additional Disclosures

4.12.1 Provisions and Contingencies

To facilitate easy reading of the financial statements and to make the information on all Provisions and Contingencies available at one place, banks are required to disclose in the 'Notes to Accounts' the following information:

<i>Break up of 'Provisions and Contingencies' shown under the head Expenditure in Profit and Loss Account</i>	<i>Current Year</i>	<i>Previous Year</i>
Provisions for depreciation on Investment		
Provision towards NPA		
Provision towards Standard Asset		
Provision made towards Income tax		
Other Provision and Contingencies (with details)		

4.12.2 Floating Provisions

Banks should make comprehensive disclosures on floating provisions in the "notes to accounts" to the balance sheet as follows:

<i>Particulars</i>	<i>Current year</i>	<i>Previous year</i>
(a) Opening balance in the floating provisions account		
(b) The quantum of floating provisions made in the accounting year		
(c) Amount of draw down made during the accounting year		
(d) Closing balance in the floating provisions account		

Note: The purpose of draw down made during the accounting year may be mentioned

4.12.3 Draw Down from Reserves

Suitable disclosures are to be made regarding any draw down of reserves in the 'Notes to Accounts' to the Balance Sheet.

4.12.4 Disclosure of complaints

Banks are also advised to disclose the following brief details along with their financial results:

A. Customer Complaints

(a)	No. of complaints pending at the beginning of the year	
(b)	No. of complaints received during the year	
(c)	No. of complaints redressed during the year	
(d)	No. of complaints pending at the end of the year	

B. Awards passed by the Banking Ombudsman

(a)	No. of unimplemented Awards at the beginning of the year	
(b)	No. of Awards passed by the Banking Ombudsmen during the year	
(c)	No. of Awards implemented during the year	
(d)	No. of unimplemented Awards at the end of the year	

4.12.5 Disclosure of Letter of Comforts (LOCs) issued by banks

The banks should disclose full particulars of all the Letter of Comforts (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'.

Annex 1

S.No	List of Disclosure Items
1	Capital Adequacy Ratio
2	Capital Adequacy Ratio - Tier I capital
3	Capital Adequacy Ratio - Tier II capital
4	Percentage of Shareholding of the Government of India in the nationalised banks.
5	Amount of Subordinated debt raised as Tier-II capital
6	Gross value of investments, etc
7	Provisions made towards depreciation in the value of Investments
8	Movement of provisions held towards depreciation on investments
9	Repo Transactions
10	Non-SLR Investment Portfolio
11	Forward Rate Agreement/ Interest Rate Swap
12	Exchange Traded Interest Rate Derivatives
13	Disclosures on risk exposure in derivatives
14	Percentage of Net NPAs to Net advances.
15	Movements in NPAs
16	Amount of provisions made towards NPAs
17	Movement of provisions held towards NPAs
18	Details of Loan assets subjected to Restructuring
19	Restructuring under CDR
20	Details financial assets sold to an SC/RC for Asset Reconstruction
21	Details of non-performing asset purchased/sold
22	Provision on Standard Asset
23	Interest Income as a percentage to Working Funds
24	Non-interest Income as a percentage to Working Funds
25	Operating Profit as a percentage to Working Funds
26	Return on Assets
27	Business (deposits plus advances) per employee
28	Profit per employee
29	Maturity pattern of Loans and Advances
30	Maturity pattern of Investment Securities
31	Maturity Pattern of Deposits
32	Maturity Pattern of Borrowings

33	Foreign Currency Assets and Liabilities
34	Exposure to Real Estate Sector
35	Exposure to Capital Market - Investment in Equity Shares, etc
36	Bank Financing for Margin Trading
37	Exposure to Country Risk
38	Details of Single Borrower/Group Borrower Limit exceeded by the bank
39	Provisions made towards Income Tax during the year
40	Disclosure of Penalties imposed by RBI
41	Consolidated Financial Statements – AS 21
42	Segment Reporting – AS 17
43	Related Party Disclosure – AS 18
44	Other disclosures as required under the relevant Accounting Standards
45	Disclosure of 'Provisions and Contingencies'
46	Disclosure on Floating Provision
47.	Disclosure on Draw Down of Reserves
48	Disclosure of Complaints
49.	Disclosure of Letter of Comforts (LOCs) issued by banks

Annex 2
List of Circulars consolidated by the Master Circular

No	Circular No.	Date	Relevant Para No of the circular	Subject	Para No of the Master Circular
1	DBOD.No.BP.BC.91/C.686-91	Feb 28, 1991	All	Accounting Policies - Need for Disclosure in the Financial Statements of Banks	2
2	DBOD.No.BP.BC.78/C.686-91	Feb 06, 1991	3,4	Revised Format of the Balance Sheet and Profit & Loss Account	2
3	DBOD.No.BP.BC.59/21.04.048/97	May 21, 1997	1,2,3	Balance Sheets of Banks – Disclosures	3.1(i)(iv)(v); 3.2.(1):3.4.1(i) 3.8.1
4	DBOD.No.BP.BC.9/21.04.018/98	Jan 27, 1998	2	Balance Sheet of Banks – Disclosures	3.1(ii)(iii) 3.5(i) to (vi)
5	DBOD.No.BP.BC.32 /21.04.018/98	Apr 29, 1998	(ii)(a)(b)	Capital Adequacy-Disclosures in Balance Sheets	3.5(i) to (vi)
6	DBOD.No.BP.BC.9/21.04.018/99	Feb 10, 1999	3,4	Balance Sheet of Banks - Disclosure of Information	3.4.1(ii)(iii); 3.6
7	MPD.BC.187 /07.01. 279 /1999-2000	July 7, 1999	1,Annex 3 (v)	Forward Rate Agreements / Interest Rate Swaps	3.3.1
8	DBOD.No.BP.BC.164/21.04.048/ 2000	Apr 24, 2000	3	Prudential Norms on Capital Adequacy, Income Recognition, Asset Classification and Provisioning etc.	3.4.5
9	DBOD.No.BP.BC.73 /21.04.018/ 2000-01	Jan 30, 2001	2.6	Voluntary Retirement Scheme (VRS) Expenditure - Accounting and Prudential Regulatory Treatment	4.3
10	DBOD.No.BP.BC.98 /21.04.048/ 2000-01	Mar 30, 2001	7	Treatment of Restructured Accounts	3.4.2
11	DBOD.No.Dir.BC.47/13.07.05/2006-2007	Dec 15, 2006	2.1	Banks' exposure to Capital Markets – Rationalization of Norms	3.7.2
12	DBOD.BP.BC.27 /21.04.137/2001	Sep 22, 2001	6	Bank Financing for Margin Trading	3.7.2 (vi)
13	DBOD.BP.BC.38 /21.04.018/2001-2002	Oct 27, 2001	2(i)(ii)	Monetary and Credit Policy Measures - Mid-Term Review for the year 2001-2002 - Balance Sheet Disclosures	3.2(2); 3.4.1(iv)
14	DBOD.No.IBS.BC.65/23.10.015/ 2001-02	Feb 14, 2002	1,10	Subordinated Debt for Inclusion in Tier II Capital - Head Office Borrowings in Foreign Currency by Foreign Banks Operating in India	3.1 explanation
15	DBOD.No.BP.BC.84 /21.04.018/ 2001-02	Mar 27, 2002	2	Balance Sheet of Banks – Disclosure of Information	3.2(2)
16	DBOD.No.BP.BC.68 /21.04.132/ 2002-03	Feb 05, 2003	1, Annex 6	Corporate Debt Restructuring (CDR)	3.4.2

17	DBOD.BP.BC.71 /21.04.103/ 2002-03	Feb 19, 2003	Annex 24 (a) (b)	Guidelines on Country Risk Management by banks in India	3.7.3
18	DBOD.No.BP.BC.72 /21.04.018/ 2001-02	Feb 25, 2003	16	Guidelines for Consolidated Accounting and Other Quantitative Methods to Facilitate Consolidated Supervision	4.6
19	IDMC.3810/11.08.10 /2002-03	Mar 24, 2003	1,5(v)	Guidelines for Uniform Accounting for Repo/ Reverse Repo Transactions	3.2.1
20	DBOD.No.BP.BC.89 /21.04.018/ 2002-03	Mar 29, 2003	4.3.2, 5.1, 6.3.1, 7.3.2, 8.3.1	Guidelines on Compliance with Accounting Standards (AS) by Banks	4.1 to 4.5
21	DBOD.No.BP.BC.96 /21.04.048/ 2002-03	Apr 23, 2003	1, Annex 6	Guidelines on Sale of Financial Assets to SC/RC (Created under the SARFAESI Act, 2002) and Related Issues	3.4.3
22	IDMC.MSRD.4801 /06.01.03/ 2002-03	June 3, 2003	4(x)	Guidelines on Exchange Traded Interest Rate Derivatives	3.3.2
23	DBOD.BP.BC.44 /21.04.141/ 2003-04	Nov 12, 2003	Appendix 11 (4)	Prudential Guidelines on Banks' Investment in Non-SLR Securities	3.2.2
24	DBOD.No.BP.BC.82 /21.04.018/ 2003-04	Apr 30, 2004	4.3.2	Guidelines on compliance with Accounting Standards (AS) by banks	4.9
25	DBOD.No.BP.BC.100 /21.03.054 /2003-04	Jun 21, 2004	2(v)	Annual Policy Statement for the year 2004-05 - Prudential Credit Exposure Limits by Banks	3.7.4
26	DBOD.BP.BC.49 /21.04.018/ 2004 - 2005	Oct 19, 2004	5	Enhancement of Transparency on Bank's Affairs through Disclosure	3.8.2
27	DBOD.No.BP.BC.72 /21.04.018/ 2004-05	Mar 3, 2005	Annex	Disclosures on risk exposure in derivatives	3.3.3
28	DBS.CO.PP.BC.21/11.01.005/ 2004-05	Jun 29, 2005	2. (a) (b)	Exposure to Real Estate Sector	3.7.1
29	DBOD.NO.BP. BC.16/21.04.048/ 2005-06	July 13 2005	7	Guidelines on purchase/sale of Non Performing Assets	3.4.4
30	DBOD.BP.BC.No. 86/21.04.018/2005-06	May 29, 2006	3	Disclosure in Balance Sheets – Provisions and Contingencies	4.12.1
31	DBOD.NO.BP. BC.89/21.04.048/ 2005-06	June 22, 2006	2.(iv)	Prudential norms on creation and utilisation of floating provisions	4.12.2
32	DBOD.BP.BC No.31/21.04.018/ 2006-07	September 20, 2006	3.(iii)	Section 17 (2) of Banking Regulation Act, 1949 – Appropriation from Reserve Fund	4.12.3
33	DBOD.No.Leg BC.60/09.07.005/ 2006-07	February 22, 2007	3.	Analysis and Disclosure of complaints - Disclosure of complaints / unimplemented	4.12.4

				awards of Banking Ombudsmen alongwith Financial Results	
34	DBOD.No. BP.BC. 81 / 21.04.018/ 2006- 07	April18, 2007	4	Guidelines - Accounting Standard 17(Segment Reporting) – Enhancement of disclosures	4.4
35	DBOD No. BP. BC.65 / 21.04.009/ 2007- 08	March 4, 2008	2.(iv)	Prudential Norms for Issuance of Letters of Comfort by Banks regarding their Subsidiaries	4.12.5
36	DBOD.No.BP.BC. 90/20.06.001/ 2006-07	April 27, 2007	10	"Implementation of the New Capital Adequacy Framework"	

RBI/2008- 09/80
DBOD No. Dir. BC. 19/13.03.00/ 2008- 09

July 1, 2008
Ashadha 10, 1930(Saka)

All Scheduled Commercial Banks
(excluding RRBs)

Dear Sir

Master Circular – Exposure Norms

Please refer to the Master Circular DBOD No. Dir. BC. 11/13.03.00/2006-07 dated July 2, 2007 consolidating the instructions / guidelines issued to banks till that date relating to Exposure Norms. The Master Circular has been suitably updated by incorporating the instructions issued up to June 30, 2008 and has also been placed on the RBI website (<http://www.rbi.org.in>). A copy of the Master Circular is enclosed.

Yours faithfully

(P. Vijaya Bhaskar)
Chief General Manager

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MASTER CIRCULAR ON EXPOSURE NORMS

A. Purpose

This Master Circular provides a framework of the rules/regulations/instructions issued by the Reserve Bank of India to Scheduled Commercial Banks relating to credit exposure limits for individual / group borrowers and credit exposure to specific industry or sectors, and the capital market exposure of banks.

B. Classification

A statutory guideline issued by the Reserve Bank in exercise of the powers conferred by the Banking Regulation Act, 1949.

C. Previous instructions

This Master Circular consolidates and updates the instructions on the above subject contained in the circulars listed in **Annex 4**.

D. Application

To all scheduled commercial banks, excluding Regional Rural Banks.

Structure

1. INTRODUCTION

2. GUIDELINES

- 2.1 Credit Exposures to Individual / Group Borrowers
- 2.2 Credit Exposure to Industry or Certain Sectors
- 2.3 Banks' Exposure to Capital Market – Rationalisation of Norms
- 2.4 Financing of equities and investments in shares
- 2.5 Risk Management and Internal Control System
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3 ANNEX

- Annex 1 Definition of infrastructure lending and list of items included under infrastructure sector
- Annex 2 List of All-India Financial Institutions guaranteeing bonds of corporate
- Annex 3 List of All-India Financial Institutions whose instruments are exempted from Capital Market Exposure ceiling
- Annex 4 List of circulars consolidated

1. INTRODUCTION

As a prudential measure aimed at better risk management and avoidance of concentration of credit risks, the Reserve Bank of India has advised the banks to fix limits on their exposure to specific industry or sectors and has prescribed regulatory limits on banks' exposure to individual and group borrowers in India. In addition, banks are also required to observe certain statutory and regulatory exposure limits in respect of advances against / investments in shares, convertible debentures /bonds, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs). Banks should comply with the following guidelines relating to exposure norms.

2. GUIDELINES

2.1 Credit Exposures to Individual/Group Borrowers

2.1.1 Ceilings

- 2.1.1.1 The exposure ceiling limits would be 15 percent of capital funds in case of a single borrower and 40 percent of capital funds in the case of a borrower group. The capital funds for the purpose will comprise of Tier I and Tier II capital as defined under capital adequacy standards (please also refer to paragraph 2.1.3.5 of this Master Circular).

2.1.1.2 Credit exposure to a single borrower may exceed the exposure norm of 15 percent of the bank's capital funds by an additional 5 percent (i.e. up to 20 percent) provided the additional credit exposure is on account of extension of credit to infrastructure projects. Credit exposure to borrowers belonging to a group may exceed the exposure norm of 40 percent of the bank's capital funds by an additional 10 percent (i.e., up to 50 percent), provided the additional credit exposure is on account of extension of credit to infrastructure projects. The definition of infrastructure lending and the list of items included under infrastructure sector are furnished in **Annex 1**.

2.1.1.3 In addition to the exposure permitted under paragraphs 2.1.1.1 and 2.1.1.2 above, banks may, in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to a borrower (single as well as group) up to a further 5 percent of capital funds subject to the borrower consenting to the borrower consenting to the banks making appropriate disclosures in their Annual Reports.

2.1.1.4 With effect from May 29, 2008, the exposure limit in respect of single borrower has been raised to twenty five percent of the capital funds, only in respect of Oil Companies who have been issued Oil Bonds (which do not have SLR status) by Government of India. In addition to this, banks may in exceptional circumstances, as hitherto, in terms of paragraph 2.1.1.3 of the Master Circular, consider enhancement of the exposure to the Oil Companies up to a further 5 percent of capital funds.

2.1.1.5 The bank should make appropriate disclosures in the 'Notes on account' to the annual financial statements in respect of the exposures where the bank had exceeded the prudential exposure limits during the year.

2.1.1.6 Exposures to NBFCs

The exposure (both lending and investment, including off balance sheet exposures) of a bank to a single NBFC / NBFC-AFC (Asset Financing Companies) should not exceed 10% / 15% respectively, of the bank's capital funds as per its last audited balance sheet. Banks may, however, assume exposures on a single NBFC / NBFC-AFC up to 15%/20% respectively, of their capital funds provided the exposure in excess of 10%/15% respectively, is on account of funds on-lent by the NBFC / NBFC-AFC to the infrastructure sector. Further, banks may also consider fixing internal limits for their aggregate exposure to all NBFCs put together. Infusion of capital funds after the published balance sheet date may also be taken into account for the purpose of reckoning capital funds. Banks should obtain an external auditor's certificate on completion of the augmentation of capital and submit the same to the Reserve Bank of India (Department of Banking Supervision) before reckoning the additions to capital funds.

2.1.1.7 Lending under Consortium Arrangements

The exposure limits will also be applicable to lending under consortium arrangements.

2.1.1.8 Bills discounted under Letter of Credit (LC)

Bills purchased / discounted / negotiated under LC (where the payment to the beneficiary is not made 'under reserve') will be treated as an exposure on the LC issuing bank and not on the borrower. In the case of negotiations 'under reserve' the exposure should be treated as on the borrower.

2.1.2 Exemptions

2.1.2.1 Rehabilitation of Sick/Weak Industrial Units

The ceilings on single/group exposure limits are not applicable to existing/additional credit facilities (including funding of interest and irregularities) granted to weak/sick industrial units under rehabilitation packages.

2.1.2.2 Food credit

Borrowers, to whom limits are allocated directly by the Reserve Bank for food credit, will be exempt from the ceiling.

2.1.2.3 Guarantee by the Government of India

The ceilings on single /group exposure limit would not be applicable where principal and interest are fully guaranteed by the Government of India.

2.1.2.4 Loans against Own Term Deposits

Loans and advances (both funded and non-funded facilities) granted against the security of a bank's own term deposits may not be reckoned for computing the exposure to the extent that the bank has a specific lien on such deposits.

2.1.3 Definitions

2.1.3.1 Exposure

Exposure shall include credit exposure (funded and non-funded credit limits) and investment exposure (including underwriting and similar commitments). The sanctioned limits or outstandings, whichever are higher, shall be reckoned for arriving at the exposure limit. However, in the case of fully drawn term loans, where there is no scope for re-drawal of any portion of the sanctioned limit, banks may reckon the outstanding as the exposure.

2.1.3.2 Measurement of Credit Exposure of Derivative Products

a) Derivative products such as Forward Rate Agreements and Interest Rate Swaps are also captured for computing exposure by applying the conversion factors to notional principal amounts. Banks should also include forward contracts in foreign exchange and other derivative products like Currency Swaps, options etc. at their replacement cost value in determining individual / group borrower exposure. The methodology to be adopted by banks for arriving at the replacement cost value is given below.

b) Banks may adopt, either of the two methods viz. (i) Original Exposure Method, and (ii) Current Exposure Method, consistently, for all derivative products such as Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRSs), forward contracts in foreign exchange and other derivative products like currency swaps, options, etc., in determining individual / group borrower exposure.

c) Under the Original Exposure Method, credit exposure is calculated at the beginning of the derivative transaction by multiplying the notional principal amount with a conversion factor. In order to arrive at the credit equivalent amount using the Original Exposure Method, a bank would apply the following credit conversion factors to the notional principal amounts of each instrument according to the nature of the instrument and its original maturity:

Original Maturity	Conversion factor to be applied on Notional Principal Amount	
	Interest Rate Contract	Exchange Rate Contract
Less than one year	0.5%	2.0%
One year and less than two years	1.0%	5.0%(2% +3%)
For each additional year	1.0%	3.0%

d) The other method (Current Exposure Method) to assess the exposure on account of credit risk on interest rate and exchange rate derivative contracts is to calculate periodically the current replacement cost by marking these contracts to market, thus capturing the current exposure without any need for estimation and then adding a factor (“add-on”) to reflect the potential future exposure over the remaining life of the contract. Therefore, in order to calculate the credit exposure equivalent of off-balance sheet interest rate and exchange rate instruments under Current Exposure Method, a bank would sum:

- (i) the total of replacement cost (obtained by “marking to market”) of all its contracts with positive value (i.e. when the bank has to receive money from the counter party), and
- (ii) an amount for potential future changes in credit exposure calculated on the basis of the total notional principal amount of the contract multiplied by the following credit conversion factors according to the residual maturity:

Residual Maturity	Conversion factor to be applied on Notional Principal amount	
	Interest Rate Contract	Exchange Rate Contract
Less than one year	Nil	1.0%
One year and over	0.5%	5.0%

Banks which have implemented the new capital adequacy framework (Basel II) with effect from March 31, 2008 may be guided by the instructions contained in paragraph 5.15.4 of the Annex to the circular DBOD. No. BP. BC. 90/ 20.06.001/ 2006-07 dated April 27, 2007 on 'Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of the New Capital Adequacy Framework'.

e) Banks should mark to market the derivative products at least on a monthly basis and they may follow their internal methods of determining the marked to market value of the derivative products.

f) Banks would not be required to calculate potential credit exposure for single currency floating / floating interest rate swaps. The credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

g) Banks are encouraged to follow the Current Exposure Method, which is an accurate method of measuring credit exposure in a derivative product. In case a bank is not in a position to adopt the Current Exposure method, it may follow the Original Exposure Method. However, its endeavour should be to move over to the Current Exposure Method in course of time.

2.1.3.3. Credit Exposure

Credit exposure comprises of the following elements:

- (a) all types of funded and non-funded credit limits.
- (b) facilities extended by way of equipment leasing, hire purchase finance and factoring services.

2.1.3.4 Investment Exposure

- a) Investment exposure comprises of the following elements:
 - (i) investments in shares and debentures of companies.
 - (ii) investment in PSU bonds
 - (iii) investments in Commercial Papers (CPs).
- b) Banks' / FIs' investments in debentures/ bonds / security receipts / pass-through certificates (PTCs) issued by a SC / RC as compensation consequent upon sale of financial assets will constitute exposure on the SC / RC. In view of the extraordinary nature of the event, banks / FIs will be allowed, in the initial years, to exceed the prudential exposure ceiling on a case-to-case basis.
- c) The investment made by the banks in bonds and debentures of corporates which are guaranteed by a PFI¹ (as per list given in **Annex 2**) will be treated as an exposure by the bank on the PFI and not on the corporate.
- d) Guarantees issued by the PFI to the bonds of corporates will be treated as an exposure by the PFI to the corporates to the extent of 50 percent, being a non-fund facility, whereas the exposure of the bank on the PFI guaranteeing the corporate bond will be 100 percent. The PFI before guaranteeing the bonds/debentures should, however, take into account the overall exposure of the guaranteed unit to the financial system.

¹ With the merger of ICICI Ltd. with ICICI Bank Ltd. effective from 30.03.2002, the entire liabilities of ICICI Ltd. have been taken over by ICICI Bank Ltd. As per the scheme of merger all loans and guarantee facilities to ICICI Ltd. provided by Government would be transferred to the merged entity. Similarly, the investments made in erstwhile ICICI Ltd. by banks would be treated outside the ceiling of 40% till redemption.

¹ With the merger of IDBI Bank Ltd. with IDBI Ltd., effective April 2, 2005, the entire liabilities of the erstwhile IDBI Bank Ltd. have been taken over by the new, combined entity Industrial Development Bank of India Ltd. Therefore, for the purpose of exposure norms, investments made by the banks in the bonds and debentures of corporates guaranteed by the erstwhile IDBI Ltd. would continue to be treated as an exposure of the banks on IDBI Ltd. and not on the corporates, till redemption. Similarly, investments made in the erstwhile IDBI Ltd. by banks would be treated as outside the capital market exposure ceiling of 40%, till redemption.

2.1.3.5 Capital Funds

Capital funds for the purpose will comprise of Tier I and Tier II capital as defined under capital adequacy standards and as per the published accounts as on March 31 of the previous year. The infusion of capital under Tier I and Tier II, either through domestic or overseas issue, after the published balance sheet date will also be taken into account for determining the exposure ceiling. Other accretion to capital funds by way of quarterly profits etc. would not be eligible to be reckoned for determining the exposure ceiling. Banks are also prohibited from taking exposure in excess of the ceiling in anticipation of infusion of capital at a future date.

2.1.3.6 Group

- a) The concept of 'Group' and the task of identification of the borrowers belonging to specific industrial groups is left to the perception of the banks/financial institutions. Banks/financial institutions are generally aware of the basic constitution of their clientele for the purpose of regulating their exposure to risk assets. The group to which a particular borrowing unit belongs, may, therefore, be decided by them on the basis of the relevant information available with them, the guiding principle being commonality of management and effective control. In so far as public sector undertakings are concerned, only single borrower exposure limit would be applicable.
- b) In the case of a split in the group, if the split is formalised the splinter groups will be regarded as separate groups. If banks and financial institutions have doubts about the bona fides of the split, a reference may be made to RBI for its final view in the matter to preclude the possibility of a split being engineered in order to prevent coverage under the Group Approach.

2.1.4 Review

An annual review of the implementation of exposure management measures may be placed before the Board of Directors before the end of June.

2.2. Credit Exposure to Industry and certain Sectors

2.2.1 Internal Exposure Limits

2.2.1.1 Fixing of Sectoral Limits

Apart from limiting the exposures to an individual or a Group of borrowers, as indicated above, banks may also consider fixing internal limits for aggregate commitments to specific sectors, e.g. textiles, jute, tea, etc., so that the exposures are evenly spread over various sectors. These limits could be fixed by the banks having regard to the performance of different sectors and the risks perceived. The limits so fixed may be reviewed periodically and revised, as necessary.

2.2.1.2 Exposure to Real Estate

- (i) Banks should frame comprehensive prudential norms relating to the ceiling on the total amount of real estate loans, single/group exposure limits for such loans, margins, security, repayment schedule and availability of supplementary finance and the policy should be approved by the banks' Boards.

(i) While appraising loan proposals involving real estate, banks should ensure that the borrowers have obtained prior permission from government / local governments / other statutory authorities for the project, wherever required. In order that the loan approval process is not hampered on account of this, while the proposals could be sanctioned in the normal course, the disbursements should be made only after the borrower has obtained requisite clearances from the government authorities. Banks' Boards may also consider incorporation of aspects relating to adherence to National Building Code (NBC) in their policies on exposure to real estate. The information regarding the NBC can be accessed from the website of Bureau of Indian Standards (www.bis.org.in).

(iii) The exposure of banks to entities for setting up Special Economic Zones (SEZs) or for acquisition of units in SEZs which includes real estate would be treated as exposure to commercial real estate sector for the purpose of risk weight and capital adequacy from a prudential perspective. Banks would, therefore, have to make provisions, as also assign appropriate risk weights for such exposures, as per the existing guidelines. The above exposure may be treated as exposure to Infrastructure sector only for the purpose of Exposure norms which provide some relaxations for the Infrastructure sector.

(iv) While framing the bank's policy, the guidelines issued by the Reserve Bank should be taken into account. Banks should ensure that the bank credit is used for productive construction activity and not for any activity connected with speculation in real estate.

2.2.2 Exposure to Leasing, Hire Purchase and Factoring Services

Banks have been permitted to undertake leasing, hire purchase and factoring activities departmentally. Where banks undertake these activities departmentally, they should maintain a balanced portfolio of equipment leasing, hire purchase and factoring services vis-à-vis the aggregate credit. Their exposure to each of these activities should not exceed 10 percent of total advances.

2.2.3 Exposure to Indian Joint Ventures/Wholly-owned Subsidiaries Abroad and Overseas Step-down Subsidiaries of Indian Corporates

2.2.3.1 Banks are allowed to extend credit/non-credit facilities (viz. letters of credit and guarantees) to Indian Joint Ventures/Wholly-owned Subsidiaries abroad and step-down subsidiaries which are wholly owned by the overseas subsidiaries of Indian Corporates. Banks are also permitted to provide at their discretion, buyer's credit/acceptance finance to overseas parties for facilitating export of goods & services from India.

2.2.3.2 The above exposure will, however, be subject to a limit of 20 percent of banks' unimpaired capital funds (Tier I and Tier II capital), subject to the following conditions:

- i. Loan will be granted only to those joint ventures where the holding by the Indian company is more than 51%.
- ii. Proper systems for management of credit and interest rate risks arising out of such cross border lending are in place.
- iii. While extending such facilities, banks will have to comply with Section 25 of the Banking Regulation Act, 1949, in terms of which the assets in India of every banking company at the close of business on the last Friday of every quarter shall not be less than 75 percent of its demand and time liabilities in India. In other words, aggregate assets outside India should not exceed 25 percent of the bank's demand and time liabilities in India.
- iv. The resource base for such lending should be funds held in foreign currency accounts such as FCNR(B), EEFC, RFC, etc. in respect of which banks have to manage exchange risk.
- v. Maturity mismatches arising out of such transactions are within the overall gap limits approved by RBI.
- vi. Adherence to all existing safeguards / prudential guidelines relating to capital adequacy, exposure norms etc. applicable to domestic credit / non-credit exposures.
- vii. The set up of the step-down subsidiary should be such that banks can effectively monitor the facilities granted by them.

2.2.3.3 Further, the loan policy for such credit / non-credit facility should be, inter alia, in keeping with the following:

- (a) Grant of such loans is based on proper appraisal and commercial viability of the projects and not merely on the reputation of the promoters backing the project. Non-fund based facilities should be subjected to the same rigorous scrutiny as fund-based limits.
- (b) The countries where the joint ventures / wholly owned subsidiaries are located should have no restrictions applicable to these companies in regard to obtaining foreign currency loans or for repatriation, etc. and should permit non-resident banks to have legal charge on securities / assets abroad and the right of disposal in case of need.

2.2.3.4 Banks should also comply with all existing safeguards/prudential guidelines relating to capital adequacy, and exposure norms indicated in paragraph 2.1, *ibid*.

2.3 Banks' Exposure to Capital Markets – Rationalisation of Norms

As announced in the Mid-Term Review of Annual Policy Statement for the year 2005-2006, the prudential capital market exposure norms prescribed for banks have been rationalized in terms of base and coverage. Accordingly, the existing guidelines on banks' exposure to capital markets were modified and the revised guidelines, which came into effect from **April 1, 2007**, are as under.

2.3.1 Components of Capital Market Exposure (CME)

Banks' capital market exposures would include both their direct exposures and indirect exposures. The aggregate exposure (both fund and non-fund based) of banks to capital markets in all forms would **include** the following:

- i. direct investment in equity shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds the corpus of which is not exclusively invested in corporate debt;
- ii. advances against shares/bonds/debentures or other securities or on clean basis to individuals for investment in shares (including IPOs/ESOPs), convertible bonds, convertible debentures, and units of equity-oriented mutual funds;
- iii. advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are taken as primary security;
- iv. advances for any other purposes to the extent secured by the collateral security of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds i.e. where the primary security other than shares/convertible bonds/convertible debentures/units of equity oriented mutual funds does not fully cover the advances;
- v. secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers;
- vi. loans sanctioned to corporates against the security of shares / bonds/ debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources;
- vii. bridge loans to companies against expected equity flows/issues;
- viii. underwriting commitments taken up by the banks in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds. However, with effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure of the solo bank as well as the consolidated bank. The position in this regard would be reviewed after an year.
- ix. financing to stockbrokers for margin trading;
- x. all exposures to Venture Capital Funds (both registered and unregistered).

2.3.2 Limits on Banks' Exposure to Capital Markets

2.3.2.1 Statutory limit on shareholding in companies

In terms of Section 19(2) of the Banking Regulation Act, 1949, no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less, except as provided in sub-section (1) of Section 19 of the Act. Shares held in demat form should also be included for the purpose of determining the exposure limit. This is an aggregate holding limit for each company. While granting any advance against shares, underwriting any issue of shares, or acquiring any shares on investment account or even in lieu of debt of any company, these statutory provisions should be strictly observed.

2.3.2.2 Regulatory Limit

A Solo Basis

The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) should not exceed 40 per cent of its net worth (as defined in paragraph 2.3.3), as on March 31 of the previous year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its net worth.

B Consolidated Basis

The aggregate exposure of a consolidated bank to capital markets (both fund based and non-fund based) should not exceed 40 per cent of its consolidated net worth as on March 31 of the previous year. Within this overall ceiling, the aggregate direct exposure by way of the consolidated bank's investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its consolidated net worth.

Note For the purpose of application of prudential norms on a group-wise basis, a 'consolidated bank' is defined as a group of entities, which include a licensed bank, which may or may not have subsidiaries.

2.3.2.3 The above-mentioned ceilings (sub-paragraphs A and B) are the maximum permissible and a bank's Board of Directors is free to adopt a lower ceiling for the bank, keeping in view its overall risk profile and corporate strategy. Banks are required to adhere the ceilings on an ongoing basis.

2.3.3 Definition of Net Worth

Net worth would comprise of Paid-up capital plus Free Reserves including Share Premium but excluding Revaluation Reserves, plus Investment Fluctuation Reserve and credit balance in Profit & Loss account, less debit balance in Profit and Loss account, Accumulated Losses and Intangible Assets. No general or specific provisions should be included in computation of net worth. Infusion of capital through equity shares, either through domestic issues or overseas floats after the published balance sheet date, may also be taken into account for determining the ceiling on exposure to capital market. Banks should obtain an external auditor's certificate on completion of the augmentation of capital and submit the same to the Reserve Bank of India (Department of Banking Supervision) before reckoning the additions, as stated above.

2.3.4 Items excluded from Capital Market Exposure

The following items would be excluded from the aggregate exposure ceiling of 40 per cent of net worth and direct investment exposure ceiling of 20 per cent of net worth (wherever applicable) :

- i. Banks' investments in own subsidiaries, joint ventures, sponsored Regional Rural Banks (RRBs) and investments in shares and convertible debentures, convertible bonds issued by institutions forming crucial financial infrastructure such as National Securities Depository Ltd. (NSDL), Central Depository Services (India) Ltd. (CDSL), National Securities Clearing Corporation Ltd. (NSCCL), National Stock Exchange (NSE), Clearing Corporation of India Ltd., (CCIL), Credit Information Bureau of India Ltd. (CIBIL), Multi Commodity Exchange Ltd. (MCX), National Commodity and Derivatives Exchange Ltd. (NCDEX), National Multi-Commodity Exchange of India Ltd. (NMCEIL), National Collateral Management Services Ltd. (NCMSL) and other All India Financial Institutions as given in **Annex 3**. After listing, the exposures in excess of the original investment (i.e. prior to listing) would form part of the Capital Market Exposure.
- ii. Tier I and Tier II debt instruments issued by other banks;
- iii. Investment in Certificate of Deposits (CDs) of other banks;
- iv. Preference Shares;
- v. Non-convertible debentures and non-convertible bonds;
- vi. Units of Mutual Funds under schemes where the corpus is invested exclusively in debt instruments;
- vii. Shares acquired by banks as a result of conversion of debt/overdue interest into equity under Corporate Debt Restructuring (CDR) mechanism;
- viii. Term loans sanctioned to Indian promoters for acquisition of equity in overseas joint ventures / wholly owned subsidiaries under the refinance scheme of Export Import Bank of India (EXIM Bank).
- ix) With effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process, for the purpose of arriving at the capital market exposure of the solo bank as well as the consolidated bank. (However, the position in this regard would be reviewed after a year).

2.3.5 Computation of exposure

For computing the exposure to the capital markets, loans/advances sanctioned and guarantees issued for capital market operations would be reckoned with reference to sanctioned limits or outstanding, whichever is higher. However, in the case of fully drawn term loans, where there is no scope for re-drawal of any portion of the sanctioned limit, banks may reckon the outstanding as the exposure. Further, banks' direct investment in shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds would be calculated at their cost price.

2.3.6 Intra-day Exposures

At present, there are no explicit guidelines for monitoring banks' intra-day exposure to the capital markets, which are inherently risky. It has been decided that the Board of each bank should evolve a policy for fixing intra-day limits and put in place an appropriate system to monitor such limits, on an ongoing basis. The position will be reviewed after an year.

2.3.7 Enhancement in limits

Banks having sound internal controls and robust risk management systems can approach the Reserve Bank for higher limits together with details thereof.

2.4 Financing of equities and investments in shares

2.4.1 Advances against shares to individuals

Loans against security of shares, convertible bonds, convertible debentures and units of equity oriented mutual funds to individuals from the banking system should not exceed the limit of Rs.10 lakh per individual if the securities are held in physical form and Rs. 20 lakhs per individual if the securities are held in demat form. Such loans are meant for genuine individual investors and banks should not support collusive action by a large group of individuals belonging to the same corporate or their inter-connected entities to take multiple loans in order to support particular scrips or stock-broking activities of the concerned firms. Such finance should be reckoned as an exposure to capital market. Banks should formulate, with the approval of their Board of Directors, a Loan Policy for granting advances to individuals against shares, debentures, and bonds keeping in view the RBI guidelines. As a prudential measure, banks may also consider laying down appropriate aggregate sub-limits of such advances.

2.4.2 Financing of Initial Public Offerings (IPOs)

Banks may grant advances to individuals for subscribing to IPOs. Loans/advances to any individual from the banking system against security of shares, convertible bonds, convertible debentures, units of equity oriented mutual funds and PSU bonds should not exceed the limit of Rs.10 lakh for subscribing to IPOs. The corporates should not be extended credit by banks for investment in other companies' IPOs. Similarly, banks should not provide finance to NBFCs for further lending to individuals for IPOs. Finance extended by a bank for IPOs should be reckoned as an exposure to capital market.

2.4.3 Bank finance to assist employees to buy shares of their own companies

2.4.3.1 Banks may extend finance to employees for purchasing shares of their own companies under Employees Stock Option Plan(ESOP)/ reserved by way of employees' quota under IPO to the extent of 90% of the purchase price of the shares or Rs.20 lakh, whichever is lower. Finance extended by banks for ESOPs/ employees' quota under IPO would be treated as an exposure to capital market within the overall ceiling of 40 per cent of their net worth. These instructions will not be applicable for extending financial assistance by banks to their own employees for acquisition of shares under ESOPs/ IPOs, as banks are not allowed to extend advances including advances to their employees / Employees' Trusts set up by them for the purpose of purchasing their own banks' shares under ESOPs / IPOs or from the secondary market. This prohibition will apply irrespective of whether the advances are secured or unsecured.

2.4.3.2 Banks should obtain a declaration from the borrower indicating the details of the loans / advances availed against shares and other securities specified above, from any other bank/s in order to ensure compliance with the ceilings prescribed for the purpose.

2.4.4 Advances against shares to Stock Brokers & Market Makers

2.4.4.1 Banks are free to provide credit facilities to stockbrokers and market makers on the basis of their commercial judgment, within the policy framework approved by their Boards. However, in order to avoid any nexus emerging between inter-connected stock broking entities and banks, the Board of each bank should fix, within the overall ceiling of 40 percent of their net worth as on March 31 of the previous year, a sub-ceiling for total advances to –

- i. all the stockbrokers and market makers (both fund based and non-fund based, i.e. guarantees); and
- ii. to any single stock broking entity, including its associates/ inter-connected companies.

2.4.4.2 Further, banks should not extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchanges.

2.4.5 Bank financing to individuals against shares to joint holders or third party beneficiaries

While granting advances against shares held in joint names to joint holders or third party beneficiaries, banks should be circumspect and ensure that the objective of the regulation is not defeated by granting advances to other joint holders or third party beneficiaries to circumvent the above limits placed on loans/advances against shares and other securities specified above.

2.4.6 Advances against units of mutual funds

While granting advances against units of mutual funds, the banks should adhere to the following guidelines:

- i) The units should be listed in the stock exchanges or repurchase facility for the units should be available at the time of lending.
- ii) The units should have completed the minimum lock-in-period stipulated in the relevant scheme.
- iii) The amount of advances should be linked to the Net Asset Value (NAV) / repurchase price or the market value, whichever is less and not to the face value of the units.
- iv) Advances against units of mutual funds (except units of exclusively debt oriented mutual funds) would attract the quantum and margin requirements as are applicable to advances against shares and debentures. However, the quantum and margin requirement for loans/ advances to individuals against units of exclusively debt-oriented mutual funds may be decided by individual banks themselves in accordance with their loan policy.
- v) The advances should be purpose oriented taking into account the credit requirement of the investor. Advances should not be granted for subscribing to or boosting up the sales of another scheme of a mutual fund or for the purchase of shares/ debentures/ bonds etc.

2.4.7 Advances to other borrowers against shares/debentures/bonds

2.4.7.1 The question of granting advances against primary security of shares and debentures including promoters' shares to industrial, corporate or other borrowers should not normally arise. However, such securities can be accepted as collateral for secured loans granted as working capital or for other productive purposes from borrowers other than NBFCs. In such cases, banks should accept shares only in dematerialised form. Banks may accept shares of promoters only in dematerialised form wherever demat facility is available.

2.4.7.2 In the course of setting up of new projects or expansion of existing business or for the purpose of raising additional working capital required by units other than NBFCs, there may be situations where such borrowers may not be able to find the required funds towards margin, in anticipation of mobilising of long-term resources. In such cases, there would be no objection to the banks' obtaining collateral security of shares and debentures by way of margin. Such arrangements would be of a temporary nature and may not be continued beyond a period of one year. Banks have to satisfy themselves regarding the capacity of the borrower to raise the required funds and to repay the advance within the stipulated period.

2.4.8 Bank Loans for Financing Promoters' Contributions

- 2.4.8.1 Loans sanctioned to corporates against the security of shares (as far as possible, demat shares) for meeting promoters' contribution to the equity of new companies in anticipation of raising resources, should be treated as a bank's investments in shares which would thus come under the ceiling of 40 percent of the bank's net worth as on March 31 of the previous year prescribed for the bank's total exposure including both fund based and non-fund based to capital market in all forms.
- 2.4.8.2 These loans will also be subject to individual/group of borrowers exposure norms as well as the statutory limit on shareholding in companies, as detailed above.

2.4.9 Bridge Loans

- 2.4.9.1 Banks have been permitted to sanction bridge loans to companies for a period not exceeding one year against expected equity flows/issues. Such loans should be included within the ceiling of 40 percent of the banks' net worth as on March 31 of the previous year prescribed for total exposure, including both fund-based and non-fund based exposure to capital market in all forms.
- 2.4.9.2 Banks should formulate their own internal guidelines with the approval of their Board of Directors for grant of such loans, exercising due caution and attention to security for such loans.
- 2.4.9.3 Banks may also extend bridge loans against the expected proceeds of Non-Convertible Debentures, External Commercial Borrowings, Global Depository Receipts and/or funds in the nature of Foreign Direct Investments, provided the banks are satisfied that the borrowing company has already made firm arrangements for raising the aforesaid resources/funds.

2.4.10 Investments in Venture Capital Funds (VCFs)

As announced in the Annual Policy Statement for the year 2006-2007 and advised in our circulars DBOD.BP.BC.84 & 27/21.01.002/2005-2006 dated May 25 and August 23, 2006 respectively, banks' exposures to VCFs (both registered and unregistered) will be deemed to be on par with equity and hence will be reckoned for compliance with the capital market exposure ceilings (both direct and indirect).

2.4.11 Margins on advances against shares/ issue of guarantees

A uniform margin of 50 per cent shall be applied on all advances / financing of IPOs / issue of guarantees on behalf of stockbrokers and market makers. A minimum cash margin of 25 per cent (within the margin of 50%) shall be maintained in respect of guarantees issued by banks for capital market operations.

2.4.12 Disinvestment Programme of the Government of India

In the context of the Government of India's programme of disinvestments of its holdings in some public sector undertakings (PSUs), banks can extend finance to the successful bidders for acquisition of shares of these PSUs. If on account of banks' financing acquisition of PSU shares under the Government of India's disinvestment programmes, any bank is likely to exceed the regulatory ceiling of 40 per cent of its net worth as on March 31 of the previous year, such requests for relaxation of the ceiling would be considered by RBI on a case by case basis, subject to adequate safeguards regarding margin, bank's overall exposure to capital market, internal control and risk management systems, etc. The relaxation would be considered in such a manner that the bank's exposure to capital market in all forms, net of its advances for financing of acquisition of PSU shares, shall be within the regulatory ceiling of 40 per cent. RBI would also consider relaxation on specific requests from banks in the individual / group credit exposure norms on a case by case basis, provided that the bank's total exposure to the borrower, net of its exposure due to acquisition of PSU shares under the Government of India disinvestments programme, should be within the prudential individual/ group borrower exposure ceiling prescribed by RBI.

2.4.13 Refinance scheme of Export Import Bank of India (EXIM Bank)

Under the refinance scheme of Export Import Bank of India (EXIM Bank), the banks may sanction term loans on merits of eligible Indian promoters for acquisition of equity in overseas joint ventures / wholly owned subsidiaries, provided that the term loans have been approved by the EXIM Bank for refinance. Further, the banks may extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures / wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy duly incorporated in the Loan Policy of the banks. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc.

2.4.14 Arbitrage Operations

Banks should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchanges. While banks are permitted to acquire shares from the secondary market, they should ensure that no sale transaction is undertaken without actually holding the shares in their investment accounts.

2.4.15 Margin Trading

2.4.15.1 Banks may extend finance to stockbrokers for margin trading. The Board of each bank should formulate detailed guidelines for lending for margin trading, subject to the following parameters:

- (i) The finance extended for margin trading should be within the overall ceiling of 40% of net worth prescribed for exposure to capital market.
- (ii) A minimum margin of 50 per cent should be maintained on the funds lent for margin trading.
- (iii) The shares purchased with margin trading should be in dematerialised mode under pledge to the lending bank. The bank should put in place an appropriate system for monitoring and maintaining the margin of 50% on an ongoing basis.
- (iv) The bank's Board should prescribe necessary safeguards to ensure that no "nexus" develops between inter-connected stock broking entities/ stockbrokers and the bank in respect of margin trading. Margin trading should be spread out by the bank among a reasonable number of stockbrokers and stock broking entities.

2.4.15.2 The Audit Committee of the Board should monitor periodically the bank's exposure by way of financing for margin trading and ensure that the guidelines formulated by the bank's Board, subject to the above parameters, are complied with. Banks should disclose the total finance extended for margin trading in the "Notes on Account" to their Balance Sheet.

2.5. Risk Management and Internal Control System

Banks desirous of making investment in equity shares/ debentures, financing of equities and issue of guarantees etc., within the above ceiling, should observe the following guidelines:

2.5.1 Investment Policy

- (i) The banks should formulate transparent policy and procedure for investment in shares etc., with the approval of their Board.
- (ii) The banks should build up adequate expertise in equity research by establishing a dedicated equity research department, wherever warranted by their scale of operations.

2.5.2 Investment Committee

The decision in regard to direct investment should be taken by an Investment Committee set up by the bank's Board. The Investment Committee should be held accountable for all investments made by the bank.

2.5.3 Risk Management

- (i) Banks should ensure that their exposure to stockbrokers is well diversified in terms of number of broker clients, individual inter-connected broking entities.
- (ii) While sanctioning advances to stockbrokers, the banks should take into account the track record and credit worthiness of the broker, financial position of the broker, operations on his own account and on behalf of clients, average turnover period of stocks and shares, the extent to which broker's funds are required to be involved in his business operations, etc.
- (iii) While processing proposals for loans to stockbrokers, banks should obtain details of facilities enjoyed by the broker and all his connected companies from other banks.
- (iv) While granting advances against shares and debentures to other borrowers, banks should obtain details of credit facilities availed by them or their associates / inter-connected companies from other banks for the same purpose (i.e. investment in shares etc.) in order to ensure that high leverage is not built up by the borrower or his associate or inter-connected companies with bank finance.

2.5.4 Audit Committee

- (i) The surveillance and monitoring of investment in shares / advances against shares shall be done by the Audit Committee of the Board, which shall review in each of its meetings, the total exposure of the bank to capital market both fund based and non-fund based, in different forms and ensure that the guidelines issued by RBI are complied with and adequate risk management and internal control systems are in place;
- (ii) The Audit Committee shall keep the Board informed about the overall exposure to capital market, the compliance with the RBI and Board guidelines, adequacy of risk management and internal control systems;
- (iii) In order to avoid any possible conflicts of interest, it should be ensured that the stockbrokers as directors on the Boards of banks or in any other capacity, do not involve themselves in any manner with the Investment Committee or in the decisions in regard to making investments in shares, etc., or advances against shares.

2.6 Valuation and Disclosure

Equity shares in a bank's portfolio - as primary security or as collateral for advances or for issue of guarantees and as an investment - should be marked to market preferably on a daily basis, but at least on weekly basis. Banks should disclose the total investments made in equity shares, convertible bonds and debentures and units of equity oriented mutual funds as also aggregate advances against shares in the "Notes on Account" to their balance sheets.

2.7 Cross holding of capital among banks / financial institutions

- 2.7.1 (i) Banks' / FIs' investment in the following instruments, which are issued by other banks / FIs and are eligible for capital status for the investee bank / FI, should not exceed 10 percent of the investing bank's capital funds (Tier I plus Tier II):
- a. Equity shares;
 - b. Preference shares eligible for capital status;
 - c. Subordinated debt instruments;
 - d. Hybrid debt capital instruments; and
 - e. Any other instrument approved as in the nature of capital.
- (ii) Banks / FIs should not acquire any fresh stake in a bank's equity shares, if by such acquisition, the investing bank's / FI's holding exceeds 5 percent of the investee bank's equity capital.
- 2.7.2 Banks' / FIs' investments in the equity capital of subsidiaries are at present deducted from their Tier I capital for capital adequacy purposes. Investments in the instruments issued by banks / FIs which are listed at paragraph 2.7.1(i) above, which are not deducted from Tier I capital of the investing bank/ FI, will attract 100 percent risk weight for credit risk for capital adequacy purposes.

2.8 Banks' Exposure to Commodity Markets – Margin Requirements

In terms of extant instructions, banks may issue guarantees on behalf of share and stock brokers in favour of stock exchanges in lieu of margin requirements as per stock exchange regulations. While issuing such guarantees banks should obtain a minimum margin of 50 percent. A minimum cash margin of 25 percent (within the above margin of 50 percent) should be maintained in respect of such guarantees issued by banks. The above minimum margin of 50 percent and minimum cash margin requirement of 25 percent (within the margin of 50 percent) will also apply to guarantees issued by banks on behalf of commodity brokers in favour of the national level commodity exchanges, viz., National Commodity & Derivatives Exchange (NCDEX), Multi Commodity Exchange of India Limited (MCX) and National Multi-Commodity Exchange of India Limited (NMCEIL), in lieu of margin requirements as per the commodity exchange regulations.

2.9 Limits on exposure to unsecured guarantees and unsecured advances

- 2.9.1 The instruction that banks have to limit their commitment by way of unsecured guarantees in such a manner that 20 percent of the bank's outstanding unsecured guarantees plus the total of outstanding unsecured advances do not exceed 15 percent of total outstanding advances has been withdrawn to enable banks' Boards to formulate their own policies on unsecured exposures. Simultaneously, all exemptions allowed for computation of unsecured exposures also stand withdrawn.
- 2.9.2 With a view to ensuring uniformity in approach and implementation, 'unsecured exposure' is defined as an exposure where the realisable value of the security, as assessed by the bank /approved valuers / Reserve Bank's inspecting officers, is not more than 10 percent, ab-initio, of the outstanding exposure. 'Exposure' shall include all funded and non-funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly charged to the bank and will not include intangible securities like guarantees, comfort letters, etc.

2.10 'Safety Net' Schemes for Public Issues of Shares, Debentures, etc.

2.10.1 'Safety Net' Schemes

Reserve Bank had observed that some banks/their subsidiaries were providing buy-back facilities under the name of 'Safety Net' Schemes in respect of certain public issues as part of their merchant banking activities. Under such schemes, large exposures are assumed by way of commitments to buy the relative securities from the original investors at any time during a stipulated period at a price determined at the time of issue, irrespective of the prevailing market price. In some cases, such schemes were offered *suo motto* without any request from the company whose issues are supported under the schemes. Apparently, there was no undertaking in such cases from the issuers to buy the securities. There is also no income commensurate with the risk of loss built into these schemes, as the investor will take recourse to the facilities offered under the schemes only when the market value of the securities falls below the pre-determined price. Banks/their subsidiaries have therefore been advised that they should refrain from offering such 'Safety Net' facilities by whatever name called.

2.10.2 Provision of buy back facilities

In some cases, the issuers provide buy-back facilities to original investors up to Rs. 40,000/- in respect of non-convertible debentures after a lock-in-period of one year, to provide liquidity to debentures issued by them. If, at the request of the issuers, the banks or their subsidiaries find it necessary to provide additional facilities to small investors subscribing to new issues, such buy-back arrangements should not entail commitments to buy the securities at pre-determined prices. Prices should be determined from time to time, keeping in view the prevailing stock market prices for the securities. Commitments should also be limited to a moderate proportion of the total issue in terms of the amount and should not exceed 20 percent of the owned funds of the banks/their subsidiaries. These commitments will also be subject to the overall exposure limits which have been or may be prescribed from time to time.

**The definition of infrastructure lending and the list of the items
included under infrastructure sector
[paragraph 2.1.1.2]**

Any credit facility in whatever form extended by lenders (i.e. banks, FIs or NBFCs) to an infrastructure facility as specified below falls within the definition of "infrastructure lending". In other words, a credit facility provided to a borrower company engaged in:

- o developing or
 - o operating and maintaining, or
 - o developing, operating and maintaining any infrastructure facility that is a project in any of the following sectors, or any infrastructure facility of a similar nature :
- i. a road, including toll road, a bridge or a rail system;
- ii. a highway project including other activities being an integral part of the highway project;
- iii. a port, airport, inland waterway or inland port;
- iv. a water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system;
- v. telecommunication services whether basic or cellular, including radio paging, domestic satellite service (i.e., a satellite owned and operated by an Indian company for providing telecommunication service), network of trunking, broadband network and internet services;
- vi. an industrial park or special economic zone ;
- vii. generation or generation and distribution of power
- viii. transmission or distribution of power by laying a network of new transmission or distribution lines.
- ix. construction relating to projects involving agro-processing and supply of inputs to agriculture;
- x. construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality;
- xi. construction of educational institutions and hospitals.
- xii. laying down and / or maintenance of gas, crude oil and petroleum pipelines.
- xiii. any other infrastructure facility of similar nature.

ANNEX 2

**List of All-India Financial Institutions
(Counter party exposure - List of institutions guaranteeing bonds of corporates)
[paragraphs 2.1.3.4(c)]**

1. Industrial Finance Corporation of India Ltd.
2. Industrial Investment Bank of India Ltd.
3. Tourism Finance Corporation of India Ltd.
4. Risk Capital and Technology Finance Corporation Ltd.
5. Technology Development and Information Company of India Ltd.
6. Power Finance Corporation Ltd.
7. National Housing Bank
8. Small Industries Development Bank of India
9. Rural Electrification Corporation Ltd.
10. Indian Railways Finance Corporation Ltd.
11. National Bank for Agriculture and Rural Development
12. Export Import Bank of India
13. Infrastructure Development Finance Company Ltd.
14. Housing and Urban Development Corporation Ltd.
15. Indian Renewable Energy Development Agency Ltd.

List of All-India Financial Institutions

**[Investment in equity/convertible bonds/ convertible debentures by banks - List of FIs
whose instruments are exempted from Capital Market Exposure ceiling]
[paragraph 2.3.4.(i)]**

1. Industrial Finance Corporation of India Ltd. (IFCI)
2. Tourism Finance Corporation of India Ltd. (TFCI)
3. Risk Capital and Technology Finance Corporation Ltd. (RCTC)
4. Technology Development and Information Company of India Ltd. (TDICI)
5. National Housing Bank (NHB)
6. Small Industries Development Bank of India (SIDBI)
7. National Bank for Agriculture and Rural Development (NABARD)
8. Export Import Bank of India (EXIM Bank)
9. Industrial Investment Bank of India (IIBI)
10. Life Insurance Corporation of India (LIC)
11. General Insurance Corporation of India (GIC)

ANNEX 4**List of circulars consolidated by the
Master Circular on 'Exposure Norms'**

1.	DBOD. No. Dir. BC.	92/13.03.00/2007-08	09.06.2008
2.	DBOD. No. Dir. BC.	87/13.27.00/2007-08	29.05.2008
3.	DBOD. No. Dir. BC.	57/13.03.00/2007-08	14.12.2007
4.	DBOD. No. BP. BC.	52/21.04.048/2007-08	30.11.2007
5.	DBOD. No. Dir. BC.	11/13.03.00/2007-08	02.07.2007

RBI/2008-2009/79

DBOD. No. Dir. BC. 18/13.03.00/2008-09

July 1, 2008

Ashadha 10, 1930(Saka)

**All Scheduled Commercial Banks
(excluding RRBs)**

Dear Sir

Master Circular - Guarantees and Co-acceptances

Please refer to the Master Circular DBOD.No.Dir.BC.10/13.03.00/2007-08 dated July 2, 2007 updating instructions/ guidelines issued to banks till June 30, 2007 on matters relating to issue of Guarantees and Co-acceptances by banks. The Master Circular has been suitably updated by incorporating instructions issued on the subject up to June 30, 2008 and has also been placed on the RBI website (<http://www.rbi.org.in>). A copy of the Master Circular is enclosed.

Yours faithfully

(P. Vijaya Bhaskar)
Chief General Manager

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Master Circular - Guarantees and Co-acceptances

A. Purpose

This Master Circular provides a framework of the rules/regulations/instructions issued by the Reserve Bank of India relating to the conduct of guarantee business by banks.

B. Classification

A statutory directive issued by the Reserve Bank in exercise of the powers conferred by the Banking Regulation Act, 1949.

C. Previous instructions

This Master Circular updates the previous instructions on the above subject contained in the Master Circular dated July 2, 2007.

D. Application

To all Scheduled Commercial Banks, excluding Regional Rural Banks.

Structure

1. INTRODUCTION

2. GUIDELINES

- 2.1 General Guidelines
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3. ANNEX

- Annex 1 Model Form of Bank Guarantee Bond
- Annex 2 Guarantees / LoUs/ LoCs invoked by ADs

1. INTRODUCTION

An important criterion for judging the soundness of a banking institution is the size and character, not only of its assets portfolio but also, of its contingent liability commitments such as guarantees, letters of credit, etc. As a part of business, banks issue guarantees on behalf of their customers for various purposes. The guarantees executed by banks comprise both performance guarantees and financial guarantees. The guarantees are structured according to the terms of agreement, viz., security, maturity and purpose. With the introduction of risk weights for both on-Balance Sheet and off-Balance Sheet exposures, banks have become more risk sensitive, resulting in structuring of their business exposures in a more prudent manner. Banks should comply with the following guidelines in the conduct of their guarantee business.

2. GUIDELINES

2.1 General Guidelines

2.1.1 As regards the purpose of the guarantee, as a general rule, the banks should confine themselves to the provision of financial guarantees and exercise due caution with regard to performance guarantee business.

2.1.2 As regards maturity, as a rule, banks should guarantee shorter maturities and leave longer maturities to be guaranteed by other institutions.

2.1.3 No bank guarantee should normally have a maturity of more than 10 years.

2.2 Guidelines relating to conduct of guarantee business

2.2.1 Norms for unsecured advances & guarantees

Until June 17, 2004, banks were required to limit their commitments by way of unsecured guarantees in such a manner that 20 percent of a bank's outstanding unsecured guarantees plus the total of its outstanding unsecured advances should not exceed 15 percent of its total outstanding advances. In order to provide further flexibility to banks on their loan policies, the above limit on unsecured exposure of banks was withdrawn and banks' Boards have been given the freedom to fix their own policies on their unsecured exposures. "Unsecured exposure" is defined as an exposure where the realisable value of the security, as assessed by the bank/ approved valuers/ Reserve Bank's inspecting officers, is not more than 10 per cent, ab-initio, of the outstanding exposure. Exposure shall include all funded and non-funded exposures (including underwriting and similar commitments). 'Security' will mean tangible security properly charged to the bank and will not include intangible securities like guarantees, comfort letters, etc. All exemptions allowed for computation of unsecured advances stand withdrawn.

2.2.2 Precautions for issuing guarantees

Banks should adopt the following precautions while issuing guarantees on behalf of their customers.

- i. As a rule, banks should avoid giving unsecured guarantees in large amounts and for medium and long-term periods. They should avoid undue concentration of such unsecured guarantee commitments to particular groups of customers and/or trades.
- ii. Unsecured guarantees on account of any individual constituent should be limited to a reasonable proportion of the bank's total unsecured guarantees. Guarantees on behalf of an individual should also bear a reasonable proportion to the constituent's equity.
- iii. In exceptional cases, banks may give deferred payment guarantees on an unsecured basis for modest amounts to first class customers who have entered into deferred payment arrangements in consonance with Government policy.
- iv. Guarantees executed on behalf of any individual constituent, or a group of constituents, should be subject to the prescribed exposure norms.

It is essential to realise that guarantees contain inherent risks and that it would not be in the bank's interest or in the public interest, generally, to encourage parties to over-extend their commitments and embark upon enterprises solely relying on the easy availability of guarantee facilities.

2.2.3 Precautions for Averting Frauds

While issuing guarantees on behalf of customers, the following safeguards should be observed by banks:

- i. At the time of issuing financial guarantees, banks should be satisfied that the customer would be in a position to reimburse the bank in case the bank is required to make payment under the guarantee.
- ii. In the case of performance guarantee, banks should exercise due caution and have sufficient experience with the customer to satisfy themselves that the customer has the necessary experience, capacity and means to perform the obligations under the contract, and is not likely to commit any default.
- iii. Banks should, normally, refrain from issuing guarantees on behalf of customers who do not enjoy credit facilities with them.

2.2.4 Ghosh Committee Recommendations

Banks should implement the following recommendations made by the High Level Committee (Chaired by Shri A. Ghosh, the then Dy. Governor of RBI):

- i. In order to prevent unaccounted issue of guarantees, as well as fake guarantees, as suggested by IBA, bank guarantees should be issued in serially numbered security forms.
- ii. Banks should, while forwarding guarantees, caution the beneficiaries that they should, in their own interest, verify the genuineness of the guarantee with the issuing bank.

2.2.5 Internal Control Systems

Bank guarantees issued for Rs.50,000/- and above should be signed by two officials jointly. A lower cut-off point, depending upon the size and category of branches, may be prescribed by banks, where considered necessary. Such a system will reduce the scope for malpractices/ losses arising from the wrong perception/ judgement or lack of honesty/ integrity on the part of a single signatory. Banks should evolve suitable systems and procedures, keeping in view the spirit of these instructions and allow deviation from the two signatures discipline only in exceptional circumstances. The responsibility for ensuring the adequacy and effectiveness of the systems and procedures for preventing perpetration of frauds and malpractices by their officials would, in such cases, rest on the top managements of the banks. In case, exceptions are made for affixing of only one signature on the instruments, banks should devise a system for subjecting such instruments to special scrutiny by the auditors or inspectors at the time of internal inspection of branches.

2.2.6 Guarantees on behalf of Banks' Directors

- 2.2.6.1 Section 20 of the Banking Regulation Act, 1949 prohibits banks from granting loans or advances to any of their directors or any firm or company in which any of their directors is a partner or guarantor. However, certain facilities which, inter alia, include issue of guarantees, are not regarded as 'loan and advances' within the meaning of Section 20 of the Act, *ibid*. In this regard, it is pertinent to note with particular reference to banks giving guarantees on behalf of their directors, that in the event of the principal debtor committing default in discharging his liability and the bank being called upon to honour its obligation under the guarantee, the relationship between the bank and the director could become one of creditor and debtor. Further, directors would also be able to evade the provisions of Section 20 by borrowing from a third party against the guarantee given by the bank. These types of transactions are likely to defeat the very purpose of enacting Section 20, if banks do not take appropriate steps to ensure that the liabilities thereunder do not devolve on them.

2.2.6.2 In view of the above, banks should, while extending non-fund based facilities such as guarantees, etc. on behalf of directors and the companies/firms in which the director is interested, ensure that:

- i. adequate and effective arrangements have been made to the satisfaction of the bank that the commitments would be met out of their own resources by the party on whose behalf guarantee was issued, and
- ii. the bank will not be called upon to grant any loan or advance to meet the liability, consequent upon the invocation of guarantee.

2.2.6.3 In case, such contingencies arise as at (ii) above, the bank will be deemed to be a party to the violation of the provisions of Section 20 of the Banking Regulation Act, 1949.

2.2.7 Bank Guarantee Scheme of Government of India

2.2.7.1 The Bank Guarantee Scheme formulated by the Government of India for the issuance of bank guarantees in favour of Central Government Departments, in lieu of security deposits, etc. by contractors, has been modified from time to time. Under the scheme, it is open to Government Departments to accept freely guarantees, etc. from all scheduled commercial banks.

2.2.7.2 Banks should adopt the Model Form of Bank Guarantee Bond given in **Annex 1**. The Government of India have advised all the Government departments/ Public Sector Undertakings, etc. to accept bank guarantees in the Model Bond and to ensure that alterations/additions to the clauses whenever considered necessary are not one-sided and are made in agreement with the guaranteeing bank. Banks should mention in the guarantee bonds and their correspondence with the various State Governments, the names of the beneficiary departments and the purposes for which the guarantees are executed. This is necessary to facilitate prompt identification of the guarantees with the concerned departments. In regard to the guarantees furnished by the banks in favour of Government Departments in the name of the President of India, any correspondence thereon should be exchanged with the concerned ministries/ departments and not with the President of India. In respect of guarantees issued in favour of Directorate General of Supplies and Disposal, the following aspects should be kept in view:

- i. In order to speed up the process of verification of the genuineness of the bank guarantee, the name, designation and code numbers of the officer/officers signing the guarantees should be incorporated under the signature(s) of officials signing the bank guarantee.
- ii. The beneficiary of the bank guarantee should also be advised to invariably obtain the confirmation of the concerned banks about the genuineness of the guarantee issued by them as a measure of safety.
- iii. The initial period of the bank guarantee issued by banks as a means of security in Directorate General of Supplies and Disposal contract administration would be for a period of six months beyond the original delivery period. Banks may incorporate a suitable clause in their bank guarantee, providing automatic extension of the validity period of the guarantee by 6 months, and also obtain suitable undertaking from the customer at the time of establishing the guarantee to avoid any possible complication later.

- iv. A clause would be incorporated by Directorate General of Supplies and Disposal in the tender forms of Directorate General of Supplies and Disposal 229 (Instruction to the tenderers) to the effect that whenever a firm fails to supply the stores within the delivery period of the contract wherein bank guarantee has been furnished, the request for extension for delivery period will automatically be taken as an agreement for getting the bank guarantee extended. Banks should make similar provisions in the bank guarantees for automatic extension of the guarantee period.
- iv. The bank guarantee, as a means of security in the Directorate General of Supplies and Disposal contract administration and extension letters thereof, would be on non-judicial stamp paper.

2.2.8 Guarantees on Behalf of Share and Stock Brokers/ Commodity Brokers

Banks may issue guarantees on behalf of share and stock brokers in favour of stock exchanges in lieu of security deposit to the extent it is acceptable in the form of bank guarantee as laid down by stock exchanges. Banks may also issue guarantees in lieu of margin requirements as per stock exchange regulations. Banks have further been advised that they should obtain a minimum margin of 50 percent while issuing such guarantees. A minimum cash margin of 25 per cent (within the above margin of 50 per cent) should be maintained in respect of such guarantees issued by banks. The above minimum margin of 50 percent and minimum cash margin requirement of 25 percent (within the margin of 50 percent) will also apply to guarantees issued by banks on behalf of commodity brokers in favour of the national level commodity exchanges, viz., National Commodity & Derivatives Exchange (NCDEX), Multi Commodity Exchange of India Limited (MCX) and National Multi-Commodity Exchange of India Limited (NMCEIL), in lieu of margin requirements as per the commodity exchange regulations. Banks should assess the requirement of each applicant borrower and observe usual and necessary safeguards including the exposure ceilings.

2.2.9 Guidelines relating to obtaining of personal guarantees of directors and other managerial personnel of borrowing concerns

2.2.9.1 Personal guarantees of directors

Banks should take personal guarantees of directors for the credit facilities, etc. granted to corporates, public or private, only, when absolutely warranted after a careful examination of the circumstances of the case and not, as a matter of course. In order to identify the circumstances under which the guarantee may or may not be considered necessary, banks should be guided by the following broad considerations:

A. Where guarantees need not be considered necessary

i. Ordinarily, in the case of public limited companies, when the lending institutions are satisfied about the management, its stake in the concern, economic viability of the proposal and the financial position and capacity for cash generation, no personal guarantee need be insisted upon. In fact, in the case of widely owned public limited companies, which may be rated as first class and satisfying the above conditions, guarantees may not be necessary even if the advances are unsecured. Also, in the case of companies, whether private or public, which are under professional management, guarantees may not be insisted upon from persons who are connected with the management solely by virtue of their professional/technical qualifications and not consequent upon any significant shareholding in the company concerned.

ii. Where the lending institutions are not so convinced about the aspects of loan proposals mentioned above, they should seek to stipulate conditions to make the proposals acceptable without such guarantees. In some cases, more stringent forms of financial discipline like restrictions on distribution of dividends, further expansion, aggregate borrowings, creation of further charge on assets and stipulation of maintenance of minimum net working capital may be necessary. Also, the parity between owned funds and capital investment and the overall debt-equity ratio may have to be taken into account.

B. Where guarantees may be considered helpful

i. Personal guarantees of directors may be helpful in respect of companies, whether private or public, where shares are held closely by a person or connected persons or a group (not being professionals or Government), irrespective of other factors, such as financial condition, security available, etc. The exception being in respect of companies where, by court or statutory order, the management of the company is vested in a person or persons, whether called directors or by any other name, who are not required to be elected by the shareholders. Where personal guarantee is considered necessary, the guarantee should preferably be that of the principal members of the group holding shares in the borrowing company rather than that of the director/managerial personnel functioning as director or in any managerial capacity.

ii. Even if a company is not closely held, there may be justification for a personal guarantee of directors to ensure continuity of management. Thus, a lending institution could make a loan to a company whose management is considered good. Subsequently, a different group could acquire control of the company, which could lead the lending institution to have well-founded fears that the management has changed for the worse and that the funds lent to the company are in jeopardy. One way by which lending institutions could protect themselves in such circumstances is to obtain guarantees of the directors and thus ensure either the continuity of the management or that the changes in management take place with their knowledge. Even where personal guarantees are waived, it may be necessary to obtain an undertaking from the borrowing company that no change in the management would be made without the consent of the lending institution. Similarly, during the formative stages of a company, it may be in the interest of the company, as well as the lending institution, to obtain guarantees to ensure continuity of management.

- iii. Personal guarantees of directors may be helpful with regard to public limited companies other than those which may be rated as first class, where the advance is on an unsecured basis.
- iv. There may be public limited companies, whose financial position and/or capacity for cash generation is not satisfactory even though the relevant advances are secured. In such cases, personal guarantees are useful.
- v. Cases where there is likely to be considerable delay in the creation of a charge on assets, guarantee may be taken, where deemed necessary, to cover the interim period between the disbursement of loan and the creation of the charge on assets.
- vi. The guarantee of parent companies may be obtained in the case of subsidiaries whose own financial condition is not considered satisfactory.
- vii. Personal guarantees are relevant where the balance sheet or financial statement of a company discloses interlocking of funds between the company and other concerns owned or managed by a group.

C. Worth of the guarantors, payment of guarantee, commission, etc.

- i. Where personal guarantees of directors are warranted, they should bear reasonable proportion to the estimated worth of the person. The system of obtaining guarantees should not be used by the directors and other managerial personnel as a source of income from the company. Banks should obtain an undertaking from the borrowing company as well as the guarantors that no consideration whether by way of commission, brokerage fees or any other form, would be paid by the former or received by the latter, directly or indirectly. This requirement should be incorporated in the bank's terms and conditions for sanctioning of credit limits. During the periodic inspections, the bank's inspectors should verify that this stipulation has been complied with. There may, however, be exceptional cases where payment of remuneration may be permitted e.g. where assisted concerns are not doing well and the existing guarantors are no longer connected with the management but continuance of their guarantees is considered essential because the new management's guarantee is either not available or is found inadequate and payment of remuneration to guarantors by way of guarantee commission is allowed.

D. Personal guarantees in the case of sick units

As the personal guarantees of promoters/ directors generally instill greater accountability and responsibility on their part and prompt the managements to conduct the running of the assisted units on sound and healthy lines and to ensure financial discipline, banks, may in their discretion, obtain guarantees from directors (excluding the nominee directors) and other managerial personnel in their individual capacities. In case, for any reasons, a guarantee is not considered expedient by the bank at the time of sanctioning the advance, an undertaking should be obtained from the individual directors and a covenant should invariably be incorporated in the loan agreement that in case the borrowing unit show cash losses or adverse current ratio or diversion of fund, the directors would be under an obligation to execute guarantees in their individual capacities, if required by the banks. Banks may also obtain guarantees at their discretion from the parent/holding company when credit facilities are extended to borrowing units in the same Group.

2.2.10 Guarantees of State Government

The guidelines laid down in paragraph 2.2.9 above, for taking personal guarantees of directors and other managerial personnel, should also be followed in respect of proposal of State Government undertakings/projects and guarantees may not be insisted upon unless absolutely warranted. In other words, banks could obtain guarantees of State Governments on merits and only in circumstances absolutely necessary after thorough examination of the circumstances of each case, and not as matter of course.

2.3 **Guarantees governed by regulations issued under Foreign Exchange Management (Guarantees) Regulations**

2.3.1 Bid bonds and performance bonds or guarantees for exports

- i. In terms of Notification No.FEMA.8/2000-RB dated May 3, 2000, Authorised Dealer banks have the permission to give performance bond or guarantee in favour of overseas buyers on account of bona fide exports from India.
- ii. Prior approval of RBI should be obtained by the Authorised Dealer banks for issue of performance bonds/ guarantees in respect of caution-listed exporters. Before issuing any such guarantees, they should satisfy themselves with the bona fides of the applicant and his capacity to perform the contract and also that the value of the bid/ guarantee as a percentage of the value of the contract/ tender is reasonable and according to the normal practice in international trade, and that the terms of the contract are in accordance with the Foreign Exchange Management regulations.
- iii. Authorised Dealer banks, should also, subject to what has been stated above, issue counter-guarantees in favour of their branches/ correspondents abroad in cover of guarantees required to be issued by the latter on behalf of Indian exporters, in cases where guarantees of only resident banks are acceptable to overseas buyers in accordance with local laws/ regulations.
- iv. If and when the bond/ guarantee is invoked, Authorised Dealer banks may make payments due thereunder to non-resident beneficiaries.

2.3.2 Issue of Bank Guarantee

In terms of Regulation 4 of the Foreign Exchange Management (Guarantees) Regulations, 2000 notified by Notification no. FEMA.8/2000-RB dated May 3, 2000, AD banks are allowed to give guarantees in certain cases, as stated therein.

(i) Issue of Bank Guarantee in favour of Foreign Airlines/IATA

Indian agents of foreign airline companies who are members of International Air Transport Association (IATA), are required to furnish bank guarantees in favour of foreign airline companies/IATA, in connection with their ticketing business. As this is a standard requirement in this business, Authorised Dealer banks in their ordinary course of business can issue guarantees in favour of the foreign airline companies/IATA on behalf of Indian agents of foreign airline companies, who are members of International Air Transport Association (IATA), in connection with their ticketing business.

(ii) Issue of Bank Guarantee on behalf of Service Importers

With a view to further liberalise the procedure for import of services, AD Category-I banks have been permitted (with effect from November 17, 2006) to issue guarantee on behalf of their customers importing services, provided:

- (a) the guarantee amount does not exceed USD 100,000;
- (b) the AD Category-I bank is satisfied about the bona fides of the transaction;
- (c) the AD Category-I bank ensures submission of documentary evidence for import of services in the normal course; and
- (d) the guarantee is to secure a direct contractual liability arising out of a contract between a resident and a non-resident.

(iii) In case of invocation of the guarantee, the authorised dealer bank should send a detailed report to the Chief General Manager-in-Charge, Foreign Exchange Department, External Payments Division (EPD), Reserve Bank of India, Central Office, Mumbai – 400 001, explaining the circumstances leading to the invocation of the guarantee.

2.3.3 Other Stipulations

- i. With a view to boost exports, banks should adopt a flexible approach in the matter of obtaining cover and earmarking of assets/ credit limits, drawing power, while issuing bid bonds and performance guarantees for export purposes. Banks may, however, safeguard their interests by obtaining an Export Performance Guarantee of ECGC, wherever considered necessary.
- ii. Export Credit & Guarantee Corporation (ECGC) would provide 90 percent cover for bid bonds, provided the banks give an undertaking not to insist on cash margins.
- iii. Banks may not, therefore, ask for any cash margin in respect of bid bonds and guarantees which are counter-guaranteed by ECGC.
- iv. In other cases, where such counter-guarantees of ECGC are not available, for whatever reasons, the banks may stipulate a reasonable cash margin only where it is considered absolutely necessary, as they satisfy themselves generally about the capacity and financial position of the exporter while issuing such bid bonds/ guarantees.
- v. Banks may consider sanctioning separate limits for issue of bid bonds. Within the limits so sanctioned, bid bonds against individual contracts may be issued, subject to usual considerations.

2.3.4 Unconditional Guarantees in favour of Overseas Employers/ Importers on behalf of Indian Exporters

i. While agreeing to give unconditional guarantee in favour of overseas employers/importers on behalf of Indian Exporters, banks should obtain an undertaking from the exporter to the effect that when the guarantee is invoked, the bank would be entitled to make payment, notwithstanding any dispute between the exporter and the importer. Although, such an undertaking may not prevent the exporter from approaching the Court for an injunction order, it might weigh with the Court in taking a view whether injunction order should be issued.

ii. Banks should, while issuing guarantees in future, keep the above points in view and incorporate suitable clauses in the agreement, in consultation with their legal advisers. This is considered desirable as non-honouring of guarantees on invocation might prompt overseas banks not to accept guarantees of Indian banks, thus hampering the country's export promotion effort.

2.3.5 Certain Precautions in case of Project Exports

i. Banks are aware that the Working Group mechanism has been evolved for the purpose of giving package approvals in principle at post-bid stages for high value overseas project exports. The role of the Working Group is mainly regulatory in nature, but the responsibility of project appraisal and that of monitoring the project lies solely on the sponsor bank.

ii. As the Working Group approvals are based on the recommendations of the sponsor banks, the latter should examine the project proposals thoroughly with regard to the capacity of the contractor/ sub-contractors, protective clauses in the contracts, adequacy of security, credit ratings of the overseas sub-contractors, if any, etc.

iii. Therefore, the need for a careful assessment of financial and technical demands involved in the proposals vis-à-vis the capability of the contractors (including sub-contractors) as well as the overseas employers can hardly be under-rated to the financing of any domestic projects. In fact, the export projects should be given more attention, in view of their high values and the possibilities of foreign exchange losses in case of failure, apart from damage to the image of Indian entrepreneurs.

iv. While bid bonds and performance guarantees cannot be avoided, it is to be considered whether guarantees should be given by the banks in all cases of overseas borrowings for financing overseas projects. Such guarantees should not be executed as a matter of course, merely because of the participation of Exim Bank and availability of counter-guarantee of ECGC. Appropriate arrangements should also be made for post-award follow-up and monitoring of the contracts.

2.3.6 Guarantees for Export Advance

(i) It had come to the notice of Reserve Bank that exporters with low export turnover are receiving large amounts as export advances, in low interest rate currencies, against domestic bank guarantees and are depositing such advances with banks in Indian Rupees for interest rate arbitrage. Further, the guarantees are being issued even before the receipt of the advances, with a proviso that the guarantees would be operational only upon receipt of the advances. The guarantees have been issued at par values, against the discounted values of the export advances. The exporters have also been allowed to freely book, cancel and rebook forward contracts without any crystallized exports and / or past performances, in contravention of the FEMA regulations. It has also been observed that the exporters keep a substantial part of their Indian Rupee – US Dollar leg of the currency exposure open, thereby exposing both the exporters and the domestic banks to foreign exchange risk. In such cases, generally no exports have taken place and the exporters have neither the track record nor the ability to execute large export orders. The transactions have basically been designed for taking advantage of the interest rate differential and currency movements and have implications for capital flows.

(ii) Guarantees are permitted in respect of debt or other liability incurred by an exporter on account of exports from India. It is therefore intended to facilitate execution of export contracts by an exporter and not for other purposes. In terms of extant instructions banks have also been advised that guarantees contain inherent risks, and that it would not be in the banks' interest or in the public interest generally to encourage parties to over-extend their commitments and embark upon enterprises solely relying on the easy availability of guarantee facilities. It is, therefore, reiterated that as guarantees contain inherent risks, it would not be in the interest of the banks or the financial system if such transactions, as mentioned at paragraph 2.3.6(i) above, are entered into by banks. Banks should, therefore, be careful while extending guarantees against export advances so as to ensure that no violation of FEMA regulations takes place and banks are not exposed to various risks. It will be important for the banks to carry out due diligence and verify the track record of such exporters to assess their ability to execute such export orders.

(iii) Banks should also ensure that the export advances received by the exporters are in compliance with the regulations/ directions issued under the Foreign Exchange Management Act, 1999.

2.3.7 Review of Banks' Procedures

Banks may periodically review the position regarding delegation of powers and their procedures, and take such action as may be necessary with a view to expediting decision on export proposals. They may also consider designating a specified branch, equipped with adequately qualified and trained staff, in each important centre to deal expeditiously with all export credit proposals at the centre.

2.3.8 Other Guarantees regulated by Foreign Exchange Management Rules

Issue of the following types of guarantees are governed by the Foreign Exchange Management Regulations:

- i. Minor Guarantees
- ii. Bank Guarantees - Import under Foreign Loans/Credits
- iii. Guarantees for Non-Residents

For operative instructions, a reference may be made to the notification issued under FEMA.8/ 2000 dated May 3, 2000 cited above, as well as to the guidelines issued by the Foreign Exchange Department in its Master Circular No.7/2004-05 dated July 1, 2004 and No.8/2004-05 dated July 1, 2004 relating to Imports and Exports, respectively. However, for ease of reference, instructions/ guidelines in regard to issue of these guarantees are reproduced hereunder.

2.3.8.1 Minor guarantees

Authorised Dealer banks may freely give on behalf of their customers and overseas branches and correspondents, guarantees in the ordinary course of business in respect of missing or defective documents, authenticity of signatures and for other similar purposes.

2.3.8.2 Bank guarantees - Import under foreign loans/credits

i) Issue of guarantees in favour of foreign lenders or suppliers (in the case of Supplier's Credits) requires approval of RBI. While granting approval for raising the foreign currency loan/ credit, RBI will grant the required permission to the concerned Authorised Dealer banks. In the event of invocation of the guarantee, the concerned Authorised Dealer banks may make the necessary remittance without reference to RBI. A report should, however, be sent to RBI giving full details citing reference to the approval for furnishing the guarantee. A copy of the claim received from the overseas party should be enclosed with such report.

ii) Banks are not permitted to issue guarantees/ standby letters of credit or letters of comfort in favour of overseas lenders relating to External Commercial Borrowing (ECB). Applications for providing guarantees/ standby letters of credit or letters of comfort by banks relating to ECB in the case of SMEs will be considered by the Reserve Bank on merit under the Approval Route, subject to prudential norms. Applications by banks for issue of guarantees, standby letters of credit, letters of undertaking or letter of comfort in respect of ECB by textile companies for modernization or expansion of the textile units, after the phasing out of Multi Fibre Agreements, will be considered by Reserve Bank under the Approval Route subject to prudential norms.

2.3.8.3 Trade Credits for imports into India – Issue of Guarantees - Delegation of powers

- i. Credit extended for imports directly by the overseas supplier, bank and financial institution for original maturity of less than three years is hereinafter referred to as 'trade credit' for imports. Depending on the source of finance, such trade credit will include suppliers' credit or buyers' credit. It may be noted that buyers' credit and suppliers' credit for three years and above come under the category of External Commercial Borrowings (ECB), which are governed by ECB guidelines issued vide A. P. (DIR Series) Circular No. 60 dated January 31, 2004 and modified from time to time.
- ii. AD banks can approve trade credits for imports into India up to USD 20 million per import transaction for import of all items (permissible under the EXIM Policy) with a maturity period (from the date of shipment) up to one year. For import of capital goods, AD banks may approve trade credits up to USD 20 million per import transaction with a maturity period of more than one year and less than three years. No roll-over/ extension will be permitted by the AD banks beyond the permissible period.
- iii. General permission has been granted to Authorised Dealer banks to issue guarantees/ Letter of Undertaking (LoU)/ Letter of Comfort (LoC) in favour of the overseas supplier, bank and financial institution up to USD 20 million per import transaction for a period up to one year for import of all non-capital goods permissible, under the Foreign Trade Policy (except gold) and up to three years for import of capital goods, subject to prudential norms issued by the Reserve Bank from time to time. The period of such guarantees/LoUs/LoCs has to be co-terminus with the period of credit, reckoned from the date of shipment.
- iv. As regards reporting arrangements, AD banks are required to furnish data on issuance of guarantees/LoUs/LoCs by all its branches, in a consolidated statement, at quarterly intervals (format in **Annex 2**) to the Chief General Manager, Foreign Exchange Department, ECB Division, Reserve Bank of India, Central Office Building, 11th floor, Fort, Mumbai – 400 001 (and in MS-Excel file through email to fedcoecbd@rbi.org.in) from December, 2004 onwards so as to reach the department not later than the 10th of the following month.

2.3.8.4 Loans abroad against securities provided in India

In terms of Regulation 4(2) of Notification No. FEMA.8/2000-RB dated May 3, 2000, an AD may give guarantee in respect of any debt, obligations or other liability incurred by a person resident outside India, among others, where such debt, obligation or liability is owed to a person resident in India in connection with a bona fide trade transaction, provided that the guarantee is covered by a counter guarantee of a bank of international repute resident abroad.

2.3.8.5 Guarantees for non-residents

- i. Reserve Bank has granted general permission to Authorised Dealer banks, vide its Notification No. FEMA/8/ 2000 dated 3rd May 2000, to give guarantees in favour of persons resident in India in respect of any debt or other obligation or liability of a person resident outside India, subject to such instructions as may be issued by RBI from time to time.
- ii. Authorised Dealer banks may, accordingly, give on behalf of their overseas branches/ correspondents or a bank of international repute, guarantees/ performance bonds in favour of residents of India in connection with genuine transactions involving debt, liability or obligation of non-residents, provided the bond/ guarantee is covered by a counter-guarantee of the overseas Head Office/ branch/ correspondent or a bank of international repute.
- iii. Authorised Dealer banks should ensure that counter-guarantees are properly evaluated and their own guarantees against such guarantees are not issued in a routine manner. Before issuing a guarantee against the counter-guarantee from an overseas Head Office/branch/ correspondent/ bank of international repute, Authorised Dealer banks should satisfy themselves that the obligations under the counter-guarantee, when invoked, would be honoured by the overseas bank promptly. If the Authorised Dealer bank desires to issue guarantee with the condition that payment will be made, provided reimbursement has been received from the overseas bank which had issued the counter-guarantee, this fact should be made clearly known to the beneficiary in the guarantee document itself.
- iv. Authorised Dealer banks may make rupee payments to the resident beneficiaries immediately when the guarantee is invoked and, simultaneously, arrange to obtain the reimbursement from the overseas bank concerned, which had issued the counter-guarantee.
- v. Cases where payments are not received by the Authorised Dealer banks when the guarantees of overseas banks are invoked, should be reported to RBI indicating the steps being taken by the bank to recover the amount due under the guarantee.
- vi. Authorised Dealer banks may issue guarantees in favour of overseas organisations issuing travellers cheques in respect of blank travellers cheques stocked for sale by them or on behalf of their constituents who are full-fledged money changers holding valid licences from Reserve Bank, subject to suitable counter-guarantee being obtained from the latter. In the event of the guarantee being invoked, Authorised Dealer banks may effect remittance but should send a separate report thereon furnishing full details to the Chief General Manager, Foreign Exchange Department, (Forex Markets Division), Reserve Bank of India, Central Office, Mumbai - 400 001.

2.3.8.6 Overseas Investment – Guarantee on behalf of Wholly Owned Subsidiaries (WOSs)/Joint Ventures (JVs) abroad

- i. Presently, only promoter corporates are permitted to offer guarantees on behalf of their Wholly Owned Subsidiaries (WOSs)/Joint Ventures (JVs), under the Automatic Route and issue of personal, collateral and third party guarantees requires prior approval of Reserve Bank and is considered by RBI, on a case by case basis.
- ii. The scope of guarantees covered under the Automatic Route has been enlarged. Indian entities are now permitted to offer any forms of guarantee – corporate or personal/ primary or collateral/ guarantee by the promoter company/ guarantee by group company, sister concern or associate company in India, provided:
 - a) All "financial commitments" including all forms of guarantees are within the overall prescribed ceiling for overseas investment of the Indian party i.e. currently within 200 per cent of the net worth of the investing company (Indian party).
 - b) No guarantee is 'open ended' i.e. the amount of the guarantee should be specified upfront, and
 - c) As in the case of corporate guarantees, all guarantees are required to be reported to RBI in form ODR.
- iii. Guarantees issued by banks in India in favour of WOS/ JVs outside India are outside this ceiling and would be subject to prudential norms issued by RBI from time to time.

2.4 Restrictions on guarantees of inter-company deposits/loans

Banks should not execute guarantees covering inter-company deposits/loans thereby guaranteeing refund of deposits/loans accepted by NBFC/firms from other NBFC/firms.

2.4.1 Restriction on guarantees for placement of funds with NBFCs

These instructions would cover all types of deposits/ loans irrespective of their source, including deposits/loans received by NBFCs from trusts and other institutions. Guarantees should not be issued for the purpose of indirectly enabling the placement of deposits with NBFCs.

2.4.2 Restrictions on Inter-Institutional Guarantees

- 2.4.2.1 Banks should not execute guarantees covering inter-company deposits/ loans. Guarantees should not, also, be issued for the purpose of indirectly enabling the placement of deposits with non-banking institutions. This stipulation will apply to all types of deposits/loans irrespective of their source, e.g. deposits/ loans received by non-banking companies from trusts and other institutions.

2.4.2.2 Transactions of the following type are in the nature of guarantees executed by banks in respect of funds made available by one non-banking to another non-banking company and banks should therefore, desist from such practices:

- a) A seller drew bills, normally of 120 to 180 days usance, on the buyer which were accepted by the buyer and co-accepted by his banker. The bills were discounted by the seller with the accommodating company, which retained the bills till the due date. The bank which gave co-acceptance invariably earmarked funds for the liability under the bills against the drawing power in respect of stocks held in the cash credit account of its client, the buyer, or
- b) The accommodating company kept deposits for a specific period with the bank's borrowers under a guarantee executed by the bank. In such a case also, the bank earmarked the amount against drawing power available in the cash credit account.

2.4.2.3 (a) Banks may issue guarantees favouring other banks/ FIs/ other lending agencies for the loans extended by the latter, subject to strict compliance with the following conditions.

- i. The Board of Directors should reckon the integrity/ robustness of the bank's risk management systems and, accordingly, put in place a well-laid out policy in this regard.

The Board approved policy should, among others, address the following issues:

- a. Prudential limits, linked to bank's Tier I capital, up to which guarantees favouring other banks/FIs/other lending agencies may be issued
 - b. Nature and extent of security and margins
 - c. Delegation of powers
 - d. Reporting system
 - e. Periodical reviews
- ii. The guarantee shall be extended only in respect of borrower constituents and to enable them to avail of additional credit facility from other banks/FIs/lending agencies.
 - iii. The guaranteeing bank should assume a funded exposure of at least 10% of the exposure guaranteed.
 - iv. Banks should not extend guarantees or letters of comfort in favour of overseas lenders including those assignable to overseas lenders. However, AD banks may also be guided by the provisions contained in Notification No. FEMA 8/2000-RB dated May 3, 2000.
 - v. The guarantee issued by the bank will be an exposure on the borrowing entity on whose behalf the guarantee has been issued and will attract appropriate risk weight, as per the extant guidelines.
 - vi. Banks should ensure compliance with the recommendations of the Ghosh Committee and other internal requirements relating to issue of guarantees, to obviate the possibility of frauds in this area.

2.4.2.3 (b) Lending Banks

Banks extending credit facilities against the guarantees issued by other banks/FIs should ensure strict compliance with the following conditions:

- i. The exposure assumed by the bank against the guarantee of another bank/FI will be deemed as an exposure on the guaranteeing bank/FI and will attract appropriate risk weight as per the extant guidelines.
- ii. Exposures assumed by way of credit facilities extended against the guarantees issued by other banks should be reckoned within the inter bank exposure limits prescribed by the Board of Directors. Since the exposure assumed by the bank against the guarantee of another bank/FI will be for a fairly longer term than those assumed on account of inter-bank dealings in the money market, foreign exchange market and securities market, the Board of Directors should fix an appropriate sub-limit for the longer term exposures, since these exposures attract greater risk.
- iii. Banks should monitor the exposure assumed on the guaranteeing bank/ FI, on a continuous basis and ensure strict compliance with the prudential limits/ sub limits prescribed by the Board for banks and the prudential single borrower limits prescribed by RBI for FIs.
- iv. Banks should comply with the recommendations of the Ghosh Committee and other internal requirements relating to acceptance of guarantees of other banks, to obviate the possibility of frauds in this area.

2.4.2.4 Exceptions

- i. In regard to rehabilitation of sick/weak industrial units, in exceptional cases, where banks are unable to participate in rehabilitation packages on account of temporary liquidity constraints, the concerned banks could provide guarantees in favour of the banks which take up their additional share. Such guarantees will remain extant until such time that the banks providing additional finance against guarantees are re-compensated.
- ii. In respect of infrastructure projects, banks may issue guarantees favouring other lending institutions, provided the bank issuing the guarantee takes a funded share in the project at least to the extent of 5 percent of the project cost and undertakes normal credit appraisal, monitoring and follow up of the project.
- iii. In cases of Sellers Line of Credit Scheme (since renamed as Direct Discounting Scheme) operated by Industrial Development Bank of India Ltd.¹ and all India financial institutions like SIDBI, PFC, etc for sale of machinery, the primary credit is provided by the seller's bank to the seller through bills drawn on the buyer and the seller's bank has no access to the security covered by the transaction which remains with the buyer. As such, buyer's banks are permitted to extend guarantee/ co-acceptance facility for the bills drawn under seller's line of credit.

¹ The scheme which was having operated by the erstwhile IDBI is being continued by Industrial Development Bank of India Ltd.

iv. Similarly, guarantees can be issued in favour of HUDCO/ State Housing Boards and similar bodies/ organisations for the loans granted by them to private borrowers who are unable to offer clear and marketable title to property, provided banks are otherwise satisfied with the capacity of the borrowers to adequately service such loans.

v. Banks may sanction issuance of guarantees on behalf of their constituents, favouring Development Agencies/ Boards like Indian Renewable Energy Development Agency, National Horticulture Board, etc., for obtaining soft loans and/or other forms of development assistance.

2.4.2.5 Infrastructure projects

Keeping in view the special features of lending to infrastructure projects viz., the high degree of appraisal skills on the part of lenders and availability of resources of a maturity matching with the project period, banks have been given discretion in the matter of issuance of guarantees favouring other lending agencies, in respect of infrastructure projects alone, subject to the following conditions:

- (i) The bank issuing the guarantee takes a funded share in the project at least to the extent of 5 percent of the project cost and undertakes normal credit appraisal, monitoring and follow-up of the project.
- (ii) The guarantor bank has a satisfactory record in compliance with the prudential regulations, such as, capital adequacy, credit exposure, norms relating to income recognition, asset classification and provisioning, etc.

2.5. Payment of invoked guarantees

- 2.5.1 Where guarantees are invoked, payment should be made to the beneficiaries without delay and demur. An appropriate procedure for ensuring such immediate honouring of guarantees should be laid down so that there is no delay on the pretext that legal advice or approval of higher authorities is being obtained.
- 2.5.2 Delays on the part of banks in honouring the guarantees when invoked tend to erode the value of the bank guarantees, the sanctity of the scheme of guarantees and image of banks. It also provides an opportunity to the parties to take recourse to courts and obtain injunction orders. In the case of guarantees in favour of Government departments, this not only delays the revenue collection efforts but also give an erroneous impression that banks are actively in collusion with the parties, which tarnish the image of the banking system.
- 2.5.3 There should be an effective system to process the guarantee business to ensure that the persons on whose behalf the guarantees are issued will be in a position to perform their obligations in the case of performance guarantees and honour their commitments out of their own resources, as and when needed, in the case of financial guarantees.
- 2.5.4 The top management of the banks should bestow their personal attention to the need to put in place a proper mechanism for making payments in respect of invoked guarantees promptly, so that no room is given for such complaints. When complaints are made, particularly by the Government departments for not honouring the guarantees issued, the top management of the bank, including its Chief Executive Officer, should personally look into such complaints.

2.5.5 In this regard, the Delhi High Court has made adverse remarks against certain banks in not promptly honouring the commitment of guarantees when invoked. It has been observed that a bank guarantee is a contract between the beneficiary and the bank. When the beneficiary invokes the bank guarantee and a letter invoking the same is sent in terms of the bank guarantee, it is obligatory on the bank to make payment to the beneficiary.

2.5.6 The Supreme Court had observed [U.P. Co-operative Federation Private Ltd. versus Singh Consultants and Engineers Private Ltd. (1988 IC SSC 174)] that the commitments of the banks must be honoured, free from interference by the courts. The relevant extract from the judgement of the Supreme Court in a case is as under:

'We are, therefore, of the opinion that the correct position of law is that commitment of banks must be honoured free from interference by the courts and it is only in exceptional cases, that is, to say, in case of fraud or any case where irretrievable injustice would be done if bank guarantee is allowed to be encashed, the court should interfere'.

2.5.7 In order to avoid such situations, it is absolutely essential for banks to appraise the proposals for guarantees also with the same diligence, as in the case of fund based limits, and obtain adequate cover by way of margin so as to prevent the constituents to develop a tendency of defaulting in payments when invoked guarantees are honoured by the banks.

2.5.8 i. In the interest of the smooth working of the Bank Guarantee Scheme, it is essential to ensure that there is no discontentment on the part of the Government departments regarding its working. Banks are required to ensure that the guarantees issued by them are honoured without delay and hesitation when they are invoked by the Government departments in accordance with the terms and conditions of the guarantee deed, unless there is a Court order restraining the banks.

ii. Any decision not to honour the obligation under the guarantee invoked may be taken after careful consideration, at a fairly senior level, and only in the circumstances where the bank is satisfied that any such payment to the beneficiary would not be deemed a rightful payment in accordance with the terms and conditions of the guarantee under the Indian Contract Act.

iii. The Chief Executive Officers of banks should assume personal responsibility for such complaints received from Government departments. Sufficient powers should be delegated to the line functionaries so that delay on account of reference to higher authorities for payment under the guarantee does not occur.

iv. Banks should also introduce an appropriate procedure for ensuring immediate honouring of guarantees, so that there is no delay on the pretext that legal advice or approval of higher authorities is being obtained.

v. For any non-payment of guarantee in time, staff accountability should be fixed and stern disciplinary action including award of major penalty such as dismissal, should be taken against the delinquent officials at all levels.

- vi. Where banks have executed bank guarantees in favour of Customs and Central Excise authorities to cover differential duty amounts in connection with interim orders issued by High Courts, the guarantee amount should be released immediately when they are invoked on vacation of the stay orders by Courts. Banks should not hold back the amount on the pretext that it would affect their liquidity position.
- 2.5.9.
- i. There have also been complaints by Ministry of Finance that some of the departments such as Department of Revenue, Government of India are finding it difficult to execute judgements delivered by various Courts in their favour as banks do not honour their guarantees, unless certified copies of the Court judgements are made available to them. In this regard, the banks may follow the following procedure:
 - ii. Where the bank is a party to the proceedings initiated by Government for enforcement of the bank guarantee and the case is decided in favour of the Government by the Court, banks should not insist on production of certified copy of the judgement, as the judgement/ order is pronounced in open Court in presence of the parties/ their counsels and the judgement is known to the bank.
 - iii. In case the bank is not a party to the proceedings, a signed copy of the minutes of the order certified by the Registrar/ Deputy or Assistant Registrar of the High Court or the ordinary copy of the judgement/ order of the High Court, duly attested to be true copy by Government Counsel, should be sufficient for honouring the obligation under guarantee, unless the guarantor bank decides to file any appeal against the order of the High Court.
 - iv. Banks should honour the guarantees issued by them as and when they are invoked in accordance with the terms and conditions of the guarantee deeds. In case of any disputes, such honouring can be done under protest, if necessary, and the matters of dispute pursued separately.
 - v. The Government, on their part, have advised the various Government departments, etc. that the invocation of guarantees should be done after careful consideration at a senior-level that a default has occurred in accordance with the terms and conditions of the guarantees and as provided in the guarantee deed.
 - vi. Non-compliance of the instructions in regard to honouring commitments under invoked guarantees will be viewed by Reserve Bank very seriously and Reserve Bank will be constrained to take deterrent action against the banks.

2.6 Co-acceptance of bills

2.6.1 General

Reserve Bank has observed that some banks co-accept bills of their customers and also discount bills co-accepted by other banks in a casual manner. These bills subsequently turn out to be accommodation bills drawn by groups of sister concerns on each other where no genuine trade transaction takes place. Banks, while discounting such bills, appear to ignore this important aspect presumably because of the co-acceptance given by other banks. The bills, on maturity, are not honoured by the drawees and the banks which co-accept the bills have to make payment of these bills, and they find it difficult to recover the amount from the drawers/ drawees of bills. Banks also discount bills for sizeable amounts, which are co-accepted by certain Urban Co-operative Banks. On maturity, the bills are not honoured and the co-operative banks, which co-accept the bills, also find it difficult to make the payment. The financial position and capacity of the co-accepting bank to honour the bills, in the event of need, is not being gone into. Cases have also been observed where the particulars regarding co-acceptance of bills are not recorded in the bank's books, with the result that the extent thereof cannot be verified during inspections, and the Head Office becomes aware of the co-acceptance only when a claim is received from the discounting bank.

2.6.2 Safeguards

In the light of the above, banks should keep in view the following safeguards:

- i. While sanctioning co-acceptance limits to their customers, the need therefor should be ascertained, and such limits should be extended only to those customers who enjoy other limits with the bank.
- ii. Only genuine trade bills should be co-accepted and the banks should ensure that the goods covered by bills co-accepted are actually received in the stock accounts of the borrowers.
- iii. The valuation of the goods as mentioned in the accompanying invoice should be verified to see that there is no over-valuation of stocks.
- iv. The banks should not extend their co-acceptance to house bills/ accommodation bills drawn by group concerns on one another.
- v. The banks discounting such bills, co-accepted by other banks, should also ensure that the bills are not accommodation bills and that the co-accepting bank has the capacity to redeem the obligation in case of need.
- vi. Bank-wise limits should be fixed, taking into consideration the size of each bank for discounting bills co-accepted by other banks, and the relative powers of the officials of the other banks should be got registered with the discounting banks.
- vii. Care should be taken to see that the co-acceptance liability of any bank is not disproportionate to its known resources position.

- viii. A system of obtaining periodical confirmation of the liability of co-accepting banks in regard to the outstanding bills should be introduced.
- ix. Proper records of the bills co-accepted for each customer should be maintained, so that the commitments for each customer and the total commitments at a branch can be readily ascertained, and these should be scrutinised by Internal Inspectors and commented upon in their reports.
- x. It is also desirable for the discounting bank to advise the Head Office/ Controlling Office of the bank, which has co-accepted the bills, whenever such transactions appear to be disproportionate or large.
- xi. Proper periodical returns may be prescribed so that the Branch Managers report such co-acceptance commitments entered into by them to the Controlling Offices.
- xii. Such returns should also reveal the position of bills that have become overdue, and which the bank had to meet under the co-acceptance obligation. This will enable the Controlling Offices to monitor such co-acceptances furnished by the branches and take suitable action in time, in difficult cases.
- xiii. Co-acceptances in respect of bills for Rs.10,000/- and above should be signed by two officials jointly, deviation being allowed only in exceptional cases, e.g. non-availability of two officials at a branch.
- xiv. Before discounting/ purchasing bills co-accepted by other banks for Rs. 2 lakh and above from a single party, the bank should obtain written confirmation of the concerned Controlling (Regional/ Divisional/ Zonal) Office of the accepting bank and a record of the same should be kept.
- xv. When the value of the total bills discounted/ purchased (which have been co-accepted by other banks) exceeds Rs. 20 lakh for a single borrower/ group of borrowers, prior approval of the Head Office of the co-accepting bank must be obtained by the discounting bank in writing.
- 2.6.3 In addition to the above safeguards to be observed by banks in co-accepting the bills, it must be noted that the banks are precluded from co-accepting bills drawn under Buyers Line of Credit Schemes introduced by Industrial Development Bank of India Ltd. and all India financial institutions like SIDBI, Power Finance Corporation Ltd. (PFC), etc. Similarly, banks should not co-accept bills drawn by NBFCs. In addition, banks are advised not to extend co-acceptance on behalf of their buyers/constituents under the SIDBI Scheme.
- 2.6.4 However, banks may co-accept bills drawn under the Sellers Line of Credit Schemes (since renamed as Direct Discounting Scheme) operated by Industrial Development Bank of India Ltd.² and all India financial institutions for Bill Discounting operated by Industrial Development Bank of India Ltd.³ and all India financial institutions like SIDBI, PFC, etc. without any limit, subject to the buyer's capability to pay, and compliance with the exposure norms prescribed by the bank for individual/ group borrowers.

² The scheme which was having operated by the erstwhile IDBI is being continued by Industrial Development Bank of India Ltd.

³ The Scheme which was being operated by the erstwhile IDBI is being continued by Industrial Development Bank of India Ltd.

- 2.6.5 There have been instances where branches of banks open L/Cs on behalf of their constituents and also co-accept the bills drawn under such L/Cs. Legally, if a bank co-accepts a bill drawn under its own L/C, the bill so co-accepted becomes an independent document. The special rules applicable to commercial credits do not apply to such a bill and the bill is exclusively governed by the law relating to Bills of Exchange, i.e. the Negotiable Instruments Act. The negotiating bank of such a bill is not under any obligation to check the particulars of the bill with reference to the terms of the L/C. This practice is, therefore, superfluous and defeats the purpose of issuing the L/C. The discounting banks should first ascertain from the co-accepting banks, the reason for such co-acceptance of bills drawn under their own L/C and only after satisfying themselves of genuineness of such transactions, they may consider discounting such bills.
- 2.6.6 It should be ensured that the branch officials strictly adhere to the above referred instructions at the time of co-acceptance of bills. It would be advisable to determine clear accountability in this respect and officials found to be not complying with the instructions must be dealt with sternly.

2.7 Precautions to be taken in the case of Letters of Credit

- 2.7.1 Banks should not extend any non-fund based facilities or additional/ad-hoc credit facilities to parties who are not their regular constituents, nor should they discount bills drawn under LCs, or otherwise, for beneficiaries who are not their regular clients. In the case of LCs for import of goods, banks should be very vigilant while making payment to the overseas suppliers on the basis of shipping documents. They should exercise precaution and care in comparing the clients. The payments should be released to the foreign parties only after ensuring that the documents are strictly in conformity with the terms of the LCs. There have been many irregularities in the conduct of LC business, such as the LC transactions not being recorded in the books of the branch by officials issuing them, the amount of LCs being much in excess of the powers vested in the officials, fraudulent issue of LCs involving a conspiracy/collusion between the beneficiary and the constituent. In such cases, the banks should take action against the concerned officials as well as the constituent on whose behalf the LCs were opened and the beneficiary of LCs, if a criminal conspiracy is involved.
- 2.7.2 Settlement of claims under Letters of Credits(LCs)

In case the bills drawn under LCs are not honoured, it would adversely affect the character of LCs and the relative bills as an accepted means of payment. This could also affect the creditability of the entire payment mechanism through banks and affect the image of the banks. Banks should, therefore, honour their commitments under LCs and make payments promptly.

ANNEX 1

Revised Model Form of Bank Guarantee Bond
[paragraph 2.2.7.2]

GUARANTEE BOND

1. In consideration of the President of India (hereinafter called 'the Government') having agreed to exempt _____ [hereinafter called 'the said Contractor(s)'] from the demand, under the terms and conditions of an Agreement dated _____ made between _____ and _____ for _____ (hereinafter called 'the said Agreement'), of security deposit for the due fulfilment by the said Contractor(s) of the terms and conditions contained in the said Agreement, on production of a bank Guarantee for Rs. _____ (Rupees _____ Only) We, _____, (hereinafter referred (indicate the name of the bank) to as 'the Bank') at the request of _____ [contractor(s)] do hereby undertake to pay to the Government an amount not exceeding Rs. _____ against any loss or damage caused to or suffered or would be caused to or suffered by the Government by reason of any breach by the said Contractor(s) of any of the terms or conditions contained in the said Agreement.

2. We _____ (indicate the name of the bank) do hereby undertake to pay the amounts due and payable under this guarantee without any demur, merely on a demand from the Government stating that the amount claimed is due by way of loss or damage caused to or would be caused to or suffered by the Government by reason of breach by the said contractor(s) of any of the terms or conditions contained in the said Agreement or by reason of the contractor(s)' failure to perform the said Agreement. Any such demand made on the bank shall be conclusive as regards the amount due and payable by the Bank under this guarantee. However, our liability under this guarantee shall be restricted to an amount not exceeding Rs. _____.

3. We undertake to pay to the Government any money so demanded notwithstanding any dispute or disputes raised by the contractor(s)/supplier(s) in any suit or proceeding pending before any Court or Tribunal relating thereto our liability under this present being absolute and unequivocal.

The payment so made by us under this bond shall be a valid discharge of our liability for payment thereunder and the contractor(s)/supplier(s) shall have no claim against us for making such payment.

4. We, _____ (indicate the name of bank) further agree that the guarantee herein contained shall remain in full force and effect during the period that would be taken for the performance of the said Agreement and that it shall continue to be enforceable till all the dues of the Government under or by virtue of the said Agreement have been fully paid and its claims satisfied or discharged or till _____ Office/Department/Ministry of _____ certifies that the terms and conditions of the said

Agreement have been fully and properly carried out by the said contractor(s) and accordingly discharges this guarantee. Unless a demand or claim under this guarantee is made on us in writing on or before the _____ we shall be discharged from all liability under this guarantee thereafter.

5. We, _____ (indicate the name of bank) further agree with the Government that the Government shall have the fullest liberty without our consent and without affecting in any manner our obligations hereunder to vary any of the terms and conditions of the said Agreement or to extend time of performance by the said contractor(s) from time to time or to postpone for any time or from time to time any of the powers exercisable by the Government against the said Contractor(s) and to forbear or enforce any of the terms and conditions relating to the said agreement and we shall not be relieved from our liability by reason of any such variation, or extension being granted to the said Contractor(s) or for any forbearance, act or omission on the part of the Government or any indulgence by the Government to the said Contractor(s) or by any such matter or thing whatsoever which under the law relating to sureties would, but for this provision, have effect of so relieving us.

6. This guarantee will not be discharged due to the change in the constitution of the Bank or the Contractor(s)/Supplier(s).

7. We, _____ (indicate the name of bank) lastly undertake not to revoke this guarantee during its currency except with the previous consent of the Government in writing.

8. Dated the _____ day of _____ for
_____ (indicate the name of the Bank).

ANNEX 2

**Annex to A. P. DIR Series Circular No. 24 dated November 1, 2004
[paragraph 2.3.8.3(iv)]**

Guarantees / Letter of Undertaking / Letter of Comfort issued / invoked by ADs

As on quarter ended

Name of the AD :		Contact Person:
Address :		Tel:
e-mail:		Fax:

(USD million)

On behalf of Residents	Guarantees / Letter of Undertaking / Letter of Comfort	
	Issued	
	Buyer's Credit	Supplier's Credit
Trade Credits (less than 3 years) a. Up to one year b. Above one year and less than three years ** ** (Limited to Import of Capital Goods)		

1

Place:----- ----			Signature of the Authorised Signatory
Date: ----- ---	[Stamp]		

RBI/2008-09/ 41

RPCD.SME&NFS. BC. No. 2 / 06.02.31/ 2008-09

July 1 , 2008

**The Chairman/Managing Director/
Chief Executive Officer
All Scheduled Commercial Banks
(including Regional Rural Banks/Local Area Banks)**

Dear Sir,

**MASTER CIRCULAR -
LENDING TO MICRO, SMALL & MEDIUM ENTERPRISES (MSME) SECTOR**

As you are aware, the Reserve Bank of India has, from time to time, issued a number of guidelines/instructions/directives to banks in regard to matters relating to lending to Micro, Small & Medium Enterprises Sector. To enable the banks to have current instructions at one place, a Master Circular incorporating the existing guidelines/instructions/directives on the subject has been prepared and is appended. This Master Circular consolidates the instructions issued by the RBI up to June 30, 2008, which are listed in the *Appendix*, to the extent they deal with the MSME sector lending by commercial banks.

Please acknowledge receipt.

Yours faithfully,

(G.Srinivasan)
Chief General Manager

LENDING TO SME SECTOR

SECTION-I

1	SMALL ENTERPRISES
1.1.1	Small (manufacturing) Enterprises
	Enterprise engaged in the manufacture/production or preservation of goods and whose investment in plant and machinery (original cost excluding land and building and the items specified by the Ministry of Small Scale Industries vide its notification No. S.O. 1722(E) dated October 5, 2006 as furnished in Annexure I) does not exceed Rs. 5 crore
1.1.2	Small (service) Enterprises
	Enterprise engaged in the providing/rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings and other not directly related to the service rendered or as may be under the Micro, Small and Medium Enterprises Development, (MSMED), Act 2006) does not exceed Rs. 2 crore.
1.2.1	Micro (manufacturing) Enterprises
	Enterprise engaged in the manufacture/production or preservation of goods and whose investment in plant and machinery (original cost excluding land and building and such items as in 1.1.1) does not exceed Rs. 25 lakh , irrespective of the location of the unit.
1.2.2	Micro (service) Enterprises
	Enterprise engaged in the providing/rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings and such items as in 1.1.2) does not exceed Rs. 10 lakh.
1.3.1	Medium (manufacturing) Enterprises
	Enterprise engaged in the manufacture/production or preservation of goods and whose investment in plant and machinery (original cost excluding land and building and the items specified by the Ministry of Small Scale Industries vide its notification No. S.O. 1722(E) dated October 5, 2006) is more than Rs. 5 crore but does not exceed Rs. 10 crore.

1.3.2	Medium (service) Enterprises Enterprise engaged in the providing/rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings and such items as in 1.1.2) is more than Rs. 2 crore but does not exceed Rs. 5 crore. The small and micro (service) enterprises shall include small road & water transport operators, small business, professional & self-employed persons and all other service enterprises. Bank's lending to medium enterprises will not be included for the purpose of reckoning under priority sector.
1.4	Khadi and Village Industries Sector (KVI) All advances granted to units in the KVI sector, irrespective of their size of operations, location and amount of original investment in plant and machinery. Such advances will be eligible for consideration under the sub-target (60 per cent) of the small enterprises segment within the priority sector.

1.5 INDIRECT FINANCE

1.5.1	Persons involved in assisting the decentralised sector in the supply of inputs and marketing of outputs of artisans, village and cottage industries.
1.5.2	Advances to cooperatives of producers in the decentralised sector viz. artisans, village and cottage industries.
1.5.3	Existing investments as on March 31, 2007, made by banks in special bonds issued by NABARD with the objective of financing exclusively non- farm sector may be classified as indirect finance to Small Enterprises sector till the date of maturity of such bonds or March 2010, whichever is earlier. Investments in such special bonds made subsequent to March 31, 2007 will, however, not be eligible for such classification.
1.5.4	Deposits placed with SIDBI by foreign banks, having offices in India, on account of non-achievement of priority sector lending targets/sub-targets and outstanding as on April 30, 2007 would be eligible for classification as indirect finance to Small Enterprises sector till the date of maturity of such deposits or March 31, 2010, whichever is earlier. However, fresh deposits placed by banks' on or after April 30, 2007 with SIDBI on account of non-achievement of priority sector lending targets/sub-targets would not be eligible for classification as indirect finance to Small Enterprises Sector.
1.5.5	Loans granted by banks to NBFCs for on-lending to small and micro enterprises (manufacturing as well as service)

SECTION II

CERTAIN TYPES OF FUNDS DEPLOYMENT ELIGIBLE AS PRIORITY SECTOR ADVANCES

1.	INVESTMENTS
1.1	SECURITIZED ASSETS Investments made by banks in securitised assets, representing loans to various categories of priority sector, shall be eligible for classification under respective categories of priority sector (direct or indirect) depending on the underlying assets, provided the securitised assets are originated by banks and financial institutions and fulfil the Reserve Bank of India guidelines on securitisation. This would mean that the bank's investments in the above categories of securitised assets shall be eligible for classification under the respective categories of priority sector only if the securitised advances were eligible to be classified as priority sector advances before their securitisation.
1.2	Outright purchases of any loan asset eligible to be categorised under priority sector, shall be eligible for classification under the respective categories of priority sector (direct or indirect), provided the loans purchased are eligible to be categorised under priority sector; the loan assets are purchased (after due diligence and at fair value) from banks and financial institutions, without any recourse to the seller; and the eligible loan assets are not disposed of, other than by way of repayment, within a period of six months from the date of purchase.
1.3	Investments by banks in Inter Bank Certificates (IBPCs), on a risk sharing basis, shall be eligible for classification under respective categories of priority sector, provided the underlying assets are eligible to be categorised under the respective categories of priority sector and are held for at least 180 days from the date of investment.

2. SCHEME OF SMALL ENTERPRISES FINANCIAL CENTRES (SEFCs):

As per announcement made by the Governor in the Annual Policy Statement 2005-06, a scheme for strategic alliance between branches of banks and SIDBI located in clusters, named as “Small Enterprises Financial Centres” has been formulated in consultation with the Ministry of SSI and Banking Division, Ministry of Finance, Government of India, SIDBI, IBA and select banks and circulated to all scheduled commercial banks on May 20, 2005 for implementation. Initially, SIDBI had decided to start 149 such centres. SIDBI has so far executed MoU with 15 banks so far (Bank of India, UCO Bank, YES Bank, Bank of Baroda, Oriental Bank of Commerce, Punjab National Bank, Dena Bank, Andhra Bank, Indian Bank, Corporation Bank, IDBI Bank, Indian Overseas Bank, Union Bank of India, State Bank of India and Federal Bank). List of SME clusters covered by existing SIDBI branches is furnished in ***Annexure II***.

SECTION III

TARGETS FOR PRIORITY SECTOR LENDING BY DOMESTIC COMMERCIAL BANKS (EXCLUDING RRBS)	
1.	MAIN TARGETS FOR ALL DOMESTIC COMMERCIAL BANKS EXCLUDING FOREIGN BANKS
1.1	The domestic commercial banks are expected to enlarge credit to priority sector and ensure that priority sector advances (which includes the small enterprises sector) constitute 40 per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.
1.2	While there is no sub-target fixed for lending to small enterprises sector, as per the policy package announced by the Government of India for stepping up credit to MSME sector, banks may fix self set target for growth in advances to SME sector in order to achieve a minimum 20% year on year growth in credit to MSMEs with the objective to double the flow of credit to the MSME sector within a period of 5 years i.e. from 2005-06 to 2009-10.
1.3	In order to ensure that credit is available to all segments of the Small Enterprises sector, banks should ensure that :-
(a)	40 per cent of the total advances to small enterprises sector should go to micro (manufacturing) enterprises having investment in plant and machinery up to Rs. 5 lakh and micro (service) enterprises having investment in equipment up to Rs. 2 lakh;
(b)	20 per cent of the total advances to small enterprises sector should go to micro (manufacturing) enterprises with investment in plant and machinery above Rs. 5 lakh and up to Rs. 25 lakh, and micro (service) enterprises with investment in equipment above Rs. 2 lakh and up to Rs. 10 lakh. (Thus 60 per cent of small enterprises advances should go to the micro enterprises)
2.	TARGETS FOR FOREIGN BANKS
2.1.1	Foreign banks are expected to enlarge credit to priority sector and ensure that priority sector advances (which includes the Small Enterprises sector) constitute 32 per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.
2.1.2	Within the overall target of 32 per cent to be achieved by foreign banks, the advances to small enterprises sector should not be 10 per cent of the adjusted net bank credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.

2.1.3	In order to ensure that credit is available to all segments of the Small Enterprises sector, banks should ensure that :- (a) 40 per cent of the total advances to small enterprises sector should go to micro (manufacturing) enterprises having investment in plant and machinery up to Rs. 5 lakh and micro (service) enterprises having investment in equipment up to Rs. 2 lakh; (b) 20 per cent of the total advances to small enterprises sector should go to micro (manufacturing) enterprises with investment in plant and machinery above Rs. 5 lakh and up to Rs. 25 lakh, and micro (service) enterprises with investment in equipment above Rs. 2 lakh and up to Rs. 10 lakh. (Thus 60 per cent of small enterprises advances should go to the micro enterprises) [The net bank credit should tally with the figures reported in the fortnightly return submitted under section 42(2) of the Reserve Bank of India Act, 1934. Outstanding deposits under the FCNR (B) and NRNR Schemes are excluded from net bank credit for computation of priority sector lending target/ sub-targets. However, as the NRNR scheme has been discontinued, the existing accounts under NRNR account scheme may be continued only up to the date of maturity as advised vide circular DBOD. DIR. BC. 93/13.01.09/2001-02 dated April 29, 2002.]
3.	DEPOSIT BY FOREIGN BANKS WITH SIDBI TOWARDS SHORTFALL IN PRIORITY SECTOR LENDING
3.1	The foreign banks having shortfall in lending to stipulated priority sector targets /sub-targets will be required to contribute to Small Enterprises Development Fund (SEDF) to be set up by Small Industries Development Bank of India (SIDBI), or for such other purpose as may be stipulated by Reserve bank of India.
3.2	For the purpose of such allocation, the achievement level of priority sector lending as on the last reporting Friday of March of the immediately preceding financial year will be taken into account.

3.3	The corpus of SEDF shall be decided by Reserve Bank of India on a year-to-year basis. The tenor of the deposits shall be for a period of three years or as decided by Reserve Bank from time to time. Fifty percent of the corpus shall be contributed by foreign banks having shortfall in lending to priority sector target of 32 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher, on a pro-rata basis. The balance fifty per cent of the corpus shall be contributed by foreign banks having aggregate shortfall in lending to Small Enterprises sector and export sector of 10 per cent and 12 per cent respectively, of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher, on a pro-rata basis. The contribution required to be made by foreign banks would, however, not be more than the amount of shortfall in priority sector lending target/sub-target of the foreign banks.
3.4	The concerned foreign banks will be called upon by SIDBI/or such other institution as may be decided by Reserve Bank, as and when funds are required by them, after giving one month's notice.
3.5	The interest rates on foreign banks' contribution, period of deposits, etc. shall be fixed by Reserve Bank of India from time to time.
3.6.	Non-achievement of priority sector targets and sub-targets will be taken into account while granting regulatory clearances/approvals for various purposes.
	<i>[ANBC or credit equivalent of Off-Balance Sheet Exposures (as defined by Department of Banking Operations and Development of Reserve Bank of India from time to time) will be computed with reference to the outstanding as on March 31 of the previous year. For this purpose, outstanding FCNR (B) and NRNR deposits balances will no longer be deducted for computation of ANBC for priority sector lending purposes For the purpose of priority sector lending, ANBC denotes NBC <u>plus</u> investments made by banks in non-SLR bonds held in HTM category. Investments made by banks in the Recapitalisation Bonds floated by Government of India will not be taken into account for the purpose of calculation of ANBC. Existing investments, as on the date of circular RPCD.No.Plan. BC.84/04.09.01/2006-07 dated April 30, 2007, made by banks in non-SLR bonds held in HTM category will not be taken into account for calculation of ANBC, up to March 31, 2010. However, fresh. investments by banks in non-SLR bonds held in HTM category will be taken into account for the purpose. Deposits placed with NABARD/SIDBI, as the case may be, in lieu of non-achievement of priority sector lending targets/sub-targets, though shown under Schedule 8 –'Investments' in the Balance Sheet at item I (vi)- 'Others', will not be treated as investment in non-SLR bonds held under HTM category. For the purpose of calculation of credit equivalent of off-balance sheet exposures, banks may use current exposure method. Inter-bank exposures will not be taken into account for the purpose of priority sector lending targets/sub-targets.]</i>

SECTION IV	
COMMON GUIDELINES/INSTRUCTIONS FOR LENDING TO SMALL ENTERPRISES SECTOR	
1. Disposal of Applications	All loan applications for SSI up to a credit limit of Rs. 25,000/- should be disposed of within 2 weeks and those up to Rs. 5 lakh within 4 weeks provided the loan applications are complete in all respects and accompanied by a 'check list'.
2 Collateral	
	The limit for all MSME borrowal accounts for obtention of collateral security (both manufacturing or production and providing or rendering of services) is Rs 5 lakh. Banks may on the basis of good track record and financial position of the MSME units, increase the limit of dispensation of collateral requirement for loans up to Rs.25 lakh (with the approval of the appropriate authority).
3. Composite loan	
	A composite loan limit of Rs.1crore can be sanctioned by banks to enable the MSME entrepreneurs to avail of their working capital and term loan requirement through Single Window.
4. Specialised SME branches	
	Public sector banks have been advised to open at least one Specialised branch in each district. Further banks have been permitted to categorise their SME general banking branches having 60% or more of their advances to MSME sector in order to encourage them to open more specialised SME branches for providing better service to this sector as a whole. As per the policy package announced by the Government of India for stepping up credit to MSME sector, the public sector banks will ensure specialized SME branches in identified clusters/centres with preponderance of small enterprises to enable the entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop requisite expertise. The existing specialised SSI branches may be also be redesignated as SME branches. Though their core competence will be utilized for extending finance and other services to MSME sector, they will have operational flexibility to extend finance/render other services to other sectors/borrowers

5.	Delayed Payment Under the Amendment Act, 1998 of Interest on Delayed Payment to Small Scale and Ancillary Industrial Undertakings, penal provisions have been incorporated to take care of delayed payments to SSI units which inter-alia stipulates a) agreement between seller and buyer shall not exceed more than 120 days b) payment of interest by the buyers at the rate of one and a half times the prime lending rate (PLR) of SBI for any delay beyond the agreed period not exceeding 120 days. Further, banks have been advised to fix sub-limits within the overall working capital limits to the large borrowers specifically for meeting the payment obligation in respect of purchases from SSI. After the enactment of the Micro, Small and Medium Enterprises Development (MSMED), Act 2006, the existing provisions of the Interest on Delayed Payment Act, 1998 to Small Scale and Ancillary Industrial Undertakings, have been strengthened as under: (i)The buyer to make payment on or before the date agreed on between him and the supplier in writing or, in case of no agreement before the appointed day. The agreement between seller and buyer shall not exceed more than 45 days. (ii)The buyer fails to make payment of the amount to the supplier, he shall be liable to pay compound interest with monthly rests to the supplier on the amount from the appointed day or, on the date agreed on, at three times of the Bank Rate notified by Reserve Bank. (iii)For any goods supplied or services rendered by the supplier, the buyer shall be liable to pay the interest as advised at (ii) above. (iv)In case of dispute with regard to any amount due, a reference shall be made to the Micro and Small Enterprises Facilitation Council, constituted by the respective State Government.

6.	Guidelines on rehabilitation of sick SSI units (based on Kohli Working Group recommendations) As per the definition, a unit is considered as sick when any of the borrowal account of the unit remains substandard for more than 6 months or there is erosion in the net worth due to accumulated cash losses to the extent of 50% of its net worth during the previous accounting year and the unit has been in commercial production for at least two years. The criteria will enable banks to detect sickness at an early stage and facilitate corrective action for revival of the unit. As per the guidelines, the rehabilitation package should be fully implemented within six months from the date the unit is declared as potentially viable/viable. During this six months period of identifying and implementing rehabilitation package banks/FIs are required to do “holding operation” which will allow the sick unit to draw funds from the cash credit account at least to the extent of deposit of sale proceeds Following are broad parameters for grant of relief and concessions for revival of potentially viable sick SSI units: <table border="0"> <tr> <td data-bbox="300 766 722 829">(i) Interest on Working Capital</td><td data-bbox="722 766 1395 829">Interest 1.5% below the prevailing fixed/ prime lending rate, wherever applicable</td></tr> <tr> <td data-bbox="300 871 722 913">(ii) Funded Interest Term Loan</td><td data-bbox="722 871 1395 913">Interest Free</td></tr> <tr> <td data-bbox="300 934 722 1039">(iii) Working Capital Term Loan</td><td data-bbox="722 934 1395 1039">Interest to be charged 1.5% below the prevailing fixed / prime lending rate, wherever applicable</td></tr> <tr> <td data-bbox="300 1060 722 1207">(iv) Term Loan</td><td data-bbox="722 1060 1395 1207">Concessions in the interest to be given not more than 2 % (not more than 3 % in the case of tiny / decentralised sector units) below the document rate.</td></tr> <tr> <td data-bbox="300 1228 722 1312">(v) Contingency Loan Assistance</td><td data-bbox="722 1228 1395 1312">The Concessional rate allowed for Working Capital Assistance</td></tr> </table>	(i) Interest on Working Capital	Interest 1.5% below the prevailing fixed/ prime lending rate, wherever applicable	(ii) Funded Interest Term Loan	Interest Free	(iii) Working Capital Term Loan	Interest to be charged 1.5% below the prevailing fixed / prime lending rate, wherever applicable	(iv) Term Loan	Concessions in the interest to be given not more than 2 % (not more than 3 % in the case of tiny / decentralised sector units) below the document rate.	(v) Contingency Loan Assistance	The Concessional rate allowed for Working Capital Assistance
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7.	State Level Inter Institutional Committee In order to deal with the problems of co-ordination for rehabilitation of sick small scale units, State Level Inter-Institutional Committees (SLIICs) have been set up in all the States. The meetings of these Committees are convened by Regional Offices of RBI and presided over by the Secretary, Industry of the concerned State Government. It provides a useful forum for adequate interfacing between the State Government Officials and State Level Institutions on the one side and the term lending institutions and banks on the other. It closely monitors timely sanction of working capital to units which have been provided term loans by SFCs, implementation of special schemes such as Margin Money Scheme of State Government, National Equity Fund Scheme of SIDBI, and reviews general problems faced by industries and sickness in SSI sector based on the data furnished by banks. Among others, the representatives of the local state level SSI associations are invited to the meetings of SLIIC which are held quarterly. A sub-committee of SLIIC looks into the problems of individual sick SSI unit and submits its recommendations to the forum of SLIIC for consideration.
8.	Empowered Committee on MSMEs As part of the announcement made by the Union Finance Minister, at the Regional Offices of Reserve Bank of India, Empowered Committees on MSMEs have been constituted under the Chairmanship of the Regional Directors with the representatives of SLBC Convenor, senior level officers from two banks having predominant share in MSME financing in the state, representative of SIDBI Regional Office, the Director of Industries of the State Government, one or two senior level representatives from the MSME/SSI Associations in the state, and a senior level officer from SFC/SIDC as members. The Committee will meet periodically and review the progress in MSME financing as also rehabilitation of sick Micro Small and ME units. It will also coordinate with other banks/financial institutions and the state government in removing bottlenecks, if any, to ensure smooth flow of credit to the sector. The committees may decide the need to have similar committees at cluster/district levels.
	9. Debt Restructuring Mechanism for MSMEs As part of announcement made by the Hon'ble Finance Minister for stepping up credit to small and medium enterprises, a debt restructuring mechanism for units in MSME sector has been formulated by Department of Banking Operations & Development of Reserve Bank of India and advised all commercial banks vide circular DBOD. BP. BC. No. 34 / 21.04.132/ 2005-06 dated September 8, 2005. These detailed guidelines have been issued to ensure restructuring of debt of all eligible small and medium enterprises. These guidelines would be applicable to the following entities, which are viable or potentially viable:

	a) All non-corporate MSMEs irrespective of the level of dues to banks. b) All corporate MSMEs, which are enjoying banking facilities from a single bank, irrespective of the level of dues to the bank. c) All corporate MSMEs, which have funded and non-funded outstanding up to Rs.10 crore under multiple/ consortium banking arrangement. (d) Accounts involving wilful default, fraud and malfeasance will <u>not</u> be eligible for restructuring under these guidelines. (e) Accounts classified by banks as “Loss Assets” will <u>not</u> be eligible for restructuring. For all corporate MSMEs, which have funded and non-funded outstanding of Rs.10 crore and above, Department of Banking Operations & Development has issued separate guidelines vide circular DBOD. No.BP. BC.45/ 21.04. 132/2005-06 dated November 10, 2005.

10	Cluster Approach 60 clusters have been identified by the Ministry of Micro, Small and Medium Enterprises, Government of India for focused development of Small Enterprises sector. All SLBC Convenor banks have been advised to incorporate in their Annual Credit Plans, the credit requirement in the clusters identified by the Ministry of Micro, Small and Medium Enterprises, Government of India. As per Ganguly Committee recommendations banks have been advised that a full-service approach to cater to the diverse needs of the SSI sector may be achieved through extending banking services to recognized SME clusters by adopting a 4-C approach namely, Customer focus, Cost control, Cross sell and Contain risk. A cluster based approach to lending may be more beneficial: (i) in dealing with well-defined and recognized groups; (ii) availability of appropriate information for risk assessment and (iii) monitoring by the lending institutions. Clusters may be identified based on factors such as trade record, competitiveness and growth prospects and/or other cluster specific data.
11	Government of India, Ministry of Micro, Small and Medium Enterprises has conveyed their approval for continuation of the Credit Linked Capital Subsidy Scheme (CLCSS) for Technology Upgradation of Micro and Small Enterprises from X Plan to XI Plan (2007-12) subject to the following terms and conditions: (i) Ceiling on the loan under the scheme is Rs. 1 crore. (ii) The rate of subsidy is 15% for all units of micro and small enterprises upto loan ceiling at Sr. No. (i) above. (iii) Calculation of admissible subsidy will be done with reference to the purchase price of plant and machinery instead of the term loan disbursed to the beneficiary unit. (iv) SIDBI and NABARD will continue to be the implementing agencies for the scheme

11. Committees on flow of Credit to MSME sector

11.1 Report of the Committee to Examine the Adequacy of Institutional Credit to SME Sector and Related Aspects (Nayak Committee)

The Committee was constituted by Reserve Bank of India in December 1991 under the Chairmanship of Shri P. R. Nayak, the then Deputy Governor to examine the issues confronting SSIs in the matter of obtaining finance. The Committee submitted its report in 1992. All the major recommendations of the Committee have been accepted and the banks have been inter-alia advised to:

- i) give preference to village industries, tiny industries and other small scale units in that order, while meeting the credit requirements of the small scale sector;
- ii) grant working capital credit limits to SSI units computed on the basis of minimum 20% of their estimated annual turnover whose credit limit in individual cases is upto Rs.2 crore [since raised to Rs.5 crore];
- iii) prepare annual credit budget on the 'bottom-up' basis to ensure that the legitimate requirements of SSI sector are met in full;
- iv) extend 'Single Window Scheme' of SIDBI to all districts to meet the financial requirements (both working capital and term loan) of SSIs;
- v) ensure that there should not be any delay in sanctioning and disbursal of credit. In case of rejection/curtailment of credit limit of the loan proposal, a reference to higher authorities should be made;
- vi) not to insist on compulsory deposit as a 'quid pro-quo' for sanctioning the credit;
- vii) open specialised SSI bank branches or convert those branches which have a fairly large number of SSI borrowal accounts, into specialised SSI branches;
- viii) identify sick SSI units and take urgent action to put them on nursing programmes;
- ix) standardise loan application forms for SSI borrowers; and
- x) impart training to staff working at specialised branches to bring about attitudinal change in them.

11.2 Report of the High Level Committee on Credit to SSI (Kapur Committee)

Reserve Bank of India had appointed a one-man High Level Committee headed by Shri S.L. Kapur, (IAS, Retd.), Former Secretary, Government of India, Ministry of Industry to suggest measures for improving the delivery system and simplification of procedures for credit to SSI sector. The Committee made 126 recommendations covering wide range of areas pertaining to financing of SSI sector. These recommendations have been examined by the RBI and it has been decided to accept 88 recommendations which include the following important recommendations:

- i) Delegation of more powers to branch managers to grant ad-hoc limits;
- ii) Simplification of application forms;
- iii) Freedom to banks to decide their own norms for assessment of credit requirements;
- iv) Opening of more specialised SSI branches;
- v) Enhancement in the limit for composite loans to Rs. 5 lakh. *(since enhanced to Rs.1 crore);*

- vi) Strengthening the recovery mechanism;
- vi) Banks to pay more attention to the backward states;
- viii) Special programmes for training branch managers for appraising small projects;
- ix) Banks to make customers grievance machinery more transparent and simplify the procedures for handling complaints and monitoring thereof.

11.3 Report of the Working Group on Flow of Credit to SSI Sector (Ganguly Committee)

As per the announcement made by the Governor, Reserve Bank of India, in the Mid-Term Review of the Monetary and Credit Policy 2003-2004, a "Working Group on Flow of Credit to SSI sector" was constituted under the Chairmanship of Dr.A.S.Ganguly

The Committee made 31 recommendations covering wide range of areas pertaining to financing of SSI sector. The recommendations pertaining to RBI and banks have been examined and has accepted 8 recommendations so far and commended to banks for implementation which are as under:

- i) adoption of cluster based approach for financing MSME sector;
- ii) sponsoring specific projects as well as widely publicising successful working models of NGOs by Lead Banks which service small and tiny industries and individual entrepreneurs;
- iii) sanctioning of higher working capital limits by banks operating in the North East region to SSIs, based on their commercial judgement due to the peculiar situation of hilly terrain and frequent floods causing hindrance in the transportation system;
- iv) exploring new instruments by banks for promoting rural industry and to improve the flow of credit to rural artisans, rural industries and rural entrepreneurs, and
- v) revision of tenure as also interest rate structure of deposits kept by foreign banks with SIDBI for their shortfall in priority sector lending.

11.4 Internal Group to Review Guidelines on Credit Flow to SME Sector

An Internal Group was constituted under the Chairmanship of Shri C.S.Murthy, CGM-in-Charge, RPCD, Central Office, Reserve Bank of India, to inter-alia review all circulars and guidelines issued by Reserve Bank in the past regarding financing of SSIs, to suggest appropriate terms for restructuring of the borrowal accounts of SSI/Medium Enterprises and also to examine the guidelines issued by Reserve Bank for nursing sick SSIs and suggest suitable relaxation and liberalization of these norms. The Group has submitted its report on June 6, 2005

The internal group has recommended:

- (i) Constitution of empowered committees at the regional office of Reserve Bank to periodically review the progress in SSI and Medium Enterprises financing and also to coordinate with other banks/financial institutions and the state government in removing bottlenecks, if any, to ensure smooth flow of credit to the sector.
- (ii) Opening of specialised SME branches in identified clusters/centres with preponderance of SSI and ME units to enable the entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop the requisite expertise.
- (iii) The group has proposed to empower the boards of banks to formulate policies relating to restructuring of accounts of SME units subject to certain guidelines. Restructuring of accounts of corporate SSI/ME borrowers having credit limits aggregating Rs.10 crore or more under multiple banking arrangements will be covered under the revised CDR mechanism.
- (iv) While recommending continuation of the extant guidelines on definition of a sick SSI unit, the group has recommended that all other instructions relating to viability and parameters for relief and concessions to be provided to sick SSI units, as prescribed by the Reserve Bank be withdrawn and banks be given freedom to lay down their own guidelines with the approval of their Board of Directors.

Majority of the recommendations of the Group have been accepted by the Government of India and incorporated as part of policy package announced by the Union Finance Minister for stepping up credit to SME sector.

12. Policy Package for Stepping up Credit to Small and Medium Enterprises- Announced by the Union Finance Minister

Based on the policy package announced by the Union Finance Minister for stepping up credit to small and medium enterprises, two circulars have been issued separately to public sector banks (RPCD.PLNFS. BC.No.31/ 06.02.31/200506 dated August 19, 2005) and private, foreign banks and RRBs (RPCD.PLNFS. BC.No.35/ 06.02.31 / 2005 -06 dated August 25, 2005) for implementation. Some of the salient features of the policy package are:

- Definition of Small and Medium Enterprises (SMEs)
- Fixing of self-targets for financing to SME sector by banks
- Measures to rationalize the cost of loans to SME sector
- Measures to increase the outreach of formal credit to the SME sector
- Cluster based approach for financing SME sector
- Constitution of Empowered Committees for SMEs in the Regional Offices of Reserve Bank
- Steps to rationalize the cost of loans to SME sector by adopting a transparent rating system with cost of credit being linked to the credit rating of enterprise.
- Banks to consider taking advantage of Credit Appraisal & Rating Tool (CART), Risk Assessment Model (RAM) and the comprehensive rating model for risk assessment of SME proposals, developed by SIDBI for reduction of their transaction costs.

- Banks to consider the ratings of SSI units carried out through reputed credit rating agencies under the Credit Rating Scheme introduced by National Small Industries Corporation.
- Wider dissemination and easy accessibility of the policy guidelines formulated by Boards of banks as well as instructions/guidelines issued by Reserve Bank by displaying them on the respective banks' web sites as well as web site of SIDBI and also prominently displaying them at the bank branches.

A copy of the "Policy Package for stepping up Credit to SME Sector", announced by the Union Finance Minister in the Parliament on August 10, 2005 is furnished in **Annexure IV**.

13. Micro, Small & Medium Enterprises Development (MSMED) Act, 2006

The Government of India has enacted the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 on June 16, 2006 which was notified on October 2, 2006. Consistent with the notification of the Micro, Small and Medium Enterprises Development (MSMED) Act 2006, the definition of micro, small and medium enterprises engaged in manufacturing or production and providing or rendering of services has been modified and is required to be implemented by the banks alongwith other policy measures with immediate effect as advised vide circular RPCD.PLNFS.BC.No.63/06.02.31/2006-07 dated April 4, 2007.

14. Banking Codes and Standard Board of India (BCSBI)

The Banking Codes and Standard Board of India (BCSBI) has formulated a Code of Bank's Commitment to Micro and Small Enterprises. This is a voluntary Code, which sets minimum standards of banking practices for banks to follow when they are dealing with Micro and Small Enterprises (MSEs) as defined in the Micro Small and Medium Enterprises Development (MSMED) Act, 2006. It provides protection to MSE and explains how banks are expected to deal with MSE for their day to-day operations and in times of financial difficulty.

The Code does not replace or supersede regulatory or supervisory instructions issued by the Reserve Bank of India (RBI) and will comply with such instructions /directions issued by the RBI from time to time.

14.1 Objectives Of The Code

The Code has been developed to

- a. Give a positive thrust to the MSE sector by providing easy access to efficient banking services.
- b. Promote good and fair banking practices by setting minimum standards in dealing with MSE.
- c. Increase transparency so that a better understanding of what can reasonably expected of the services.
- d. Improve our understanding of business through effective communication.
- e. Encourage market forces, through competition, to achieve higher operating standards.
- f. Promote a fair and cordial relationship between MSE and banks and also

ensure timely and quick response to banking needs.
g. Foster confidence in the banking system.

The complete text of the Code is available at the BCSBI's website www.bcsbi.org.in

MINISTRY OF SMALL SCALE INDUSTRIES**NOTIFICATION****New Delhi, the 5th October, 2006**

S.O. 1722(E) – In exercise of the powers conferred by sub-section (1) of 2006) herein referred to as the said Act, the Central Government specifies the following items, the cost of which shall be excluded while calculating the investment in plant and machinery in the case of the enterprises mentioned in Section 7(1)(a) of the said Act, namely:

- (i) equipment such as tools, jigs, dyes, moulds and spare parts for maintenance and the cost of consumables stores;
- (ii) installation of plant and machinery;
- (iii) research and development equipment and pollution controlled equipment
- (iv) power generation set and extra transformer installed by the enterprise as per regulations of the State Electricity Board;
- (v) bank charges and service charges paid to the National Small Industries Corporation or the State Small Industries Corporation;
- (vi) procurement or installation of cables, wiring, bus bars, electrical control panels (not mounded on individual machines), oil circuit breakers or miniature circuit breakers which are necessarily to be used for providing electrical power to the plant and machinery or for safety measures;
- (vii) gas producers plants;
- (viii) transportation charges (excluding sales-tax or value added tax and excise duty) for indigenous machinery from the place of the manufacture to the site of the enterprise;
- (ix) charges paid for technical know-how for erection of plant and machinery;
- (x) such storage tanks which store raw material and finished produces and are not linked with the manufacturing process; and
- (xi) fire fighting equipment.

2. While calculating the investment in plant and machinery refer to paragraph 1, the original price thereof, irrespective of whether the plant and machinery are new or second handed, shall be taken into account provided that in the case of imported machinery, the following shall be included in calculating the value, namely;

- (i) Import duty (excluding miscellaneous expenses such as transportation from the port to the site of the factory, demurrage paid at the port);
- (ii) Shipping charges;
- (iii) Customs clearance charges; and
- (iv) Sales tax or value added tax.

(F.No.4(1)/2006-MSME- Policy)
JAWHAR SIRCAR, Addl. Secy.

Annexure II

LIST OF SME CLUSTERS COVERED BY EXISTING SIDBI BRANCHES

Sr. No.	Branch Offices	No.of SSI clusters	Product
1	Hyderabad	5	Ceiling Fan, Electronic Goods, Pharmaceuticals- Bulk Drugs, Hand Pump sets & Foundry
2	Patna	1	Brass and German Utensils
3	Delhi	19	Stainless Steel Utensils & Cutlery, Chemicals, Electrical Engineering Equipment, Electronic Goods, Food Products, Leather Products, Mechanical Engineering Equipment, Packaging Material, Paper Products, Plastic Products, Wire Drawing, Metal Fabrication, Furniture, Electro Plating, Auto Components, Hosiery, Readymade Garments, Sanitary Fittings
4	Ahmedabad	17	Pharmaceuticals, Dyes & Intermediates, Moulded Plastic Products, Readymade Garments, Textile Machinery Parts, Diamond Processing, Machine Tools, Castings & Forging, Steel Utensils, Wood Product & Furniture, Paper Products, Leather Footwear, Washing Powder & Soap, Marble Slabs, Power Driven Pumps, Electronic Goods, Auto Parts
5	Surat	4	Diamond Processing, Powerloom, Wood Product & Furniture, Textile Machinery
6	Baroda	3	Pharmaceutical- Bulk drugs, Plastic processing & Wood product & furniture
7	Goa	1	Pharmaceutical
8	Faridabad	3	Auto components, Engineering Cluster, Stone Crushing
9	Gurgaon	5	Auto Components, Electronic Goods, Electrical Engineering Equipment, Readymade Garments, Mechanical Engineering Equipment
10	Parwanoo(Baddi)	1	Engineering Equipment
11	Jammu	3	Steel Re-rolling, Oil mills, Rice Mills
12	Jamshedpur	1	Engineering & Fabrication
13	Bangalore	6	Powerloom, Electronic goods, Readymade garments, Light engineering, Leather products
14	Kochi/Ernakulam	3	Rubber products, Powerlooms & Sea Food processing
15	Aurangabad	2	Auto components & Pharmaceuticals- Bulk drugs

16	Mumbai	11	Electronic Goods , Pharmaceutical-Basic drugs, Toys (plastic), Ready made garments, Hosiery, Machine Tools, Engineering equipment, Chemicals, Packaging material, Handtools, Plastic products
17	Nagpur	6	Powerlooms, Engineering & Fabrication, Steel furniture, Ready made garments, Handtools, Food processing
18	Pune	6	Auto components, Electronic goods, Food products, Ready made Garments, Pharmaceuticals –Bulk Drugs, Fibre glass
19	Thane	2	Pharmaceuticals –Bulk Drugs & Sea food
20	Bhopal	1	Engineering equipment
21	Indore	4	Pharmaceuticals- Bulk drugs, Readymade garments, food processing, Auto components
22	Ludhana	9	Auto Components, Bicycle Parts, Hosiery, Sewing M/C Components, Industrial Fastners, Handtools, Machine tools, Forging, Electroplating
23	Jaipur	7	Gems & Jewellery, Ball Bearing, Electrical Engineering Equipment, Food Products, Garments, Lime, Mechanical Engineering Equipment
24	Chennai	3	Auto components, Leather products, Electroplating
25	Coimbatore	6	Diesel Engines, Agricultural Implements, Machine Tools, Castings & Forging, Powerloom, Wet Grinding Machines
26	Tirupur	1	Hosiery
27	Noida/Gaziabad	10	Electronic goods, Toys, Chemicals, Electrical engineering equipment, Garments, Mechanical engineering equipment, Packaging material, Plastic products, Chemicals
28	Kanpur	3	Saddlery, Cotton hosiery, Leather products
29	Varanasi	4	Sheetwork (Globe Lamp), Powerloom, Agriculture implements, Electric fan
30	Dehradun	1	Miniature Vacuum bulb
31	Nashik (shortly to be opened)	1	Steel furniture
Total		149	

Annexure III

List of SME Clusters in India (identified by UNIDO)				
S. No.	State	District	Location	Product
1	Andhra Pradesh	Anantpur	Rayadurg	Readymade Garments
2	Andhra Pradesh	Anantpur	Chitradurg	Jeans Garments
3	Andhra Pradesh	Chittoor	Nagari	Powerloom
4	Andhra Pradesh	Chittoor	Ventimalta, Srikalahasti, Chundur	Brass Utensils
5	Andhra Pradesh	East Godavari	East Godavari	Rice Mills
6	Andhra Pradesh	East Godavari	Rajahmundry	Graphite Crucibles
7	Andhra Pradesh	East Godavari	East Godavari	Coir & Coir Products
8	Andhra Pradesh	East Godavari	Rajahmundry	Aluminium Utensils
9	Andhra Pradesh	East Godavari & West Godavari	East Godavari(EG) & West Godavari	Refractory Products
10	Andhra Pradesh	Guntur	Guntur	Powerloom
11	Andhra Pradesh	Guntur	Guntur	Lime Calcination
12	Andhra Pradesh	Guntur	Macherla	Wooden Furniture
13	Andhra Pradesh	Hyderabad	Hyderabad	Ceiling Fan
14	Andhra Pradesh	Hyderabad	Hyderabad	Electronic Goods
15	Andhra Pradesh	Hyderabad	Hyderabad	Pharmaceuticals- Bulk Drugs
16	Andhra Pradesh	Hyderabad	Musheerabad	Leather Tanning
17	Andhra Pradesh	Hyderabad	Hyderabad	Hand Pumpsets
18	Andhra Pradesh	Hyderabad	Hyderabad	Foundry
19	Andhra Pradesh	Karimnagar	Sirsilla	Powerloom
20	Andhra Pradesh	Krishna	Machilipatnam	Gold Plating & Imitation Jewellery
21	Andhra Pradesh	Krishna	Vijayawada	Rice Mills
22	Andhra Pradesh	Krishna	Chundur, Kavadiguda, Charminar, Vijayawada	Steel Furniture
23	Andhra Pradesh	Kurnool	Adoni	Oil Mills
24	Andhra Pradesh	Kurnool	Kurnool	Artificial Diamonds
25	Andhra Pradesh	Kurnool, Cuddapah	Kurnool(Banaganapalle,	Polished Slabs

	Pradesh		Bethamcheria,Kolimigundla)Cuddapah	
26	Andhra Pradesh	Prakasam	Markapuram	Stone Slate
27	Andhra Pradesh	Ranga Reddy	Balanagar, Jeedimetla & Kukatpally	Machine Tools
28	Andhra Pradesh	Srikakulam	Palasa	Cashew Processing
29	Andhra Pradesh	Visakhapatnam,East Godavari	Visakhapatnam, Kakinada	Marine Foods
30	Andhra Pradesh	Warangal	Warangal	Powerloom
31	Andhra Pradesh	Warangal	Warangal	Brassware
32	Andhra Pradesh	West Godavari	West Godavari	Rice Mills
33	Bihar	Begusarai	Barauni	Engineering & Fabrication
34	Bihar	Muzzafarpur	Muzzafarpur	Food Products
35	Bihar	Patna	Patna	Brass and German Silver Utensils
36	Chhattisgarh	Durg, Rajnandgaon, Raipur	Durg, Rajnandgaon, Raipur	Steel Re-rolling
37	Chhattisgarh	Durg, Raipur	Durg, Raipur	Castings & Metal Fabrication
38	Delhi	North West Delhi	Wazirpur, Badli	Stainless Steel Utensils & Cutlery
39	Delhi	South & West Delhi	Okhla, Mayapuri	Chemicals
40	Delhi	West & South	Naraina & Okhla	Electrical Engineering Equipment
41	Delhi	West & South	Naraina & Okhla	Electronic Goods
42	Delhi	North Delhi	Lawrence Road	Food Products
43	Delhi	South Delhi	Okhla, Wazirpur Flatted Factories Complex	Leather Products
44	Delhi	South, West Delhi	Okhla,Mayapuri, Anand Parbat	Mechanical Engineering Equipment
45	Delhi	West,South, East Delhi	Naraina,Okhla, Patparganj	Packaging Material
46	Delhi	West & South	Naraina & Okhla	Paper Products
47	Delhi	West & South	Naraina Udyog Nagar & Okhla	Plastic Products
48	Delhi	West, South, North West	Naraina,Okhla,Shivaji Marg,Najafgarh Road	Rubber Products
49	Delhi	North East Delhi	Shahadara & Vishwasnagar	Wire Drawing
50	Delhi	West & North West	Mayapuri & Wazirpur	Metal Fabrication
51	Delhi	West & North East	Kirtinagar & Tilak Nagar	Furniture
52	Delhi	North West Delhi	Wazirpur	Electro Plating
53	Delhi	South,West,North West & North West	Okhla, Mayapuri,Naraina, Wazirpur Badli & G.T. Karnal Road	Auto Components
54	Delhi	North East Delhi, East Delhi & South	Shahdara,Gandhinagar, Okhla & Maidangari	Hosiery
55	Delhi	South & North East	Okhla & Shahdara	Readymade Garments
56	Delhi	South Delhi	Okhla	Sanitary Fittings
57	Gujarat	Ahmedabad	Ahmedabad	Pharmaceuticals
58	Gujarat	Ahmedabad	Ahmedabad	Dyes & Intermediates
59	Gujarat	Ahmedabad	Ahmedabad	Moulded Plastic Products

60	Gujarat	Ahmedabad	Ahmedabad	Readymade Garments
61	Gujarat	Ahmedabad	Ahmedabad	Textile Machinery Parts
62	Gujarat	Ahmedabad	Ahmedabad, Dhanduka	Diamond Processing
63	Gujarat	Ahmedabad	Ahmedabad	Machine Tools
64	Gujarat	Ahmedabad	Ahmedabad	Castings & Forging
65	Gujarat	Ahmedabad	Ahmedabad	Steel Utensils
66	Gujarat	Ahmedabad	Ahmedabad	Wood Product & Furniture
67	Gujarat	Ahmedabad	Ahmedabad	Paper Products
68	Gujarat	Ahmedabad	Ahmedabad	Leather Footware
69	Gujarat	Ahmedabad	Ahmedabad	Washing Powder & Soap
70	Gujarat	Ahmedabad	Ahmedabad	Marble Slabs
71	Gujarat	Ahmedabad	Ahmedabad	Power Driven Pumps
72	Gujarat	Ahmedabad	Ahmedabad	Electronic Goods
73	Gujarat	Ahmedabad	Ahmedabad	Auto Parts
74	Gujarat	Amreli	Savarkundla	Weights & Measures
75	Gujarat	Amreli, Juna Garh, Rajkot	Amreli Juna Garh Rajkot belt	Oil Mills Machinery
76	Gujarat	Bhavnagar	Alang	Ship Breaking
77	Gujarat	Bhavnagar	Bhavnagar	Steel Re-rolling
78	Gujarat	Bhavnagar	Bhavnagar	Machine Tools
79	Gujarat	Bhavnagar	Bhavnagar	Plastic Processing
80	Gujarat	Bhavnagar	Bhavnagar	Diamond Processing
81	Gujarat	Gandhinagar	Kalol	Powerloom
82	Gujarat	Jamnagar	Jamnagar	Brass Parts
83	Gujarat	Jamnagar	Jamnagar	Wood Product & Furniture
84	Gujarat	Mahesana	Vijapur	Cotton Cloth Weaving
85	Gujarat	Rajkot	Dhoraji, Gondal, Rajkot	Oil Mills
86	Gujarat	Rajkot	Jetpur	Textile Printing
87	Gujarat	Rajkot	Morvi & Wankaner	Flooring Tiles(Clay)
88	Gujarat	Rajkot	Morvi	Wall Clocks
89	Gujarat	Rajkot	Rajkot	Diesel Engines
90	Gujarat	Rajkot	Rajkot	Electric Motors
91	Gujarat	Rajkot	Rajkot	Castings & Forging
92	Gujarat	Rajkot	Rajkot	Machine Tools
93	Gujarat	Rajkot	Rajkot	Diamond Processing
94	Gujarat	Surat	Surat, Choryasi	Diamond Processing
95	Gujarat	Surat	Surat	Powerloom
96	Gujarat	Surat	Surat	Wood Product & Furniture
97	Gujarat	Surat	Surat	Textile Machinery
98	Gujarat	Surendranagar	Surendranagar & Thangadh	Ceramics
99	Gujarat	Surendranagar	Chotila	Sanitary Fittings
100	Gujarat	Vadodara	Vadodara	Pharmaceuticals- Bulk Drugs
101	Gujarat	Vadodara	Vadodara	Plastic Processing
102	Gujarat	Vadodara	Vadodara	Wood Product & Furniture
103	Gujarat	Valsad	Pardi	Dyes & Intermediates
104	Gujarat	Valsad/Bharuch	Vapi/Ankleshwar	Chemicals
105	Gujarat	Valsad/Bharuch	Vapi/Ankleshwar	Pharmaceuticals- Bulk Drugs
106	Goa	South Goa	Margao	Pharmaceutical

107	Haryana	Ambala	Ambala	Mixies & Grinders
108	Haryana	Ambala	Ambala	Scientific Instruments
109	Haryana	Bhiwani	Bhiwani	Powerloom
110	Haryana	Bhiwani	Bhiwani	Stone Crushing
111	Haryana	Faridabad	Faridabad	Auto Components
112	Haryana	Faridabad	Faridabad	Engineering Cluster
113	Haryana	Faridabad	Faridabad	Stone Crushing
114	Haryana	Gurgaon	Gurgaon	Auto Components
115	Haryana	Gurgaon	Gurgaon	Electronic Goods
116	Haryana	Gurgaon	Gurgaon	Electrical Engineering Equipment
117	Haryana	Gurgaon	Gurgaon	Readymade Garments
118	Haryana	Gurgaon	Gurgaon	Mechanical Engineering Equipment
119	Haryana	Kaithal	Kaithal	Rice Mills
120	Haryana	Karnal	Karnal	Agricultural Implements
121	Haryana	Karnal, Kurukshetra, Panipat	Karnal, Kurukshetra, Panipat	Rice Mills
122	Haryana	Panchkula	Pinjore	Engineering Equipment
123	Haryana	Panchkula	Panchkula	Stone Crushing
124	Haryana	Panipat	Panipat	Powerloom
125	Haryana	Panipat	Panipat	Shoddy Yarn
126	Haryana	Panipat	Samalkha	Foundry
127	Haryana	Panipat	Panipat	Cotton Spinning
128	Haryana	Rohtak	Rohtak	Nuts/ Bolts
129	Haryana	Yamuna Nagar	Yamuna Nagar	Plywood/Board/Blackboard
130	Haryana	Yamunanagar	Jagadhri	Utensils
131	Himachal Pradesh	Kullu & Sirmaur	Kullu & Sirmaur	Food Processing
132	Himachal Pradesh	Kangra	Damtal	Stone Crushing
133	Himachal Pradesh	Solan	Parwanoo	Engineering Equipment
134	Jammu & Kashmir	Anantnag	Anantnag	Cricket Bat
135	Jammu & Kashmir	Jammu	Jammu	Steel Re-rolling
136	Jammu & Kashmir	Jammu/ Kathua	Jammu/ Kathua	Oil Mills
137	Jammu & Kashmir	Jammu/ Kathua	Jammu/ Kathua	Rice Mills
138	Jammu & Kashmir	Srinagar	Srinagar	Timber Joinery/ Furniture
139	Jharkhand	Sarikela-Kharsawan	Adityapur	Auto Components
140	Jharkhand	East Singhbhum	Jamshedpur	Engineering & Fabrication
141	Jharkhand	Bokaro	Bokaro	Engineering & Fabrication
142	Karnataka	Bangalore	Bangalore	Machine Tools
143	Karnataka	Bangalore	Bangalore	Powerloom
144	Karnataka	Bangalore	Bangalore	Electronic Goods
145	Karnataka	Bangalore	Bangalore	Readymade Garments
146	Karnataka	Bangalore	Bangalore	Light Engineering
147	Karnataka	Bangalore	Bangalore	Leather Products

148	Karnataka	Belgaum	Belgaum	Foundry
149	Karnataka	Belgaum	Belgaum	Powerloom
150	Karnataka	Bellary	Bellary	Jeans Garments
151	Karnataka	Bijapur	Bijapur	Oil Mills
152	Karnataka	Dharwad	Hubli, Dharwad	Agriculture Implements and Tractor Trailer
153	Karnataka	Gadag	Gadag Betgeri	Powerloom
154	Karnataka	Gulburga	Gulburga Gadagh belt	Dal Mills
155	Karnataka	Hassan	Arasikara	Coir & Coir Products
156	Karnataka	Mysore	Mysore	Food Products
157	Karnataka	Mysore	Mysore	Silk
158	Karnataka	Raichur	Raichur	Leather Products
159	Karnataka	Shimoga	Shimoga	Rice Mills
160	Karnataka	South Kannada	Mangalore	Food Products
161	Kerala	Alappuzha	Alappuzha	Coir & Coir Products
162	Kerala	Ernakulam	Ernakulam	Rubber Products
163	Kerala	Ernakulam	Ernakulam	Powerloom
164	Kerala	Ernakulam	Kochi	Sea Food Processing
165	Kerala	Kannur	Kannur	Powerloom
166	Kerala	Kollam	Kollam	Coir & Coir Products
167	Kerala	Kottayam	Kottayam	Rubber Products
168	Kerala	Mallappuram	Mallappuram	Powerloom
169	Kerala	Palakkad	Palakkad	Powerloom
170	Kerala		Faizlure	Powerloom
171	Maharashtra	Ahmednagar	Ahmednagar	Auto Components
172	Maharashtra	Akola	Akola	Oil Mills (Cotton seed)
173	Maharashtra	Akola	Akola	Dal Mills
174	Maharashtra	Aurangabad	Aurangabad	Auto Components
175	Maharashtra	Aurangabad	Aurangabad	Pharmaceuticals- Bulk Drugs
176	Maharashtra	Bhandara	Bhandara	Rice Mills
177	Maharashtra	Chandrapur	Chandrapur	Roofing Tiles
178	Maharashtra	Chandrapur	Chandrapur	Rice Mills
179	Maharashtra	Dhule	Dhule	Chilly Powder
180	Maharashtra	Gadchiroli	Gadchiroli	Castings & Forging
181	Maharashtra	Gadchiroli	Gadchiroli	Rice Mills
182	Maharashtra	Gondia	Gondiya	Rice Mills
183	Maharashtra	Jalgaon	Jalgaon	Dal Mills
184	Maharashtra	Jalgaon	Jalgaon	Agriculture Implements
185	Maharashtra	Jalna	Jalna	Engineering Equipment
186	Maharashtra	Kolhapur	Kolhapur	Diesel Engines
187	Maharashtra	Kolhapur	Kolhapur	Foundry
188	Maharashtra	Kolhapur	Ichalkaranji	Powerloom
189	Maharashtra	Mumbai	Mumbai	Electronic Goods
190	Maharashtra	Mumbai	Mumbai	Pharmaceutical - Basic Drugs
191	Maharashtra	Mumbai	Mumbai	Toys (Plastic)
192	Maharashtra	Mumbai	Mumbai	Readymade Garments
193	Maharashtra	Mumbai	Mumbai	Hosiery
194	Maharashtra	Mumbai	Mumbai	Machine Tools

195	Maharashtra	Mumbai	Mumbai	Engineering Equipment
196	Maharashtra	Mumbai	Mumbai	Chemicals
197	Maharashtra	Mumbai	Mumbai	Packaging Material
198	Maharashtra	Mumbai	Mumbai	Handtools
199	Maharashtra	Mumbai	Mumbai	Plastic Products
200	Maharashtra	Nagpur	Nagpur	Powerloom
201	Maharashtra	Nagpur	Nagpur	Engineering & Fabrication
202	Maharashtra	Nagpur	Nagpur	Steel Furniture
203	Maharashtra	Nagpur	Nagpur(Butibori)	Readymade Garments
204	Maharashtra	Nagpur	Nagpur	Handtools
205	Maharashtra	Nagpur	Nagpur	Food Processing
206	Maharashtra	Nanded	Nanded	Dal Mills
207	Maharashtra	Nashik	Malegaon	Powerloom
208	Maharashtra	Nashik	Nashik	Steel Furniture
209	Maharashtra	Pune	Pune	Auto Components
210	Maharashtra	Pune	Pune	Electronic Goods
211	Maharashtra	Pune	Pune	Food Products
212	Maharashtra	Pune	Pune	Readymade Garments
213	Maharashtra	Pune	Pune	Pharmaceuticals- Bulk Drugs
214	Maharashtra	Pune	Pune	Fibre Glass
215	Maharashtra	Ratnagiri	Ratnagiri	Canned & Processed Fish
216	Maharashtra	Sangli	Sangli	M S Rods
217	Maharashtra	Sangli	Madhavanagar	Powerloom
218	Maharashtra	Satara	Satara	Leather Tanning
219	Maharashtra	Sholapur	Sholapur	Powerloom
220	Maharashtra	Sindhudurg	Sindhudurg	Cashew Processing
221	Maharashtra	Sindhudurg	Sindhudurg	Copper Coated Wires
222	Maharashtra	Thane	Bhiwandi	Powerloom
223	Maharashtra	Thane	Kalyan	Confectionery
224	Maharashtra	Thane	Vashind	Chemicals
225	Maharashtra	Thane	Tarapur, Thane-Belapur	Pharmaceuticals- Bulk Drugs
226	Maharashtra	Thane	Thane	Sea Food
227	Maharashtra	Wardha	Wardha	Solvent Oil
228	Maharashtra	Yavatmal	Yavatmal	Dal Mills
229	Madhya Pradesh	Bhopal	Bhopal	Engineering Equipment
230	Madhya Pradesh	Dewas	Dewas	Electrical Goods
231	Madhya Pradesh	East Nimar	Burhanpur	Powerloom
232	Madhya Pradesh	Indore	Indore	Pharmaceuticals-Bulk Drugs
233	Madhya Pradesh	Indore	Indore	Readymade Garments
234	Madhya Pradesh	Indore	Indore	Food Processing
235	Madhya Pradesh	Indore	Pithampur	Auto Components
236	Madhya Pradesh	Jabalpur	Jabalpur	Readymade Garments

	Pradesh			
237	Madhya Pradesh	Jabalpur	Jabalpur	Powerloom
238	Madhya Pradesh	Ujjain	Ujjain	Powerloom
239	Orissa	Balangir	Balangir	Rice Mills
240	Orissa	Balasore	Balasore	Rice Mills
241	Orissa	Balasore	Balasore	Powerloom
242	Orissa	Cuttack	Cuttack	Rice Mills
243	Orissa	Cuttack	Cuttack	Chemicals & Pharmaceuticals
244	Orissa	Cuttack	Cuttack(Jagatpur)	Engineering & Fabrication
245	Orissa	Cuttack	Cuttack	Spices
246	Orissa	Dhenkanal	Dhenkanal	Powerloom
247	Orissa	Ganjam	Ganjam	Powerloom
248	Orissa	Ganjam	Ganjam	Rice Mills
249	Orissa	Koraput	Koraput	Rice Mills
250	Orissa	Puri	Puri	Rice Mills
251	Orissa	Sambhalpur	Sambhalpur	Rice Mills
252	Punjab	Amritsar	Amritsar	Rice Mills
253	Punjab	Amritsar	Amritsar	Shoddy Yarn
254	Punjab	Amritsar	Amritsar	Powerloom
255	Punjab	Fatehgarh Sahib	Mandi Govindgarh	Steel Re-rolling
256	Punjab	Gurdaspur	Batala	Machine Tools
257	Punjab	Gurdaspur	Batala,Gurdaspur	Rice Mills
258	Punjab	Gurdaspur	Batala	Castings & Forging
259	Punjab	Jalandhar	Jalandhar	Sports Goods
260	Punjab	Jalandhar	Jalandhar	Agricultural Implements
261	Punjab	Jalandhar	Jalandhar	Handtools
262	Punjab	Jalandhar	Jalandhar	Rubber Goods
263	Punjab	Jalandhar	Kartarpur	Wooden Furniture
264	Punjab	Jalandhar	Jalandhar	Leather Tanning
265	Punjab	Jalandhar	Jalandhar	Leather Footwear
266	Punjab	Jalandhar	Jalandhar	Surgical Instruments
267	Punjab	Kapurthala	Kapurthala	Rice Mills
268	Punjab	Kapurthala	Phagwara	Diesel Engines
269	Punjab	Ludhiana	Ludhiana	Auto Components
270	Punjab	Ludhiana	Ludhiana	Bicycle Parts
271	Punjab	Ludhiana	Ludhiana	Hosiery
272	Punjab	Ludhiana	Ludhiana	Sewing M/C Components
273	Punjab	Ludhiana	Ludhiana	Industrial Fastners
274	Punjab	Ludhiana	Ludhiana	Handtools
275	Punjab	Ludhiana	Ludhiana	Machine Tools
276	Punjab	Ludhiana	Ludhiana	Forging
277	Punjab	Ludhiana	Ludhiana	Electroplating
278	Punjab	Moga	Moga	Wheat Threshers
279	Punjab	Patiala	Patiala	Agricultural Implements
280	Punjab	Patiala	Patiala	Cutting Tools
281	Punjab	Sangrur	Sangrur	Rice Mills
282	Rajasthan	Alwar,S. Madhopur,	Alwar,S. Madhopur Bharatpur belt	Oil Mills

		Bharatpur		
283	Rajasthan	Ajmer	Kishangarh	Marbe Slabs
284	Rajasthan	Ajmer	Kishangarh	Powerloom
285	Rajasthan	Alwar	Alwar	Chemicals
286	Rajasthan	Bikaner	Bikaner	Papad Mangodi, Namkin
287	Rajasthan	Bikaner	Bikaner	Plaster of Paris
288	Rajasthan	Dausa	Mahuwa	Sand Stone
289	Rajasthan	Gaganagar	Ganganagar	Food Processing
290	Rajasthan	Jaipur	Jaipur	Gems & Jewellery
291	Rajasthan	Jaipur	Jaipur	Ball Bearing
292	Rajasthan	Jaipur	Jaipur	Electrical Engineering Equipment
293	Rajasthan	Jaipur	Jaipur	Food Products
294	Rajasthan	Jaipur	Jaipur	Garments
295	Rajasthan	Jaipur	Jaipur	Lime
296	Rajasthan	Jaipur	Jaipur	Mechanical Engineering Equipment
297	Rajasthan	Jhalawar	Jhalawar	Marble Slabs
298	Rajasthan	Nagaur	Nagaur	Handtools
299	Rajasthan	Sikar	Shikhawati	Wooden Furniture
300	Rajasthan	Sirohi	Sirohi	Marble Slabs
301	Rajasthan	Udaipur	Udaipur	Marble Slabs
302	Tamil Nadu	Chennai	Chennai	Auto components
303	Tamil Nadu	Chennai	Chennai	Leather Products
304	Tamil Nadu	Chennai	Chennai	Electroplating
305	Tamil Nadu	Coimbatore	Coimbatore	Diesel Engines
306	Tamil Nadu	Coimbatore	Coimbatore	Agricultural Implements
307	Tamil Nadu	Coimbatore	Tirupur	Hosiery
308	Tamil Nadu	Coimbatore	Coimbatore	Machine Tools
309	Tamil Nadu	Coimbatore	Coimbatore	Castings & Forging
310	Tamil Nadu	Coimbatore	Coimbatore, Palladam, Kannam Palayam	Powerloom
311	Tamil Nadu	Coimbatore	Coimbatore	Wet Grinding Machines
312	Tamil Nadu	Erode	Surampatti	Powerloom
313	Tamil Nadu	Karur	Karur	Powerloom
314	Tamil Nadu	Madurai	Madurai	Readymade Garments
315	Tamil Nadu	Madurai	Madurai	Rice Mills
316	Tamil Nadu	Madurai	Madurai	Dal Mills
317	Tamil Nadu	Namakkal	Thiruchengode	Rigs
318	Tamil Nadu	Salem	Salem	Readymade Garments
319	Tamil Nadu	Salem	Salem	Starch & Sago
320	Tamil Nadu	Thanjavur	Thanjavur	Rice Mills
321	Tamil Nadu	Tiruchirappalli	Tiruchirappalli	Engineering Equipment
322	Tamil Nadu	Tiruchirappalli	Tiruchirappalli (Rural)	Artificial Diamonds
323	Tamil Nadu	Tuticorin	Kovilpathi	Safety Matches
324	Tamil Nadu	Vellore	Ambur, Vaniyambadi, Pallar Valley	Leather Tanning
325	Tamil Nadu	Virudhunagar	Rajapalayam	Cotton Mills (Gauge Cloth)
326	Tamil Nadu	Virudhunagar	Virudhunagar	Tin Container
327	Tamil Nadu	Virudhunagar	Sivakasi	Printing
328	Tamil Nadu	Virudhunagar	Sivakasi	Safety Matches & Fire

				Works
329	Tamil Nadu	Virudhunagar	Srivilliputhur	Toilet Soap
330	Uttar Pradesh	Agra	Agra	Foundry
331	Uttar Pradesh	Agra	Agra	Leather Footwear
332	Uttar Pradesh	Agra	Agra	Mechanical Engineering Equipment
333	Uttar Pradesh	Aligarh	Aligarh	Brass & Gunmetal Statues
334	Uttar Pradesh	Aligarh	Aligarh	Locks
335	Uttar Pradesh	Aligarh	Aligarh	Building Hardware
336	Uttar Pradesh	Allahabad	Mau	Powerloom
337	Uttar Pradesh	Allahabad	Mau Aima	Leather Products
338	Uttar Pradesh	Banda	Banda	Powerloom
339	Uttar Pradesh	Bulandshahr	Khurja	Ceramics
340	Uttar Pradesh	Firozabad	Firozabad	Glass Products
341	Uttar Pradesh	Gautam Buddha Nagar	Noida	Electronic Goods
342	Uttar Pradesh	Gautam Buddha Nagar	Noida	Toys
343	Uttar Pradesh	Gautam Buddha Nagar	Noida	Chemicals
344	Uttar Pradesh	Gautam Buddha Nagar	Noida	Electrical Engineering Equipment
345	Uttar Pradesh	Gautam Buddha Nagar	Noida	Garments
346	Uttar Pradesh	Gautam Buddha Nagar	Noida	Mechanical Engineering Equipment
347	Uttar Pradesh	Gautam Buddha Nagar	Noida	Packaging Material
348	Uttar Pradesh	Gautam Buddha Nagar	Noida	Plastic Products
349	Uttar Pradesh	Ghaziabad	Ghaziabad	Chemicals
350	Uttar Pradesh	Ghaziabad	Ghaziabad	Mechanical Engineering Equipment
351	Uttar Pradesh	Ghaziabad	Ghaziabad	Packaging Material
352	Uttar Pradesh	Gorakhpur	Gorakhpur	Powerloom
353	Uttar Pradesh	Hathras	Hathras	Sheetwork (Globe, Lamp)
354	Uttar Pradesh	Jhansi	Jhansi	Powerloom
355	Uttar Pradesh	Kannauj	Kannauj	Perfumery & Essential Oils
356	Uttar Pradesh	Kanpur	Kanpur	Saddlery

	Pradesh			
357	Uttar Pradesh	Kanpur	Kanpur	Cotton Hosiery
358	Uttar Pradesh	Kanpur	Kanpur	Leather Products
359	Uttar Pradesh	Meerut	Meerut	Sports Goods
360	Uttar Pradesh	Meerut	Meerut	Scissors
361	Uttar Pradesh	Moradabad	Moradabad	Brassware
362	Uttar Pradesh	Muzaffarnagar	Muzaffarnagar	Rice Mills
363	Uttar Pradesh	Saharanpur	Saharanpur	Rice Mills
364	Uttar Pradesh	Saharanpur	Saharanpur	Woodwork
365	Uttar Pradesh	Varanasi	Varanasi	Sheetwork (Globe, Lamp)
366	Uttar Pradesh	Varanasi	Varanasi	Powerloom
367	Uttar Pradesh	Varanasi	Varanasi	Agricultural Implements
368	Uttar Pradesh	Varanasi	Varanasi	Electric Fan
369	Uttaranchal	Dehradun	Dehradun	Miniature Vacuum Bulb
370	Uttaranchal	Haridwar	Roorkee	Survey Instruments
371	Uttaranchal	Udham Singh Nagar	Rudrapur	Rice Mills
372	West Bengal	Bankura	Barjora	Fishing Hooks(Information awaited)
373	West Bengal	HMC & Bally Municipal area	Howrah	Foundry
374	West Bengal	Howrah	Bargachia,Mansinghapur, Hantal, Sahadatpur & Jagatballavpur	Locks
375	West Bengal	Howrah	HMC & Bally Municipal area Sevok Rd	Steel Re-rolling
376	West Bengal	Howrah	Domjur	Artificial & Real Jewellery
377	West Bengal	Cooch Bihar	Cooch Bihar-I, Tufanganj,Mathabangha, Mekhliganj	Sitalpati/ Furniture
378	West Bengal	Kolkata	Wellington, Khanpur	Electric Fans
379	West Bengal	Kolkata	Sovabazar, Cossipur	Hosiery
380	West Bengal	Kolkata	Metiaburuj Ward No. 138 to 141	Readymade Garments
381	West Bengal	Kolkata	Tiljala, Topsia,Phoolbagan	Leather Goods
382	West Bengal	Kolkata	Daspara(Ultadanga), Ahiritola	Dal Mills
383	West Bengal	Kolkata	Taltala, Lenin, Sarani	Mechanical Engineering Equipment
384	West Bengal	Kolkata	Bowbazar, Kalighat	Wood Products
385	West Bengal	Nadia	Matiary,Dharmada,Nabadwip	Bell/Metal Utensils
386	West Bengal	Nadia	Ranaghat	Powerloom
387	West Bengal	Purulia	Jhalda Proper, Purulia, Begunkodar & Tanasi	Handtools
388	West Bengal	South 24 Parganas	Kalyanpur,Purandarpur, Dhopagachi	Surgical Instruments

Policy Package for stepping up credit to Small and Medium Enterprises

The small-scale industries (SSI) produce about 8000 products, contribute 40% of the industrial output and offer the largest employment after agriculture. The sector, therefore, presents an opportunity to the nation to harness local competitive advantages for achieving global dominance. In recognition of these aspects, the National Common Minimum Programme makes the following declarations for accelerating the development of small-scale sector.

“Household and artisanal manufacturing will be given greater technological, investment and marketing support. Small-scale industry will be freed from Inspector Raj and given full credit, technological and marketing support. Infrastructure upgradation in major industrial clusters will receive urgent attention.”

2. From SSI to SME: Defining the New Paradigm

2.1 Government policy as well as credit policy has so far concentrated on manufacturing units in the small-scale sector. The lowering of trade barriers across the globe has increased the minimum viable scale of enterprises. The size of the unit and technology employed for firms to be globally competitive is now of a higher order. The definition of small-scale sector needs to be revisited and the policy should consider inclusion of services and trade sectors within its ambit. In keeping with global practice, there is also a need to broaden the current concept of the sector and include the medium enterprises in a composite sector of Small and Medium Enterprises (SMEs). A comprehensive legislation, which would enable the paradigm shift from small-scale industry to small and medium enterprises under consideration of Parliament. The Reserve Bank of India, had meanwhile set up an Internal Group which has recommended:

“Current SSI/tiny industries definition may continue. Units with investment in plant and machinery in excess of SSI limit and up to Rs.10 crore may be treated as Medium Enterprises (ME). The definition may be reviewed after enactment of the Small and Medium Enterprises Development Bill. Only SSI financing will be included in Priority Sector.”

2.2 It is proposed to accept the recommendation with regard to the credit facilities being offered by the banking sector and accordingly request the Reserve Bank of India to advise the banks to frame a policy for enhancing the flow of credit to both small and medium enterprises, within the overall framework of credit policy of banks to small and medium enterprises.

2.3. The challenges being faced by the small and medium scale sector may be briefly set out as follows-

a. Small and Medium Enterprises (SME), particularly the tiny segment of the small enterprises have inadequate access to finance due to lack of financial information and non-formal business practices. SMEs also lack access to private equity and venture capital and have a very limited access to secondary market instruments.

b. SMEs face fragmented markets in respect of their inputs as well as products and are vulnerable to market fluctuations.

c. SMEs lack easy access to inter-state and international markets.

d. The access of SMEs to technology and product innovations is also limited. There is lack of awareness of global best practices.

e. SMEs face considerable delays in the settlement of dues/payment of bills by the large scale buyers.

With the deregulation of the financial sector, the ability of the banks to service the credit

requirements of the SME sector depends on the underlying transaction costs, efficient recovery processes and available security. There is an immediate need for the banking sector to focus on credit and finance requirements of SMEs.

3. Measures to increase the quantum of credit to SMEs at the right price

3.1 Public Sector Banks will be advised to fix their own targets for funding SMEs in order to achieve a **minimum** 20% year on year growth in credit to SMEs. The objective is to **double** the flow of credit from Rs.67,600 crore in 2004-05 to Rs.135,200 crore to the SME sector by 2009-10, i.e. within a period of 5 years.

3.2 Public Sector Banks will be advised to follow a transparent rating system with cost of credit being linked to the credit rating of the enterprise.

3.3 SIDBI in association with Credit Information Bureau(India) Ltd. (CIBIL) will expedite setting up a credit rating agency.

3.4 SIDBI in association with Indian Banks' Association (IBA) would collect and pool common data on risk in each identified cluster and develop an IT-enabled application, appraisal and monitoring system for small (including tiny) enterprises. This would help reduce transaction cost as well as improve credit flow to small (including tiny) enterprises in the clusters.

3.5 The National Small Industries Corporation has recently introduced a Credit Rating Scheme for encouraging SSI units to get themselves credit rated by reputed credit rating agencies. Public Sector Banks will be advised to consider these ratings appropriately and as per availability, and structure their rates suitably.

3.6 SIDBI has developed a Credit Appraisal & Rating Tool (CART) as well as a Risk Assessment Model (RAM) and a comprehensive rating model for risk assessment of credit proposals for SMEs. Public sector banks will be advised to take advantage of these models as appropriate and reduce their transaction costs.

4. Outreach of Formal Credit: Opening of New Accounts

The commercial banks (including regional rural banks) with over 67,000 branches, **will** make concerted efforts to provide credit cover on an average to at least 5 new **tiny**, small and medium enterprises at each of their semi urban/urban branches per year.

5. Nursing the Sick Units Back to Health: Debt Restructuring

Reserve Bank will issue detailed guidelines relating to debt restructuring mechanism so as to ensure restructuring of debt of all eligible small and medium enterprises at terms which are not less favourable than the Corporate Debt Restructuring (CDR) mechanism in the banking sector. The restructuring would follow upon a request to that effect from the borrowing unit. All accounts, except those classified as 'loss assets' will be eligible for restructuring, provided the industrial units are viable or potentially viable.

Based on the Reserve Bank's guidelines, banks may formulate, with the approval of their Boards of Directors, more liberal policies relating to restructuring of accounts. Until the banks formulate their own policies, Reserve Bank's guidelines will be operative.

A one-time settlement scheme to apply to small-scale NPA accounts in the books of the banks as on March 31, 2004 will be introduced. The scheme will be in force upto March 31, 2006.

6. Facilitative Measures

Reserve Bank had issued a detailed master circular on March 2005 on the time to be taken for disposing of loan applications of SSI units, the limit up to which banks are obliged to grant collateral-free and composite loans, norms for computation of working capital credit limits to SSI units, opening of atleast one specialized SSI branch in each district, etc. Taking these guidelines as indicative minimum, banks will formulate a comprehensive and more liberal policy relating to advances to SME sector. Untill the banks formulate such a policy, the extant instructions of Reserve Bank will be applicable to advances granted or to be granted by banks to SME units.

7. Credit Guarantee Fund Trust Scheme for Small Industries(CGTSI)

At present, Member Lending Institutions (MLIs), like banks, are provided guarantee cover of 75% of the amount of default by CGTSI, I respect of term loan and/or working capital facilities up to Rs.25 lakh extended by the MLIs to new and existing SSI units/IT/software units/small scale service business enterprises (SSSBs), without collateral security and/or third party guarantee. One-time guarantee fee of 2.5% and annual service fee of 0.75% of the credit facility sanctioned are currently charged by CGTSI from the MLIs. In order to reduce the cost of guarantee to the weaker segments of the borrowers, particularly tiny units, the CGTSI will be advised to reduce the one-time guarantee fee from 2.5% to 1.5% for all (i) loans up to Rs.2 lakh, (ii) eligible women entrepreneurs, and (iii) eligible borrowers located in the North Eastern regions (Sikkim) and Jammu & Kashmir. Further, public sector banks will be encouraged to absorb the annual service fee in excess of 0.25% in respect of guarantee for all (i) loans up to Rs.2 lakh, (ii) eligible women entrepreneurs, and (iii) eligible borrowers located in the North Eastern regions(Sikkim) and Jammu & Kashmir.

8. Cluster based approach

Cluster based approach for financing SME sector offers possibilities of reduction of transaction costs and mitigation of risk. About 388 clusters have already been identified. Cluster based approach now be treated as a thrust area. Banks will increasingly adopt the cluster-based approach for SME financing. To broaden the financing options for infrastructure development in clusters through public private partnership, SIDBI will formulate a scheme in consultation with the stakeholders.

SIDBI has already initiated the process of establishing Small Enterprises Financial Centres in select clusters. Risk profile of each cluster would be studied by a professional credit rating agency and such risk profile reports would be made available to commercial banks. Each lead bank of a district will consider adoption of atleast one cluster.

9. Setting up of Watchdogs: Monitoring and Review

The following supervisory arrangements will be ensured:

a. The existing institutional arrangements for review of credit to SSI sector like the Standing Advisory Committee in Reserve Bank of India and cells at the banks' head office level as well as at important regional centres will be made more rigorous and regular. They will also review the flow of credit to small (SSI) and medium enterprises.

b. At the Regional offices, the Reserve Bank will constitute empowered committees with the Regional Director of the Reserve Bank as the Chairman to review the progress in SME financing and rehabilitation of sick small (SSI) and medium units and to coordinate with other banks/financial institutions and the state governments in removing bottlenecks, if any, to ensure smooth flow of credit to the sector. The said Regional level committees may decide on

the need to have similar committees at cluster/district levels.

c. The banks will ensure specialized SME branches in identified clusters/centres with preponderance of small enterprises to enable the entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop requisite expertise. The existing specialised SSI branches may be also be redesignated as SME branches.

d. Boards of banks will be advised to review the progress in achieving the self-set targets as also rehabilitation and restructuring of SME accounts on a quarterly basis to ensure that the required emphasis is given to this sector.

e. For wider dissemination and easy accessibility, the policy guidelines formulated by Boards of banks as well as instructions/guidelines issued by Reserve Bank will be displayed on the respective websites of Public Sector Banks as well as website of SIDBI. The banks would also be advised to prominently display all the facilities/schemes offered by them to the small entrepreneurs at each of their branches.

Appendix

Master Circular SME SECTOR LENDING

List of Circulars consolidated by the Master Circular

No.	Circular No.	Date	Subject	Paragraph No.
1	RPCD,SME&NFS.No,12372/06.02.31(P)/2007-08	23.05.2008	Credit Linked Capital Subsidy Scheme	11
2	RPCD.No.Plan.BC.84/04.09.01/2006-07	30.04.2007	Guidelines on Lending to priority sector-revised	1
3	RPCD.PLNFS.BC.No.63/06.02.31/2006-07	04.04.2007	Credit flow to Micro, Small and Medium Enterprises Sector – Enactment of the Micro, Small and Medium Enterprises Development (MSMED), Act 2006	1-1,IV,13.6
4	RPCD.PLNFS.BC.No.35/06.02.31/2005-06	25-08-2005	Policy Package for Stepping up Credit to Small and Medium Enterprises --Announcements made by the Union Finance Minister (for private sector, foreign banks & RRBs)	IV,13.5
5	RPCD.PLNFS.BC.No.31/06.02.31/2005-06	19-08-2005	Policy Package for Stepping up Credit to Small and Medium Enterprises --Announcements made by the Union Finance Minister (for public sector banks)	IV,13.5
6	RPCD.PLNFS.BC.No.101/06.02.31/2004-05	20.05. 2005	Scheme for Small Enterprises Financial Centres (SEFCs)	1.6.4,4,II.6
7	RPCD. Plan. BC. 64/04.09.01/2004-05	15.12.2004	Priority Sector Lending-Investment in Special Bonds issued by Specified Institutions	I.1, 1.1.1,1.1.2, 1.1.3
8	RPCD.PLNFS.BC.61/06.02.31 (WG)/ 2004-05	08.12.2004	Working Group on Flow of Credit to SSI Sector-Interest rates on with SIDBI-in lieu of shortfall in priority sector obligations	III.3.1,3.5
9	RPCD. PLNFS. BC. 43/06.02.31/ 2004-05	26.10.2004	Investment by banks in securitized assets pertaining to SSI sector	II,2.1,2 2,2.3
10	RPCD.PLNFS.BC.28/06.02.31 (WG)/ 2004-05	04.09.2004	Working Group on Flow of Credit to SSI sector	IV. 13.3
11	RPCD. Plan. BC. 41/04.09.01/2003-04	03.11.2003	Priority sector lending – Deposit of shortfall with SIDBI	III. 3.1
12	RPCD. PLNFS. BC. 40/06.02.31/ 2003-04	03.11.2003	Credit facilities for SSIs – Lending by banks to NBFCs for the purpose of on-lending to SSIs	1.6.5
13	RPCD. PLNFS. BC. 39/06.02.80/ 2003-04	03.11.2003	Credit facilities for SSIs – Collateral Free Loans	IV 2.4
14	RPCD. PLNFS No.620/06.02.28(i)/ 2002-03	11.09.2003	SAC meeting Implementation of Action Points- Interest rate- Slab basis	IV 5

No.	Circular No.	Date	Subject	Paragraph No.
15	RPCD. PLNFS.1 /06.02.28(i)/ 2003-04	01.07.2003	SAC meeting Implementation of Action Points- Identification of Clusters	IV.2.9 IV13.3
16	RPCD. PLNFS. 2292/06.02. 28(i)/ 2003-04	13.06.2003	SAC meeting Implementation of Action Points- Self Set target for SSI	III.1.1,2.1.1 2.1.2
17	RPCD. PLNFS. BC. 24/06.02.77/ 2002-03	04.10.2002	Flow of credit to SSIs – Time schedule for disposal of loan applications	IV. 2.2
18	DBOD.No,BL.BC.74/22.01.001/ 2002	11.03.2002	Conversion of General Banking Branches to Specialised SSI Branches	IV 2.6
19	RPCD. PLNFS. BC.58/ 06.02.80/ 2001-02	23.01.2002	Collateral free loans- SSIs	IV 2.4
20	RPCD. PLNFS. BC.57/ 06.04.01/ 2001-02	16.01.2002	Guidelines for rehabilitation of Sick Small Scale Industrial Units	IV 2.8
21	IECD.No.5/08.12.01/2000-01	16.10.2000	Flow of Credit to SSI Sector- Decision of the Group of Ministers	IV 2.7
22	RPCD.PLNFS.BC.No.57/06.02. 31/ 99-2000	02.02.2000	Priority Sector Advances – Credit Deployment to SSI Sector	1.1.1,1.1.2
23	RPCD.No.PLNFS.BC.89/06.02. 31-98/99	14.06.1999	Interest on Delayed Payment to Small Scale and Ancillary Industrial Undertakings Act, 1998	IV 2.7
24	RPCD.No.PLNFS.BC.89/06.02. 31-98/99	01.03.1999	Flow of Credit to SSI sector- Computation of Working Capital limits	II 3.3
25	RPCD.No.PLNFS.BC.22/06.02. 31 (ii) -98/99	28.08.1998	High Level Committee on SSI- Kapur Committee- Implementation of recommendations	IV.13.2
26	RPCD.No.PLNFS.BC.127/06.0 2. 31/97/98	08.06.1998	Flow of Credit to SSI Sector	IV 5
27	RPCD.PLNFS.No.792/06.02.31 /97/98	02.03.1998	Flow of Credit to SSI Sector-Opening of Specialised SSI Branches	IV 2.6
28	RPCD.No.PLNFS.BC.89/06.02. 31-97/98	19.02.1998	Priority Sector Advances - Credit Deployment to SSI Sector	I 1.1, III 1.3,1.1.2
29	RPCD.No.PLNFS.BC.66/06.02. 31-97/98	05.01.1998	Priority Sector Advances - Credit Deployment to SSI Sector	III 1.3,1.1, 1.1.2
30	RPCD.No.Plan.BC.74/04.09.01/ 96-97	11.12.1996	Priority Sector Lending - Shortfall in Achievement of Target	III 4.1-4.4
31	RPCD.No.PLNFS.BC.23/06.06. 12/94-95	01.09.1995	Bank Credit to KVI Sector	I 1.5
32	RPCD.No.Plan.BC.38/04.09.09/ 94-95	22.09.1994	Lending to Priority Sector by foreign banks	III 2.1.1,2.1.3
33	RPCD.No.PLNFS.BC.16/06.06. 12/94-95	28.07.1994	Bank Credit to KVI Sector	I 1.6
34	RPCD.No.PLNFS.BC.84/06.06. 12/93-94	07.01.1994	Bank Credit to KVI Sector - Priority Sector Advances	I 1.5
35	RPCD.No.PLNFS.BC.99/06.02 31/92-93	17.04.1993	Report of the Committee to examine the adequacy of institutional credit to SSI sector and related aspects- Nayak Committee	IV 13.1
36	RPCD.No.PLNFS.BC.45/PS.72/ 86	20.01.1986	Financing of Bought Leaf Factories for Manufacturing	I 1.9
37	RPCD.No.PLNFS.BC.44/PS.72/ 86	17.01.1986	Bank Finance to Ship-breaking Industry	I 1.8

RBI/2008-09/69

RPCD. CO. Plan. BC. 9 /04.09.01/ 2008-09

July 1, 2008

**The Chairman/ Managing Director/
Chief Executive Officer**

***[All scheduled commercial banks
(excluding Regional Rural Banks)]***

Dear Sir,

MASTER CIRCULAR - LENDING TO PRIORITY SECTOR

The Reserve Bank of India has, from time to time, issued a number of guidelines/instructions/directives to banks on lending to Priority Sector. In order to enable the banks to have current instructions at one place, a Master Circular incorporating the existing guidelines/instructions/directives on the subject has been prepared and enclosed. This Master Circular consolidates all the circulars issued by Reserve Bank on the subject up to June 30, 2008 as indicated in the *Appendix*.

2. Please acknowledge receipt.

Yours faithfully,

(G. Srinivasan)
Chief General Manager-in-Charge

LENDING TO PRIORITY SECTOR

At a meeting of the National Credit Council held in July 1968, it was emphasised that commercial banks should increase their involvement in the financing of priority sectors, viz., agriculture and small scale industries. The description of the priority sectors was later formalised in 1972 on the basis of the report submitted by the Informal Study Group on Statistics relating to advances to the Priority Sectors constituted by the Reserve Bank in May 1971. On the basis of this report, the Reserve Bank prescribed a modified return for reporting priority sector advances and certain guidelines were issued in this connection indicating the scope of the items to be included under the various categories of priority sector. Although initially there was no specific target fixed in respect of priority sector lending, in November 1974 the banks were advised to raise the share of these sectors in their aggregate advances to the level of 33 1/3 per cent by March 1979.

At a meeting of the Union Finance Minister with the Chief Executive Officers of public sector banks held in March 1980, it was agreed that banks should aim at raising the proportion of their advances to priority sector to 40 per cent by March 1985. Subsequently, on the basis of the recommendations of the Working Group on the Modalities of Implementation of Priority Sector Lending and the Twenty Point Economic Programme by Banks (Chairman: Dr. K. S. Krishnaswamy), all commercial banks were advised to achieve the target of priority sector lending at 40 per cent of aggregate bank advances by 1985. Sub-targets were also specified for lending to agriculture and the weaker sections within the priority sector. Since then, there have been several changes in the scope of priority sector lending and the targets and sub-targets applicable to various bank groups.

On the basis of the recommendations made in September 2005 by the Internal Working Group (Chairman: Shri C. S. Murthy), set up in Reserve Bank to examine, review and recommend changes, if any, in the existing policy on priority sector lending including the segments constituting the priority sector, targets and sub-targets, etc. and the comments/suggestions received thereon from banks, financial institutions, public and the Indian Banks' Association (IBA), it was decided to include only those sectors as part of the priority sector, that impact large sections of the population, the weaker sections and the sectors which are employment-intensive such as agriculture, and tiny and small enterprises.

Presently, the broad categories of priority sector for all scheduled commercial banks are as under:

I. CATEGORIES OF PRIORITY SECTOR

- (i) **Agriculture (Direct and Indirect finance):** Direct finance to agriculture shall include short, medium and long term loans given for agriculture and allied activities (dairy, fishery, piggery, poultry, bee-keeping, etc.) directly to individual farmers, Self-Help Groups (SHGs) or Joint Liability Groups (JLGs) of individual farmers without limit and to others (such as corporates, partnership firms and institutions) up to the limits indicated in Section I, for taking up agriculture/allied activities.

Indirect finance to agriculture shall include loans given for agriculture and allied activities as specified in Section I, appended.

- (ii) **Small Enterprises (Direct and Indirect Finance):** Direct finance to small enterprises shall include all loans given to micro and small (manufacturing) enterprises engaged in manufacture/production, processing or preservation of goods, and micro and small (service) enterprises engaged in providing or rendering of services, and whose investment in plant and machinery and equipment (original cost excluding land and building and such items as mentioned therein) respectively, does not exceed the amounts specified in Section I, appended. The micro and small (service) enterprises shall include small road & water transport operators, small business, professional & self-employed persons, and all other service enterprises, as per the definition given in Section I appended.

Indirect finance to small enterprises shall include finance to any person providing inputs to or marketing the output of artisans, village and cottage industries, handlooms and to cooperatives of producers in this sector.

- (iii) **Retail Trade** shall include retail traders/private retail traders dealing in essential commodities (fair price shops), and consumer co-operative stores, as per the definition given in Section I appended.

- (iv) **Micro Credit:** Provision of credit and other financial services and products of very small amounts not exceeding Rs. 50,000 per borrower, either directly or indirectly through a SHG/JLG mechanism or to NBFC/MFI for on-lending up to Rs. 50,000 per borrower, will constitute micro credit.

- (v) **Education loans:** Education loans include loans and advances granted to only individuals for educational purposes up to Rs. 10 lakh for studies in India and Rs. 20 lakh for studies abroad, and do not include those granted to institutions;

(vi) Housing loans: Loans up to Rs. 20 lakh to individuals for purchase/construction of dwelling unit per family, (excluding loans granted by banks to their own employees) and loans given for repairs to the damaged dwelling units of families up to Rs. 1 lakh in rural and semi-urban areas and up to Rs. 2 lakh in urban and metropolitan areas.

II. OTHER IMPORTANT FEATURES OF THE GUIDELINES

(i) Investments by banks in securitised assets, representing loans to various categories of priority sector, shall be eligible for classification under respective categories of priority sector (direct or indirect) depending on the underlying assets, provided the securitised assets are originated by banks and financial institutions and fulfil the Reserve Bank of India guidelines on securitisation. This would mean that the banks' investments in the above categories of securitised assets shall be eligible for classification under the respective categories of priority sector only if the securitised advances were eligible to be classified as priority sector advances before their securitisation.

(ii) Outright purchases of any loan asset eligible to be categorised under priority sector, shall be eligible for classification under the respective categories of priority sector (direct or indirect), provided the loans purchased are eligible to be categorized under priority sector; the loan assets are purchased (after due diligence and at fair value) from banks and financial institutions, without any recourse to the seller; and the eligible loan assets are not disposed of, other than by way of repayment, within a period of six months from the date of purchase.

(iii) Investments by banks in Inter Bank Participation Certificates (IBPCs), on a risk sharing basis, shall be eligible for classification under respective categories of priority sector, provided the underlying assets are eligible to be categorised under the respective categories of priority sector and are held for at least 180 days from the date of investment.

(iv) The targets and sub-targets under priority sector lending would be linked to Adjusted Net Bank Credit (ANBC) (Net Bank Credit plus investments made by banks in non-SLR bonds held in HTM category) or Credit Equivalent amount of Off-Balance Sheet Exposures (OBE), whichever is higher, as on March 31 of the previous year. The outstanding FCNR (B) and NRNR deposits balances will no longer be deducted for computation of ANBC for priority sector lending purposes. Investments made by banks in the Recapitalization Bonds floated by Government of India will not be taken into account for the purpose. Existing investments, as on April 30, 2007, made by banks in non-SLR bonds held in HTM category will not be taken into account for calculation of ANBC, up to March 31, 2010. However, fresh investments by banks in non-SLR bonds held in HTM category will be taken into account for the purpose. Deposits placed by banks with NABARD/SIDBI, as the case may be, in lieu of non-achievement of priority sector lending targets/sub-targets, though shown under

Schedule 8 – 'Investments' in the Balance Sheet at item I (vi) – 'Others', will not be treated as investment in non-SLR bonds held under HTM category. For the purpose of calculation of credit equivalent of off-balance sheet exposures, banks may use current exposure method. Inter-bank exposures will not be taken into account for the purpose of priority sector lending targets/sub-targets.

(v) Fresh deposits placed by banks' on or after April 30, 2007 with NABARD/SIDBI on account of non-achievement of priority sector lending targets/sub-targets would not be eligible for classification as indirect finance to agriculture/Small Enterprises Sector, as the case may be. However, the deposits placed with NABARD/SIDBI by banks on the above account and **outstanding** as on April 30, 2007 would be eligible for classification as indirect finance to agriculture/Small Enterprises sector, as the case may be, till the date of maturity of such deposits or March 31, 2010, whichever is earlier.

III. TARGETS/SUB-TARGETS

The targets and sub-targets set under priority sector lending for domestic and foreign banks operating in India are furnished below:

	Domestic commercial banks	Foreign banks
Total Priority Sector advances	40 per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.	32 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.
Total agricultural advances	18 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher. Of this, indirect lending in excess of 4.5% of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher, will not be reckoned for computing performance under 18 per cent target. However, all agricultural advances under the categories 'direct' and 'indirect' will be reckoned in computing performance under the overall priority sector target of 40 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.	No target.
Small Enterprise advances	Advances to small enterprises sector will be reckoned in computing performance under the overall priority sector target of 40 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.	10 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.
Micro enterprises within Small Enterprises sector	(i) 40 per cent of total advances to small enterprises sector should go to micro (manufacturing) enterprises having investment in plant and machinery up to Rs 5 lakh and micro (service) enterprises having investment in equipment up to Rs. 2 lakh;	Same as for domestic banks.

	(ii) 20 per cent of total advances to small enterprises sector should go to micro (manufacturing) enterprises with investment in plant and machinery above Rs 5 lakh and up to Rs. 25 lakh, and micro (service) enterprises with investment in equipment above Rs. 2 lakh and up to Rs. 10 lakh. (Thus, 60 per cent of small enterprises advances should go to the micro enterprises).	
Export credit	Export credit is not a part of priority sector for domestic commercial banks.	12 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.
Advances to weaker sections	10 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.	No target.
Differential Rate of Interest Scheme	1 per cent of total advances outstanding as at the end of the previous year. It should be ensured that not less than 40 per cent of the total advances granted under DRI scheme go to scheduled caste/scheduled tribes. At least two third of DRI advances should be granted through rural and semi-urban branches.	No target.

[ANBC or credit equivalent of Off-Balance Sheet Exposures (as defined by Department of Banking Operations and Development of Reserve Bank of India from time to time) will be computed with reference to the outstanding as on March 31 of the previous year. For this purpose, outstanding FCNR (B) and NRNR deposits balances will no longer be deducted for computation of ANBC for priority sector lending purposes. For the purpose of priority sector lending, ANBC denotes NBC plus investments made by banks in non-SLR bonds held in HTM category. Investments made by banks in the Recapitalization Bonds floated by Government of India will not be taken into account for the purpose of calculation of ANBC. Existing investments, as on the date of this circular, made by banks in non-SLR bonds held in HTM category will not be taken into account for calculation of ANBC, up to March 31, 2010. However, fresh investments by banks in non-SLR bonds held in HTM category will be taken into account for the purpose. Deposits placed by banks with NABARD/SIDBI, as the case may be, in lieu of non-achievement of priority sector lending targets/sub-targets, though shown under Schedule 8 – 'Investments' in the Balance Sheet at item I (vi) – 'Others', will not be treated as investment in non-SLR bonds held under HTM category. For the purpose of calculation of credit equivalent of off-balance sheet exposures, banks may use current exposure method. Inter-bank exposures will not be taken into account for the purpose of priority sector lending targets/sub-targets.]

The detailed guidelines in this regard are given hereunder.

SECTION I

1.	AGRICULTURE
	DIRECT FINANCE
1.1	Finance to individual farmers [including Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual farmers, provided banks maintain disaggregated data on such finance] for Agriculture and Allied Activities (dairy, fishery, piggery, poultry, bee-keeping, etc.)
	1.1.1 Short-term loans for raising crops, i.e. for crop loans. This will include traditional/non-traditional plantations and horticulture.
	1.1.2 Advances up to Rs. 10 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months, irrespective of whether the farmers were given crop loans for raising the produce or not.
	1.1.3 Working capital and term loans for financing production and investment requirements for agriculture and allied activities.
	1.1.4 Loans to small and marginal farmers for purchase of land for agricultural purposes.
	1.1.5 Loans to distressed farmers indebted to non-institutional lenders, against appropriate collateral or group security.
	1.1.6 Loans granted for pre-harvest and post-harvest activities such as spraying, weeding, harvesting, grading, sorting, processing and transporting undertaken by individuals, SHGs and cooperatives in rural areas.
1.2	Finance to others [such as corporates, partnership firms and institutions] for Agriculture and Allied Activities (dairy, fishery, piggery, poultry, bee-keeping, etc.)
	1.2.1 Loans granted for pre-harvest and post harvest activities such as spraying, weeding, harvesting, grading, sorting and transporting.
	1.2.2 Finance up to an aggregate amount of Rs. one crore per borrower for the purposes listed at 1.1.1, 1.1.2, 1.1.3 and 1.2.1 above.
	1.2.3 One-third of loans in excess of Rs. one crore in aggregate per borrower for agriculture and allied activities.
	INDIRECT FINANCE
1.3	Finance for Agriculture and Allied Activities
	1.3.1 Two-third of loans to entities covered under 1.2 above in excess of Rs. one crore in aggregate per borrower for agriculture and allied activities.
	1.3.2 Loans to food and agro-based processing units with investments in plant and machinery up to Rs. 10 crore, undertaken by those other than 1.1.6 above.

	1.3.3	(i) Credit for purchase and distribution of fertilisers, pesticides, seeds, etc.
		(ii) Loans up to Rs. 40 lakh granted for purchase and distribution of inputs for the allied activities such as cattle feed, poultry feed, etc.
	1.3.4	Finance for setting up of Agriclincs and Agribusiness Centres.
	1.3.5	Finance for hire-purchase schemes for distribution of agricultural machinery and implements.
	1.3.6	Loans to farmers through Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi Purpose Societies (LAMPS).
	1.3.7	Loans to cooperative societies of farmers for disposing of the produce of members.
	1.3.8	Financing the farmers indirectly through the co-operative system (otherwise than by subscription to bonds and debenture issues).
	1.3.9	Existing investments as on March 31, 2007, made by banks in special bonds issued by NABARD with the objective of financing exclusively agriculture/allied activities may be classified as indirect finance to agriculture till the date of maturity of such bonds or March 31, 2010, whichever is earlier. Fresh investments in such special bonds made subsequent to March 31, 2007 will, however, not be eligible for such classification.
	1.3.10	Loans for construction and running of storage facilities (warehouse, market yards, godowns, and silos), including cold storage units designed to store agriculture produce/products, irrespective of their location.
		If the storage unit is registered as SSI unit/micro or small enterprise, the loans granted to such units may be classified under advances to Small Enterprises sector.
	1.3.11	Advances to Custom Service Units managed by individuals, institutions or organisations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake work for farmers on contract basis.
	1.3.12	Finance extended to dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, irrespective of their location, subject to the following conditions:
		(a) The dealer should be dealing exclusively in such items or if dealing in other products, should be maintaining separate and distinct records in respect of such items.
		(b) A ceiling of up to Rs. 30 lakh per dealer should be observed.
	1.3.13	Loans to <i>Arthias</i> (commission agents in rural/semi-urban areas functioning in markets/ <i>mandies</i>) for extending credit to farmers, for supply of inputs as also for buying the output from the individual farmers/ SHGs/ JLGs.
	1.3.14	Credit outstanding under loans for general purposes under General Credit Cards (GCC).

	1.3.15	The deposits placed in RIDF with NABARD by banks on account of non-achievement of priority sector lending targets/sub-targets and outstanding as on April 30, 2007 would be eligible for classification as indirect finance to agriculture sector till the date of maturity of such deposits or March 31, 2010, whichever is earlier.
	1.3.16	Loans already disbursed and outstanding as on April 30, 2007 to State Electricity Boards (SEBs) and power distribution corporations/companies, emerging out of bifurcation/restructuring of SEBs, for reimbursing the expenditure already incurred by them for providing low tension connection from step-down point to individual farmers for energising their wells and for Systems Improvement Scheme under Special Project Agriculture (SI-SPA), are eligible for classification as indirect finance till the dates of their maturity/repayment or March 31, 2010, whichever is earlier. Fresh advances will, however, not be eligible for classification as indirect finance to agriculture.
	1.3.17	Loans to National Co-operative Development Corporation (NCDC) for on-lending to the co-operative sector for purposes coming under the priority sector will be treated as indirect finance to agriculture till March 31, 2010.
	1.3.18	Loans to Non-Banking Financial Companies (NBFCs) for on lending to individual farmers or their SHGs/JLGs.
	1.3.19	Loans granted to NGOs/MFIs for on-lending to individual farmers or their SHGs/JLGs.
	1.3.20	Loans granted to RRBs for on-lending to agriculture and allied activities sector.
	1.3.21	Overdrafts, up to Rs. 25,000 (per account), granted against 'no-frills' accounts in rural and semi-urban areas.
2	SMALL ENTERPRISES	
	DIRECT FINANCE	
2.1	Direct Finance in the small enterprises sector will include credit to:	
	2.1.1 Manufacturing Enterprises	
	(a) Small (manufacturing) Enterprises	
	Enterprises engaged in the manufacture/production, processing or preservation of goods and whose investment in plant and machinery [original cost excluding land and building and the items specified by the Ministry of Small Scale Industries vide its notification no. S.O. 1722 (E) dated October 5, 2006] does not exceed Rs. 5 crore.	
	(b) Micro (manufacturing) Enterprises	
	Enterprises engaged in the manufacture/production, processing or preservation of goods and whose investment in plant and machinery [original cost excluding land and building and such items as in 2.1.1 (a)] does not exceed Rs. 25 lakh, irrespective of the location of the unit.	
	2.1.2 Service Enterprises	
	(a) Small (service) Enterprises	

Enterprises engaged in providing/rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings and other items not directly related to the service rendered or as may be notified under the MSMED Act, 2006) does not exceed Rs. 2 crore.	
(b) Micro (service) Enterprises	
Enterprises engaged in providing/rendering of services and whose investment in equipment [original cost excluding land and building and furniture, fittings and such items as in 2.1.2 (a)] does not exceed Rs. 10 lakh.	
(c) The small and micro (service) enterprises shall include small road & water transport operators, small business, professional & self-employed persons, and all other service enterprises.	
2.1.3 Khadi and Village Industries Sector (KVI)	
All advances granted to units in the KVI sector, irrespective of their size of operations, location and amount of original investment in plant and machinery. Such advances will be eligible for consideration under the sub-target (60 per cent) of the small enterprises segment within the priority sector.	
INDIRECT FINANCE	
2.2	Indirect finance to the small (manufacturing as well as service) enterprises sector will include credit to:
2.2.1	Persons involved in assisting the decentralised sector in the supply of inputs to and marketing of outputs of artisans, village and cottage industries.
2.2.2	Advances to cooperatives of producers in the decentralised sector viz. artisans village and cottage industries.
2.2.3	Existing investments as on March 31, 2007, made by banks in special bonds issued by NABARD with the objective of financing exclusively non-farm sector may be classified as indirect finance to Small Enterprises sector till the date of maturity of such bonds or March 31, 2010, whichever is earlier. Investments in such special bonds made subsequent to March 31, 2007 will, however, not be eligible for such classification.
2.2.4	The deposits placed with SIDBI by foreign banks, having offices in India, on account of non-achievement of priority sector lending targets/sub-targets and outstanding as on April 30, 2007 would be eligible for classification as indirect finance to Small Enterprises sector till the date of maturity of such deposits or March 31, 2010, whichever is earlier.
2.2.5	Loans granted by banks to NBFCs for on-lending to small and micro enterprises (manufacturing as well as service).
3.	RETAIL TRADE
3.1	Advances granted to retail traders dealing in essential commodities (fair price shops), consumer co-operative stores, and;

	3.2 Advances granted to private retail traders with credit limits not exceeding Rs. 20 lakh.	
4.	MICRO CREDIT	
	4.1 Loans of very small amount not exceeding Rs. 50,000 per borrower provided by banks either directly or indirectly through a SHG/JLG mechanism or to NBFC/MFI for on-lending up to Rs. 50,000 per borrower.	
	4.2 Loans to poor indebted to informal sector	
	Loans to distressed persons (other than farmers) to prepay their debt to non-institutional lenders, against appropriate collateral or group security, would be eligible for classification under priority sector.	
5.	STATE SPONSORED ORGANIZATIONS FOR SCHEDULED CASTES/SCHEDULED TRIBES	
	Advances sanctioned to State Sponsored Organisations for Scheduled Castes/ Scheduled Tribes for the specific purpose of purchase and supply of inputs to and/or the marketing of the outputs of the beneficiaries of these organisations.	
6.	EDUCATION	
	6.1 Educational loans granted to individuals for educational purposes up to Rs. 10 lakh for studies in India and Rs. 20 lakh for studies abroad. Loans granted to institutions will not be eligible to be classified as priority sector advances.	
	6.2 Loans granted by banks to NBFCs for on-lending to individuals for educational purposes up to Rs. 10 lakh for studies in India and Rs. 20 lakh for studies abroad.	
7.	HOUSING	
	7.1	Loans up to Rs. 20 lakh, irrespective of location, to individuals for purchase/construction of a dwelling unit per family, excluding loans granted by banks to their own employees.
	7.2	Loans given for repairs to the damaged dwelling units of families up to Rs. 1 lakh in rural and semi-urban areas and up to Rs. 2 lakh in urban and metropolitan areas.
	7.3	Assistance given to any governmental agency for construction of dwelling units or for slum clearance and rehabilitation of slum dwellers, subject to a ceiling of Rs. 5 lakh of loan amount per dwelling unit.
	7.4	Assistance given to a non-governmental agency approved by the NHB for the purpose of refinance for construction/reconstruction of dwelling units or for slum clearance and rehabilitation of slum dwellers, subject to a ceiling of loan component of Rs. 5 lakh per dwelling unit.
8.	Weaker Sections	
	The weaker sections under priority sector shall include the following:	

	(a) Small and marginal farmers with land holding of 5 acres and less, and landless labourers, tenant farmers and share croppers;
	(b) Artisans, village and cottage industries where individual credit limits do not exceed Rs. 50,000;
	(c) Beneficiaries of Swarnjayanti Gram Swarozgar Yojana (SGSY);
	(d) Scheduled Castes and Scheduled Tribes;
	(e) Beneficiaries of Differential Rate of Interest (DRI) scheme;
	(f) Beneficiaries under Swarna Jayanti Shahari Rozgar Yojana (SJSRY);
	(g) Beneficiaries under the Scheme for Liberation and Rehabilitation of Scavengers (SLRS);
	(h) Advances to Self Help Groups;
	(i) Loans to distressed poor to prepay their debt to informal sector, against appropriate collateral or group security.
	(j) Loans granted under (a) to (i) above to persons from minority communities as may be notified by Government of India from time to time. In States, where one of the minority communities notified is, in fact, in majority, item (j) will cover only the other notified minorities. These States/Union Territories are Jammu & Kashmir, Punjab, Meghalaya, Mizoram, Nagaland and Lakshadweep.

9. Export Credit

This category will form part of priority sector for foreign banks only.

SECTION II

PENALTIES FOR NON-ACHIEVEMENT OF PRIORITY SECTOR LENDING TARGET / SUB-TARGETS

1.	Domestic scheduled commercial banks – Contribution by banks to Rural Infrastructure Development Fund (RIDF) or Funds with other Financial Institutions, as specified by the Reserve Bank:
1.1	Domestic scheduled commercial banks having shortfall in lending to priority sector target (40 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher) and / or agriculture target (18 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher) and / or weaker sections lending target (10 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposures, whichever is higher) shall be allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD or Funds with other Financial Institutions, as specified by the Reserve Bank. The achievement level of banks in weaker sections lending target will be taken into account for the purpose of allocations in RIDF or any other Fund with effect from April 2009. For the purpose of allocation of RIDF tranche or any other Fund, as decided by Reserve Bank from time to time, the achievement level of priority sector lending as on the last reporting Friday of March of the immediately preceding financial year will be taken into account (i.e. For allocation in RIDF or any other Fund in the year 2009-2010, the achievement level of priority sector lending as on the last reporting Friday of March 2009 will be taken into account). The concerned banks will be called upon by NABARD or such other Financial Institution as may be decided by Reserve Bank, as and when funds are required by them, after giving one month's notice.
1.2	The corpus of a particular tranche of RIDF is decided by Government of India every year. The amount of contribution by banks to a particular tranche of RIDF or any other Fund will be decided in the beginning of the financial year.

	1.3 The interest rates on banks' contribution to RIDF or any other Fund, periods of deposits, etc. shall be fixed by Reserve Bank of India from time to time.
	1.4 Details regarding operationalisation of the RIDF or any other Fund, such as the amounts to be deposited by banks, interest rates on deposits, period of deposits, etc., will be communicated to the concerned banks separately by August of each year to enable them to plan their deployment of funds.
2.	Foreign Banks – Deposit by Foreign Banks with SIDBI or Funds with other Financial Institutions, as specified by the Reserve Bank
	2.1 The foreign banks having shortfall in lending to stipulated priority sector lending target/sub-targets will be required to contribute to Funds to be set up with Small Industries Development Bank of India (SIDBI) or with other Financial Institutions, for such other purpose as may be stipulated by Reserve Bank of India from time to time.
	2.2 For the purpose of such allocation, the achievement level of priority sector lending as on the last reporting Friday of March of the immediately preceding financial year will be taken into account (i.e. For allocation in Funds with SIDBI or any other Financial Institutions in the year 2009-2010, the achievement level of priority sector lending target/sub-targets as on the last reporting Friday of March 2009 will be taken into account).
	2.3 The corpus of Funds shall be decided by Government of India / Reserve Bank of India on a year-to-year basis. The tenor of the deposits shall be for a period of three years or as decided by Reserve Bank from time to time. The contribution required to be made by foreign banks would not be more than the amount of shortfall in priority sector lending target/sub-targets of the foreign banks.
	2.4 The concerned foreign banks will be called upon by SIDBI/or such other Financial Institution as may be decided by Reserve Bank, as and when funds are required by them, after giving one month's notice.
	2.5 The interest rates on foreign banks' contribution, period of deposits, etc. shall be fixed by Reserve Bank of India from time to time.
3.	Non-achievement of priority sector targets and sub-targets will be taken into account while granting regulatory clearances/approvals for various purposes.

<u>SECTION III</u>	
<u>COMMON GUIDELINES FOR PRIORITY SECTOR ADVANCES</u>	
1	Banks should follow the following common guidelines prescribed by the Reserve Bank for <u>all</u> categories of advances under the priority sector.
2	PROCESSING OF APPLICATIONS
2.1	Completion of Application Forms
	In case of Government sponsored schemes such as SGSY, the concerned project authorities like DRDAs, DICs, etc. should arrange for completion of application forms received from borrowers. In other areas, the bank staff should help the borrowers for this purpose.
2.2	Issue of Acknowledgement of Loan Applications
	Banks should give acknowledgement for loan applications received from weaker sections. Towards this purpose, it may be ensured that all loan application forms have perforated portion for acknowledgement to be completed and issued by the receiving branch. Each branch may affix on the main application form as well as the corresponding portion for acknowledgement, a running serial number. While using the existing stock of application forms which do not have a perforated portion for acknowledgement separately given, care should be taken to ensure that the serial number given on the acknowledgement is also recorded on the main application. The loan applications should have a check list of documents required for guidance of the prospective borrowers.
2.3	Disposal of Applications
	(i) All loan applications up to a credit limit of Rs. 25,000 should be disposed of within a fortnight and those for over Rs. 25,000, within 8 to 9 weeks.
	(ii) All loan applications for Small Enterprises up to a credit limit of Rs. 25,000 should be disposed of within 2 weeks and those up to Rs. 5 lakh within 4 weeks, provided the loan applications are complete in all respects and are accompanied by a 'check list'.
2.4	Rejection of Proposals
	Branch Managers may reject applications (except in respect of SC/ST) provided the cases of rejection are verified subsequently by the Divisional/Regional Managers. In the case of proposals from SC/ST, rejection should be at a level higher than that of Branch Manager.
2.5	Register of Rejected Applications
	A register should be maintained at the branch, wherein the date of receipt, sanction/rejection/disbursement with reasons therefor, etc., should be recorded. The register should be made available to all inspecting agencies.
3	MODE OF DISBURSEMENT OF LOAN
	With a view to providing farmers wider choice as also eliminating undesirable practices, banks may disburse all loans for agricultural purposes in cash which will facilitate dealer choice to borrowers and foster an environment of trust. However, banks may continue the practice of obtaining receipts from borrowers.

4	REPAYMENT SCHEDULE	
4.1	Repayment programme should be fixed taking into account the sustenance requirements, surplus generating capacity, the break-even point, the life of the asset, etc., and not in an "ad hoc" manner. In respect of composite loans, repayment schedule may be fixed for term loan component only.	
4.2	As the repaying capacity of the people affected by natural calamities gets severely impaired due to the damage to the economic pursuits and loss of economic assets, the benefits such as restructuring of existing loans, etc. as envisaged under our circular RPCD.CO.PLFS.NO. BC 16/05.04.02/2006-07 dated August 9, 2006 may be extended to the affected borrowers.	
5	RATES OF INTEREST	
5.1	The rates of interest on various categories of priority sector advances will be as per RBI directives issued from time to time.	
5.2	(a) In respect of direct agricultural advances, banks should not compound the interest in the case of current dues, i.e. crop loans and instalments not fallen due in respect of term loans, as the agriculturists do not have any regular source of income other than sale proceeds of their crops.	
	(b) When crop loans or instalments under term loans become overdue, banks can add interest to the principal.	
	(c) Where the default is due to genuine reasons banks should extend the period of loan or reschedule the instalments under term loan. Once such a relief has been extended, the overdues become current dues and banks should not compound interest.	
	(d) Banks should charge interest on agricultural advances in respect of long duration crops, at annual rests instead of quarterly or longer rests, and could compound the interest, if the loan/instalment becomes overdue.	
6	PENAL INTEREST	
6.1.1	The issue of charging penal interests that should be levied for reasons such as default in repayment, non-submission of financial statements, etc. has been left to the Board of each bank. Banks have been advised to formulate policy for charging such penal interest with the approval of their Boards, to be governed by well accepted principles of transparency, fairness, incentive to service the debt and due regard to difficulties of customers.	
6.1.2	No penal interest should be charged by banks for loans under priority sector up to Rs 25,000 as hitherto. However, banks will be free to levy penal interest for loans exceeding Rs 25,000, in terms of the above guidelines.	
7.	SERVICE CHARGES / INSPECTION CHARGES	
7.1.1	No service charges/inspection charges should be levied on priority sector loans up to Rs. 25,000.	
7.1.2	For loans above Rs. 25,000/- banks will be free to prescribe service charges with the prior approval of their Boards, in terms of circular No. DBOD.Dir.BC.86/03.01.00/99-2000 dated September 7, 1999.	

8.	INSURANCE AGAINST FIRE AND OTHER RISKS	
8.1	Banks may waive insurance of assets financed by bank credit in the following cases:	
No.	Category	Type of Risk
(a)	All categories of priority sector advances up to and inclusive of Rs. 10,000	Fire & other risks
(b)	Advances to Small Enterprises up to and inclusive of Rs. 25,000 by way of -	
	• Composite loans to artisans, village and cottage industries	Fire
	• All term loans	Fire
	• Working capital where these are against non-hazardous goods	Fire
8.2	Where, however, insurance of vehicle or machinery or other equipment/assets is compulsory under the provisions of any law or where such a requirement is stipulated in the refinance scheme of any refinancing agency or as part of a Government-sponsored programmes such as SGSY, insurance should not be waived even if the relative credit facility does not exceed Rs. 10,000 or Rs. 25,000, as the case may be.	
9.	PHOTOGRAPHS OF BORROWERS	
	While there is no objection to taking photographs of the borrowers for purposes of identification, banks themselves should make arrangements for the photographs and also bear the cost of photographs of borrowers falling in the category of Weaker Sections. It should also be ensured that the procedure does not involve any delay in loan disbursement.	
10	DISCRETIONARY POWERS	
	All Branch Managers of banks should be vested with discretionary powers to sanction proposals from weaker sections without reference to any higher authority. If there are difficulties in extending such discretionary powers to all the Branch Managers, such powers should exist at least at the district level and arrangements be ensured that credit proposals on weaker sections are cleared promptly.	
11	MACHINERY TO LOOK INTO COMPLAINTS	
11.1.1	There should be machinery at the regional offices to entertain complaints from the borrowers if the branches do not follow these guidelines, and to verify periodically that these guidelines are scrupulously implemented by the branches.	
11.1.2	The names and addresses of the officer with whom complaints can be lodged should be displayed on the notice board of every branch.	
12	AMENDMENTS	
	These guidelines are subject to any instructions that may be issued by the RBI from time to time.	

Master Circular
LENDING TO PRIORITY SECTOR
List of Circulars consolidated by the Master Circular

No.	Circular No.	Date	Subject	Paragraph No.
1.	RPCD.CO.Plan.BC. 65/04.09.01/2007-08	06.05.08	Weaker Section Lending targets – Ensuring adherence	II. 1.1
2.	RPCD.CO.Plan.BC. 66/04.09.01/2007-08	06.05.08	General Purpose Credit Cards and Overdrafts against 'No-frills' Account as indirect finance to agriculture under priority sector	I. 1.3.14, 1.3.21
3.	RPCD.CO.Plan.BC. 42/04.09.01/2007-08	12.12.07	Priority Sector Lending – Funds provided by sponsor banks/commercial banks to RRBs	I. 1.3.20
4.	RPCD.CO.Plan.BC. 30/04.09.01/2007-08	11.10.07	Revised Guidelines on Lending to Priority Sector – Weaker Sections	I. 8 (j)
5.	RPCD.Plan.BC.No. 10856/04.09.01/2006-07	18.05.07	Revised Guidelines on Lending to Priority Sector – Weaker Sections	I. 8 (j)
6.	RPCD.Plan.BC.No.84/04.09.01/2006-07	30.04.07	Guidelines on lending to priority sector -- Revised	Section I & II
7.	RPCD. Plan. BC. 53/04.09.01/ 2002-03	20.10.02	Levying of service charges and inspection charges by banks in respect of priority sector loans	III. 7.1.1, 7.1.2
8.	RPCD. PLNFS. BC. 24/06.02.77/ 2002-03	04.10.02	Flow of credit to SSIs – Time schedule for disposal of loan applications	III. 2.3 (ii)
9.	RPCD. Plan. BC. 15/ 04.09.01/ 2001-02	17.08.20 01	Charging of penal interest by banks on priority sector loans	III.6.1.1, 6.1.2
10.	RPCD.No.Plan.BC.77/PL-09.01/ 89-90	18.01.90	Lending to Priority Sector – Loan Application Forms	III. 2.2
11.	RPCD.No.Plan.BC.67/PS.22/ 87-88	12.12.87	Advances to Priority Sector - Issue of Acknowledgement to Applicants from Weaker Sections	III. 2.2
12.	RPCD.No.SP.BC.64/C.568A(P)/87-88	08.12.87	IRDP – Uniform Application Form - Issue of Acknowledgement Slip	III. 2.2
13.	RPCD.No.PS.BC.22/C.682/83-84	06.02.84	Monitoring advances to priority sector	---
14.	DBOD.No.BP.BC.126/C.464 (M)-80	29.10.80	Report of the Working Group on the Modalities of Implementation of Priority Sector Lending	---
15.	DBOD.No.BP.BC.178/C.453 (U)-78	22.12.78	Differential Rate of Interest Scheme	---
16.	DBOD.No.BP.1900/C.453 (U)-77	06.07.77	Scheme of DRI	---

RBI/2008-09/45
RPCD. MFFI. BC.No.08 / 12.01.001/ 2008-09

July 1, 2008

The Chairman/ Managing Director/
Chief Executive Officer
All Scheduled Commercial Banks

Dear Sir,

Master Circular on Micro Credit

Please refer to our Master Circular RPCD. MFFI. BC.No.08/ 12.01.001/ 2007-08 July 2, 2007 on the above subject. The enclosed Master Circular consolidates the instructions issued by Reserve Bank on the subject up to June 30, 2008. The list of circulars containing these instructions is given in the Appendix to the Master Circular.

Please acknowledge receipt.

Yours faithfully

(B.P.Vijayendra)
Chief General Manager

Master Circular on Micro Credit

1. Micro Credit

Micro Credit has been defined as the provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve their living standards. Micro Credit Institutions are those, which provide these facilities.

2. The Self Help Group (SHG)- Bank Linkage Programme

Despite the vast expansion of the formal credit system in the country, the dependence of the rural poor on moneylenders continues in many areas, especially for meeting emergent requirements. Such dependence is pronounced in the case of marginal farmers, landless labourers, petty traders and rural artisans belonging to socially and economically backward classes and tribes whose propensity to save is limited or too small to be mopped up by the banks. For various reasons, credit to these sections of the population has not been institutionalized. The studies conducted by NABARD, APRACA and ILO on the informal groups promoted by non governmental organizations (NGOs) brought out that Self-Help Savings and Credit Groups have the potential to bring together the formal banking structure and the rural poor for mutual benefit and that their working has been encouraging.

The NABARD accordingly launched a pilot project for the purpose and supported it by way of refinance. It also provided technical support and guidance to the agencies participating in the programme. The following criteria would broadly be adopted by NABARD for selecting SHGs:

- a) The Group should be in existence for at least six months.
- b) The Group should have actively promoted the savings habit.
- c) Groups could be formal (registered) or informal (unregistered).
- d) Membership of the group could be between 10 to 25 persons.

The advances given by the banks to the groups were treated as advances to "weaker sections" under the priority sector. While the norms relating to margin, security as also scales of finance and unit cost would broadly guide the banks for lending to the SHGs, deviations therefrom could be made by banks, where deemed necessary. These relaxations in margin, security norms, etc. were only in respect of SHGs to be financed under the pilot project.

NABARD, vide its circular letter No.NB.DPD.FS.4631/92-A/91-92, dated 26 February, 1992, issued detailed operational guidelines to banks for implementation of the project. Quick studies conducted by NABARD in a few states to assess the impact of the linkage project brought out encouraging and positive features like increase in loan volume of the SHGS, definite shift in the loaning pattern of the members from non-income generating activities to production activities, nearly 100% recovery performance, significant reduction in the transaction costs for both the banks and the borrowers, etc., besides leading to gradual increase in the income level of the SHG members. Another significant feature observed in the linkage project was that about 85% of the groups linked with the banks are formed exclusively by women.

With a view to studying the functioning of SHGs and NGOs for expanding their activities and deepening their role in the rural sector, in November 1994, RBI constituted a Working Group comprising eminent NGO functionaries, academicians, consultants and bankers under the Chairmanship of Shri S.K. Kalia, the then Managing Director, NABARD.

As a follow up of the recommendations of the Working Group, banks were advised in April 1996 as under:

a) SHG Lending as Normal Lending Activity

The SHGs linkage programme would be treated as a normal business activity of banks. Accordingly, the banks were advised that they may consider lending to SHGs as part of their mainstream credit operations both at policy and implementation level. They may include SHG linkage in their corporate strategy/plan, training curriculum of their officers and staff and implement it as a regular business activity and monitor and review it periodically.

b) Separate Segment under priority sector

In order to enable the banks to report their SHG lending without difficulty, it was decided that the banks should report their lending to SHGs and/or to NGOs for on-lending to SHGs/members of SHGs/discrete individuals or small groups which are in the process of forming into SHGs under the new segment, viz. 'Advances to SHGs' irrespective of the purposes for which the members of SHGs have been disbursed loans. Lending to SHGs should be included by the banks as part of their lending to the weaker sections.

c) Inclusion in Service Area Approach

Banks may identify branches having potential for linkage and provide necessary support services to such branches and include SHG lending within their Service Area Plan. Keeping in view the potential realisability, the Service Area Branches may fix their own programme for lending to SHGs as in the case of other activities under the priority sector.

With a view to enabling the bank branches to get the benefit of catalytic services of NGOS, the names of NGOs dealing with the SHGs would be indicated on a block-wise basis in the "Background Paper for Service Area Credit Plans". The Service Area branch managers may have constant dialogue and rapport with the NGOs and SHGs of the area for effecting linkage. If a NGO/SHG feels more confident and assured to deal with a particular branch other than Service Area branch and the particular branch is willing to finance, such a NGO/SHG may, at its discretion, deal with a branch other than the Service Area branch. The lending to SHGs by banks should be included in the LBR reporting system and reviewed, to start with at SLBC Level. However, it has to be borne in mind that the SHG linkage is a credit innovation and not a targeted credit programme.

d) Opening of Savings Bank A/c.

The SHGs registered or unregistered which are engaged in promoting savings habits among their members would be eligible to open savings bank accounts with banks. These SHGs need not necessarily have already availed of credit facilities from banks before opening savings bank accounts.

e) Margin and Security Norms

As per operational guidelines of NABARD, SHGs are sanctioned savings linked loans by banks (varying from a saving to loan ratio of 1:1 to 1:4). Experience showed that group dynamics and peer pressure brought in excellent recovery from members of the SHGs. Banks were advised that the flexibility allowed to the banks in respect of margin, security norms, etc. under the pilot project would continue to be operational under the linkage programme even beyond the pilot phase.

f) Documentation

Keeping in view the nature of lending and status of borrowers, the banks may prescribe simple documentation for lending to SHGs.

g) Presence of defaulters in SHGs

The defaults by a few members of SHGs and/or their family members to the financing bank should not ordinarily come in the way of financing SHGs per se by banks provided the SHG is not in default to it. However, the bank loan may not be utilized by the SHG for financing a defaulter member to the bank.

h) Training

An important step in the Linkage Programme would be the training of the field level officials and sensitization of the controlling and other senior officials of the bank. Considering the need and magnitude of training requirements of bank officers/staff both at field level and controlling office level, the banks may initiate suitable steps to internalize the SHGs linkage project and organize exclusive short duration programmes for the field level functionaries. In addition, suitable awareness/sensitization programmes may be conducted for their middle level controlling officers as well as senior officers.

i) Monitoring and Review of SHG Lending

Having regard to the emerging potential of the SHGs and the relative non-familiarity of the bank branches with lending to SHGS, banks may have to closely monitor the progress regularly at various levels. Further the progress of the programme may be reviewed by the banks at regular intervals. A progress report may be sent to NABARD (Micro Credit Innovations Department), Mumbai, in the format as per Annexure, on a half-yearly basis, as on 30 September and 31 March each year so as to reach within 30 days of the half-year to which the report relates.

In order to give a boost to the on going SHG bank linkage programme for credit flow to the unorganised sector, banks were advised in January 2004 that monitoring of SHG bank linkage programme may be made a regular item on the agenda for discussion at the SLBC and DCC meetings.

3. NBFCs engaged in micro-financing activities

The Task Force on Supportive Policy and Regulatory Framework for Microfinance set up by NABARD in 1999 recommended that the policy and regulatory framework should give a fillip to the Self Help Groups (SHGs) or Non-Governmental Organisations (NGOs) engaged in micro-financing activities. Accordingly, it was decided to exempt such NBFCs which are engaged in (i) micro financing activities, (ii) licensed under Section 25 of the Companies Act, 1956 and (iii) which are not accepting public deposits from the purview of Sections 45-IA (registration), 45-IB (maintenance of liquid assets) and 45-IC (transfer of profits to Reserve Fund) of the RBI Act, 1934.

Based on the recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Vyas Committee), in the Annual Policy Statement for the year 2004-05, it has been announced that, in view of the need to protect the interests of depositors, microfinance institutions (MFIs) would not be permitted to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank.

4. Interest rates

The interest rate applicable to loans given by banks to micro-credit organisations or by the micro-credit organisations to Self Help Groups/member beneficiaries would be left to their discretion.

5. Mainstreaming and enhancing outreach

A Micro Credit Special Cell was set up in RBI to suggest measures for augmenting flow of micro credit as announced in Governor's Monetary and Credit Policy for the year 1999-2000. In the meantime, a Task Force on Supportive Policy and Regulatory Framework for Micro Credit was also set up by NABARD. On the basis of their recommendations, banks were advised to follow the under noted guidelines for mainstreaming micro credit and enhancing the outreach of micro credit providers:

- (i) The banks may formulate their own model(s) or choose any conduit/ intermediary for extending micro credit. They may choose suitable branches/pockets/areas where micro credit programmes can be implemented. It will be useful to start with a selected small area and concentrate fully on the poor in that area and thereafter with the experience gained replicate the arrangement in other selected areas. Micro Credit extended by banks to individual borrowers directly or through any intermediary would be reckoned as part of their priority sector lending.
- (ii) The criteria for selection of micro credit organisations are not prescribed. It may, however, be desirable for banks to deal with micro credit organisations having proper credentials, track record, system of maintaining accounts and records with regular audits in place and manpower for closer supervision and follow-up.

(iii) Banks may prescribe their own lending norms keeping in view the ground realities. They may devise appropriate loan and savings products and the related terms and conditions including the size of the loan, unit cost, unit size, maturity period, grace period, margins, etc. The intention is to provide maximum flexibility in regard to micro lending, keeping in view the prevalent local conditions and the need for provision of finance to the poor. Such credit should, therefore, cover not only consumption and production loans for various farm and non-farm activities of the poor but also include their other credit needs such as housing and shelter improvements.

(iv) Micro credit should be included in branch credit plan, block credit plan and state credit plan of each bank. While no target is being prescribed for micro credit, utmost priority is to be accorded to the micro credit sector in preparation of these plans. Micro credit should also form an integral part of the bank's corporate credit plan and should be reviewed at the highest level on a quarterly basis.

(v) A simple system requiring minimum procedures and documentation is a pre-condition for augmenting flow of micro credit. Hence, banks should strive to remove all operational irritants and make arrangements to expeditiously sanction and disburse micro credit by delegating adequate sanctioning powers to branch managers. The loan application forms, procedures and documents should be made simple which would help in providing prompt and hassle-free micro credit.

6. Delivery Issues

The Reserve Bank constituted four informal groups in October 2002 to examine various issues concerning micro-finance delivery. On the basis of the recommendations of the groups and as announced in Paragraph 55 of the Governor's Statement on mid-term Review of the Monetary and Credit Policy for the year 2003-04, banks have been advised as under:

(i) Banks should provide adequate incentives to their branches in financing the Self Help Groups (SHGs) and establish linkages with them, making the procedures absolutely simple and easy while providing for total flexibility in such procedures to suit local conditions.

(ii) The group dynamics of working of the SHGs may be left to themselves and need neither be regulated nor formal structures imposed or insisted upon.

(iii) The approach to micro-financing of SHGs should be totally hassle-free and may include consumption expenditures.

7. Financing of MFIs by banks

A joint fact-finding study on microfinance conducted by Reserve Bank and a few major banks made the following observations:

(i) Some of the microfinance institutions (MFIs) financed by banks or acting as their intermediaries/partners appear to be focussing on relatively better banked areas, including areas covered by the SHG-Bank linkage programme. Competing MFIs were operating in the same area, and trying to reach out to the same set of poor, resulting in multiple lending and overburdening of rural households.

(ii) Many MFIs supported by banks were not engaging themselves in capacity building and empowerment of the groups to the desired extent. The MFIs were disbursing loans to the newly formed groups within 10-15 days of their formation, in contrast to the practice obtaining in the SHG - Bank linkage programme which takes about 6-7 months for group formation / nurturing / handholding. As a result, cohesiveness and a sense of purpose were not being built up in the groups formed by these MFIs.

(iii) Banks, as principal financiers of MFIs, do not appear to be engaging them with regard to their systems, practices and lending policies with a view to ensuring better transparency and adherence to best practices. In many cases, no review of MFI operations was undertaken after sanctioning the credit facility.

These findings were brought to the notice of the banks to enable them to take necessary corrective action where required.

8. Total Financial Inclusion and Credit Requirement of SHGs

Attention is invited to Paragraph 93 of the Union Budget announcement made by the Honourable Finance Minister for the year 2008-09 where in it has been stated as under:

"Banks will be encouraged to embrace the concept of Total Financial Inclusion. Government will request all scheduled commercial banks to follow the example set by some public sector banks and meet the entire credit requirements of SHG members, namely, (a) income generation activities, (b) social needs like housing, education, marriage, etc. and (c) debt swapping".

Banks are advised to meet the entire credit requirements of SHG members, as envisaged therein.

Appendix

List of Circulars consolidated in the Master Circular

Sr. No.	Circular No.	Date	Subject
1.	RPCD.No.Plan.BC.13/PL-09.22/91/92	July 24, 1991	Improving Access of Rural Poor to Banking - Role of Intervening Agencies - Self Help Groups
2.	RPCD.No.PL.BC.120/04.09.22/95-96	April 2, 1996	Linking of Self Help Groups with Banks- Working Group on NGOs and SHGs- Recommendations-Follow up
3	DBOD.No.DIR.BC.11/13.01.08/98	February 10, 1998	Opening of savings bank accounts in the name of Self Help Groups (SHGs)
4	RPCD.No.PL.BC.12/04.09.22/98-99	July 24,1998	Linking of Self Help Groups with Banks
5	RPCD.No.PLAN.BC.94/04.09.01/98-99	April 24,1999	Loans to Micro credit Organizations- Rates of Interest
6	RPCD.PL.BC.28/04.09.22/99-2000	September 30, 1999	Credit Delivery through Micro Credit Organizations/Self Help Groups
7	DNBS. (PD). CC.No.12/02.01/99-2000	January 13, 2000	Amendments to NBFC Regulations
8	RPCD.No.PL.BC.62/04.09.01/99-2000	February 18, 2000	Micro Credit
9	RPCD. No. Plan.BC.42/04.09.22/2003-04	November 3, 2003	Micro finance
10	RPCD.No.Plan.BC.61/04.09.22/2003-04	January 9, 2004	Credit flow to unorganized sector
11	RBI/385/2004-05, RPCD.No.Plan.BC.84/04.09.22/2004-05	March 3, 2005	Submitting progress report under micro credit
12	RBI 2006-07/185 RPCD.CO.Plan. BC. No.34/ 04.09.22/ 2006-07	November 22, 2006	Microfinance - Joint fact-finding study with the banks
13	RBI/2006-07/441 RPCD.CO.MFFI.BC.No.103/12.01.01/2006-07	June 20, 2007	Microfinance-Submission of progress reports
14	RBI/282/2007-08 RPCD.MFFI.BC.No.56/12.01.001/2007-08	April 15, 2008	Total Financial Inclusion and Credit Requirement of SHGs

Micro Finance Progress Report

	As at the end of March/ Sept.	

Name of the bank		State	

Part 'A' – SHG Bank Linkage Program

(All amounts in Rs. '000)

1. SHGs maintaining Savings A/c in the Bank

	No. of SHGs	No. of Members	Savings Amount
a. Total no. of SHGs			
b. Of which under SGSY & other Govt. sponsored schemes			
c. Exclusive Women SHGs [Out of (a) above]			
d. Of which under SGSY & other Govt. sponsored schemes			

Part 'A' – SHG Bank Linkage Program

2. SHGs financed directly by Banks

(All amounts in Rs. '000)

	During the year			Loan outstanding		Gross NPAs**		Percentage of Recovery to Demand
	Loan Amount Disbursed	No. of SHGs	No. of Members	Amount	No. of SHGs	Amount	No. of SHGs with NPAs	
Total no. of SHGs (b) Of which under SGSY & other Govt. sponsored Programs								
Exclusive Women SHGs (b) Of which under SGSY & other Govt. sponsored Programs								

****Applicable to March return only.**

Part 'A' – SHG Bank Linkage Program

3. SHGs financed directly by Banks with NGOs' facilitation

(All amounts in Rs. '000)

	During the year			Loan outstanding		Gross NPAs**		Percentage of Recovery to Demand
	Loan Amount Disbursed	No. of SHGs	No. of members	Amount	No. of SHGs	Amount	No. of SHGs with NPAs	
Total no. of SHGs (b) Of which under SGSY & other Govt. sponsored Programs								
Exclusive Women SHGs (b) Of which under SGSY & other Govt. sponsored Programs								

****Applicable to March return only.**

Part 'B' : MFOs / MFIs - Bank Linkage for on-lending to groups and others

MFOs/ MFIs maintaining Savings A/c in the Bank

(All amounts in Rs. '000)

S. No.	Nature of Intermediary	No. of MFIs/ MFOs	Savings Amount
1.	NGO MFOs – Societies Registration Act 1860 and Indian Trust Act 1880		
2.	Cooperative MFOs- Cooperative Societies Act of each State		
3.	Cooperative MFOs- Mutually Aided Cooperative Societies Act (MACS)		
4.	Cooperative MFOs- Multi State Coop. Societies Act 2002		
5.	NBFC MFIs under Section 25 of Companies Act 1956 (Not for profit)		
6.	NBFC MFIs incorporated under Companies Act 1956 & registered with RBI		
7.	Others (To be specified)		
	Total		

Part 'B' : MFOs / MFIs- bank Linkage for on-lending to groups and others

2. MFOs/ MFIs financed by the Bank

(All amounts in Rs. '000)

S. No.	Nature of Intermediary		During the year		Loan outstanding		Percentage of Recovery to Demand	Gross NPAs**	
			Loan disbursed	No. of MFOs/ MFIs	Amount	No. of MFIs having O/S loans		Amount	No. of MFOs/ MFIs with NPAs
1.	NGO MFOs – Societies Registration Act 1860 and Indian Trust Act 1880	SHG Model							
		Non-SHG Model							
2.	Cooperative MFOs- Cooperative Societies Act of each State	SHG Model							
		Non-SHG Model							
3.	Cooperative MFOs- Mutually Aided Cooperative Societies Act (MACS)	SHG Model							
		Non-SHG Model							
4.	Cooperative MFOs- Multi State Coop. Societies Act 2002	SHG Model							
		Non-SHG Model							
5.	NBFC MFIs under Section 25 of Companies Act 1956 (Not for profit)	SHG Model							
		Non-SHG Model							
6.	NBFC MFIs incorporated under Companies Act 1956 & registered with RBI	SHG Model							
		Non-SHG Model							
7.	Others (To be specified)	SHG Model							
		Non-SHG Model							
	Total	SHG Model							
		Non-SHG Model							

****Applicable to March return only**

RBI/2008-09/40
DBOD. No.FSD.BC. 7/ 24.01.001/ 2008-09

July 1, 2008
Ashadha 10 , 1930 (Saka)

All Scheduled Commercial Banks
(excluding RRBs)

Dear Sir,

Master Circular - Para-banking Activities

Please refer to the Master Circular No.DBOD.FSD.BC.18/24.01.001/2007-08 dated July 2, 2007 consolidating instructions/guidelines issued to banks till June 30, 2007 on para-banking activities. The Master Circular has been suitably updated by incorporating instructions issued upto June 30, 2008. The Master Circular has also been placed on the RBI website (<http://www.rbi.org.in>). A copy of the Master Circular is enclosed. A separate Master Circular has been issued on the Credit Card Operations of banks.

Yours faithfully

(P.Vijaya Bhaskar)
Chief General Manager

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MASTER CIRCULAR – PARA-BANKING ACTIVITIES

A. Purpose

To provide a framework of rules/regulations/instructions to the Scheduled Commercial Banks for undertaking certain financial services or para-banking activities as permitted by RBI. Banks should adopt adequate safeguards and implement the following guidelines in order to ensure that the financial services or para-banking activities undertaken by them are run on sound, and prudent lines.

B. Classification

A statutory guideline issued by the RBI

C. Previous guidelines consolidated

This Master Circular consolidates the instructions contained in the circulars listed in the Appendix.

D. Scope of Application

To all scheduled commercial banks (excluding RRBs) that undertake financial services or para-banking activities departmentally or through their subsidiaries or affiliated companies controlled by them

Structure

1. Introduction
2. Subsidiary Companies
3. Investment ceiling in financial services companies etc.
4. Equipment leasing, Hire purchase business and Factoring services
5. Equipment leasing, Hire purchase and Factoring services as departmental activities
6. Guidelines for banks undertaking PD business
 - 6.1 Eligibility Criteria
 - 6.2 Authorisation
 - 6.3 Obligations of Bank-PDs
 - 6.4 Prudential Norms
 - 6.5 Regulation and Supervision
 - 6.6 Application for Primary Dealership
 - 6.7 Applicability of the guidelines issued for Primary Dealers to bank-PDs
 - 6.8 Maintenance of books and accounts
7. Mutual Fund Business
8. Relationship with subsidiaries
9. Smart/Debit Card Business
10. Money Market Mutual Funds (MMMFs)

11. Cheque Writing Facility for Investors of Money Market Mutual Funds (MMMFs)
12. Entry of banks into Insurance business
13. Pension Funds Management (PFM) by banks
14. Underwriting of Corporate Shares and Debentures
15. Underwriting of bonds of Public Sector Undertakings
16. 'Safety Net' Schemes

Annex-1 Guidelines for Issue of Smart Cards/Debit Cards by banks

Annex-2 Reporting format for the issue and operations of Smart Cards/Debit Cards

Annex-3 Entry of banks into Insurance business

Annex-4 Entry of banks into Insurance business - insurance agency business/ referral arrangement

Annex-5 Guidelines for banks' acting as Pension Fund Managers

1. Introduction

Banks can undertake certain eligible financial services or para-banking activities either departmentally or by setting up subsidiaries. Banks may form a subsidiary company for undertaking the types of business which a banking company is otherwise permitted to undertake, with prior approval of Reserve Bank of India. The instructions issued by Reserve Bank of India to banks for undertaking certain financial services or para-banking activities as permitted by RBI have been compiled in this Master Circular.

2. Subsidiary Companies

Under the provisions of Section 19(1) of the Banking Regulation Act, 1949, banks may form subsidiary companies for undertaking types of banking business which they are otherwise permitted to undertake [under clauses (a) to (o) of sub-section 1 of Section 6 of the Banking Regulation Act, 1949], carrying on the business of banking exclusively outside India and for such other business purposes as may be approved by the Central Government. Prior approval of the Reserve Bank of India should be taken by a bank to set up a subsidiary company.

3. Investment ceiling in financial services companies, etc.

Under the provisions of Section 19(2) of the Banking Regulation Act, 1949, a banking company cannot hold shares in any company whether as pledgee or mortgagee or absolute owner of an amount exceeding 30 per cent of the paid-up share capital of that company or 30 per cent of its own paid-up share capital and reserves, whichever is less. Besides, the investment by a bank in a subsidiary company, financial services company, financial institution, stock and other exchanges should not exceed 10 per cent of the bank's paid-up share capital and reserves and the investments in all such companies, financial institutions, stock and other exchanges put together should not exceed 20 per cent of the bank's paid-up share capital and reserves. Investments which are made as part of the treasury operations of banks purely for the purpose of trading, can be excluded for the purpose of the 20% cap and also the banks need not obtain RBI's prior approval for such investments, provided that the investments are classified under 'Held for Trading' category and are not held beyond 90 days, as envisaged in para 2.2 (i) and 2.2 (iv) of the Master Circular on Prudential norms for classification, valuation and operation of investment portfolio by banks (Circular DBOD.No.BP.BC.15/21.04.141/2007-08 dated July 2, 2007) Banks cannot, however, participate in the equity of financial services ventures including stock exchanges, depositories, etc. without obtaining the prior specific approval of the Reserve Bank of India notwithstanding the fact that such investments may be within the ceiling prescribed under Section 19(2) of the Banking Regulation Act.

4. Equipment leasing, Hire purchase business and Factoring services

With the prior approval of the Reserve Bank of India, banks can form subsidiary companies for undertaking equipment leasing, hire purchase business and factoring services. The subsidiaries formed should primarily be engaged in any of these activities and such other activities as are incidental to equipment leasing, hire purchase business and factoring services. In other words, they should not engage themselves in direct lending or carrying on of activities which are not approved by the Reserve Bank and financing of other companies or concerns engaged in equipment leasing, hire purchase business and factoring services.

5. Equipment leasing, Hire purchase and Factoring services as departmental activities

Banks can also undertake equipment leasing, hire purchase and factoring services departmentally. Prior approval of the RBI is not necessary for undertaking these activities departmentally. The banks should, however, report to the RBI about the nature of these activities together with the names of the branches from where these activities are taken up. The banks should comply with the following prudential guidelines when they undertake these activities departmentally:

i) As activities like equipment leasing and factoring services require skilled personnel and adequate infrastructural facilities, they should be undertaken only by certain select branches of banks.

ii) These activities should be treated on par with loans and advances and should accordingly be given risk weight of 100 per cent for calculation of capital to risk asset ratio. Further, the extant guidelines on income recognition, asset classification and provisioning would also be applicable to them.

iii) The facilities extended by way of equipment leasing, hire purchase finance and factoring services would be covered within the exposure ceilings with regard to single borrower (i.e. 15 percent of the bank's capital funds ;20 percent provided the additional credit exposure is on account of extension of credit to infrastructure projects) and borrower group (40 percent of the bank's capital funds;50 percent provided the additional credit exposure is on account of extension of credit to infrastructure projects). Banks may, in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure both for a single borrower and a borrower group up to a further 5 per cent of capital funds subject to the borrower consenting to the banks for making appropriate disclosures in their Annual Reports. As regards banks' exposures to NBFCs, the instructions contained in para 16(A)(i) of the circular DBOD.No.FSD.BC.46/24.01.028/2006-07 dated December 12, 2006 would be applicable.

iv) Banks should maintain a balanced portfolio of equipment leasing, hire purchase and factoring services vis-à-vis the aggregate credit. Their exposure to each of these activities should not exceed 10 per cent of total advances.

v) Banks are required to frame an appropriate policy on leasing business with the approval of the Boards and evolve safeguards to avoid possible asset liability mismatch. While banks are free to fix the period of lease finance in accordance with such policy framed by them, they should ensure compliance with the Accounting Standard 19 (AS 19) prescribed by the Institute of Chartered Accountants of India (ICAI).

vi) The finance charge component of finance income [as defined in 'AS 19 Leases' issued by the Council of the Institute of Chartered Accountants of India (ICAI)] on the leased asset which has accrued and was credited to income account before the asset became nonperforming, and remaining unrealised, should be reversed or provided for in the current accounting period.

vii) Any changes brought about in respect of guidelines in asset classification, income recognition and provisioning for loans/advances and other credit facilities would also be applicable to leased assets of banks undertaking leasing activity departmentally.

viii) Banks should not enter into leasing agreement with equipment leasing companies and other non-banking finance companies engaged in equipment leasing.

ix) Lease rental receivables arising out of sub-lease of an asset by a Non-Banking Financial Company undertaking leasing should not be included for the purpose of computation of bank finance for such company.

x) Banks undertaking factoring services departmentally should carefully assess the client's working capital needs taking into account the invoices purchased. Factoring services should be extended only in respect of those invoices which represent genuine trade transactions. Banks should take particular care to ensure that by extending factoring services, the client is not overfinanced.

6. Guidelines for banks undertaking PD business

The permitted structure of Primary Dealership (PD) business has been expanded to include banks and banks fulfilling the following minimum eligibility criteria may apply to the Reserve Bank of India for approval for undertaking Primary Dealership (PD) business.

6.1 Eligibility Criteria

The following categories of banks may apply for PD licence:

(i) Banks, which do not at present, have a partly or wholly owned subsidiary and fulfill the following criteria:

- a. Minimum Net Owned Funds of Rs. 1,000 crore.
- b. Minimum CRAR of 9 percent
- c. Net NPAs of less than 3% and a profit making record for the last three years.

(ii) Indian banks which are undertaking PD business through a partly or wholly owned subsidiary and wish to undertake PD business departmentally by merging/ taking over PD business from their partly/ wholly owned subsidiary subject to fulfilling the criteria mentioned in 6.1.i (a) to (c) above.

(iii) Foreign banks operating in India who wish to undertake PD business departmentally by merging the PD business being undertaken by group companies subject to fulfillment of criteria at 6.1.i (a) to (c).

6.2 Authorisation

The authorization granted by the Reserve Bank will be initially for a period of one year (July-June) and thereafter, RBI will review the authorization on a yearly basis.

6.3 Obligations of Bank-PDs

The Bank-PDs will be subject to underwriting and all other obligations as applicable to standalone PDs.

6.4 Prudential Norms

(i) No separate capital adequacy requirement is prescribed for PD business. The usual capital adequacy requirement/risk management guidelines applicable for a bank will also apply to its PD business. The bank undertaking PD activity may put in place adequate risk management systems to measure and provide for the risks emanating from the PD activity.

(ii) The Government Dated Securities and Treasury Bills under PD business will count for SLR, if they are notified by RBI as SLR securities.

(iii) The classification, valuation and operation of investment portfolio guidelines as applicable to banks in regard to “Held for Trading” portfolio will also apply to the portfolio of Government Dated Securities and Treasury Bills earmarked for PD business.

(iv) The banks shall have to maintain separate SGL accounts for their subsidiaries. The bank should also develop proper MIS in this regard.

6.5 Regulation and Supervision

(i) RBI's instructions to Primary Dealers will apply to Bank-PDs to the extent applicable.

(ii) As banks have access to the call money market and the Liquidity Adjustment Facility (LAF) of RBI, Bank-PDs will not have separate access to these facilities.

(iii) RBI will conduct on-site inspection of Bank-PD business.

(iv) Bank-PDs will be required to submit prescribed returns, as advised by RBI from time to time.

(v) A Bank-PD should bring to the RBI's attention any major complaint against it or action initiated / taken against it by the authorities such as the Stock Exchanges, SEBI, CBI, Enforcement Directorate, Income Tax, etc.

(vi) Reserve Bank of India reserves the right to cancel the Bank-PD authorisation if, in its view, the concerned bank has not fulfilled any of the prescribed eligibility and performance criteria.

6.6 Application for Primary Dealership

Banks eligible to apply for Primary Dealership should approach the Chief General Manager, Department of Banking Operations and Development, Reserve Bank of India, Central Office, World Trade Centre, Cuffe Parade, Mumbai-400005 for in-principle approval. On obtaining an in-principle approval from DBOD, banks may then apply to the Chief General Manager, Internal Debt Management Department, Reserve Bank of India, 16th Floor, Central Office Building, Fort, Mumbai-400 001 for an authorization for undertaking PD business departmentally.

6.7 Applicability of the guidelines issued for Primary Dealers to bank-PDs

(i) The bank-PDs are expected to join Primary Dealers Association of India (PDAI) and Fixed Income Money Market and Derivatives Association (FIMMDA) and abide by the code of conduct framed by them and such other actions initiated by them in the interests of the securities markets.

(ii) The requirement of ensuring minimum investment in Government Securities and Treasury Bills on a daily basis based on net call / RBI borrowing and Net Owned Funds will not be applicable to bank-PDs.

(iii) It is clarified that for the purpose of "when-issued trades" permitted vide circular IDMD.No/3426 /11.01.01 (D)/2005-06 dated May 3, 2006, bank-PDs will be treated as Primary Dealers.

(iv) Bank-PDs shall be guided by the extant guidelines applicable to the banks as regards borrowing in call / notice / term money market, Inter-Corporate Deposits, FCNR (B) loans / External Commercial Borrowings and other sources of funds.

(v) The investment policy of the bank may be suitably amended to include PD activities also. Within the overall framework of the investment policy, the PD business undertaken by the bank will be limited to dealing, underwriting and market-making in Government Securities. Investments in Corporate /PSU / FIs bonds, Commercial Papers, Certificate of deposits, debt mutual funds and other fixed income securities will not be deemed to be a part of PD business.

6.8 Maintenance of books and accounts

(i) The transactions related to Primary Dealership business, undertaken by a bank departmentally, would be executed through the existing Subsidiary General Ledger (SGL) account of the bank. However, such banks will have to maintain separate books of accounts for transactions relating to PD business (distinct from normal banking business) with necessary

audit trails. It should be ensured that, at any point of time, there is a minimum balance of Rs. 100 crore of Government Securities earmarked for PD business.

(ii) Bank-PDs should subject the transactions by PD department to concurrent audit. An auditors' certificate for having maintained the minimum stipulated balance of Rs. 100 crore of Government Securities in the PD-book on an ongoing basis and having adhered to the guidelines / instructions issued by RBI, should be forwarded to IDMD, RBI on quarterly basis.

7. Mutual Fund business

(i) Prior approval of the RBI should be obtained by banks before undertaking mutual fund business. Bank-sponsored mutual funds should comply with guidelines issued by SEBI from time to time.

(ii) The bank-sponsored mutual funds should not use the name of the sponsoring bank as part of their name. Where a bank's name has been associated with a mutual fund, a suitable disclaimer clause should be inserted while publicising new schemes that the bank is not liable or responsible for any loss or shortfall resulting from the operations of the scheme.

(iii) Banks may enter into agreements with mutual funds for marketing the mutual fund units subject to the following terms and conditions:

a. Banks should only act as an agent of the customers, forwarding the investors' applications for purchase / sale of MF units to the Mutual Funds/ the Registrars / the transfer agents. The purchase of units should be at the customers' risk and without the bank guaranteeing any assured return.

b. Banks should not acquire units of Mutual Funds from the secondary market.

c. Banks should not buy back units of Mutual Funds from their customers.

d. If banks propose to extend any credit facility to individuals against the security of units of Mutual Funds, sanction of such facility should be in accordance with the extant instructions of RBI on advances against shares / debentures and units of mutual funds.

e. Banks holding custody of MF units on behalf of their customers, should ensure that their own investments and investments made by / belonging to their customers are kept distinct from each other.

f. Banks should put in place adequate and effective control mechanisms in this regard. Besides, with a view to ensuring better control, retailing of units of mutual funds may be confined to certain select branches of a bank.

8. Relationship with subsidiaries

The sponsor bank is required to maintain an "arms length" relationship from the subsidiary/mutual fund sponsored by it in regard to business parameters such as, taking undue advantage in borrowing/lending funds, transferring/selling/buying of securities at rates other than market rates, giving special consideration for securities transactions, overindulgence in supporting / financing the subsidiary, financing the bank's clients through them when the bank itself is not able or is not permitted to do so, etc. Supervision by the parent bank should not, however, result in interference in the day-to-day management of the affairs of the subsidiary/mutual fund. Banks should evolve appropriate strategies such as:

- i) The Board of Directors of the parent/sponsor bank may review the working of subsidiaries/mutual fund at periodical intervals (say once in six months) covering the major aspects relating to their functioning and give proper guidelines/suggestions for improvement, wherever considered necessary.
- ii) The parent bank may cause inspection/audit of the books and accounts of the subsidiaries/mutual fund at periodical intervals, as appropriate, and ensure that the deficiencies noticed are rectified without lapse of time. If the bank's own inspection staff is not adequately equipped to undertake the inspection/audit, the task may be entrusted to outside agencies like firms of Chartered Accountants. In case there is technical difficulty for causing inspection/audit (e.g. on account of non-existence of an enabling clause in the Memorandum and Articles of Association of the subsidiary or Asset Management Company), steps should be taken to amend the same suitably.
- iii) Where banks have equity participation by way of portfolio investment in companies offering financial services, they may review the working of the latter at least on an annual basis.

9. Smart / Debit Card Business

Banks can introduce smart/on-line debit cards with the approval of their Boards, keeping in view the Guidelines contained in **Annex- 1**. In the case of debit cards where authorization and settlement are off-line or where either authorization or settlement is off-line, banks should obtain prior approval of the Reserve Bank of India for introduction of the same after submitting the details on mode of authorization and settlement, authentication method employed, technology used, tie-ups with other agencies/service providers (if any), together with Board note/Resolution. However, only banks with networth of Rs.100 crore and above should undertake issue of off-line debit cards. Banks cannot issue smart/debit cards in tie-up with other non-bank entities. Banks should review operations of smart/debit cards and put up review notes to their Boards at half-yearly intervals, say at the end of March and September, every year. A report on the operations of smart/debit cards issued by banks should be forwarded to the Department of Payment and Settlement Systems (DPSS) with a copy to the concerned

Regional Office of Department of Banking Supervision on a half yearly basis, say at the end of March and September every year, incorporating information as indicated in **Annex-2**.

There is no objection to banks offering incentives to promote debit card usage without prior approval of RBI, provided that no element of lottery or chance is involved in such incentive schemes.

10. Money Market Mutual Funds (MMMFs)

MMMFs would come under the purview of SEBI regulations. Banks and Financial Institutions desirous of setting up MMMFs would however have to seek necessary clearance from RBI for undertaking this additional activity before approaching SEBI for registration.

11. Cheque Writing Facility for investors of Money Market Mutual Funds (MMMFs)

Banks are permitted to tie-up with MMMFs as also with MFs in respect of Gilt Funds and Liquid Income Schemes which predominantly invest in money market instruments (not less than 80 per cent of the corpus) to offer cheque writing facilities to investors subject to the following safeguards.

(i) In the case of a MMMF set up by a bank, the tie-up arrangement should be with the sponsor bank. In other cases, the tie-up should be with a designated bank. The name of the bank should be clearly indicated in the Offer Document of the Scheme.

(ii) The Offer Document should clearly indicate that the tie-up to offer cheque writing facility is purely a commercial arrangement between the MMMF/MF and the designated bank, and as such, the servicing of the units of MMMF/MF will not in any way be the direct obligation of the bank concerned. This should be clearly stated in all public announcements and communications to individual investors.

(iii) The facility to any single investor in the MMMF/MF can be permitted at the investor's option, in only one of the branches of the designated bank.

(iv) It should be in the nature of a drawing account, distinct from any other account, with clear limits for drawals, the number of cheques that can be drawn, etc, as prescribed by MMMF/MF. It should not however be used as a regular bank account and cheques drawn on this account should only be in favour of the investor himself (as part of redemption) and not in favour of third parties. No deposits can be made in the account. Each drawal made by the investor under the facility should be consistent with the terms prescribed by the MMMF/MF and treated as redemption of the holdings in the MMMF/MF to that extent.

(v) The facility can be availed of by investors only after the minimum lock-in period of 15 days for investments in MMMFs (not applicable in the case of eligible Gilt Funds and Liquid Income Schemes of Mutual Funds and any prescription of lock-in-period in such cases will be governed by SEBI Regulations).

(vi) The bank should ensure pre-funding of the drawing account by the MMMF/MF at all times and review the funds position on a daily basis.

(vii) Such other measures as may be considered necessary by the bank.

12. Entry of banks into Insurance business

With the issuance of Government of India Notification dated August 3, 2000, specifying 'Insurance' as a permissible form of business that could be undertaken by banks under Section 6(1)(o) of the Banking Regulation Act, 1949, banks were advised that any bank intending to undertake insurance business as per the guidelines set out in the **Annex-3** should obtain prior approval of Reserve Bank of India before engaging in such business. Banks may, therefore, submit necessary applications to RBI furnishing full details in respect of the parameters as specified in the above guidelines, details of equity contribution proposed in the joint venture/strategic investment, the name of the company with whom the bank would have tie-up arrangements in any manner in insurance business, etc. The relative Board note and Resolution passed thereon approving the bank's proposal together with viability report prepared in this regard may also be forwarded to Reserve Bank. However, insurance business will not be permitted to be undertaken departmentally by the banks. Further, banks need not obtain prior approval of the RBI for engaging in insurance agency business or referral arrangement without any risk participation, subject to certain conditions (**Annex- 4**).

13. Pension Funds Management (PFM) by banks

Consequent upon the issue of Government of India Notification F.No.13/6/2005-BOA dated May 24, 2007 specifying "acting as Pension Fund Manager" as a form of business in which it would be lawful for a banking company to engage in, in exercise of the powers conferred by clause (o) of sub-section (1) of Section 6 of the Banking Regulation Act, 1949, banks have been advised that they may now undertake Pension Funds Management (PFM) through their subsidiaries set up for the purpose. This would be subject to their satisfying the eligibility criteria prescribed by PFRDA for Pension Fund Managers. PFM should not be undertaken departmentally. Banks intending to undertake pension funds management as per the guidelines set out in **Annex-5** should obtain prior approval of Reserve Bank of India before engaging in such business and may submit necessary applications to the Department of Banking Operations and Development, Reserve Bank of India, World Trade Centre, Centre-I, Mumbai-400 005 furnishing full details in respect of the various eligibility criteria as specified in the **Annex-5** along with the details of the equity contribution proposed to be made in the subsidiary. The relative Board Note and Resolution passed thereon approving the bank's

proposal together with a detailed viability report prepared in this regard may also be forwarded to Reserve Bank.

14 . Underwriting of Corporate Shares and Debentures

Generally, there are demands on the banks for underwriting the issues of shares and debentures. In order to ensure that there is no overexposure to underwriting commitments, the guidelines detailed below should be strictly adhered to.

i) The statutory provision contained in Section 19(2) & (3) of the Banking Regulation Act, 1949 regarding holding of shares in any company as pledgee / mortgagee or absolute owner, should be strictly adhered to.

ii) The banks have to ensure that underwriting commitments taken up by them in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity-oriented mutual funds comply with the ceiling prescribed for the banks' exposure to the capital markets. However, with effect from April 16, 2008 banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure both on a solo and consolidated basis. The position in this regard would be reviewed after a year.

a. The underwriting exposure to any company is to be reckoned for the purpose of arriving at the exposure limits for single and group borrower as laid down in the Master Circular on Exposure Norms.

b. Banks could consider sub-underwriting for every underwritten issue so as to minimise chances of devolution on their own account. This is not mandatory. The need for and extent of such sub-underwriting is a matter of bank's discretion.

c. While taking up underwriting obligations, banks should carefully evaluate the proposals so as to ensure that the issues will have adequate public response and the prospect of devolution of such shares/debentures on the underwriting banks will be minimal.

d. Banks should ensure that the portfolio is diversified and that no unduly large underwriting obligations are taken up in the shares and debentures of a company or a group of companies. Banks should make enquiries regarding the other underwriters and their capacity to fulfil the obligations.

iii) Banks should not underwrite issue of Commercial Paper by any Company or Primary Dealer.

iv) Banks should not extend Revolving Underwriting Facility to short term Floating Rate Notes/Bonds or debentures issued by corporate entities.

v) An annual review covering the underwriting operations taken up during the year, with company-wise details of such operations, the shares/debentures devolved on the banks, the loss (or expected loss) from unloading the devolved shares/debentures indicating the face-

value and market value thereof, the commission earned, etc. may be placed before their Boards of Directors within 2 months of the close of the fiscal year.

vi) Banks/ merchant banking subsidiaries of banks undertaking underwriting activities are also required to comply with the guidelines contained in the SEBI (Underwriters) Rules and Regulations, 1993, and those issued from time to time.

15. Underwriting of bonds of Public Sector Undertakings

The banks can play a useful role in relation to issue of bonds by Public Sector Undertakings (PSUs) by underwriting a part of these issues. Banks should subject the proposals for underwriting to proper scrutiny having regard to all the relevant factors and accept such commitments only on well-reasoned commercial considerations with the approval of the appropriate authority.

The banks should formulate their own internal guidelines as approved by their Boards of Directors on investments in and underwriting of PSU bonds, including norms to ensure that excessive investment in any single PSU is avoided.

Banks should undertake an annual review of the underwriting operations relating to bonds of the public sector undertakings, with PSU-wise details of such operations, bonds devolved on the banks, the loss (or expected loss) from unloading the devolved bonds indicating the face-value and market value thereof, the commission earned, etc. and place the same before their Boards of Directors within two months from the close of the fiscal year.

16. 'Safety Net' Schemes

Reserve Bank had observed that some banks/their subsidiaries were providing buy-back facilities under the name of 'Safety Net' Schemes in respect of certain public issues as part of their merchant banking activities. Under such schemes, large exposures are assumed by way of commitments to buy the relative securities from the original investors at any time during a stipulated period at a price determined at the time of issue, irrespective of the prevailing market price. In some cases, such schemes were offered *suo motto* without any request from the company whose issues are supported under the schemes. Apparently, there was no undertaking in such cases from the issuers to buy the securities. There is also no income commensurate with the risk of loss built into these schemes, as the investor will take recourse to the facilities offered under the schemes only when the market value of the securities falls below the pre-determined price. Banks/their subsidiaries have therefore been advised that they should refrain from offering such 'Safety Net' facilities by whatever name called.

Guidelines for Issue of Smart Cards/Debit Cards by banks**1. Coverage**

The guidelines apply to the smart cards/cards encompassing all or any of the following operations :

- Electronic payment involving the use of card, in particular at point of sale and such other places where a terminal/device for the use/access of the card is placed.
- The withdrawing of bank notes, the depositing of bank notes and cheques and connected operations in electronic devices such as cash dispensing machines and ATMs.
- Any card or a function of a card which contains real value in the form of electronic money which someone has paid for in advance, some of which can be reloaded with further funds or one which can connect to the cardholder's bank account (on-line) for payment through such account and which can be used for a range of purposes.

2. Cash Withdrawals

No cash transaction, that is, cash withdrawals or deposits should be offered at the Point of Sale, with the smart/debit cards under any facility, without prior authorization of RBI under Section 23 of the Banking Regulation Act, 1949.

3. Eligibility of Customers

The banks can issue smart (both on-line and off-line)/on-line debit cards to select customers with good financial standing even if they have maintained the accounts with the banks for less than six months subject to their ensuring the implementation of 'Know Your Customer' concept as stipulated in para 9.2 of the Report of the Study Group on Large Value Bank Frauds forwarded vide circular No.DBS. FGV.BC.56/23.04.001/98-99 dated 21st June 1999. However, banks introducing off-line mode of operation of debit cards should adhere to the minimum period of satisfactory maintenance of accounts for six months. Banks can extend the smart card/ debit card facility to those having saving bank account/current account/fixed deposit accounts with built-in liquidity features maintained by individuals, corporate bodies and firms. Smart card/debit card facility should not be extended to cash credit/loan account holders. The banks can, however, issue on-line debit cards against personal loan accounts, where operations through cheques are permitted.

4. Treatment of Liability

The outstanding balances/unspent balances stored on the smart/debit cards shall be subject to the computation for the purpose of maintenance of reserve requirements. This position will be computed on the basis of the balances appearing in the books of the bank as on the date of reporting.

5. Payment of Interest

In case of smart cards having stored value (as in case of the off-line mode of operation of the smart card), no interest may be paid on the balances transferred to the smart cards. In case of debit cards or on line smart cards, the payment of interest should be in accordance with the interest rate directives issued to banks from time to time under Sections 21 and 35A of the Banking Regulation Act, 1949.

6. Security and other aspects

- (a) The bank shall ensure full security of the smart card. The security of the smart card shall be the responsibility of the bank and the losses incurred by any party on account of breach of security, failure of the security mechanism shall be borne by the bank.
- (b) No bank shall despatch a card to a customer unsolicited, except in the case where the card is a replacement for a card already held by the customer.
- (c) Banks shall keep for a sufficient period of time, internal records to enable operations to be traced and errors to be rectified (taking into account the law of limitation for the time barred cases).
- (d) The cardholder shall be provided with a written record of the transaction after he has completed it, either immediately in the form of receipt or within a reasonable period of time in another form such as the customary bank statement.
- (e) The cardholder shall bear the loss sustained up to the time of notification to the bank of any loss, theft or copying of the card but only up to a certain limit (of fixed amount or a percentage of the transaction agreed upon in advance between the cardholder and the bank), except where the cardholder acted fraudulently, knowingly or with extreme negligence.
- (f) Each bank shall provide means whereby his customers may at any time of the day or night notify the loss, theft or copying of their payment devices.
- (g) On receipt of notification of the loss, theft or copying of the card, the bank shall take all action open to it to stop any further use of the card.

7. Terms and Conditions for issue

The relationship between the bank and the card holder shall be contractual. In case of contractual relationship between the cardholder and the bank:

- a) Each bank shall make available to the cardholders in writing, a set of contractual terms and conditions governing the issue and use of such a card. These terms shall maintain a fair balance between the interests of the parties concerned.
- b) The terms shall be expressed clearly.
- c) The terms shall specify the basis of any charges, but not necessarily the amount of charges at any point of time.
- d) The terms shall specify the period within which the cardholder's account would normally be debited.
- e) The terms may be altered by the bank, but sufficient notice of the change shall be given to the cardholder to enable him to withdraw if he so chooses. A period shall be specified after which time the cardholder would be deemed to have accepted the terms if he had not withdrawn during the specified period.
- (f) (i) The terms shall put the cardholder under an obligation to take all appropriate steps to keep safe the card and the means (such as PIN or code) which enable it to be used.
(ii) The terms shall put the cardholder under an obligation not to record the PIN or code, in any form that would be intelligible or otherwise accessible to any third party if access is gained to such a record, either honestly or dishonestly.
(iii) The terms shall put the cardholder under an obligation to notify the bank immediately after becoming aware:
 - of the loss or theft or copying of the card or the means which enable it to be used;
 - of the recording on the cardholder's account of any unauthorised transaction;

- of any error or other irregularity in the maintaining of that account by the bank.

(iv) The terms shall specify a contact point to which such notification can be made. Such notification can be made at any time of the day or night.

(v) The terms shall put the cardholder under an obligation not to countermand an order which he has given by means of his card.

g) The terms shall specify that the bank shall exercise care when issuing PINs or codes and shall be under an obligation not to disclose the cardholder's PIN or code, except to the cardholders.

h) The terms shall specify that the bank shall be responsible for direct losses incurred by a cardholder due to a system malfunction directly within the bank's control. However, the bank shall not be held liable for any loss caused by a technical breakdown of the payment system if the breakdown of the system was recognizable for the cardholder by a message on the display of the device or otherwise known. The responsibility of the bank for the non-execution or defective execution of the transaction is limited to the principal sum and the loss of interest subject to the provisions of the law governing the terms.

Reporting format for the issue and operations of Smart Cards/Debit Cards

1. Name of the bank:
2. Period of reporting:
3. Type of the card with the hardware components – (I.C. Chip) e.g. Magnetic stripe, CPU, memory:
4. Type of the software used:
5. Names of products offered through the smart card:
6. Limits on the storage of the amount:
7. Re-loadability features:
8. Security standards followed:
9. Service provider: (self or otherwise)
10. Total no. of outlets where the smart cards can be used of which :
 - a. POS Terminals:
 - b. Merchant Establishments:
 - c. ATMs:
 - d. Others – (please specify)
11. Total no of cards issued of which :
 - a. against savings bank a/c.
 - b. against current a/c.
 - c. against float a/c.
12. Total amount of balance stored on the smart cards as on the date of reporting:
13. Total amount of unspent balance on the smart cards as on the date of reporting:
14. Total no. of transactions during the period:
15. Amount involved in the total no. of transactions:
16. Transaction settlement mechanism (full procedure):
 - a. whether on-line or
 - b. off-line
17. Instances of fraud, if any, during the period
 - a. No. of frauds:
 - b. Amount involved:
 - c. Amount of loss to the bank:
 - d. Amount of loss to the card holder:

Annex-3
[Paragraph 12]

Entry of banks into Insurance business

1. Any scheduled commercial bank would be permitted to undertake insurance business as agent of insurance companies on fee basis, without any risk participation. The subsidiaries of banks will also be allowed to undertake distribution of insurance product on agency basis.

2. Banks which satisfy the eligibility criteria given below will be permitted to set up a joint venture company for undertaking insurance business with risk participation, subject to safeguards. The maximum equity contribution such a bank can hold in the joint venture company will normally be 50 per cent of the paid-up capital of the insurance company. On a selective basis the Reserve Bank of India may permit a higher equity contribution by a promoter bank initially, pending divestment of equity within the prescribed period (see Note 1 below).

The eligibility criteria for joint venture participant are as under:

- (i) The net worth of the bank should not be less than Rs.500 crore;
- (ii) The CRAR of the bank should not be less than 10 per cent;
- (iii) The level of non-performing assets should be reasonable;
- (iv) The bank should have net profit for the last three consecutive years;
- (v) The track record of the performance of the subsidiaries, if any, of the concerned bank should be satisfactory.

3. In cases where a foreign partner contributes 26 per cent of the equity with the approval of Insurance Regulatory and Development Authority/Foreign Investment Promotion Board, more than one public sector bank or private sector bank may be allowed to participate in the equity of the insurance joint venture. As such participants will also assume insurance risk, only those banks which satisfy the criteria given in paragraph 2 above, would be eligible.

4. A subsidiary of a bank or of another bank will not normally be allowed to join the insurance company on risk participation basis. Subsidiaries would include bank subsidiaries undertaking merchant banking, securities, mutual fund, leasing finance, housing finance business, etc.

5. Banks which are not eligible as joint venture participant as above, can make investments up to 10% of the networth of the bank or Rs.50 crore, whichever is lower, in the insurance company for providing infrastructure and services support. Such participation shall be treated as an investment and should be without any contingent liability for the bank.

The eligibility criteria for these banks will be as under:

- (i) The CRAR of the bank should not be less than 10%;
- (ii) The level of NPAs should be reasonable;
- (iii) The bank should have net profit for the last three consecutive years.

6. All banks entering into insurance business will be required to obtain prior approval of the Reserve Bank. The Reserve Bank will give permission to banks on case to case basis keeping in view all relevant factors including the position in regard to the level of non-performing assets of the applicant bank so as to ensure that non-performing assets do not pose any future threat to the bank in its present or the proposed line of activity, viz., insurance business. It should be ensured that risks involved in insurance business do not get transferred to the bank and that

the banking business does not get contaminated by any risks which may arise from insurance business. There should be 'arms length' relationship between the bank and the insurance outfit.

Note :

1. Holding of equity by a promoter bank in an insurance company or participation in any form in insurance business will be subject to compliance with any rules and regulations laid down by the IRDA/Central Government. This will include compliance with Section 6AA of the Insurance Act as amended by the IRDA Act, 1999, for divestment of equity in excess of 26 per cent of the paid up capital within a prescribed period of time.
2. Latest audited balance sheet will be considered for reckoning the eligibility criteria.
3. Banks which make investments under paragraph 5 of the above guidelines, and later qualify for risk participation in insurance business (as per paragraph 2 of the guidelines) will be eligible to apply to the Reserve Bank for permission to undertake insurance business on risk participation basis.

**Entry of banks into Insurance business - insurance agency business/
referral arrangement**

The banks need not obtain prior approval of the RBI for engaging in insurance agency business or referral arrangement without any risk participation, subject to the following conditions:

- (i) The bank should comply with the IRDA regulations for acting as 'composite corporate agent' or referral arrangement with insurance companies.
- (ii) The bank should not adopt any restrictive practice of forcing its customers to go in only for a particular insurance company in respect of assets financed by the bank. The customers should be allowed to exercise their own choice.
- (iii) The bank desirous of entering into referral arrangement, besides complying with IRDA regulations, should also enter into an agreement with the insurance company concerned for allowing use of its premises and making use of the existing infrastructure of the bank. The agreement should be for a period not exceeding three years at the first instance and the bank should have the discretion to renegotiate the terms depending on its satisfaction with the service or replace it by another agreement after the initial period. Thereafter, the bank will be free to sign a longer term contract with the approval of its Board in the case of a private sector bank and with the approval of Government of India in respect of a public sector bank.
- (iv) As the participation by a bank's customer in insurance products is purely on a voluntary basis, it should be stated in all publicity material distributed by the bank in a prominent way. There should be no 'linkage' either direct or indirect between the provision of banking services offered by the bank to its customers and use of the insurance products.
- (v) The risks, if any, involved in insurance agency/referral arrangement should not get transferred to the business of the bank.

Guidelines for banks' acting as Pension Fund Managers**1. Eligibility Criteria**

Banks will be allowed to undertake Pension Fund Management (PFM) through their subsidiaries only. Pension Fund Management should not be undertaken departmentally. Banks may lend their names/abbreviations to their subsidiaries formed for Pension Fund Management, for leveraging their brand names and associated benefits thereto, only subject to the banks maintaining 'arms length' relationship with the subsidiary. In order to provide adequate safeguards against associated risks and ensure that only strong and credible banks enter into the business of pension fund management, the banks complying with the following eligibility criteria (as also the solvency margin prescribed by PFRDA) may approach the Reserve Bank of India for necessary permission to enter into the business of pension funds management.

- (i) Networth of the bank should be not less than Rs.500 crore.
- (ii) CRAR should be not less than 11% during the last three years.
- (iii) Bank should have made net profit for the last three consecutive years.
- (iv) Return on Assets (ROA) should be atleast 0.6% or more.
- (v) Level of net non-performing assets (NPAs) should be less than 3%.
- (vi) Performance of the bank's subsidiary/ies, if any, should be satisfactory.
- (vii) Management of the bank's investment portfolio should be good as per the AFI Report of the Reserve Bank and there should not be any adverse remark/s in the Report involving supervisory concerns.

2. Pension Fund Subsidiary - Safeguards

The banks fulfilling the above eligibility criteria as also the criteria prescribed by PFRDA for Pension Fund Managers will be permitted to set up subsidiaries for pension fund management subject to the following conditions.

- (i) The bank should obtain prior permission of the Reserve Bank for investing in the equity for the purpose of setting up the subsidiary. Transferring or otherwise dealing with its shareholding in the subsidiary in any manner would also require prior approval of the Reserve Bank.

- (ii) Composition of the Board of Directors of the subsidiary should be broad based and should be as per the guidelines, if any, prescribed by PFRDA.
- (iii) The parent bank should maintain "arms length" with the subsidiary. Any transaction between the bank and the subsidiary should be at market related rates.
- (iv) Any further equity contribution by the bank to the subsidiary should be with the prior approval of the Reserve Bank and total equity contribution by the bank to the subsidiary at any point of time should be within 10% of the bank's paid-up capital and reserves.
- (v) The bank's total investment by way of equity contributions in its existing subsidiaries, the proposed pension funds subsidiary and those formed in future together with portfolio investments in other financial services companies as well as mutual funds should not exceed 20% of its paid-up capital and reserves.
- (vi) The parent bank's Board should lay down a comprehensive risk management policy for the group as a whole including the subsidiary; incorporating appropriate risk management tools. It should also ensure effective implementation thereof.
- (vii) The bank should evolve a suitable system to monitor operations of the subsidiary.
- (viii) The subsidiary should confine itself to the business of pension fund management and any other business, which is purely incidental and directly related thereto.
- (ix) The pension fund subsidiary should not set up another subsidiary without prior approval of the Reserve Bank.
- (x) The subsidiary should not promote a new company, which is not a subsidiary thereof, without the prior approval of the Reserve Bank.
- (xi) The subsidiary should not make any portfolio investment in another existing company with an intention of acquiring controlling interest, without prior approval of the Reserve Bank.
- (xii) The bank should submit a Business Plan to the Reserve Bank highlighting the business projections of the subsidiary for the first five years so as to determine whether subsidiary would be able to comply with the solvency margin as may be prescribed by PFRDA and not fall back on the bank for augmenting its capital for the purpose.
- (xiii) The permission granted by the Reserve Bank to a bank to set up the subsidiary shall be without prejudice to the decision of PFRDA to grant a license to the subsidiary to do the pension fund management business.
- (xiv) The subsidiary should abide by all the instructions, guidelines etc., on pension fund management issued by PFRDA from time to time.
- (xv) The bank should ensure that the subsidiary does not have on-line access to the customers' accounts maintained with the bank.
- (xvi) In order to maintain systems integrity of the bank, adequate safeguards between the systems of the bank and that of the subsidiary should be put in place by the bank.

(xvii) The bank should strictly comply with the reporting requirements prescribed under the "financial conglomerates" framework, wherever applicable.

(xviii) The bank should not grant any unsecured advances to the JV or subsidiary without the prior approval of the Reserve Bank.

List of Circulars consolidated by the Master Circular

No	Circular No.	Date	Subject
1.	RBI/2007-2008/33 DBOD.No.FSD.BC.18/24.01.001/2007-08	July 2, 2007	Master Circular on Para Banking Activities
2.	RBI/2006 -2007/446 DBOD.No.FSD.BC.102/24.01.022/2006-07	June 28, 2007	Pension Fund Management (PFM) by banks
3.	RBI/2006-07/140 IDMD.PDRS.1431/03.64.00/ 2006-2007	October 5, 2006	Operational Guidelines for Banks undertaking/proposing to undertake Primary Dealer Business
4.	RBI/2006-07/104 DBOD.FSD.BC.No.25/ 24.92.001/2006-07	August 9, 2006	Guidelines for banks undertaking PD business
5.	RBI 2005-06/ 308 DBOD. FSD. BC. No. 64/ 24.92.001/ 2005-06	February 27, 2006	Guidelines for banks' undertaking PD Business
6.	RBI/2004/260 DBOD.BP.BC.No.100/21.03. 054/2003-04	June 21, 2004	Annual Policy Statement for the year 2004-05 - Prudential Credit Exposure Limits by Banks
7.	DBOD.FSC.BC.27/24.01.018/ 2003-2004	September 22, 2003	Entry of banks into Insurance business
8.	DBOD.FSC.BC.88/24.01.011 A/2001-02	April 11, 2002	Issue of Smart Cards by banks
9.	DBOD.FSC.BC.32/24.01.019/ 2001-02	September 29, 2001	Issue of Debit Cards by banks
10.	DBOD.FSC.BC.133/24.01.01 9/2000-01	June 18, 2001	Guidelines for the issue of Smart/Debit Cards by banks
11.	DBOD.FSC.BC.41/24.01.011/ 2000-01	October 30, 2000	Issue of Credit/Debit Cards by banks
12.	DBOD.FSC.BC/16/24.01.018/ 2000-2001	August 9, 2000	Entry of banks into Insurance business
13.	DBOD.FSC.BC.145/24.01.013-2000	March 7, 2000	Guidelines relating to Money Market Mutual Funds (MMMFs)
14.	DBOD.FSC.BC.123/24.01.019/99-2000	November 12, 1999	Guidelines for the issue of Smart/Debit Cards by banks

RBI/2008-2009/31

DBOD.No.BP.BC. 2 /21.01.002/2008-09

July 1, 2008

All Commercial Banks
(excluding RRBs)

Dear Sir,

Master Circular - Prudential Norms on Capital Adequacy-Basel I Framework

Please refer to the Master Circular No. DBOD.BP.BC.4/21.01.002/2007-2008 dated July 2, 2007 consolidating instructions / guidelines issued to banks till June 30, 2007 on matters relating to prudential norms on capital adequacy. The Master Circular has been suitably updated by incorporating instructions issued up to 30th June 2008 and has also been placed on the RBI web-site (<http://www.rbi.org.in>).

2. It may be noted that all relevant instructions on the above subject contained in the circulars listed in the Appendix have been consolidated. For banks that have migrated to Basle II norms with effect from March 31, 2008, instructions contained in Master Circular On Basel II norms will be applicable. For banks, which are migrating to Basle II norms with effect from March 31,2009, the instructions contained in this circular will continue to be applicable.

Yours faithfully,

(Prashant Saran)

Chief General Manager-in-Charge

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Master Circular on 'Prudential Norms on Capital Adequacy'

Purpose

The Reserve Bank of India decided in April 1992 to introduce a risk asset ratio system for banks (including foreign banks) in India as a capital adequacy measure in line with the Capital Adequacy Norms prescribed by Basel Committee. This circular prescribes the risk weights for the balance sheet assets, non-funded items and other off-balance sheet exposures and the minimum capital funds to be maintained as ratio to the aggregate of the risk weighted assets and other exposures, as also, capital requirements in the trading book, on an ongoing basis.

Previous instructions

This master circular consolidates and updates the instructions on the above subject contained in the circulars listed in Annex 13.

Application

To all the commercial banks, excluding Regional Rural Banks

1. INTRODUCTION

This master circular covers instructions regarding the components of capital and capital charge required to be provided for by the banks for credit and market risks. It deals with providing explicit capital charge for credit and market risk and addresses the issues involved in computing capital charges for interest rate related instruments in the trading book, equities in the trading book and foreign exchange risk (including gold and other precious metals) in both trading and banking books. Trading book for the purpose of these guidelines includes securities included under the Held for Trading category, securities included under the Available For Sale category, open gold position limits, open foreign exchange position limits, trading positions in derivatives, and derivatives entered into for hedging trading book exposures.

1.1. Capital

The basic approach of capital adequacy framework is that a bank should have sufficient capital to provide a stable resource to absorb any losses arising from the risks in its business. Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. For supervisory purposes capital is split into two categories: Tier I

and Tier II. These categories represent different instruments' quality as capital. Tier I capital consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses. Tier II capital on the other hand consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital.

1.2. Credit Risk

Credit risk is most simply defined as the potential that a bank's borrower or counterparty may fail to meet its obligations in accordance with agreed terms. It is the possibility of losses associated with diminution in the credit quality of borrowers or counterparties. In a bank's portfolio, losses stem from outright default due to inability or unwillingness of a customer or a counterparty to meet commitments in relation to lending, trading, settlement and other financial transactions. Alternatively, losses result from reduction in portfolio arising from actual or perceived deterioration in credit quality.

For most banks, loans are the largest and the most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank, including in the banking book and in the trading book, and both on and off balance sheet. Banks increasingly face credit risk (or counterparty risk) in various financial instruments other than loans, including acceptances, inter-bank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options and in guarantees and settlement of transactions.

The goal of credit risk management is to maximize a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the entire portfolio, as well as, the risk in the individual credits or transactions. Banks should have a keen awareness of the need to identify measure, monitor and control credit risk, as well as, to determine that they hold adequate capital against these risks and they are adequately compensated for risks incurred.

1.3. Market Risk

Market risk refers to the risk to a bank resulting from movements in market prices in particular changes in interest rates, foreign exchange rates and equity and commodity prices. In simpler terms, it may be defined as the possibility of loss to a bank caused by changes in the market variables. The Bank for International Settlements (BIS) defines market risk as "the risk that the value of 'on' or 'off' balance sheet positions will be

adversely affected by movements in equity and interest rate markets, currency exchange rates and commodity prices”. Thus, Market Risk is the risk to the bank’s earnings and capital due to changes in the market level of interest rates or prices of securities, foreign exchange and equities, as well as, the volatilities of those changes.

2. GUIDELINES

2.1. Components of Capital

Capital funds: The capital funds for the banks are being discussed under two heads i.e. the capital funds of Indian banks and the capital funds of foreign banks operating in India

2.1.1. Capital funds of Indian banks: For Indian banks, 'capital funds' would include the components Tier I capital and Tier II capital.

2.1.1.1. Elements of Tier I capital: The elements of Tier I capital include

- i) Paid-up capital (ordinary shares), statutory reserves, and other disclosed free reserves, if any.
- ii) Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital - subject to laws in force from time to time;
- iii) Innovative Perpetual Debt Instruments (IPDI) eligible for inclusion as Tier I capital
- iv) Capital reserves representing surplus arising out of sale proceeds of assets.

The guidelines covering Perpetual Non-Cumulative Preference Shares (PNCPS) eligible for inclusion as Tier I capital indicating the minimum regulatory requirements are furnished in Annex 1. The guidelines governing the Innovative Perpetual Debt Instruments eligible for inclusion as Tier I capital indicating the minimum regulatory requirements are furnished in Annex 2.

2.1.1.2. Elements of Tier II capital: The elements of Tier II capital include undisclosed reserves, revaluation reserves, general provisions and loss reserves, hybrid capital instruments, subordinated debt, bonds issued to Employees under VRS and investment reserve account.

a. Undisclosed reserves

They can be included in capital, if they represent accumulations of post-tax profits and are not encumbered by any known liability and should not be routinely used for absorbing normal loss or operating losses. .

b. Revaluation reserves

It would be prudent to consider revaluation reserves at a discount of 55 percent while determining their value for inclusion in Tier II capital. Such reserves will have to be reflected on the face of the Balance Sheet as revaluation reserves.

c. General provisions and loss reserves

Such reserves can be included in Tier II capital if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier II capital. General provisions/loss reserves will be admitted up to a maximum of 1.25 percent of total risk weighted assets.

'Floating Provisions' held by the banks, which is general in nature and not made against any identified assets, may be treated as a part of Tier II capital within the overall ceiling of 1.25 percent of total risk weighted assets, if such provisions are not netted off from gross NPAs to arrive at disclosure of net NPAs.

d. Hybrid debt capital instruments

Those instruments which have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital. At present the following instruments have been recognized and placed under this category.

- i. Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable Cumulative Preference Shares (RCPS) as part of Upper Tier 2 Capital
- ii. Debt capital instruments eligible for inclusion as Upper Tier II capital;

The guidelines governing the instruments at (i) above, indicating the minimum regulatory requirements are furnished in Annex 3. The guidelines governing the instruments at (ii) above, indicating the minimum regulatory requirements are furnished in Annex 4

e. Subordinated debt

Banks can raise, with the approval of their Boards, rupee-subordinated debt as Tier II capital, subject to the terms and conditions given in the Annex 5.

f. Bonds issued to Employees under VRS

In the case of public sector banks, the bonds issued to the VRS employees as a part of the compensation package, net of the unamortised VRS Deferred Revenue Expenditure, could be treated as Tier II capital, subject to compliance with the terms and conditions stipulated in para 2.1.1.2 (e).

g. Investment Reserve Account

In the event of provisions created on account of depreciation in the 'Available for Sale' or 'Held for Trading' categories being found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 –“Reserves & Surplus” under the head “Revenue and other Reserves” and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves.

- h.** Banks are allowed to include the 'General Provisions on Standard Assets' and 'provisions held for country exposures' in Tier II capital. However, the provisions on 'standard assets' together with other 'general provisions/ loss reserves' and 'provisions held for country exposures' will be admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

2.1.2. Capital funds of foreign banks operating in India

For the foreign banks operating in India, 'capital funds' would include the two components i.e. Tier I capital and Tier II capital.

2.1.2.1. Elements of Tier I capital: The elements of Tier I capital include

- i) Interest-free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.
- ii) Innovative Instruments eligible for inclusion as Tier I capital
- iii) Statutory reserves kept in Indian books.
- iv) Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India.

2.1.2.2. Elements of Tier II capital: The elements of Tier II capital include the following elements.

- a) Elements of Tier II capital as applicable to Indian banks.
 - b) Head Office (HO) borrowings raised in foreign currency (for inclusion in Upper Tier II Capital) subject to the terms and conditions as mentioned at para 7 of Annex 3 to this circular. Regarding the capital of foreign banks they are also required to follow the following instructions.
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- a) The foreign banks are required to furnish to Reserve Bank, (if not already done), an undertaking to the effect that the banks will not remit abroad the remittable surplus retained in India and included in Tier I capital as long as the banks function in India.
 - b) These funds may be retained in a separate account titled as 'Amount Retained in India for Meeting Capital to Risk-weighted Asset Ratio (CRAR) Requirements' under 'Capital Funds'.
 - c) An auditor's certificate to the effect that these funds represent surplus remittable to Head Office once tax assessments are completed or tax appeals are decided and do not include funds in the nature of provisions towards tax or for any other contingency may also be furnished to Reserve Bank.
 - d) Foreign banks operating in India are permitted to hedge their entire Tier I capital held by them in Indian books subject to the following conditions:
 - (i) The forward contract should be for tenor of one year or more and may be rolled over on maturity. Rebooking of cancelled hedge will require prior approval of Reserve Bank

- (ii) The capital funds should be available in India to meet local regulatory and CRAR requirements. Therefore, foreign currency funds accruing out of hedging should not be parked in nostro accounts but should remain swapped with banks in India at all times.
- e) Capital reserve representing surplus arising out of sale of assets in India held in a separate account is not eligible for repatriation so long as the bank functions in India.
- f) Interest-free funds remitted from abroad for the purpose of acquisition of property should be held in a separate account in Indian books.
- g) The net credit balance, if any, in the inter-office account with Head Office/overseas branches will not be reckoned as capital funds. However, any debit balance in Head Office account will have to be set-off against the capital.

2.1.2.3 Other terms and conditions for issue of Tier I/Tier II capital

- h) Foreign banks in India may raise Head Office (HO) borrowings in foreign currency for inclusion as Tier I /Tier II capital subject to the terms and conditions indicated at **Annex 2, 3, 5 and 7**.
- i) Foreign banks operating in India are also required to comply with the instructions on limits for Tier II elements and norms on cross holdings as applicable to Indian banks. The elements of Tier I and Tier II capital do not include foreign currency loans granted to Indian parties.

2.1.3 Deductions from computation of Capital funds:

2.1.2.3. Tier I capital: The following deductions should be made from Tier I capital

- a) Intangible assets and losses in the current period and those brought forward from previous periods should be deducted from Tier I capital.
- b) In the case of public sector banks which have introduced Voluntary Retirement Scheme (VRS), in view of the extra-ordinary nature of the event, the VRS related Deferred Revenue Expenditure would not be reduced from Tier I capital. However, it will attract 100% risk weight for capital adequacy purpose.
- c) Creation of deferred tax asset (DTA) results in an increase in Tier I capital of a bank without any tangible asset being added to the banks' balance sheet. Therefore, DTA, which is an intangible asset, should be deducted from Tier I capital.

2.1.2.4. Tier I and Tier II Capital

a. Equity/non equity investments in subsidiaries

The investments of a bank in the equity as well as non-equity capital instruments issued by a subsidiary, which are reckoned towards its regulatory capital as per norms prescribed by the respective regulator, should be deducted at 50 per cent each, from Tier I and Tier II capital of the parent bank, while assessing the capital adequacy of the bank on 'solo' basis, under the Basel I Framework.

b. Credit Enhancements pertaining to Securitization of Standard Assets

a) Treatment of First Loss Facility

The first loss credit enhancement provided by the originator shall be reduced from capital funds and the deduction shall be capped at the amount of capital that the bank would have been required to hold for the full value of the assets, had they not been securitised. The deduction shall be made at 50% from Tier I and 50% from Tier II capital.

b) Treatment of Second Loss Facility

The second loss credit enhancement provided by the originator shall be reduced from capital funds to the full extent. The deduction shall be made 50% from Tier I and 50% from Tier II capital.

c) Treatment of credit enhancements provided by third party

In case, the bank is acting as a third party service provider, the first loss credit enhancement provided by it shall be reduced from capital to the full extent as indicated at para (a) above.

d) Underwriting by an originator

Securities issued by the SPVs and devolved / held by the banks in excess of 10 per cent of the original amount of issue, including secondary market purchases, shall be deducted 50% from Tier I capital and 50% from Tier II capital.

e) Underwriting by third party service providers

If the bank has underwritten securities issued by SPVs devolved and held by banks which are below investment grade the same will be deducted from capital at 50% from Tier I and 50% from Tier II.

2.1.3. Limit for Tier II elements

Tier II elements should be limited to a maximum of 100 percent of total Tier I elements for the purpose of compliance with the norms.

2.1.4. Norms on cross holdings

- (i) A bank's / FI's investments in all types of instruments listed at 2.1.5 (ii) below, which are issued by other banks / FIs and are eligible for capital status for the investee bank / FI, will be limited to 10 per cent of the investing bank's capital funds (Tier I plus Tier II capital).
- (ii) Banks' / FIs' investment in the following instruments will be included in the prudential limit of 10 per cent referred to at 2.1.5(i) above.
 - a. Equity shares;
 - b. Preference shares eligible for capital status;
 - c. Innovative Perpetual Debt Instruments eligible as Tier I capital;
 - d. Subordinated debt instruments;
 - e. Debt capital Instruments qualifying for Upper Tier II status ; and
 - f. Any other instrument approved as in the nature of capital.
- (iii) Banks / FIs should not acquire any fresh stake in a bank's equity shares, if by such acquisition, the investing bank's / FI's holding exceeds 5 per cent of the investee bank's equity capital.
- (iv) Banks' / FIs' investments in the equity capital of subsidiaries are at present deducted from their Tier I capital for capital adequacy purposes. Investments in the instruments issued by banks / FIs which are listed at paragraph 2.1.5(ii) above, which are not deducted from Tier I capital of the investing bank/ FI, will attract 100 per cent risk weight for credit risk for capital adequacy purposes.

Note:

The following investments are excluded from the purview of the ceiling of 10 percent prudential norm prescribed above:

- a) Investments in equity shares of other banks /FIs in India held under the provisions of a statute.
- b) Strategic investments in equity shares of other banks/FIs incorporated outside India as promoters/significant shareholders (i.e. Foreign Subsidiaries / Joint Ventures / Associates).
- c) Equity holdings outside India in other banks / FIs incorporated outside India.

2.1.5. Swap Transactions

Banks are advised not to enter into swap transactions involving conversion of fixed rate rupee liabilities in respect of Innovative Tier I/Tier II bonds into floating rate foreign currency liabilities.

2.1.6. Minimum requirement of capital funds

Banks are required to maintain a minimum CRAR of 9 percent on an ongoing basis.

2.2. Capital charge for Market risk

2.2.1. As an initial step towards prescribing capital requirement for market risk, banks were advised to:

- i) assign an additional risk weight of 2.5 per cent on the entire investment portfolio;
- ii) assign a risk weight of 100 per cent on the open position limits on foreign exchange and gold; and
- iii) build up Investment Fluctuation Reserve up to a minimum of five per cent of the investments held in Held for Trading and Available for Sale categories in the investment portfolio.

2.2.2. Subsequently, keeping in view the ability of the banks to identify and measure market risk, it was decided to assign explicit capital charge for market risk. Thus banks are required to maintain capital charge for market risk on securities included in the Held for Trading and Available for Sale categories, open gold position, open

forex position, trading positions in derivatives and derivatives entered into for hedging trading book exposures. Consequently, the additional risk weight of 2.5% towards market risk on the investment included under Held for Trading and Available for Sale categories is not required.

2.2.3. To begin with, capital charge for market risks is applicable to banks on a global basis. At a later stage, this would be extended to all groups where the controlling entity is a bank.

2.2.4. Banks are required to manage the market risks in their books on an ongoing basis and ensure that the capital requirements for market risks are being maintained on a continuous basis, i.e. at the close of each business day. Banks are also required to maintain strict risk management systems to monitor and control intra-day exposures to market risks.

2.2.5. Capital charge for interest rate risk: The capital charge for interest rate related instruments and equities would apply to current market value of these items in bank's trading book. The current market value will be determined as per extant RBI guidelines on valuation of investments. The minimum capital requirement is expressed in terms of two separate capital charges i.e. *Specific risk charge* for each security both for short and long positions and *General market risk charge* towards interest rate risk in the portfolio where long and short positions in different securities or instruments can be offset. In India short position is not allowed except in case of derivatives and Central Government Securities. The banks have to provide the capital charge for interest rate risk in the trading book other than derivatives as per the guidelines given below for both *specific risk* and *general risk* after measuring the risk of holding or taking positions in debt securities and other interest rate related instruments in the trading book.

2.2.5.1. Specific risk: This refers to risk of loss caused by an adverse price movement of a security principally due to factors related to the issuer. The specific risk charge is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer. The specific risk charge is graduated for various exposures under three heads i.e. claims on Government, claims on banks, claims on others and is given in Annex 7

2.2.5.2. General Market Risk:

The capital requirements for general market risk are designed to capture the risk of loss arising from changes in market interest rates. The capital charge is the sum of four components:

- the net short (short position is not allowed in India except in derivatives and Central Government Securities) or long position in the whole trading book;
- a small proportion of the matched positions in each time-band (the “vertical disallowance”);
- a larger proportion of the matched positions across different time-bands (the “horizontal disallowance”), and
- a net charge for positions in options, where appropriate.

2.2.5.3. Computation of capital charge for market risk: The Basel Committee has suggested two broad methodologies for computation of capital charge for market risks i.e. the Standardised method and the banks’ Internal Risk Management models (IRM) method. It has been decided that, to start with, banks may adopt the standardised method. Under the standardised method there are two principal methods of measuring market risk, a “maturity” method and a “duration” method. As “duration” method is a more accurate method of measuring interest rate risk, it has been decided to adopt Standardised Duration method to arrive at the capital charge. Accordingly, banks are required to measure the general market risk charge by calculating the price sensitivity (modified duration) of each position separately. Under this method, the mechanics are as follows:

- first calculate the price sensitivity (modified duration) of each instrument;
- next apply the assumed change in yield to the modified duration of each instrument between 0.6 and 1.0 percentage points depending on the maturity of the instrument as given in Annex 8
- slot the resulting capital charge measures into a maturity ladder with the fifteen time bands as set out in Annex 8;
- subject long and short positions (short position is not allowed in India except in derivatives and Central Government Securities) in each time band to a 5 per cent vertical disallowance designed to capture basis risk; and
- carry forward the net positions in each time-band for horizontal offsetting subject to the disallowances set out in Annex 9.

2.2.5.4. Capital charge for interest rate derivatives:

The measurement of capital charge for market risks should include all interest rate derivatives and off-balance sheet instruments in the trading book and derivatives entered into for hedging trading book exposures which would react to changes in the interest rates, like FRAs, interest rate positions, etc.

The details of measurement of capital charge for interest rate derivatives and options are furnished below.

2.2.5.5. Measurement system in respect of Interest rate Derivatives and Option

2.2.5.5.1 Interest rate derivatives

The measurement system should include all interest rate derivatives and off-balance-sheet instruments in the trading book, which react to changes in interest rates, (e.g. forward rate agreements (FRAs), other forward contracts, bond futures, interest rate and cross-currency swaps and forward foreign exchange positions). Options can be treated in a variety of ways as described at para 2.2.5.5.2 below. A summary of the rules for dealing with interest rate derivatives is set out at the end of this section.

a) Calculation of positions

The derivatives should be converted into positions in the relevant underlying and be subjected to specific and general market risk charges as described in the guidelines. In order to calculate the capital charge, the amounts reported should be the market value of the principal amount of the underlying or of the notional underlying. For instruments where the apparent notional amount differs from the effective notional amount, banks must use the effective notional amount.

i. Futures and forward contracts, including Forward Rate Agreements (FRA)

These instruments are treated as a combination of a long and a short position in a notional government security. The maturity of a future or a FRA will be the period until delivery or exercise of the contract, plus - where applicable - the life of the underlying instrument. For example, a long position in a June three-month interest rate future (taken in April) is to be reported as a long position in a government security with a maturity of five months and a short position in a government security with a maturity of two months. Where a range of deliverable instruments may be delivered to fulfill the contract, the

bank has flexibility to elect which deliverable security goes into the duration ladder but should take account of any conversion factor defined by the exchange.

ii. Swaps

Swaps will be treated as two notional positions in government securities with relevant maturities. For example, an interest rate swap under which a bank is receiving floating rate interest and paying fixed will be treated as a long position in a floating rate instrument of maturity equivalent to the period until the next interest fixing and a short position in a fixed-rate instrument of maturity equivalent to the residual life of the swap. For swaps that pay or receive a fixed or floating interest rate against some other reference price, e.g. a stock index, the interest rate component should be slotted into the appropriate re-pricing maturity category, with the equity component being included in the equity framework. Separate legs of cross-currency swaps are to be reported in the relevant maturity ladders for the currencies concerned.

b) Calculation of capital charges for derivatives under the standardised methodology:

i. Allowable offsetting of matched positions

Banks may exclude the following from the interest rate maturity framework altogether (for both specific and general market risk);

- Long and short positions (both actual and notional) in identical instruments with exactly the same issuer, coupon, currency and maturity.
- A matched position in a future or forward and its corresponding underlying may also be fully offset (the leg representing the time to expiry of the future should however be reported) and thus excluded from the calculation.

When the future or the forward comprises a range of deliverable instruments, offsetting of positions in the future or forward contract and its underlying is only permissible in cases where there is a readily identifiable underlying security which is most profitable for the trader with a short position to deliver. The price of this security, sometimes called the "cheapest-to-deliver", and the price of the future or forward contract should in such cases move in close alignment.

No offsetting will be allowed between positions in different currencies; the separate legs of cross-currency swaps or forward foreign exchange deals are to be treated as notional

positions in the relevant instruments and included in the appropriate calculation for each currency.

In addition, opposite positions in the same category of instruments can in certain circumstances be regarded as matched and allowed to offset fully. To qualify for this treatment the positions must relate to the same underlying instruments, be of the same nominal value and be denominated in the same currency. In addition:

- for futures: offsetting positions in the notional or underlying instruments to which the futures contract relates must be for identical products and mature within seven days of each other;
- for swaps and FRAs: the reference rate (for floating rate positions) must be identical and the coupon closely matched (i.e. within 15 basis points); and
- for swaps, FRAs and forwards: the next interest fixing date or, for fixed coupon positions or forwards, the residual maturity must correspond within the following limits:
 - o less than one month hence: same day;
 - o between one month and one year hence: within seven days;
 - o over one year hence: within thirty days.

Banks with large swap books may use alternative formulae for these swaps to calculate the positions to be included in the duration ladder. The method would be to calculate the sensitivity of the net present value implied by the change in yield used in the duration method and allocate these sensitivities into the time-bands set out in Annex 8

ii. Specific risk

Interest rate and currency swaps, FRAs, forward foreign exchange contracts and interest rate futures will not be subject to a specific risk charge. This exemption also applies to futures on an interest rate index (e.g. LIBOR). However, in the case of futures contracts where the underlying is a debt security, or an index representing a basket of debt securities, a specific risk charge will apply according to the credit risk of the issuer as set out in paragraphs above.

iii. General market risk

General market risk applies to positions in all derivative products in the same manner as for cash positions, subject only to an exemption for fully or very closely matched positions in identical instruments as defined in paragraphs above. The various categories of instruments should be slotted into the maturity ladder and treated according to the rules identified earlier.

Table - Summary of treatment of interest rate derivatives

Instrument	Specific risk charge	General Market risk charge
Exchange-traded future		
- Government debt security	No	Yes, as two positions
- Corporate debt security	Yes	Yes, as two positions
- Index on interest rates (e.g. MIBOR)	No	Yes, as two positions
OTC forward		
- Government debt security	No	Yes, as two positions
- Corporate debt security	Yes	Yes, as two positions
- Index on interest rates (e.g. MIBOR)	No	Yes, as two positions
FRAs, Swaps	No	Yes, as two positions
Forward Foreign Exchange	No	Yes, as one position in each currency
Options		
- Government debt security	No	
- Corporate debt security	Yes	
- Index on interest rates (e.g. MIBOR)	No	
- FRAs, Swaps	No	

2.2.5.5.2 Treatment of Options

In recognition of the wide diversity of banks' activities in options and the difficulties of measuring price risk for options, alternative approaches are permissible as under:

- those banks which solely use purchased options¹ will be free to use the simplified approach described in Section (a) below;
- those banks which also write options will be expected to use one of the intermediate approaches as set out in Section (b) below.

a) Simplified approach

In the **simplified approach**, the positions for the options and the associated underlying, cash or forward, are not subject to the standardised methodology but rather are "carved-out" and subject to separately calculated capital charges that incorporate both general market risk and specific risk. The risk numbers thus generated are then added to the

¹ Unless all their written option positions are hedged by perfectly matched long positions in exactly the same options, in which case no capital charge for market risk is required

capital charges for the relevant category, i.e. interest rate related instruments, equities, and foreign exchange as described in Sections 2.2.5 to 2.2.7 of this circular. Banks which handle a limited range of purchased options only will be free to use the simplified approach set out in Table 1, below for particular trades. As an example of how the calculation would work, if a holder of 100 shares currently valued at Rs.10 each holds an equivalent put option with a strike price of Rs.11, the capital charge would be: Rs.1,000 x 18% (i.e. 9% specific plus 9% general market risk) = Rs.180, less the amount the option is in the money $(Rs.11 - Rs.10) \times 100 = Rs.100$, i.e. the capital charge would be Rs.80. A similar methodology applies for options whose underlying is a foreign currency or an interest rate related instrument.

Table 1 *Simplified approach: capital charges*

Position	Treatment
Long cash and Long put Or Short cash and Long call	The capital charge will be the market value of the underlying security ² multiplied by the sum of specific and general market risk charges ³ for the underlying less the amount the option is in the money (if any) bounded at zero ⁴
Long call or Long put	The capital charge will be the lesser of: (i) the market value of the underlying security multiplied by the sum of specific and general market risk charges ³ for the underlying (ii) the market value of the option ⁵

b) Intermediate approaches

² In some cases such as foreign exchange, it may be unclear which side is the "underlying security"; this should be taken to be the asset which would be received if the option were exercised. In addition the nominal value should be used for items where the market value of the underlying instrument could be zero, e.g. caps and floors, swaptions etc.

³ Some options (e.g. where the underlying is an interest rate or a currency) bear no specific risk, but specific risk will be present in the case of options on certain interest rate-related instruments (e.g. options on a corporate debt security or corporate bond index; see Section B for the relevant capital charges) and for options on equities and stock indices (see Section C). The charge under this measure for currency options will be 9%.

⁴ For options with a residual maturity of more than six months, the strike price should be compared with the forward, not current, price. A bank unable to do this must take the "in-the-money" amount to be zero.

⁵ Where the position does not fall within the trading book (i.e. options on certain foreign exchange or commodities positions not belonging to the trading book), it may be acceptable to use the book value instead.

i. Delta-plus method

The *delta-plus method* uses the sensitivity parameters or "Greek letters" associated with options to measure their market risk and capital requirements. Under this method, the delta-equivalent position of each option becomes part of the standardised methodology set out in Sections 2.2.5 to 2.2.7 with the delta-equivalent amount subject to the applicable general market risk charges. Separate capital charges are then applied to the gamma and vega risks of the option positions. Banks which write options will be allowed to include delta-weighted options positions within the standardised methodology set out in Sections 2.2.5 to 2.2.7. Such options should be reported as a position equal to the market value of the underlying multiplied by the delta.

However, since delta does not sufficiently cover the risks associated with options positions, banks will also be required to measure gamma (which measures the rate of change of delta) and vega (which measures the sensitivity of the value of an option with respect to a change in volatility) sensitivities in order to calculate the total capital charge. These sensitivities will be calculated according to an approved exchange model or to the bank's proprietary options pricing model subject to oversight by the Reserve Bank of India⁶.

Delta-weighted positions with *debt securities or interest rates as the underlying* will be slotted into the interest rate time-bands, as set out in Table at Annex 8 under the following procedure. A two-legged approach should be used as for other derivatives, requiring one entry at the time the underlying contract takes effect and a second at the time the underlying contract matures. For instance, a bought call option on a June three-month interest-rate future will in April be considered, on the basis of its delta-equivalent value, to be a long position with a maturity of five months and a short position with a maturity of two months⁷. The written option will be similarly slotted as a long position with a maturity of two months and a short position with a maturity of five months. Floating rate instruments with caps or floors will be treated as a combination of floating rate securities and a series of European-style options. For example, the holder of a three-year floating rate bond indexed to six month LIBOR with a cap of 15% will treat it as:

⁶ Reserve Bank of India may wish to require banks doing business in certain classes of exotic options (e.g. barriers, digitals) or in options "at-the-money" that are close to expiry to use either the scenario approach or the internal models alternative, both of which can accommodate more detailed revaluation approaches.

⁷ A two-months call option on a bond future, where delivery of the bond takes place in September, would be considered in April as being long the bond and short a five-months deposit, both positions being delta-weighted.

- a. a debt security that reprices in six months; and
- b. a series of five written call options on a FRA with a reference rate of 15%, each with a negative sign at the time the underlying FRA takes effect and a positive sign at the time the underlying FRA matures⁸.

The capital charge for *options with equities as the underlying* will also be based on the delta-weighted positions which will be incorporated in the measure of market risk described in Section 2.2.5. For purposes of this calculation each national market is to be treated as a separate underlying. The capital charge for *options on foreign exchange and gold positions* will be based on the method set out in Section 2.2.7. For delta risk, the net delta-based equivalent of the foreign currency and gold options will be incorporated into the measurement of the exposure for the respective currency (or gold) position.

In addition to the above capital charges arising from delta risk, there will be further capital charges for *gamma* and for *vega risk*. Banks using the delta-plus method will be required to calculate the gamma and vega for each option position (including hedge positions) separately. The capital charges should be calculated in the following way:

- a. for *each individual option* a "gamma impact" should be calculated according to a Taylor series expansion as:

$$\text{Gamma impact} = \frac{1}{2} \times \text{Gamma} \times \text{VU}^2$$
 where VU = Variation of the underlying of the option.
- b. VU will be calculated as follows:
 - for interest rate options if the underlying is a bond, the price sensitivity should be worked out as explained. An equivalent calculation should be carried out where the underlying is an interest rate.
 - for options on equities and equity indices; which are not permitted at present, the market value of the underlying should be multiplied by 9%⁹;
 - for foreign exchange and gold options: the market value of the underlying should be multiplied by 9%;
- c. For the purpose of this calculation the following positions should be treated as *the same underlying*:
 - for interest rates,¹⁰ each time-band as set out in Annex 8;¹¹

⁸ The rules applying to closely-matched positions set out in paragraph 2 (a) of this Attachment will also apply in this respect.

⁹ The basic rules set out here for interest rate and equity options do not attempt to capture specific risk when calculating gamma capital charges. However, Reserve Bank may require specific banks to do so.

- for equities and stock indices, each national market;
- for foreign currencies and gold, each currency pair and gold;
- d. Each option on the same underlying will have a gamma impact that is either positive or negative. These individual gamma impacts will be summed, resulting in a net gamma impact for each underlying that is either positive or negative. Only those net gamma impacts that are negative will be included in the capital calculation.
- e. The total gamma capital charge will be the sum of the absolute value of the net negative gamma impacts as calculated above.
- f. For *volatility risk*, banks will be required to calculate the capital charges by multiplying the sum of the vegas for all options on the same underlying, as defined above, by a proportional shift in volatility of $\pm 25\%$.
- g. The *total capital charge* for vega risk will be the sum of the absolute value of the individual capital charges that have been calculated for vega risk.

ii. Scenario approach

The *scenario approach* uses simulation techniques to calculate changes in the value of an options portfolio for changes in the level and volatility of its associated underlyings. Under this approach, the general market risk charge is determined by the scenario "grid" (i.e. the specified combination of underlying and volatility changes) that produces the largest loss. For the delta-plus method and the scenario approach the specific risk capital charges are determined separately by multiplying the delta-equivalent of each option by the specific risk weights set out in Section 2.2.5 and Section 2.2.6.

More sophisticated banks will also have the right to base the market risk capital charge for options portfolios and associated hedging positions on *scenario matrix analysis*. This will be accomplished by specifying a fixed range of changes in the option portfolio's risk factors and calculating changes in the value of the option portfolio at various points along this "grid". For the purpose of calculating the capital charge, the bank will revalue the option portfolio using matrices for simultaneous changes in the option's underlying rate or price and in the volatility of that rate or price. A different matrix will be set up for each individual underlying as defined in the preceding paragraph. As an alternative, at the discretion of each national authority, banks which are significant traders in options

¹⁰ Positions have to be slotted into separate maturity ladders by currency.

¹¹ Banks using the duration method should use the time-bands as set out in Annex.8

for interest rate options will be permitted to base the calculation on a minimum of six sets of time-bands. When using this method, not more than three of the time-bands as defined in Section 2.2.5 should be combined into any one set.

The options and related hedging positions will be evaluated over a specified range above and below the current value of the underlying. The range for interest rates is consistent with the assumed changes in yield in Annex 8. Those banks using the alternative method for interest rate options set out in the preceding paragraph should use, for each set of time-bands, the highest of the assumed changes in yield applicable to the group to which the time-bands belong.¹² The other ranges are $\pm 9\%$ for equities and $\pm 9\%$ for foreign exchange and gold. For all risk categories, at least seven observations (including the current observation) should be used to divide the range into equally spaced intervals.

The second dimension of the matrix entails a change in the volatility of the underlying rate or price. A single change in the volatility of the underlying rate or price equal to a shift in volatility of $+ 25\%$ and $- 25\%$ is expected to be sufficient in most cases. As circumstances warrant, however, the Reserve Bank may choose to require that a different change in volatility be used and / or that intermediate points on the grid be calculated.

After calculating the matrix, each cell contains the net profit or loss of the option and the underlying hedge instrument. The capital charge for each underlying will then be calculated as the largest loss contained in the matrix.

In drawing up these intermediate approaches it has been sought to cover the major risks associated with options. In doing so, it is conscious that so far as specific risk is concerned, only the delta-related elements are captured; to capture other risks would necessitate a much more complex regime. On the other hand, in other areas the simplifying assumptions used have resulted in a relatively conservative treatment of certain options positions.

Besides the options risks mentioned above, the RBI is conscious of the other risks also associated with options, e.g. rho (rate of change of the value of the option with respect to

¹² If, for example, the time-bands 3 to 4 years, 4 to 5 years and 5 to 7 years are combined, the highest assumed change in yield of these three bands would be 0.75.

the interest rate) and theta (rate of change of the value of the option with respect to time). While not proposing a measurement system for those risks at present, it expects banks undertaking significant options business at the very least to monitor such risks closely. Additionally, banks will be permitted to incorporate rho into their capital calculations for interest rate risk, if they wish to do so.

2.2.6. Measurement of capital charge for equity risk

Minimum capital requirement to cover the risk of holding or taking positions in equities in the trading book is set out below. This is applied to all instruments that exhibit market behaviour similar to equities but not to non-convertible preference shares (which are covered by the interest rate risk requirements described earlier). The instruments covered include equity shares, whether voting or non-voting, convertible securities that behave like equities, for example: units of mutual funds, and commitments to buy or sell equity. Capital charge for specific risk (akin to credit risk) will be 11.25% and specific risk is computed on the banks' gross equity positions (i.e. the sum of all long equity positions and of all short equity positions – short equity position is, however, not allowed for banks in India). The general market risk charge will also be 9% on the gross equity positions.

Investments in shares and /units of VCFs may be assigned 150% risk weight for measuring the credit risk during first three years when these are held under HTM category. When these are held under or transferred to AFS, the capital charge for specific risk component of the market risk as required in terms of the present guidelines on computation of capital charge for market risk, may be fixed at 13.5% to reflect the risk weight of 150%. The charge for general market risk component would be at 9% as in the case of other equities

2.2.7. Measurement of capital charge for foreign exchange and gold open positions

Foreign exchange open positions and gold open positions are at present risk weighted at 100%. Thus, capital charge for foreign exchange and gold open position is 9% at present. These open positions, limits or actual whichever is higher, would continue to attract capital charge at 9%. This is in line with the Basel Committee requirement.

2.3. Capital Adequacy for Subsidiaries

2.3.1. The Basel Committee on Banking Supervision has proposed that the New Capital Adequacy Framework should be extended to include, on a consolidated basis, holding companies that are parents of banking groups. On prudential

considerations, it is necessary to adopt best practices in line with international standards, while duly reflecting local conditions.

2.3.2. Accordingly, banks may voluntarily build-in the risk weighted components of their subsidiaries into their own balance sheet on notional basis, at par with the risk weights applicable to the bank's own assets. Banks should earmark additional capital in their books over a period of time so as to obviate the possibility of impairment to their net worth when switchover to unified balance sheet for the group as a whole is adopted after sometime. Thus banks were asked to provide additional capital in their books in phases, beginning from the year ended March 2001.

2.3.3. A consolidated bank defined as a group of entities which include a licensed bank should maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) as applicable to the parent bank on an ongoing basis. While computing capital funds, parent bank may consider the following points :

- i. Banks are required to maintain a minimum capital to risk weighted assets ratio of 9%. Non-bank subsidiaries are required to maintain the capital adequacy ratio prescribed by their respective regulators. In case of any shortfall in the capital adequacy ratio of any of the subsidiaries, the parent should maintain capital in addition to its own regulatory requirements to cover the shortfall.
- ii. Risks inherent in deconsolidated entities (i.e., entities which are not consolidated in the Consolidated Prudential Reports) in the group need to be assessed and any shortfall in the regulatory capital in the deconsolidated entities should be deducted (in equal proportion from Tier I and Tier II capital) from the consolidated bank's capital in the proportion of its equity stake in the entity.

2.4. Procedure for computation of CRAR

2.4.1. While calculating the aggregate of funded and non-funded exposure of a borrower for the purpose of assignment of risk weight, banks may 'net-off' against the total outstanding exposure of the borrower -

- (a) advances collateralised by cash margins or deposits,
- (b) credit balances in current or other accounts which are not earmarked for specific purposes and free from any lien,
- (c) in respect of any assets where provisions for depreciation or for bad debts have been made

(d) claims received from DICGC/ ECGC and kept in a separate account pending adjustment, and

(e) subsidies received against advances in respect of Government sponsored schemes and kept in a separate account.

2.4.2. After applying the conversion factor as indicated in Annex 10, the adjusted off Balance Sheet value shall again be multiplied by the risk weight attributable to the relevant counter-party as specified.

2.4.3. Computation of CRAR for Foreign Exchange and Interest Rate related

Contracts: Foreign exchange contracts include- Cross currency interest rate swaps, Forward foreign exchange contracts, Currency futures, Currency options purchased, and other contracts of a similar nature

Foreign exchange contracts with an original maturity of 14 calendar days or less, irrespective of the counterparty, may be assigned "zero" risk weight as per international practice.

As in the case of other off-Balance Sheet items, a two stage calculation prescribed below shall be applied:

(a) Step 1 - The notional principal amount of each instrument is multiplied by the conversion factor given below:

Original Maturity	Conversion Factor
Less than one year	2%
One year and less than two years	5% (i.e. 2% + 3%)
For each additional year	3%

(b) Step 2 - The adjusted value thus obtained shall be multiplied by the risk weight age allotted to the relevant counter-party as given in section II of Annex 10.

2.4.4. Computation of CRAR for Interest Rate related Contracts::

Interest rate contracts include the Single currency interest rate swaps, Basis swaps, Forward rate agreements, Interest rate futures, Interest rate options purchased and other contracts of a similar nature

As in the case of other off-Balance Sheet items, a two stage calculation prescribed below shall be applied:

(a) Step 1 - The notional principal amount of each instrument is multiplied by the percentages given below:

Original Maturity	Conversion Factor
Less than one year	0.5%
One year and less than two years	1.0%
For each additional year	1.0%

(b) Step 2 -The adjusted value thus obtained shall be multiplied by the risk weightage allotted to the relevant counter-party as given in II of Annex 10.

2.4.5. Aggregation of capital charge for market risks

The capital charges for specific risk and general market risk are to be computed separately before aggregation. For computing the total capital charge for market risks, the calculations may be plotted in the proforma as depicted in Table 2 below.

Table-2: Total capital charge for market risk (Rs. in crore)

Risk Category	Capital charge
I. Interest Rate (a+b)	
a. General market risk	
• Net position (parallel shift) • Horizontal disallowance (curvature) • Vertical disallowance (basis) • Options	
b. Specific risk	
II. Equity (a+b)	
a. General market risk	
b. Specific risk	
III. Foreign Exchange & Gold	
IV. Total capital charge for market risks (I+II+III)	

2.4.6. Calculation of total risk-weighted assets and capital ratio

2.4.6.1. Arrive at the risk weighted assets for credit risk in the banking book and for counterparty credit risk on all OTC derivatives.

2.4.6.2. Convert the capital charge for market risk to notional risk weighted assets by multiplying the capital charge arrived at as above in Proforma by $100 \div 9$ [the

present requirement of CRAR is 9% and hence notional risk weighted assets are arrived at by multiplying the capital charge by $(100 \div 9)$

2.4.6.3. Add the risk-weighted assets for credit risk as at 2.4.6.1 above and notional risk-weighted assets of trading book as at 2.4.6.2 above to arrive at total risk weighted assets for the bank.

2.4.6.4. Compute capital ratio on the basis of regulatory capital maintained and risk-weighted assets.

2.4.7. Computation of capital available for market risk:

Capital required for supporting credit risk should be deducted from total capital funds to arrive at capital available for supporting market risk as illustrated in Table 3 below.

Table-3: Computation of Capital for Market Risk (Rs. in Crore)

1	Capital funds		105
	• Tier I capital -----	55	
	• Tier II capital -----	50	
2	Total risk weighted assets		1140
	• RWA for credit risk -----	1000	
	• RWA for market risk -----	140	
3	Total CRAR		9.21
4	Minimum capital required to support credit risk (1000*9%)		90
	• Tier I - 45 (@ 4.5% of 1000) -----	45	
	• Tier II - 45 (@ 4.5% of 1000) -----	45	
5	Capital available to support market risk (105 - 90)		15
	• Tier I - (55 - 45) -----	10	
	• Tier II - (50 - 45) -----	5	

2.4.8 Worked out Examples:

Two examples for computing capital charge for market risk and credit risk are given in Annex 11.

Guidelines on Perpetual Non-Cumulative Preference Shares (PNCPS)
as part of Tier I capital

1. Terms of Issue

1.1 Limits

The outstanding amount of Tier 1 Preference Shares along with Innovative Tier 1 instruments shall not exceed 40% of total Tier 1 capital at any point of time. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill and other intangible assets but before the deduction of investments. Tier 1 Preference Shares issued in excess of the overall ceiling of 40%, shall be eligible for inclusion under Upper Tier 2 capital, subject to limits prescribed for Tier 2 capital. However, investors' rights and obligations would remain unchanged.

1.2 Amount

The amount of PNCPS to be raised may be decided by the Board of Directors of banks.

1.3 Maturity

The PNCPS shall be perpetual.

1.4 Options

- (i) PNCPS shall not be issued with a 'put option' or 'step up option'.
- (ii) However, banks may issue the instruments with a call option at a particular date subject to following conditions :
 - (a) The call option on the instrument is permissible after the instrument has run for at least ten years; and
 - (b) Call option shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.

1.5 Classification in the Balance sheet

These instruments will be classified as capital and shown under 'Schedule I-Capital' of the Balance sheet.

1.6 Dividend

The rate of dividend payable to the investors may be either a fixed rate or a floating rate referenced to a market determined rupee interest benchmark rate

1.7 Payment of Dividend

- (a) The issuing bank shall pay dividend subject to availability of distributable surplus out of current year's earnings, and if
 - (i) the bank's CRAR is above the minimum regulatory requirement prescribed by RBI;
 - (ii) the impact of such payment does not result in bank's capital to risk weighted assets ratio (CRAR) falling below or remaining below the minimum regulatory requirement prescribed by Reserve Bank of India;
 - (iii) In the case of half yearly payment of dividends, the balance sheet as at the end of the previous year does not show any accumulated losses; and
 - (iv) In the case of annual payment of dividends, the current year's balance sheet does not show any accumulated losses
- (b) The dividend shall not be cumulative. i.e., dividend missed in a year will not be paid in future years, even if adequate profit is available and the level of CRAR conforms to the regulatory minimum.
- (c) All instances of non-payment of dividend in consequence of conditions as at (a) above should be reported by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision, Central Office of the Reserve Bank of India, Mumbai.

1.8 Seniority of claim

The claims of the investors in PNCPS shall be senior to the claims of investors in equity shares and subordinated to the claims of all other creditors and the depositors.

Other conditions

- (a) PNCPS should be fully paid-up, unsecured, and free of any restrictive clauses.
- (b) Investment by FIIs and NRIs shall be within an overall limit of 49% and 24% of the issue respectively, subject to the investment by each FII not exceeding 10% of the issue and investment by each NRI not exceeding 5% of the issue. Investment by FIIs in these instruments shall be outside the ECB limit for rupee denominated corporate debt as fixed by Government of India from time to time. The overall non-resident holding of Preference Shares and equity shares in public sector banks will be subject to the statutory / regulatory limit.
- (c) Banks should comply with the terms and conditions, if any, stipulated by SEBI / other regulatory authorities in regard to issue of the instruments.

2. Compliance with Reserve Requirements

- (a) The funds collected by various branches of the bank or other banks for the issue and held pending finalisation of allotment of the Tier 1 Preference Shares will have to be taken into account for the purpose of calculating reserve requirements.
- (b) However, the total amount raised by the bank by issue of PNCPS shall not be reckoned as liability for calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will not attract CRR / SLR requirements.

3. Reporting Requirements

3.1 Banks issuing PNCPS shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the capital raised, including the terms of issue specified at item 1 above together with a copy of the offer document soon after the issue is completed.

3.2 The issue-wise details of amount raised as PNCPS qualifying for Tier I capital by the bank from FIIs / NRIs are required to be reported within 30 days of the issue to the Chief General Manager, Reserve Bank of India, Foreign Exchange Department, Foreign Investment Division, Central Office, Mumbai 400 001 in the proforma given in the Appendix. The details of the secondary market sales / purchases by FIIs and the NRIs in these instruments on the floor of the stock exchange shall be reported by the custodians and designated banks, respectively to the Reserve Bank of India through the soft copy of the LEC Returns, on a daily basis, as prescribed in Schedule 2 and 3 of the FEMA Notification No.20 dated 3rd May 2000, as amended from time to time.

4. Investment in perpetual non-cumulative Preference Shares issued by other banks/ FIs

- (a) A bank's investment in PNCPS issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent of investing banks' capital funds as prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004-05 dated 6th July 2004.
- (b) Bank's investments in PNCPS issued by other banks / financial institutions will attract a 100% risk weight for capital adequacy purposes.
- (c) A bank's investments in the PNCPS of other banks will be treated as exposure to capital market and be reckoned for the purpose of compliance with the prudential ceiling for capital market exposure as fixed by RBI.

5. Grant of advances against Tier 1 Preference Shares

Banks should not grant advances against the security of the PNCPS issued by them.

Terms and conditions for inclusion of Innovative Perpetual Debt Instruments as Tier I capital

The Innovative Perpetual Debt Instruments (Innovative Instruments) that may be issued as bonds or debentures by Indian banks should meet the following terms and conditions to qualify for inclusion as Tier I Capital for capital adequacy purposes.

1. Terms of issue of innovative instruments

i) Currency of issue

Banks shall issue innovative instruments in Indian Rupees as well as in foreign currency. Banks may augment their capital funds through the issue of IPDI in foreign currency, subject to compliance with the under mentioned requirements:

- a) IPDI issued in foreign currency should comply with all terms and conditions applicable in the guidelines issued on January 25, 2006, unless specifically modified in these guidelines.
- b) Not more than 49% of the eligible amount can be issued in foreign currency.
- c) IPDI issued in foreign currency shall be outside the limits for foreign currency borrowings indicated in sub paragraphs 1.i.a and 1.i.b of Annex 2.

ii) Amount

The amount of innovative instruments to be raised may be decided by the Board of Directors of banks.

iii) Limits

Innovative instruments shall not exceed 15 per cent of total Tier I capital. The above limit will be based on the amount of Tier I capital as on March 31 of previous year after deduction of goodwill and other intangible assets but before the deduction of investments.

iv) Maturity period

The innovative instruments shall be perpetual.

v) Rate of interest

The interest payable to the investors may be either at a fixed rate or at a floating rate referenced to a market determined rupee interest benchmark rate.

vi) Options

Innovative instruments shall not be issued with a 'put option'. However banks may issue the instruments with a 'call option' subject to strict compliance with each of the following conditions:

- a) Call option can be exercised after the instrument has run for at least ten years; and
- b) Call option shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after the exercise of the call option.

vii) Step-up option

The issuing bank may have a step-up option which may be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. The step-up shall not be more than 100 bps. The limits on step-up apply to the all-in cost of the debt to the issuing banks.

viii) Lock-In Clause

- a) Innovative instruments shall be subjected to a lock-in clause in terms of which the issuing bank shall not be liable to pay interest, if
 - the bank's CRAR is below the minimum regulatory requirement prescribed by RBI; or
 - the impact of such payment results in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by RBI;
- b) However, banks may pay interest with the prior approval of RBI when the impact of such payment may result in net loss or increase the net loss, provided the CRAR remains above the regulatory norm. For this purpose 'Net Loss' would mean either (a) the accumulated loss at the end of the previous financial year; or (b) the loss incurred during the current financial year.
- c) The interest shall not be cumulative.
- d) All instances of invocation of the lock-in clause should be notified by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision of the Reserve Bank of India, Mumbai.

ix) Seniority of claim

The claims of the investors in innovative instruments shall be

- a) Superior to the claims of investors in equity shares; and
- b) Subordinated to the claims of all other creditors.

x) Discount

The innovative instruments shall not be subjected to a progressive discount for capital adequacy purposes since these are perpetual.

xi) Other conditions

- a) Innovative instruments should be fully paid-up, unsecured, and free of any restrictive clauses.
- b) Investment in these instruments by FIIs and NRIs shall be within an overall limit of 49% and 24% of the issue respectively, subject to the investment by each FII not exceeding 10% of the issue and investment by each NRI not exceeding 5% of the issue.
- c) Investment by FIIs in IPDI raised in Indian Rupees shall be outside the ECB limit for rupee denominated corporate debt (currently USD 1.5 billion) fixed for investment by FIIs in corporate debt instruments.
- d) Banks should compute their overall eligibility level for raising capital through Innovative Perpetual Debt Instruments with reference to the Tier I capital as on the last annual balance sheet date (i.e. March 31). A bank may raise fresh capital through Innovative Perpetual Debt Instruments from FIIs and NRIs up to 49 percent and 24 percent, respectively, of the amount proposed to be raised within one year or the eligible limit whichever is less. The bank should, however, raise the remaining amount from the domestic investors within a period of one year from the date of issue to FIIs / NRIs, to ensure compliance with the limits set for FIIs and NRIs at the end of the one year period.
- e) Banks should comply with the terms and conditions, if any, stipulated by SEBI / other regulatory authorities in regard to issue of the instruments.

2. Compliance with Reserve Requirements

The total amount raised by a bank through IPDIs shall not be reckoned as liability for calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will not attract CRR/SLR requirements

3. Reporting Requirements

Banks issuing innovative instruments shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the debt raised, including the terms of issue specified at item 1 above together with a copy of the offer document soon after the issue is completed.

4. Investment in innovative instruments issued by other banks/ FIs

- A bank's investment in innovative instruments issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent for cross holding of capital among banks/FIs prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004-05 dated 6th July 2004 and also subject to cross holding limits.
- Bank's investments in innovative instruments issued by other banks/ financial institutions will attract a 100% risk weight for capital adequacy purposes.

5. Grant of advances against innovative instruments

Banks should not grant advances against the security of the innovative instruments issued by them.

6. Disclosure Banks may indicate the amount raised by issue of IPDI by way of explanatory notes / remarks in the Balance Sheet as well as Schedule 5 under 'Other Liabilities & Provisions'

7. Raising of innovative Instruments for inclusion as Tier I capital by foreign banks in India

Foreign banks in India may raise Head Office (HO) borrowings in foreign currency for inclusion as Tier I capital subject to the same terms and conditions as mentioned in items 1 to 5 above for Indian banks. In addition, the following terms and conditions would also be applicable:

i) Maturity period

If the amount of innovative Tier I capital raised as Head Office borrowings shall be retained in India on a perpetual basis .

ii) Rate of interest

Rate of interest on innovative Tier I capital raised as HO borrowings should not exceed the on-going market rate. Interest should be paid at half-yearly rests.

iii) Withholding tax

Interest payments to the HO will be subject to applicable withholding tax.

iv) Documentation

The foreign bank raising innovative Tier I capital as HO borrowings should obtain a letter from its HO agreeing to give the loan for supplementing the capital base

for the Indian operations of the foreign bank. The loan documentation should confirm that the loan given by Head Office shall be eligible for the same level of seniority of claim as the investors in innovative instruments capital instruments issued by Indian banks. The loan agreement will be governed by and construed in accordance with the Indian law.

v) *Disclosure*

The total eligible amount of HO borrowings shall be disclosed in the balance sheet under the head 'Innovative Tier I capital raised in the form of Head Office borrowings in foreign currency'.

vi) *Hedging*

The total eligible amount of HO borrowing should remain fully swapped in Indian Rupees with the bank at all times.

vii) *Reporting and certification*

Details regarding the total amount of innovative Tier I capital raised as HO borrowings, along with a certification to the effect that the borrowing is in accordance with these guidelines, should be advised to the Chief General Managers-in-Charge of the Department of Banking Operations & Development (International Banking Section), Department of External Investments & Operations and Foreign Exchange Department (Forex Markets Division), Reserve Bank of India, Mumbai.

**Terms and conditions applicable to Debt capital Instruments to
qualify for inclusion as Upper Tier II Capital**

The debt capital instruments that may be issued as bonds / debentures by Indian banks should meet the following terms and conditions to qualify for inclusion as Upper Tier II Capital for capital adequacy purposes.

1. Terms of Issue of Upper Tier II Capital instruments

i) Currency of issue

Banks shall issue Upper Tier II instruments in Indian Rupees. Instruments in foreign currency can be issued without seeking the prior approval of the Reserve Bank of India, subject to compliance with the under mentioned requirements:

- a. Upper Tier II Instruments issued in foreign currency should comply with all terms and conditions applicable as detailed in the guidelines issued on January 25, 2006, unless specifically modified.
- b. The total amount of Upper Tier II Instruments issued in foreign currency shall not exceed 25% of the unimpaired Tier I capital. This eligible amount will be computed with reference to the amount of Tier I capital as on March 31 of the previous financial year, after deduction of goodwill and other intangible assets but before the deduction of investments.
- c. This will be in addition to the existing limit for foreign currency borrowings by Authorised Dealers in terms of Master Circular No. RBI/2006-07/24 dated July 1, 2006 on Risk Management and Inter-Bank Dealings.
- d. Investment by FIIs in Upper Tier II Instruments raised in Indian Rupees shall be outside the limit for investment in corporate debt instruments i.e., USD 1.5 billion. However, investment by FIIs in these instruments will be subject to a separate ceiling of USD 500 million.

ii) Amount

The amount of Upper Tier II instruments to be raised may be decided by the Board of Directors of banks.

iii) Limits

Upper Tier II instruments along with other components of Tier II capital shall not exceed 100% of Tier I capital. The above limit will be based on the amount of Tier I capital after deduction of goodwill and other intangible assets but before the deduction of investments.

iv) Maturity period

The Upper Tier II instruments should have a minimum maturity of 15 years.

v) Rate of interest

The interest payable to the investors may be either at a fixed rate or at a floating rate referenced to a market determined rupee interest benchmark rate.

vi) Options

Upper Tier II instruments shall not be issued with a 'put option'. However banks may issue the instruments with a 'call option' subject to strict compliance with each of the following conditions:

- o Call options may be exercised only if the instrument has run for at least ten years;
- o Call options shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.

vii) Step-up option

The issuing bank may have a step-up option which may be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. The step-up shall not be more than 100 bps. The limits on step-up apply to the all-in cost of the debt to the issuing banks.

viii) Lock-In Clause

- a. Upper Tier II instruments shall be subjected to a lock-in clause in terms of which the issuing bank shall not be liable to pay either interest or principal, even at maturity, if
 - o the bank's CRAR is below the minimum regulatory requirement prescribed by RBI, or
 - o the impact of such payment results in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by RBI.
- b. However, banks may pay interest with the prior approval of RBI when the impact of such payment may result in net loss or increase the net loss provided CRAR remains above the regulatory norm. For this purpose 'Net Loss' would mean either (a) the accumulated loss at the end of the previous financial year; or (b) the loss incurred during the current financial year.

- c. The interest amount due and remaining unpaid may be allowed to be paid in the later years in cash/ cheque subject to the bank complying with the above regulatory requirement. While paying such unpaid interest and principal, banks are allowed to pay compound interest at a rate not exceeding the coupon rate of the relative Upper Tier II bonds, on the outstanding principal and interest.
- d. All instances of invocation of the lock-in clause should be notified by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision of the Reserve Bank of India, Mumbai.

ix) Seniority of claim

The claims of the investors in Upper Tier II instruments shall be

- o Superior to the claims of investors in instruments eligible for inclusion in Tier I capital; and
- o Subordinate to the claims of all other creditors.

x) Discount

The Upper Tier II instruments shall be subjected to a progressive discount for capital adequacy purposes as in the case of long-term subordinated debt over the last five years of their tenor. As they approach maturity these instruments should be subjected to progressive discount as indicated in the table below for being eligible for inclusion in Tier II capital.

Remaining Maturity of Instruments	Rate of Discount (%)
Less than one year	100
One year and more but less than two years	80
Two years and more but less than three years	60
Three years and more but less than four years	40
Four years and more but less than five years	20

xi) Redemption

Upper Tier II instruments shall not be redeemable at the initiative of the holder. All redemptions shall be made only with the prior approval of the Reserve Bank of India (Department of Banking Operations & Development).

xii) Other conditions

- i. Upper Tier II instruments shall be fully paid-up, unsecured, and free of any restrictive clauses.
- ii. Investment in Upper Tier II instruments by FIIs shall be within the limits as laid down in the ECB Policy for investment in debt instruments. In addition, NRIs shall also be eligible to invest in these instruments as per existing policy.
- iii. Banks should comply with the terms and conditions, if any, stipulated by SEBI/other regulatory authorities in regard to issue of the instruments.

2. Compliance with Reserve Requirements

- i) The funds collected by various branches of the bank or other banks for the issue and held pending finalisation of allotment of the Upper Tier II Capital instruments will have to be taken into account for the purpose of calculating reserve requirements.
- ii) The total amount raised by a bank through Upper Tier II instruments shall be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

3. Reporting Requirements

Banks issuing Upper Tier II instruments shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the debt raised, including the terms of issue specified at item 1 above together with a copy of the offer document soon after the issue is completed.

4. Investment in Upper Tier II instruments issued by other banks/ FIIs

- A bank's investment in Upper Tier II instruments issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent for cross holding of capital among

banks/FIs prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004-05 dated July 6, 2004 and also subject to cross holding limits.

- Bank's investments in Upper Tier II instruments issued by other banks/ financial institutions will attract a 100% risk weight for capital adequacy purposes.

5. Grant of advances against Upper Tier II instruments

Banks shall not grant advances against the security of the Upper Tier II instruments issued by them.

6. Disclosure

Banks may indicate the amount raised by issue of Upper Tier II instruments by way of explanatory notes / remarks in the Balance Sheet as well as Schedule 5 under 'Other Liabilities & Provisions

7. Raising of Upper Tier II Instruments by foreign banks in India

Foreign banks in India may raise Head Office (HO) borrowings in foreign currency for inclusion as Upper Tier II capital subject to the same terms and conditions as mentioned in items 1 to 5 above for Indian banks. In addition, the following terms and conditions would also be applicable:

i) Maturity period

If the amount of Upper Tier II capital raised as Head Office borrowings is in tranches, each tranche shall be retained in India for a minimum period of fifteen years.

ii) Rate of interest

Rate of interest on Upper Tier II capital raised as HO borrowings should not exceed the on-going market rate. Interest should be paid at half-yearly rests.

iii) Withholding tax

Interest payments to the HO will be subject to applicable withholding tax.

iv) Documentation

The foreign bank raising Upper Tier II capital as HO borrowings should obtain a letter from its HO agreeing to give the loan for supplementing the capital base for the Indian operations of the foreign bank. The loan documentation should confirm that the loan given by Head Office shall be eligible for the same level of seniority of claim as the investors in Upper Tier II debt capital instruments issued by Indian banks. The loan agreement will be governed by and construed in accordance with the Indian law.

v) *Disclosure*

The total eligible amount of HO borrowings shall be disclosed in the balance sheet under the head 'Upper Tier II capital raised in the form of Head Office borrowings in foreign currency'.

vi) *Hedging*

The total eligible amount of HO borrowing should remain fully swapped in Indian Rupees with the bank at all times.

vii) *Reporting and certification*

Details regarding the total amount of Upper Tier II capital raised as HO borrowings, along with a certification to the effect that the borrowing is in accordance with these guidelines, should be advised to the Chief General Managers-in-Charge of the Department of Banking Operations & Development (International Banking Division), Department of External Investments & Operations and Foreign Exchange Department (Forex Markets Division), Reserve Bank of India, Mumbai.

Annex - 4**Terms and conditions applicable to Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable Cumulative Preference Shares (RCPS) as part of Upper Tier 2 Capital****1. Terms of Issue****1.1 Characteristics of the instruments**

- (a) These instruments could be either perpetual (PCPS) or dated (RNCPS and RCPS) instruments with a fixed maturity of minimum 15 years.
- (b) The perpetual instruments shall be cumulative. The dated instruments could be cumulative or non-cumulative

1.2 Limits

The outstanding amount of these instruments along with other components of Tier 2 capital shall not exceed 100% of Tier 1 capital at any point of time. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill and other intangible assets but before the deduction of investments.

1.3 Amount

The amount to be raised may be decided by the Board of Directors of banks.

1.4 Options

- (i) These instruments shall not be issued with a 'put option'.
- (ii) However, banks may issue the instruments with a call option at a particular date subject to strict compliance with each of the following conditions:
 - (a) The call option on the instrument is permissible after the instrument has run for at least ten years; and
 - (b) Call option shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.

1.5 Step-up option

The issuing bank may have a step-up option which may be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. The step-up shall not be more than 100 bps. The limits on step-up apply to the all-in cost of the debt to the issuing banks.

1.6. Classification in the balance sheet

These instruments will be classified as borrowings under Schedule 4 of the Balance sheet as item No.1.

1.7 Coupon

The coupon payable to the investors may be either at a fixed rate or at a floating rate referenced to a market determined rupee interest benchmark rate.

1.8. Payment of coupon

1.8.1 The coupon payable on these instruments will be treated as interest and accordingly debited to P& L Account. However, it will be payable only if

- (a) The bank's CRAR is above the minimum regulatory requirement prescribed by RBI
- (b) The impact of such payment does not result in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by RBI
- (c) The bank does not have a net loss. For this purpose the Net Loss is defined as either (i) the accumulated loss at the end of the previous financial year / half year as the case may be; or (ii) the loss incurred during the current financial year.
- (d) In the case of PCPS and RCPS the unpaid coupon will be treated as a liability. The interest amount due and remaining unpaid may be allowed to be paid in later years subject to the bank complying with the above requirements.
- (e) In the case of RNCPS, deferred coupon will not be paid in future years, even if adequate profit is available and the level of CRAR conforms to the regulatory minimum.

1.8.2. All instances of non-payment of interest should be notified by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision, Central Office of the Reserve Bank of India, Mumbai.

1.9. Redemption / repayment of redeemable Preference Shares included in Upper Tier II

1.9.1. All these instruments shall not be redeemable at the initiative of the holder.

1.9.2. Redemption of these instruments at maturity shall be made only with the prior approval of the Reserve Bank of India (Department of Banking Operations and Development, subject inter alia to the following conditions :

- (a) the bank's CRAR is above the minimum regulatory requirement prescribed by RBI
- (b) the impact of such payment does not result in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by RBI

1.10. Seniority of claim

The claims of the investors in these instruments shall be senior to the claims of investors in instruments eligible for inclusion in Tier 1 capital and subordinate to the claims of all other creditors including those in Lower Tier 2 and the depositors. Amongst the investors

of various instruments included in Upper Tier 2, the claims shall rank pari-passu with each other.

1.11 Amortisation for the purpose of computing CRAR

The Redeemable Preference Shares (both cumulative and non-cumulative) shall be subjected to a progressive discount for capital adequacy purposes over the last five years of their tenor, as they approach maturity as indicated in the table below for being eligible for inclusion in Tier 2 capital.

Remaining Maturity of Instruments	Rate of Discount (%)
Less than one year	100
One year and more but less than two years	80
Two years and more but less than three years	60
Three years and more but less than four years	40
Four years and more but less than five years	20

1.12 Other conditions

- (a) These instruments should be fully paid-up, unsecured, and free of any restrictive clauses.
- (b) Investment by FIIs and NRIs shall be within an overall limit of 49% and 24% of the issue respectively, subject to the investment by each FII not exceeding 10% of the issue and investment by each NRI not exceeding 5% of the issue. Investment by FIIs in these instruments shall be outside the ECB limit for rupee denominated corporate debt as fixed by Government of India from time to time. However, investment by FIIs in these instruments will be subject to separate ceiling of USD 500 million. The overall non-resident holding of Preference Shares and equity shares in public sector banks will be subject to the statutory / regulatory limit.
- (c) Banks should comply with the terms and conditions, if any, stipulated by SEBI / other regulatory authorities in regard to issue of the instruments.

2. Compliance with Reserve Requirements

- (a) The funds collected by various branches of the bank or other banks for the issue and held pending finalization of allotment of these instruments will have to be taken into account for the purpose of calculating reserve requirements.
- (b) The total amount raised by a bank through the issue of these instruments shall be reckoned as liability for the calculation of net demand and time liabilities for the

purpose of reserve requirements and, as such, will attract CRR / SLR requirements.

3. **Reporting Requirements**

Banks issuing these instruments shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the debt raised, including the terms of issue specified at item 1 above together with a copy of the offer document soon after the issue is completed.

4. **Investment in these instruments issued by other banks / FIs**

(a) A bank's investment in these instruments issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent of investing banks' capital fund prescribed vide circular DBOD.BP.BC.No.3/21.01.002/ 2004-05 dated 6th July 2004 and also subject to cross holding limits.

(b) Bank's investments in these instruments issued by other banks / financial institutions will attract a 100% risk weight for capital adequacy purposes.

5. **Grant of advances against these instruments**

Banks should not grant advances against the security of these instruments issued by them.

Terms and conditions for issue of unsecured bonds as Subordinated Debt by banks to raise Tier II capital

I. Rupee Subordinated Debt

Foreign banks operating in India are not permitted to raise Rupee Tier II subordinated debt in India.

1. Terms of Issue of Bond by Indian banks

To be eligible for inclusion in Tier II capital, terms of issue of the bonds as subordinated debt instruments should be in conformity with the following:

i) Amount

The amount of subordinated debt to be raised may be decided by the Board of Directors of the bank.

ii) Maturity period

- a. Subordinated debt instruments with an initial maturity period of less than 5 years, or with a remaining maturity of one year should not be included as part of Tier II capital. Further, they should be subjected to progressive discount as they approach maturity at the rates shown below:

Remaining Maturity of Instruments	Rate of Discount (%)
Less than one year	100
More than One year and less than Two years	80
More than Two years and less than Three years	60
More than Three years and less than Four years	40
More than Four years and less than Five years	20

- b. The bonds should have a minimum maturity of 5 years. However if the bonds are issued in the last quarter of the year i.e., from 1st January to 31st March, they should have a minimum tenure of sixty three months.

iii) Rate of interest

Banks may issue Subordinated Tier II bonds at coupon rates decided by their Boards. The instruments should be 'vanilla' with no special features like options, etc.

iv) Other conditions

- o The instruments should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses and should not be redeemable at the initiative of the holder or without the consent of the Reserve Bank of India.
- o Necessary permission from Foreign Exchange Department should be obtained for issuing the instruments to NRIs/OCBs/FIIs.
- o Banks should comply with the terms and conditions, if any, set by SEBI/other regulatory authorities in regard to issue of the instruments.

v) Banks should indicate the amount of subordinated debt raised as Tier II capital by way of explanatory notes/ remarks in the Balance Sheet as well as in Schedule 5 to the Balance Sheet under 'Other Liabilities & Provisions'.

2. Inclusion in Tier II capital

Subordinated debt instruments will be limited to 50 per cent of Tier-I Capital of the bank. These instruments, together with other components of Tier II capital, should not exceed 100% of Tier I capital.

3. Grant of advances against bonds

Banks should not grant advances against the security of their own bonds.

4. Compliance with Reserve Requirements

The total amount of Subordinated Debt raised by the bank has to be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

5. Treatment of Investment in subordinated debt

Investments by banks in subordinated debt of other banks will be assigned 100% risk weight for capital adequacy purpose. Also, the bank's aggregate investment in Tier II bonds issued by other banks and financial institutions shall be within the overall ceiling of 10 percent of the investing bank's total capital. The capital for this purpose will be the same as that reckoned for the purpose of capital adequacy.

6. Subordinated Debt in foreign currency raised by Indian banks

Banks may take approval of RBI on a case-by-case basis.

7. Reporting Requirements

The banks should submit a report to Reserve Bank of India giving details of the capital raised, such as, amount raised, maturity of the instrument, rate of interest together with a copy of the offer document soon after the issue is completed.

**Subordinated debt – Head Office borrowings
in foreign currency raised by foreign banks operating
in India for inclusion in Tier II capital**

Detailed guidelines on the standard requirements and conditions for Head Office (HO) borrowings in foreign currency raised by foreign banks operating in India for inclusion , as subordinated debt in Tier II capital are as indicated below:-

1. Amount of borrowing

The total amount of HO borrowing in foreign currency will be at the discretion of the foreign bank. However, the amount eligible for inclusion in Tier II capital as subordinated debt will be subject to a maximum ceiling of 50% of the Tier I capital maintained in India, and the applicable discount rate mentioned in para 5 below. Further as per extant instructions, the total of Tier II capital should not exceed 100% of Tier I capital.

2. Maturity period

Head Office borrowings should have a minimum initial maturity of 5 years. If the borrowing is in tranches, each tranche will have to be retained in India for a minimum period of five years. HO borrowings in the nature of perpetual subordinated debt, where there may be no final maturity date, will not be permitted.

3. Features

The HO borrowings should be fully paid up, i.e. the entire borrowing or each tranche of the borrowing should be available in full to the branch(es) in India. It should be unsecured, subordinated to the claims of other creditors of the foreign bank in India, free of restrictive clauses and should not be redeemable at the instance of the HO.

4. Rate of discount

The HO borrowings will be subjected to progressive discount as they approach maturity at the rates indicated below:

Remaining maturity of borrowing	Rate of discount
More than 5 years	Not Applicable (the entire amount can be included as subordinated debt in Tier II capital subject to the ceiling mentioned in para 2)

More than 4 years and less than 5 years	20%
More than 3 years and less than 4 years	40%
More than 2 years and less than 3 years	60%
More than 1 year and less than 2 years	80%
Less than 1 year	100% (No amount can be treated as subordinated debt for Tier II capital)

5. Rate of interest

The rate of interest on HO borrowings should not exceed the on-going market rate. Interest should be paid at half yearly rests.

6. Withholding tax

The interest payments to the HO will be subject to applicable withholding tax.

7. Repayment

All repayments of the principal amount will be subject to prior approval of Reserve Bank of India, Department of Banking Operations and Development.

8. Documentation

The bank should obtain a letter from its HO agreeing to give the loan for supplementing the capital base for the Indian operations of the foreign bank. The loan documentation should confirm that the loan given by Head Office would be subordinated to the claims of all other creditors of the foreign bank in India. The loan agreement will be governed by, and construed in accordance with the Indian law. Prior approval of the RBI should be obtained in case of any material changes in the original terms of issue.

9. Disclosure

The total eligible amount of HO borrowings may be disclosed in the balance sheet under the head 'Subordinated loan in the nature of long term borrowings in foreign currency from Head Office'.

10. Reserve requirements

The total amount of HO borrowings is to be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

11. Hedging

The total eligible amount of HO borrowing should remain fully swapped with banks at all times. The swap should be in Indian rupees.

12. Reporting & Certification

Such borrowings done in compliance with the guidelines set out above would not require prior approval of RBI. However, information regarding the total amount of borrowing raised from Head Office under this circular, along with a certification to the effect that the borrowing is as per the guidelines, should be advised to the Chief General Managers-in-Charge of the Department of Banking Operations & Development (International Banking Section), Department of External Investments & Operations and Foreign Exchange Department (Forex Markets Division), RBI, Mumbai.

CAPITAL CHARGE FOR SPECIFIC RISK

Sr. No.	Nature of investment	Maturity	Specific risk capital charge (as % of exposure)
	Claims on Government		
1.	Investments in Government Securities.	All	0.0
2.	Investments in other approved securities guaranteed by Central/ State Government.	All	0.0
3.	Investments in other securities where payment of interest and repayment of principal are guaranteed by Central Govt. (This will include investments in Indira/Kisan Vikas Patra (IVP/KVP) and investments in Bonds and Debentures where payment of interest and principal is guaranteed by Central Govt.)	All	0.0
4.	Investments in other securities where payment of interest and repayment of principal are guaranteed by State Governments.	All	0.0
5.	Investments in other approved securities where payment of interest and repayment of principal are not guaranteed by Central/State Govt.	All	1.80
6.	Investments in Government guaranteed securities of Government Undertakings which do not form part of the approved market borrowing programme.	All	1.80
7	Investment in state government guaranteed securities included under items 2, 4 and 6 above where the investment is non-performing. However the banks need to maintain capital at 9.0% only on those State Government guaranteed securities issued by the defaulting entities and not on all the securities issued or guaranteed by that State Government.	All	9.00
	Claims on Banks		

Sr. No.	Nature of investment	Maturity	Specific risk capital charge (as % of exposure)
8	Claims on banks, including investments in securities which are guaranteed by banks as to payment of interest and repayment of principal	For residual term to final maturity 6 months or less	0.30
		For residual term to final maturity between 6 and 24 months	1.125
		For residual term to final maturity exceeding 24 months	1.80
9.	Investments in subordinated debt instruments and bonds issued by other banks for their Tier II capital.	All	9.00
	Claims on Others		
10.	Investment in Mortgage Backed Securities (MBS) of residential assets of Housing Finance Companies (HFCs) which are recognised and supervised by National Housing Bank (subject to satisfying terms & conditions given in Annex 8.2	All	4.50
11	Investment in Mortgage Backed Securities (MBS) which are backed by housing loan qualifying for 50% risk weight.	All	4.50
12.	Investment in securitised paper pertaining to an infrastructure facility	All	4.50
13.	All other investments including investment in securities issued by SPVs set up for securitisation transactions	All	9.00
14	Direct investment in equity shares, convertible bonds, debentures and units of equity oriented	All	11.25

Sr. No.	Nature of investment	Maturity	Specific risk capital charge (as % of exposure)
	mutual funds		
15	Investment in Mortgage Backed Securities and other securitised exposures to Commercial Real Estate	All	13.5
16	Investments in Venture Capital Funds	All	13.5
17	Investments in instruments issued by NBFC-ND-SI	All	11.25

The category 'claim on Government' will include all forms of Government securities including dated Government securities, Treasury bills and other short-term investments and instruments where repayment of both principal and interest are fully guaranteed by the Government. The category 'Claims on others' will include issuers of securities other than Government and banks.

DURATION METHOD**(Time bands and assumed changes in yield)**

Time Bands	Assumed Change in Yield
Zone 1	
1 month or less	1.00
1 to 3 months	1.00
3 to 6 months	1.00
6 to 12 months	1.00
Zone 2	
1.0 to 1.9 years	0.90
1.9 to 2.8 years	0.80
2.8 to 3.6 years	0.75
Zone 3	
3.6 to 4.3 years	0.75
4.3 to 5.7 years	0.70
5.7 to 7.3 years	0.65
7.3 to 9.3 years	0.60
9.3 to 10.6 years	0.60
10.6 to 12 years	0.60
12 to 20 years	0.60
over 20 years	0.60

ANNEX 9
Horizontal Disallowances

Zones	Time band	Within the zones	Between adjacent zones	Between zones 1 and 3
Zone 1	1 month or less	40%	40%	100%
	1 to 3 months			
	3 to 6 months			
	6 to 12 months			
Zone 2	1.0 to 1.9 years	30%		
	1.9 to 2.8 years			
	2.8 to 3.6 years			
Zone 3	3.6 to 4.3 years	30%	40%	
	4.3 to 5.7 years			
	5.7 to 7.3 years			
	7.3 to 9.3 years			
	9.3 to 10.6 years			
	10.6 to 12 years			
	12 to 20 years			
	over 20 years			

Note: Capital charges should be calculated for each currency separately and then summed with no offsetting between positions of opposite sign. In the case of those currencies in which business is insignificant (where the turnover in the respective currency is less than 5 per cent of overall foreign exchange turnover), separate calculations for each currency are not required. The bank may, instead, slot within each appropriate time-band, the net long or short position for each currency. However, these individual net positions are to be summed within each time-band, irrespective of whether they are long or short positions, to produce a gross position figure. In the case of residual currencies the gross positions in each time-band will be subject to the assumed change in yield set out in table with no further offsets.

Risk Weights for Calculation of CRAR I. Domestic Operations

Sr. No.	Item of asset or liability	Risk Weight %
I	Balances	
1.	Cash, balances with RBI	0
2.	i. Balances in current account with other banks	20
	ii. Claims on Bank	20
II	Investments(Applicable to securities held in HTM)	
1.	Investments in Government Securities.	0
2.	Investments in other approved securities guaranteed by Central/ State Government. <i>Note: If the repayment of principal / interest in respect of State Government Guaranteed securities included in item 2, 4 and 6 has remained in default, for a period of more than 90 days banks should assign 102.5% risk weight. However the banks need to assign 102.5% risk weight only on those State Government guaranteed securities issued by the defaulting entities and not on all the securities issued or guaranteed by that State Government.</i>	0
3.	Investments in other securities where payment of interest and repayment of principal are guaranteed by Central Govt. (This will include investments in Indira/Kisan Vikas Patra (IVP/KVP) and investments in Bonds and Debentures where payment of interest and principal is guaranteed by Central Govt.)	0
4.	Investments in other securities where payment of interest and repayment of principal are guaranteed by State Governments.	0
5.	Investments in other approved securities where payment of interest and repayment of principal are not guaranteed by Central/State Govt.	20
6.	Investments in Government guaranteed securities of Government Undertakings which do not form part of the approved market borrowing programme.	20

7.	Claims on commercial banks	20
8.	Investments in bonds issued by other banks	20
9.	Investments in securities which are guaranteed by banks as to payment of interest and repayment of principal.	20
10.	Investments in subordinated debt instruments and bonds issued by other banks or Public Financial Institutions for their Tier II capital.	100
11.	Deposits placed with SIDBI/NABARD in lieu of shortfall in lending to priority sector.	100
12.	Investment in Mortgage Backed Securities (MBS) of residential assets of Housing Finance Companies (HFCs) which are recognised and supervised by National Housing Bank (subject to satisfying terms & conditions furnished in Annex 10.2).	50
13.	Investment in Mortgage Backed Securities (MBS) which are backed by housing loan qualifying for 50% risk weight.	50
14.	Investment in securitised paper pertaining to an infrastructure facility. (subject to satisfying terms & conditions given in Annex 10.3).	50
15.	Investments in debentures/ bonds/ security receipts/ Pass Through Certificates issued by Securitisation Company / SPVs/ Reconstruction Company and held by banks as investment	100
16.	All other investments including investments in securities issued by PFIs.	100
	<i>Note:</i> Equity investments in subsidiaries, intangible assets and losses deducted from Tier I capital should be assigned zero weight	
17.	Direct investment in equity shares, convertible bonds, debentures and units of equity oriented mutual funds	125
18.	Investment in Mortgaged Backed Securities and other securitised exposures to Commercial Real Estate	150
19.	Investments in Venture Capital Funds	150
20.	Investments in Securities issued by SPVs (in respect of securitisation of standard assets) underwritten and devolved on originator banks during the stipulated period of three months	100

21	Investments in Securities issued by SPVs in respect of securitisation of standard asset underwritten and devolved on bank as third party service provider during the stipulated period of three months	100
22	NPA Investment purchased from other banks	100
23	Investments in instruments issued by NBFC-ND-SI	125
III	Loans & Advances including bills purchased and discounted and other credit facilities	
1.	Loans guaranteed by Govt. of India	0
2.	Loans guaranteed by State Govts. <i>Note: If the loans guaranteed by State Govts. have remained in default for a period of more than 90 days a risk weight of 100 percent should be assigned.</i>	0
3.	Loans granted to public sector undertakings of Govt. of India	100
4.	Loans granted to public sector undertakings of State Govts.	100
5.		
(i)	For the purpose of credit exposure, bills purchased/discounted /negotiated under LC (where payment to the beneficiary is not under reserve) is treated as an exposure on the LC issuing bank and assigned risk weight as is normally applicable to inter-bank exposures.	20
(ii)	Bills negotiated under LCs 'under reserve', bills purchased/discounted/negotiated without LCs, will be reckoned as exposure on the borrower constituent. Accordingly, the exposure will attract a risk weight appropriate to the borrower.	
	(i) Govt	0
	(ii) Banks	20
	(iii) Others	100
6.	Others including PFIs	100
7.	Leased assets	100

8.	Advances covered by DICGC/ECGC Note: The risk weight of 50% should be limited to the amount guaranteed and not the entire outstanding balance in the accounts. In other words, the outstandings in excess of the amount guaranteed, will carry 100% risk weight.	50
9.	SSI Advances Guaranteed by Credit Guarantee Fund Trust for Small Industries (CGTSI) up to the guaranteed portion. Note: Banks may assign zero risk weight for the guaranteed portion. The balance outstanding in excess of the guaranteed portion would attract a risk-weight as appropriate to the counter-party. Two illustrative examples are given in Annex 10.1.	0
10.	Insurance cover under Business Credit Shield the product of New India Assurance Company Ltd. (Subject to Conditions given in Annex 10.4) Note: The risk weight of 50% should be limited to the amount guaranteed and not the entire outstanding balance in the accounts. In other words, the outstandings in excess of the amount guaranteed, will carry 100% risk weight.	50
11	Advances against term deposits, Life policies, NSCs, IVPs and KVPs where adequate margin is available.	0
12.	Loans and Advances granted to staff of banks which are fully covered by superannuation benefits and mortgage of flat/house.	20
13.	Housing loans above Rs 30 lakh sanctioned to individuals against the mortgage of residential housing properties having LTV ratio equal to or less than 75%	75
14	Housing loans upto Rs 30 lakhs sanctioned to individuals against the mortgage of residential housing properties having LTV ratio equal to or less than 75%.	50
15	Consumer credit including personal loans and credit cards@	125

@ 'Educational Loans have been excluded from the purview of 'Consumer Credit' for the purpose of capital adequacy norms

16	Loans up to Rs.1 lakh against gold and silver ornaments	50
17.	Takeout Finance	
	(i) Unconditional takeover (in the books of lending institution)	20
	(a) Where full credit risk is assumed by the taking over institution	
	(b) Where only partial credit risk is assumed by taking over institution	20
	i) the amount to be taken over	100
	ii) the amount not to be taken over	
	(ii) Conditional take-over (in the books of lending and Taking over institution)	100
18	Advances against shares to individuals for investment in equity shares (including IPOs/ESOPs), bonds and debentures, units of equity oriented mutual funds, etc.	125
19	Secured and unsecured advances to stock brokers	125
20	Fund based exposures commercial real estate	150
21	Funded liquidity facility for securitisation of standard asset transactions	100
22	NPA purchased from other banks	100
23	Loans & Advances NBFC-ND-SI	125
IV	Other Assets	
1.	Premises, furniture and fixtures	100
2.	Income tax deducted at source (net of provision)	0
	Advance tax paid (net of provision)	0
	Interest due on Government securities	0
	Accrued interest on CRR balances and claims on RBI on account of Government transactions (net of claims of Government/RBI on banks on account of such transactions)	0
	All other assets	100

B. Off-Balance Sheet Items

The credit risk exposure attached to off-Balance Sheet items has to be first calculated by multiplying the face value of each of the off-Balance Sheet items by 'credit conversion factor' as indicated in the table below. This will then have to be again multiplied by the weights attributable to the relevant counter-party as specified above.

Sr. No.	Instruments	credit conversion factor
1.	Direct credit substitutes e.g. general guarantees of indebtedness (including standby L/Cs serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptance).	100
2.	Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby L/Cs related to particular transactions).	50
3.	Short-term self-liquidating trade-related contingencies (such as documentary credits collateralized by the underlying shipments).	20
4.	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the bank.	100
5.	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawdown.	100
6.	Note issuance facilities and revolving underwriting facilities.	50
7.	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of over one year.	50
8.	Similar commitments with an original maturity upto one year, or which can be unconditionally cancelled at any time.	0
9.	Aggregate outstanding foreign exchange contracts of original maturity -	
	• less than one year	2
	• for each additional year or part thereof	3
10.	Take-out Finance in the books of taking-over institution	
	(i) Unconditional take-out finance	100
	(ii) Conditional take-out finance	50

Sr. No.	Instruments	credit conversion factor
	Note: As the counter-party exposure will determine the risk weight, it will be 100 percent in respect of all borrowers or zero percent if covered by Government guarantee.	
11	Non-Funded exposures to commercial real estate	150
12	Guarantees issued on behalf of stock brokers and market makers	125
13	Commitment to provide liquidity facility for securitisation of standard asset transactions	100
14	Second loss credit enhancement for securitisation of standard asset transactions provided by third party	100
15	Non-funded exposure to NBFC-ND-SI	125

NOTE: In regard to off-balance sheet items, the following transactions with non-bank counterparties will be treated as claims on banks and carry a risk-weight of 20%

Guarantees issued by banks against the counter guarantees of other banks.

Rediscounting of documentary bills accepted by banks. Bills discounted by banks which have been accepted by another bank will be treated as a funded claim on a bank.

In all the above cases banks should be fully satisfied that the risk exposure is in fact on the other bank.

C. Risk weights for Open positions

Sr. No.	Item	Risk weight (%)
1.	Foreign exchange open position.	100
2.	Open position in gold Note: The risk weighted position both in respect of foreign exchange and gold open position limits should be added to the other risk weighted assets for calculation of CRAR	100

D. Risk weights for Forward Rate Agreement (FRA) /Interest Rate Swap (IRS)

For reckoning the minimum capital ratio, the computation of risk weighted assets on account of FRAs / IRS should be done as per the two steps procedure set out below:

Step 1

The notional principal amount of each instrument is to be multiplied by the conversion factor given below:

Original Maturity	Conversion Factor
Less than one year	0.5 per cent
One year and less than two years	1.0 per cent
For each additional year	1.0 per cent

Step 2

The adjusted value thus obtained shall be multiplied by the risk weightage allotted to the relevant counter-party as specified below:

Counter party	Risk weight
Banks	20 per cent
Central & State Govt.	0 percent
All others	100 per cent

II. Overseas operations (applicable only to Indian banks having branches abroad)

A. Funded Risk Assets

Sr. No.	Item of asset or liability	Risk Weight %
i)	Cash	0
ii)	Balances with Monetary Authority	0
iii)	Investments in Government securities	0
iv)	Balances in current account with other banks	20
v)	All other claims on banks including but not limited to funds loaned in money markets, deposit placements, investments in CDs/FRNs. Etc.	20
vi)	Investment in non-bank sectors	100
vii)	Loans and advances, bills purchased and discounted and other credit facilities	

	a) Claims guaranteed by Government of India.	0
	b) Claims guaranteed by State Governments	0
	c) Claims on public sector undertakings of Government of India.	100
	d) Claims on public sector undertakings of State Governments	100
	e) Others	100
viii)	All other banking and infrastructural assets	100

B. Non-funded risk assets

Sr. No.	Instruments	Credit Conversion Factor (%)
i)	Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances)	100
ii)	Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions)	50
iii)	Short-term self-liquidating trade related contingencies- such as documentary credits collateralised by the underlying shipments	20
iv)	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the bank.	100
v)	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain draw down	100
vi)	Note issuance facilities and revolving underwriting facilities	50
vii)	Other commitments (e.g. formal standby facilities and credit lines) with an original maturity of over one year.	50
viii)	Similar commitments with an original maturity up to one year, or which can be unconditionally cancelled at any time.	0

SSI Advances Guaranteed by Credit Guarantee Fund Trust for Small Industries (CGTSI) – Risk weights and Provisioning norms (paragraph I (A)(III)(9) of Annex 10)

Risk-Weight

Example I

CGTSI Cover : 75% of the amount outstanding or 75% of the unsecured amount or Rs.18.75 lakh , whichever is less

Realisable value of Security	: Rs.1.50 lakh	
a) Balance outstanding	: Rs. 10.00 lakh	
b) Realisable value of security	: Rs. 1.50 lakh	
c) Unsecured amount (a) - (b)	: Rs 8.50 lakh	
d) Guaranteed portion (75% of (c))	: Rs. 6.38 lakh	
e) Uncovered portion (8.50 lakh – 6.38 lakh)	: Rs. 2.12 lakh	
Risk-weight on (b) and (e)	– Linked to the counter party	
Risk-weight on (d)	– Zero	

Example II

CGTSI cover : 75% of the amount outstanding or 75% of the unsecured amount or Rs.18.75 lakh whichever is less

Realisable value of Security	: Rs. 10.00 lakh.	
a) Balance outstanding	: Rs. 40.00 lakh	
b) Realisable value of security	: Rs. 10.00 lakh	
c) Unsecured amount (a) - (b)	: Rs. 30.00 lakh	
d) Guaranteed portion (max.)	: Rs. 18.75 lakh	
e) Uncovered portion (Rs.30 lakh-18.75 lakh)	: Rs. 11.25 lakh	
Risk-weight (b) and (e)	- Linked to the counter party	
Risk-weight on (d)	- Zero	

ANNEX 10.2**Terms and conditions for the purpose of liberal Risk Weight for Capital Adequacy for investments in Mortgage Backed Securities (MBS) of residential assets of Housing Finance Companies (HFC).**

(Vide item (I)(A)(II)(12) of Annex 10)

1(a) The right, title and interest of a HFC in securitised housing loans and receivables thereunder should irrevocably be assigned in favour of a Special Purpose Vehicle (SPV) / Trust.

1(b) Mortgaged securities underlying the securitised housing loans should be held exclusively on behalf of and for the benefit of the investors by the SPV/Trust.

1(c) The SPV or Trust should be entitled to the receivables under the securitised loans with an arrangement for distribution of the same to the investors as per the terms of issue of MBS. Such an arrangement may provide for appointment of the originating HFC as the servicing and paying agent. However, the originating HFC participating in a securitisation transaction as a seller, manager, servicer or provider of credit enhancement or liquidity facilities :

- i. shall not own any share capital in the SPV or be the beneficiary of the trust used as a vehicle for the purchase and securitisation of assets. Share capital for this purpose shall include all classes of common and preferred share capital;
- ii. shall not name the SPV in such manner as to imply any connection with the bank;
- iii. shall not have any directors, officers or employees on the board of the SPV unless the board is made up of at least three members and where there is a majority of independent directors. In addition, the official(s) representing the bank will not have veto powers;
- iv. shall not directly or indirectly control the SPV; or
- v. shall not support any losses arising from the securitisation transaction or by investors involved in it or bear any of the recurring expenses of the transaction.

1(d) The loans to be securitised should be loans advanced to individuals for acquiring/constructing residential houses which should have been mortgaged to the HFC by way of exclusive first charge.

1(e) The loans to be securitised should be accorded an investment grade credit rating by any of the credit rating agencies at the time of assignment to the SPV.

1(f) The investors should be entitled to call upon the issuer - SPV - to take steps for recovery in the event of default and distribute the net proceeds to the investors as per the terms of issue of MBS.

1(g) The SPV undertaking the issue of MBS should not be engaged in any business other than the business of issue and administration of MBS of individual housing loans.

1(h) The SPV or Trustees appointed to manage the issue of MBS should have to be governed by the provisions of Indian Trusts Act, 1882.

2. If the issue of MBS is in accordance with the terms and conditions stated in paragraph 1 above and includes irrevocable transfer of risk and reward of the housing loan assets to the Special Purpose Vehicle (SPV)/Trust, investment in such MBS by any bank would not be reckoned as an exposure on the HFC originating the securitised housing loan. However, it would be treated as an exposure on the underlying assets of the SPV / Trust.

ANNEX 10.3**Conditions for availing concessional risk weight on investment in securitised paper pertaining to an infrastructure facility (*Vide item (I)(A)(II)(13) of Annex 10*)**

1. The infrastructure facility should satisfy the conditions stipulated in our circular DBOD. No. BP. BC. 92/21.04.048/ 2002- 2003 dated June 16, 2004.
2. The infrastructure facility should be generating income/ cash flows which would ensure servicing/ repayment of the securitised paper.
3. The securitised paper should be rated at least 'AAA' by the rating agencies and the rating should be current and valid. The rating relied upon will be deemed to be current and valid if :

The rating is not more than one month old on the date of opening of the issue, and the rating rationale from the rating agency is not more than one year old on the date of opening of the issue, and the rating letter and the rating rationale is a part of the offer document.

In the case of secondary market acquisition, the 'AAA' rating of the issue should be in force and confirmed from the monthly bulletin published by the respective rating agency.

The securitised paper should be a performing asset on the books of the investing/ lending institution.

Conditions for availing concessional risk weight for Advances covered by Insurance cover under Business Credit Shield the product of New India Assurance Company Ltd. (Vide item (I)(A)(III)(10) of Annex10)

New India Assurance Company Limited (NIA) should comply with the provisions of the Insurance Act, 1938, the Regulations made thereunder - especially those relating to Reserves for unexpired risks and the Insurance Regulatory and Development Authority (Assets, Liabilities and Solvency Margin of Insurers) Regulations, 2000 and any other conditions/regulations that may be prescribed by IRDA in future, if their insurance product - Business Credit Shield (BCS) - is to qualify for the above treatment.

2. To be eligible for the above regulatory treatment in respect of export credit covered by BCS policy of **NIA, banks should ensure that:**

The BCS policy is assigned in its favour, and

NIA abides by the provisions of the Insurance Act, 1938 and the regulations made there under, especially those relating to Reserves for unexpired risks and the Insurance Regulatory and Development Authority (Assets, Liabilities and Solvency Margin of Insurers) Regulations, 2000, and any other conditions/regulations that may be prescribed by IRDA in future.

3. Banks should maintain separate account(s) for the advances to exporters, which are covered by the insurance under the "Business Credit Shield" to enable easy administration/verification of risk weights/provisions.

Worked out examples for computing capital charge for credit and market risks

Example I- Case where the trading book does not contain equities and interest rate related derivative instruments

1. Assumptions:

1.1. A bank may have the following position:

Sl. No	Details	Amount Rs. Crore
1	Cash & Balances with RBI	200.00
2	Bank balances	200.00
3.	Investments	2000.00
	3.1 Held for Trading (Market Value)	500.00
	3.2 Available for Sale (Market Value)	1000.00
	3.3 Held to Maturity	500.00
4	Advances (net)	2000.00
5	Other Assets	300.00
6	Total Assets	4700.00

1.2. In terms of counter party, the investments are assumed to be as under:

Government	- Rs.1000 crore
Banks	- Rs. 500 crore
Others	- Rs. 500 crore

1.3. For simplicity sake the details of investments are assumed to be as under:

i) Government securities

Date of Issue	Date of reporting	Maturity Date	Amount Rs.in crore	Coupon (%)	Type
01/03/1992	31/03/2003	01/03/2004	100	12.50	AFS
01/05/1993	31/03/2003	01/05/2003	100	12.00	AFS
01/03/1994	31/03/2003	31/05/2003	100	12.00	AFS

Date of Issue	Date of reporting	Maturity Date	Amount Rs.in crore	Coupon (%)	Type
01/03/1995	31/03/2003	01/03/2015	100	12.00	AFS
01/03/1998	31/03/2003	01/03/2010	100	11.50	AFS
01/03/1999	31/03/2003	01/03/2009	100	11.00	AFS
01/03/2000	31/03/2003	01/03/2005	100	10.50	HFT
01/03/2001	31/03/2003	01/03/2006	100	10.00	HTM
01/03/2002	31/03/2003	01/03/2012	100	8.00	HTM
01/03/2003	31/03/2003	01/03/2023	100	6.50	HTM
Total			1000		

i) **Bank Bonds**

Date of Issue	Date of reporting	Maturity Date	Amount Rs. in crore	Coupon (%)	Type
01/03/1992	31/03/2003	01/03/2004	100	12.50	AFS
01/05/1993	31/03/2003	01/05/2003	100	12.00	AFS
01/03/1994	31/03/2003	31/05/2003	100	12.00	AFS
01/03/1995	31/03/2003	01/03/2006	100	12.50	AFS
01/03/1998	31/03/2003	01/03/2007	100	11.50	HFT
Total			500		

ii) **Other securities**

Date of Issue	Date of reporting	Maturity Date	Amount Rs. in crore	Coupon (%)	Type
01/03/1992	31/03/2003	01/03/2004	100	12.50	HFT
01/05/1993	31/03/2003	01/05/2003	100	12.00	HFT
01/03/1994	31/03/2003	31/05/2003	100	12.00	HFT
01/03/1995	31/03/2003	01/03/2006	100	12.50	HTM
01/03/1998	31/03/2003	01/03/2017	100	11.50	HTM
Total			500		

iv) Overall position

	Break-up of total investments (Rs. in crore)			
	Government Securities	Bank bonds	Other securities	Total
HFT	100	100	300	500
AFS	600	400	0	1000
Trading Book	700	500	300	1500
HTM	300	0	200	500
Total	1000	500	500	2000

2. Computation of risk weighted assets

2.1. Risk weighted assets for credit risk

As per the guidelines, Held for Trading and Available for Sale securities would qualify to be categorized as Trading Book. Thus, trading book in the instant case would be Rs.1500 crore as indicated above. While computing the credit risk, the securities held under trading book would be excluded and hence the risk-weighted assets for credit risks would be as under:

(Rs. in crore)

Sl.No.	Details of Assets	Market Value*	Risk Weight (%)	Risk weighted Assets
1	Cash & balances with RBI	200	0	0
2	Bank balances	200	20	40
3	Investments:			
	Government	300	0	0
	Banks	0	20	0
	Others	200	100	200
4	Advances (net)	2000	100	2000
5	Other Assets	300	100	300
6	Total Assets	3200		2540

*Assumed as Market Value for illustration

2.2. Risk weighted assets for market risk (Trading Book)

(Please refer to table in para 1.3(iv))

a. Specific Risk

(i) Government securities: Rs.700 crore – Nil

(ii) Bank bonds:

(Amount in Crores of Rupees)

Details	Capital charge	Amount	Capital charge
For residual term to final maturity 6 months or less	0.30%	200	0.60
For residual term to final maturity between 6 and 24 months	1.125%	100	1.125
For residual term to final maturity exceeding 24 months	1.80%	200	3.60
Total		500	5.325

(iii) Other securities : Rs.300 crore @ 9% =Rs. 27 crore

Total charge for specific risk (i)+(ii)+(iii)

= Rs.0 crore+Rs.5.325 crore + Rs.27 crore = Rs. 32.325 crore

Therefore, capital charge for specific risk in trading book is Rs.32.33 crore.

b. General Market Risk

Modified duration is used to arrive at the price sensitivity of an interest rate related instrument. For all the securities listed below, date of reporting is taken as 31/3/2003.

(Amount in Crores of Rupees)

Counter Party	Maturity Date	Amount (market value)	Coupon (%)	Capital Charge for general market risk
Govt.	01/03/2004	100	12.50	0.84
Govt.	01/05/2003	100	12.00	0.08
Govt.	31/05/2003	100	12.00	0.16
Govt.	01/03/2015	100	12.50	3.63

Counter Party	Maturity Date	Amount (market value)	Coupon (%)	Capital Charge for market risk
Govt.	01/03/2010	100	11.50	2.79
Govt.	01/03/2009	100	11.00	2.75
Govt.	01/03/2005	100	10.50	1.35
Banks	01/03/2004	100	12.50	0.84
Banks	01/05/2003	100	12.00	0.08
Banks	31/05/2003	100	12.00	0.16
Banks	01/03/2006	100	12.50	1.77
Banks	01/03/2007	100	11.50	2.29
Others	01/03/2004	100	12.50	0.84
Others	01/05/2003	100	12.00	0.08
Others	31/05/2003	100	12.00	0.16
	Total	1500		17.82

c. Total charge for market risk

Adding the capital charges for specific risk as well as general market risk would give the total capital charge for the trading book of interest rate related instruments. Therefore, capital charge for Market Risks = Rs.32.33 crore + Rs.17.82 crore, i.e., Rs.50.15 crore.

d. To facilitate computation of CRAR for the whole book, this capital charge needs to be converted into equivalent risk weighted assets. In India, the minimum CRAR is 9%. Hence, the capital charge could be converted to risk weighted assets by multiplying the capital charge by $(100 \div 9)$, Thus risk weighted assets for market risk is $50.15 \times (100 \div 9) = \text{Rs.}557.23$ crore.

2.3 Computing the capital ratio

(Amount in Crores of Rupees)

1	Total Capital	400
2	Risk weighted assets for Credit Risk	2540.00
3	Risk weighted assets for Market Risk	557.23
4	Total Risk weighted assets (2+3)	3097.23
5	CRAR $[(1 \div 4) \times 100]$	12.91 %

Example 2- indicating computation of capital charge for credit and market risks – with equities and interest rate related derivative instruments. Foreign exchange and gold open positions also have been assumed.

Assumptions

A bank may have the following position:

Sl. No	Details	Rs. in Crore
1	Cash & Balances with	200.00
2	Bank balances	200.00
3	Investments	
	3.1 Interest Rate related Securities	
	Held for Trading	500.00
	Available for Sale	1000.00
	Held to Maturity	500.00
	3.2 Equities	300.00
4	Advances (net)	2000.00
5	Other Assets	300.00
6	Total Assets	5000.00

foreign exchange open position limit is assumed as Rs.60 crore and Gold open position is assumed at Rs.40 crore.

Let us also assume that the bank is having the following positions in interest rate related derivatives:

- (i) Interest Rate Swaps (IRS), Rs.100 crore – bank received floating rate interest and pays fixed, next interest fixing after 6 months, residual life of swap 8 years, and
- (ii) Long position in interest rate future (IRF), Rs.50 crore, delivery after 6 months, life of underlying government security 3.5 years.

In terms of counter party the investments are assumed to be as under:

a) Interest rate related securities	
Government	Rs.1000 crore
Banks	Rs. 500 crore
Corporate Bonds	Rs. 500 crore
b) Equities	
Others	Rs.300 crore

For interest rate swaps and interest rate futures the counterparties are assumed to be corporates.

For simplicity sake let us assume the details of investments in interest rate related securities as under:

i) Government securities

Date of Issue	Date of reporting	Maturity Date	Amount Rs.crore	Coupon (%)	Type
01/03/1992	31/03/2003	01/03/2004	100	12.50	AFS
01/05/1993	31/03/2003	01/05/2003	100	12.00	AFS
01/03/1994	31/03/2003	31/05/2003	100	12.00	AFS
01/03/1995	31/03/2003	01/03/2015	100	12.50	AFS
01/03/1998	31/03/2003	01/03/2010	100	11.50	AFS
01/03/1999	31/03/2003	01/03/2009	100	11.00	AFS
01/03/2000	31/03/2003	01/03/2005	100	10.50	HFT
01/03/2001	31/03/2003	01/03/2006	100	10.00	HTM
01/03/2002	31/03/2003	01/03/2012	100	8.00	HTM
01/03/2003	31/03/2003	01/03/2023	100	6.50	HTM
Total			1000		

ii) Bank Bonds

Date of Issue	Date of reporting	Maturity Date	Amount Rs.crore	Coupon (%)	Type
01/03/1992	31/03/2003	01/03/2004	100	12.50	AFS

01/05/1993	31/03/2003	01/05/2003	100	12.00	AFS
01/03/1994	31/03/2003	31/05/2003	100	12.00	AFS
01/03/1995	31/03/2003	01/03/2006	100	12.50	AFS
01/03/1998	31/03/2003	01/03/2007	100	11.50	HFT
Total			500		

iii) Other securities

Date of Issue	Date of reporting	Maturity Date	Amount Rs.crore	Coupon (%)	Type
01/03/1992	31/03/2003	01/03/2004	100	12.50	HFT
01/05/1993	31/03/2003	01/05/2003	100	12.00	HFT
01/03/1994	31/03/2003	31/05/2003	100	12.00	HFT
01/03/1995	31/03/2003	01/03/2006	100	12.50	HTM
01/03/1998	31/03/2003	01/03/2017	100	11.50	HTM
Total			500		

iii) Overall Position

	Break-up of total investments					
	Interest rate related instruments				Equity	
	Govt. Securities	Bank bonds	Other securities	Total		Grand Total
HFT	100	100	300	500	300	800
AFS	600	400	0	1000	0	1000
Trading Book	700	500	300	1500	300	1800
HTM	300	0	200	500	0	500
Grand Total	1000	500	500	2000	300	2300

2. Computation of risk weighted assets

2.1 Risk weighted assets for credit risk

As per the guidelines, held for trading and available for sale securities would qualify to be categorized as Trading Book. Thus trading book in respect of interest rate related investments in the instant case would be Rs.1500 crore. In addition, equities position of Rs.300 crore would be in the trading book, as indicated above.

The derivative products held by banks are to be considered as part of trading book. Open position on foreign exchange and gold also would be considered for market risk. While computing the capital charge for credit risk, the securities held under trading book would be excluded and hence the credit risk based risk-weights would be as under:

(Amount in Crores of Rupees)

Details of Assets	Book Value	Risk Weight	Risk weighted Assets
Cash& RBI	200	0%	0
Bank balances	200	20%	40
Investments in (HTM category)			
Government	300	0%	0
Banks	0	20%	0
Corporate Bonds	200	100%	200
Advances (net)	2000	100%	2000
Other Assets	300	100%	300
Total	3200		2540
Credit Risk for OTC Derivatives:			
IRS	100 (Credit conversion factor - 1% + 1% per year)	100%	8.00
IRF	50 (Credit conversion factor for maturities less than one year – 0.5%)	100%	0.25
Total	3350		2548.25

2.2 Risk weighted assets for market risk (Trading Book)

(please refer to table in para 1.7(iv))

a. Specific Risk

1. Investments in interest rate related instruments:

(i) Government securities – Rs.700 crore – Nil

(ii) Bank bonds

(Amount in Crores of Rupees)

Details	Capital charge	Amount	Capital Charge
For residual term to final maturity 6 months or less	0.30%	200	0.600
For residual term to final maturity between 6 and 24 months	1.125%	100	1.125
For residual term to final maturity exceeding 24 months	1.80%	200	3.600
Total		500	5.325

(iii) Others Rs.300 crore @ 9% = Rs.27 crore

Total : (i)+(ii)+(iii)

= Rs.0 crore+Rs.5.325 crore+Rs.27 crore = Rs.32.325 crore

2. Equities – capital charge of 9% = Rs.27 crore

Total specific charge (1+2)

Therefore, capital charge for specific risk in the trading book is Rs. 59.33 crore (Rs. 32.33 crore + Rs. 27 crore).

b. General Market Risk

(1). Investments in interest rate related instruments:

Modified duration is used to arrive at the price sensitivity of an interest rate related instrument. For all the securities listed below, date of reporting is taken as 31/3/2003.

(Amount in Crores of Rupees)

Counter Party	Maturity Date	Amount market value	Coupon (%)	Capital charge for general market risk
Govt.	01/03/2004	100	12.50	0.84
Govt.	01/05/2003	100	12.00	0.08
Govt.	31/05/2003	100	12.00	0.16
Govt.	01/03/2015	100	12.50	3.63

Govt.	01/03/2010	100	11.50	2.79
Govt.	01/03/2009	100	11.00	2.75
Govt.	01/03/2005	100	10.50	1.35
Banks	01/03/2004	100	12.50	0.84
Banks	01/05/2003	100	12.00	0.08
Banks	31/05/2003	100	12.00	0.16
Banks	01/03/2006	100	12.50	1.77
Banks	01/03/2007	100	11.50	2.29
Others	01/03/2004	100	12.50	0.84
Others	01/05/2003	100	12.00	0.08
Others	31/05/2003	100	12.00	0.16
	Total	1500		17.82

(2) Positions in interest rate related derivatives

Interest rate swap

Counter Party	Maturity Date	Notional Amount (i.e., market value)	Modified duration or price sensitivity	Assumed change in yield (ACI)	Capital charge*
GOI	30/09/2003	100	0.47	1.00	0.47
GOI	31/03/2011	100	5.14	0.60	(-) 3.08
					(-) 2.61

Interest rate future

Counter Party	Maturity Date	Notional Amount (i.e., market value)	Modified duration or price sensitivity	Assumed change in yield	Capital charge
GOI	30/09/2003	50	0.45	1.00	(-) 0.225
GOI	31/03/2007	50	2.84	0.75	1.070
					0.840

(3) Disallowances

The price sensitivities calculated as above have been slotted into a duration-based ladder with fifteen time-bands as shown in table at the end of the Annexure. Long and short positions within a time band have been subjected to vertical disallowance of 5%. In the instant case, vertical disallowance is applicable under 3-6 month time band and 7.3-

9.3 year time band. Then, net positions in each time band have been computed for horizontal offsetting subject to the disallowances mentioned in the table. In the instant case, horizontal disallowance is applicable only in respect of Zone 3. Horizontal disallowances in respect of adjacent zones are not applicable in the instant case.

3.1 Calculation of Vertical Disallowance

While calculating capital charge for general market risk on interest rate related instruments, banks should recognize the basis risk (different types of instruments whose price responds differently for movement in general rates) and gap risk (different maturities within timebands). This is addressed by a small capital charge (5%) on matched (off-setting) positions in each time band (“Vertical Disallowance”)

An off-setting position, for vertical disallowance, will be the either the sum of long positions and or the short positions within a time band, whichever is lower. In the table at the end of the annex, except for the time band 3-6 months in Zone 1 and the time band of 7.3-9.3 years, where there are off-setting positions of (-) 0.22 and 2.79, there is no off-setting position in any other time band. The sum of long positions in the 3-6 months time band is + 0.47 and the sum of short positions in this time band is (-) 0.22. This off-setting position of 0.22 is subjected to a capital charge of 5% i.e. 0.01. The sum of long positions in the 7.3-9.3 years time band is + 2.79 and the sum of short positions in this time band is (-) 3.08. This off-setting position of 2.79 is subjected to a capital charge of 5% i.e. 0.1395. It may be mentioned here that if a bank does not have both long and short positions in the same time band, there is no need for any vertical disallowance. Banks in India are not allowed to take any short position in their books, except in derivatives. Therefore, banks in India will generally not be subject to vertical disallowance unless they have a short position in derivatives.

3.2. Calculation of Horizontal Disallowance

While calculating capital charge for general market risk on interest rate related instruments, banks must subject their positions to a second round of off-setting across time bands with a view to give recognition to the fact that interest rate movements are not perfectly correlated across maturity bands (yield curve risk and spread risk) i.e matched long and short positions in different time bands may not perfectly off-set. This is achieved by a “Horizontal Disallowance”.

An off-setting position, for horizontal disallowance, will be the either the sum of long positions and or the short positions within a Zone, whichever is lower. In the above example, except in Zone 3 (7.3 to 9.3 years) where there is an off-setting (matched) position of (-) 0.29, there is no off-setting position in any other Zone. The sum of long positions in this Zone is 9.74 and the sum of short positions in this Zone is (-) 0.29. This off-setting position of 0.29 is subject to horizontal disallowance as under:

With in the same Zone (Zone 3) 30% of 0.29	= 0.09
Between adjacent Zones (Zone 2 & 3)	= Nil
Between Zones 1 and Zone 3	= Nil

It may be mentioned here that if a bank does not have both long and short positions in different time zones, there is no need for any horizontal disallowance. Banks in India are not allowed to take any short position in their books except in derivatives. Therefore, banks in India will generally not be subject to horizontal disallowance unless they have short positions in derivatives.

Total capital charge for interest rate related instruments is shown below

For overall net position	16.06
For vertical disallowance	0.15
For horizontal disallowance in Zone 3	0.09
For horizontal disallowance in adjacent zones	nil
For horizontal disallowance between Zone 1 & 3	Nil
Total capital charge for interest rate related instruments	16.30

(4) The total capital charge in this example for general market risk for interest rate related instruments is computed as under:

Sl.No	Capital charge	Amount (Rs.)
1	For the vertical disallowance (under 3-6 month time band)	1,12,500
2	For the vertical disallowance (under 7.3-9.3 year time band)	13,95,000
3	For the horizontal disallowance (under Zone 3)	9,00,000

4	For the horizontal disallowances between adjacent zones	0
5	For the overall net open position (17.82 – 2.61 + 0.84)	16,06,00,000
6	Total capital charge for general market risk on interest rate related instruments (1 + 2 + 3 + 4 + 5)	16,30,07,500

(5) Equities

Capital charge for General Market Risk for equities is 9%. Thus, general market risk capital charge on equities would work out to Rs.27 crore.

(6) Forex / Gold Open Position

Capital charge on forex/gold position would be computed at 9%. Thus the same works out to Rs.9 crore

(7) Capital charge for market risks in this example is computed as under:

(Amount in Crores of Rupees)

Details	Capital charge for Specific Risk	Capital charge for General Market Risk	Total
Interest Rate Related instruments	32.33	16.30	48.63
Equities	27.00	27.00	54.00
Forex/Gold	-	9.00	9.00
Total	59.33	52.30	111.63

2.3 Computing Capital Ratio

To facilitate computation of CRAR for the whole book, this capital charge for market risks in the Trading Book needs to be converted into equivalent risk weighted assets. As in India, a CRAR of 9% is required, the capital charge could be converted to risk weighted assets by multiplying the capital charge by $(100 \div 9)$, i.e. Rs. 111.63*(100 ÷ 9) = Rs. 1240.33 crore. Therefore, risk weighted assets for market risk is : Rs. 1240.33 crore.

(Amount in Crores of Rupees)

1	Total Capital	400.00
2	Risk weighted assets for Credit Risk	2548.25
3	Risk weighted assets for Market Risk	1240.33
4	Total Risk weighted assets (2+3)	

		3788.58
5	CRAR [(1÷4)*100]	10.56 %

The reporting format for the purpose of monitoring the capital ratio is given in Annex 12

[illegible]

Reporting Formats

Reporting format for the purpose of monitoring the capital ratio is given hereunder:

Name of bank: _____ Position as on: _____

A. Capital Base

(Amount in Crores of Rupees)

Sl. No.	Details	Amount
A1.	Tier I Capital	
A2.	Tier II Capital	
A3.	Total Regulatory Capital	

B. Risk Weighted Assets

B1.	Risk Weighted Assets on Banking Book			
	a) On-balance sheet assets			
	b) Contingent Credits			
	c) Forex contracts			
	d) Other off-balance sheet items			
	Total			
B2.	Risk Weighted Assets on Trading Book	AFS	Other trading book exposures	Total
	a) Capital charge on account of Specific Risk			
	i) On interest rate related instruments			
	ii) On Equities			
	Sub-total			
	b) Capital charge on account of general market risk			
	i) On interest rate related instruments			
	ii) On Equities			
	iii) On Foreign Exchange and gold open positions			
	Sub-total			
	Total Capital Charge on Trading Book			
	Total Risk weighted Assets on Trading Book (total capital charge on trading book * (100/9))			

B3.	Total Risk Weighted Assets (B1 + B2)	

C. Capital Ratio

C1	Capital to Risk-weighted Assets Ratio (CRAR) (A3/B3*100)	

D. Memo items

D1	Investment Fluctuation Reserve	
D2	Book value of securities held in HFT category	
D3	Book value of securities held in AFS category	
D4	Net unrealised gains in HFT category	
D5	Net unrealised gains in AFS category	

Banks should furnish data in the above format as on the last day of each calendar quarter to the Chief General Manager-in-Charge, Department of Banking Supervision, Central Office, World Trade Centre I, 3rd floor, Cuffe Parade, Mumbai 400 005 both in hard copy and soft copy. Soft copy in excel format may also be forwarded through e-mail to osmos@rbi.org.in and dbodmrg@rbi.org.in.

List of instructions and circulars consolidated
Part – A
List of Circulars

No.	Circular No.	Date	Subject
1	DBOD.No.BP.BC. 57 / 21.01.002 / 2005-2006	January 25, 2006	Enhancement of banks' capital raising options for capital adequacy purposes
2.	DBOD.NO.BP.BC.23/21.01.002/2002-03	29.8.2002	Capital Adequacy and Provisioning Requirements for Export Credit Covered by Insurance/Guarantee.
3.	DBOD. No. IBS. BC.65/ 23. 10.015 / 2001-02	14.02.2002	Subordinated debt for inclusion in Tier II capital – Head Office borrowings in foreign currency by Foreign Banks operating in India
4.	DBOD No. BP. BC. 106/21.01.002/2001- 02	24.05 2002	Risk Weight on Housing Finance and Mortgage Backed Securities
5.	DBOD.No.BP.BC.128/21.04.048/00-01	7.06.2001	SSI Advances Guaranteed by Credit Guarantee Fund Trust for Small Industries (CGTSI)
6.	DBOD.BP.BC.110/21.01.002/00-01	20.04.2001	Risk Weight on Deposits placed with SIDBI /NABARD in lieu of shortfall in lending to Priority Sectors
7.	DBOD.BP.BC.83/21.01.002/00-01	28.02.2001	Loans and advances to staff – assignment of risk weight and treatment in the balance sheet.
8.	DBOD.No.BP.BC.87/21.01.002/99	08.09.99	Capital Adequacy Ratio - Risk Weight on Banks' Investments in Bonds/Securities Issued by Financial Institutions
9.	DBOD.No.BP.BC.5/21.01.002/98-99	08.02.99	Issue of Subordinated Debt for Raising Tier II Capital
10.	DBOD.No.BP.BC.119/21.01.002/ 98	28.12.98	Monetary & Credit Policy Measures - Capital Adequacy Ratio - Risk Weight on Banks' Investments in Bonds/Securities Issued by Financial Institutions

No.	Circular No.	Date	Subject
11.	DBOD.No.BP.BC.152/21.01.002/ 96	27.11.96	Capital Adequacy Measures
12.	DBOD.No.IBS.BC.64/23.61.001/ 96	24.05.96	Capital Adequacy Measures
13.	DBOD.No.BP.BC.13/21.01.002/96	08.02.96	Capital Adequacy Measures
14.	DBOD.No.BP.BC.99/21.01.002/94	24.08.94	Capital Adequacy Measures
15.	DBOD.No.BP.BC.9/21.01.002/94	08.02.94	Capital Adequacy Measures
16.	DBOD.No.IBS.BC.98/23-50-001-92/93	06.04.93	Capital Adequacy Measures - Treatment of Foreign Currency Loans to Indian Parties (DFF)
17.	DBOD.No.BP.BC.117/21.01.002-92	22.04.92	Capital Adequacy Measures
18	DBOD.No.BP.BC.23/21.01.002/2006-2007	July 21, 2006	Enhancement of banks' capital raising options for capital adequacy purposes

Part – B
List of Other Circulars containing Instructions/ Guidelines /Directives related to Prudential Norms

No.	Circular No.	Date	Subject
1	DBOD.BP.BC.105/21.01.002/2002-2003,	7.05.2003	Monetary And Credit Policy 2003-04 - Investment Fluctuation Reserve
2	DBOD.No.BP.BC.96/21.04.048/2002-03	23.4.2003	Guidelines on Sale Of Financial Assets to Securitisation Company (SC)/Reconstruction Company (RC) (Created Under The Securitisation and Reconstruction of Financial Assets And Enforcement of Security Interest Act, 2002) and Related Issues.
3	DBOD No. BP.BC. 89/21.04.018/2002-03	29.3.2003	Guidelines on compliance with Accounting Standards (AS) by banks
4	DBOD.No.BP.BC.72/21.04.018/2002-03	25.2.2003	Guidelines for Consolidated Accounting And Other Quantitative Methods to Facilitate Consolidated Supervision.
5	DBOD NO. BP.BC 71/21.04.103/2002-03	19.2.2003	Risk Management system in Banks Guidelines in Country Risk Managements
6	DBOD.No.BP.BC. 67/21.04.048/2002-2003	4.2.2003	Guidelines on Infrastructure Financing.
7	DBOD.Dir.BC. 62/13.07.09/2002-03	24.1.2003	Discounting/ Rediscounting of Bills by Banks.
8	A.P.(DIR Series) Circular No. 63	21.12.2002	Risk Management and Inter Bank Dealings
9	No.EC.CO.FMD.6/02.03.75/2002-2003	20.11.2002	Hedging of Tier I Capital
10	DBOD.No.BP.BC. 57/ 21.04.048/2001-02	10.01.2002	Valuation of investments by banks
11	DBOD.No.BC.34/12.01.001/2001-02	22.10.2001	Section 42(1) Of The Reserve Bank Of India Act, 1934 - Maintenance of Cash Reserve Ratio (CRR).
12	DBOD.BP.BC. 73/21.04.018/2000-01	30.01.2001	Voluntary Retirement Scheme (VRS) Expenditure – Accounting and Prudential Regulatory Treatment.
13	DBOD.No.BP.BC.31/21.04.048/ 2000	10.10.2000	Monetary & Credit Policy Measures – Mid term review for the year 2000-01
14	DBOD.No.BP.BC.169/21.01.002/ 2000	03.05.2000	Monetary & Credit Policy Measures

No.	Circular No.	Date	Subject
15	DBOD.No.BP.BC.144/21.04.048/ 2000	29.02.2000	Income Recognition, Asset Classification and Provisioning and Other Related Matters and Adequacy Standards - Takeout Finance
16	DBOD.No.BP.BC.121/21.04.124/ 99	03.11.99	Monetary & Credit Policy Measures
17	DBOD.No.BP.BC.101/21.04.048/ 99	18.10.99	Income Recognition, Asset Classification and Provisioning – Valuation of Investments by Banks in Subsidiaries.
18	DBOD.No.BP.BC.82/ 21.01.002/99	18.08.99	Monetary & Credit Policy Measures
19	FSC.BC.70/24.01.001 /99	17.7.1999	Equipment Leasing Activity - Accounting / Provisioning Norms
20	MPD.BC.187/07.01.279/1999-2001	7.7.1999	Forward Rate Agreements / Interest Rate Swaps
21	DBOD.No.BP.BC.24/ 21.04.048/99	30.03.99	Prudential Norms - Capital Adequacy - Income Recognition, Asset Classification and Provisioning
22	DBOD.No.BP.BC.35/ 21.01.002/99	24.04.99	Monetary & Credit Policy Measures
23	DBOD.No.BP.BC.103/21.01.002/ 98	31.10.98	Monetary & Credit Policy Measures
24	DBOD.No.BP.BC.32/ 21.04.018/98	29.04.98	Monetary and Credit Policy Measures
25	DBOD.No.BP.BC.9/21.04.018/98	27.01.1998	Balance Sheet of Bank - Disclosures
26	DBOD.No.BP.BC.9/21.04.048/97	29.01.97	Prudential Norms - Capital Adequacy, Income Recognition, Asset Classification and Provisioning
27	DBOD. BP. BC. No. 3/21.01.002/2004-05	06.07.04	Prudential norms on Capital Adequacy –Cross holding of capital among banks/ financial institutions
28	DBOD.No.BP.BC. 103 / 21.04.151/ 2003-04	June 24, 2004	Guidelines on Capital Charge for Market risks
29	DBOD.No.BP.BC. 92 / 21.04.048/ 2003-04	June 16, 2004	Annual Policy Statement for the year 2004-05 – Guidelines on infrastructure financing

No.	Circular No.	Date	Subject
30	DBOD.No.BP.BC. 91/21.01.002/2003-04	June 15, 2004	Annual Policy Statement for the year 2004-05 – Risk Weight for Exposure to Public Financial Institutions (PFIs)
31	F.No.11/7/2003-BOA	6 th May 2004	Permission to nationalised banks to issue subordinated debt for augmenting Tier II capital
32	DBS.FID.No.C-15/01.02.00/2003-04	15 th June 2004	Risk Weight for Exposures to PFIs
33	DBOD.BP.BC.29/21.01.048/2004-05	13 th August 2004	Prudential Norms-State Govt. guaranteed exposures
34	DBOD. BP.BC. 61 / 21.01.002/2004-05	23 rd December 2004	Mid-Term Review of the Annual Policy Statement for the year 2004-05. Risk weight on housing loans and consumer credit
35	DBOD.No.BP.BC.85/21.04.141/2004-05	30 th April 2005	Capital Adequacy- IFR
36	DBOD.No.BP.BC.16/21.04.048/2005-06	July 13, 2005	Guidelines on purchase of Non-Performing Assets
37	DBOD.No.BP.BC.21/21.01.002/2005-06	July 26, 2005	Risk weight on Capital market Exposure
38	DBOD.No.BP.BC.38/21.04.141/2005-06	Oct 10, 2005	Capital Adequacy-IFR
39	DBOD.No.BP.BC.60/21.04.048/2005-06	February 1, 2006	Guidelines on Securitisation of Standard Assts
40	DBOD.No.BP.BC.73/21.04.048/2005-06	March 24, 2006	Bills Discounted under LC-Risk Weight and Exposure Norms
41	DBOD.No.BP.BC.84/21.01.002/2005-06	May 25, 2006	APS for 2006-07-Risk Weight on Exposures to Commercial Real estate and Venture Capital Funds
42	DBOD.BP.BC. 87 /21.01.002/2005-06	June 8, 2006	Innovative Tier I/Tier II Bonds - Hedging by banks through Derivative Structures
43	DBOD.NO.BP. BC. 89 / 21.04.048/2005-06	June 22, 2006	Prudential norms on creation and utilisation of floating provisions

No.	Circular No.	Date	Subject
44	DBOD.NO.BP. BC. 53 / 21.04.048/ 2006-07	January 31, 2007	Third Quarter Review of the Annual Policy Statement on Monetary Policy for the year 2006-07-Provisioning Requirement for Standard Assets and Risk Weights for Capital Adequacy
45	IDMD.NO. /11.01.01(B)/2006-07	January 31, 2007	Secondary Market Transactions in Govt. Securities - Short-selling
46	DBOD.NO.BP. BC. 92/ 21.01.002/ 2006-07	May 3, 2007	Annual Policy Statement for the year 2006-07: Risk Weight on residential housing loans
47	DBOD.No. BP. BC.42/21.01.002/2007-2008	October 29, 2007	Guidelines for Issuing Preference Shares as part of Regulatory Capital
48	DBOD.BP.BC.No.59/21.06.001/2007-08	January 17, 2008	Prudential Norms for Capital Adequacy - Risk Weight for Educational Loans
49	DBOD.No.BP.BC.83/21.06.001/2007-08	May 14, 2008	Claims Secured by Residential Property - Change in Limits for Risk Weights
50	DBOD.No.BP.BC.88/21.06.001/2007-08	May 30, 2008	Capital Adequacy Norms - Treatment of Banks' Investments in Subsidiaries / Associates and of the Subsidiaries' / Associates' Investments in Parent Banks

4. GLOSSARY

1.	Asset	An asset is anything of value that is owned by a person or business
	Available for Sale	The securities available for sale are those securities where the intention of the bank is neither to trade nor to hold till maturity. These securities are valued at the fair value which is determined by reference to the best available source of current market quotations or other data relative to current value.
	Balance Sheet	A balance sheet is a financial statement of the assets and liabilities of a trading concern, recorded at a particular point in time.
	Banking Book	The banking book comprises assets and liabilities, which are contracted basically on account of relationship or for steady income and statutory obligations and are generally held till maturity.
	Basel Capital Accord	The Basel Capital Accord is an Agreement concluded among country representatives in 1988 to develop standardised risk-based capital requirements for banks across countries. The Accord was replaced with a new capital adequacy framework (Basel II), published in June 2004. Basel II is based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face. These three pillars are: ■ minimum capital requirements, which seek to refine the present measurement framework

		- supervisory review of an institution's capital adequacy and internal assessment process; - market discipline through effective disclosure to encourage safe and sound banking practices
	Basel Committee on Banking Supervision	The Basel Committee is a committee of bank supervisors consisting of members from each of the G10 countries. The Committee is a forum for discussion on the handling of specific supervisory problems. It coordinates the sharing of supervisory responsibilities among national authorities in respect of banks' foreign establishments with the aim of ensuring effective supervision of banks' activities worldwide.
	Basic Indicator Approach	An operational risk measurement technique permitted under Basel II. The approach sets a charge for operational risk as a fixed percentage ("alpha factor") of a single indicator. The indicator serves as a proxy for the bank's risk exposure.
	Basis Risk	The risk that the interest rate of different assets, liabilities and off-balance sheet items may change in different magnitude is termed as basis risk.
	Capital	Capital refers to the funds (e.g., money, loans, equity) which are available to carry on a business, make an investment, and generate future revenue. Capital also refers to physical assets which can be used to generate future returns.
	Capital adequacy	A measure of the adequacy of an entity's capital resources in relation to its current liabilities and also in relation to the risks

		associated with its assets. An appropriate level of capital adequacy ensures that the entity has sufficient capital to support its activities and that its net worth is sufficient to absorb adverse changes in the value of its assets without becoming insolvent. For example, under BIS (Bank for International Settlements) rules, banks are required to maintain a certain level of capital against their risk-adjusted assets.
	Capital reserves	That portion of a company's profits not paid out as dividends to shareholders. They are also known as undistributable reserves.
	Convertible Bond	A bond giving the investor the option to convert the bond into equity at a fixed conversion price or as per a pre-determined pricing formula.
	Core Capital	Tier 1 capital is generally referred to as Core Capital
	Credit risk	Risk that a party to a contractual agreement or transaction will be unable to meet their obligations or will default on commitments. Credit risk can be associated with almost any transaction or instrument such as swaps, repos, CDs, foreign exchange transactions, etc. Specific types of credit risk include sovereign risk, country risk, legal or force majeure risk, marginal risk and settlement risk.
	Debentures	Bonds issued by a company bearing a fixed rate of interest usually payable half yearly on specific dates and principal amount repayable on a particular date on redemption of the debentures.

	Deferred Tax Assets	Unabsorbed depreciation and carry forward of losses which can be set-off against future taxable income which is considered as timing differences result in deferred tax assets. The deferred Tax Assets are accounted as per the Accounting Standard 22. Deferred Tax Assets have an effect of decreasing future income tax payments, which indicates that they are prepaid income taxes and meet definition of assets. Whereas deferred tax liabilities have an effect of increasing future year's income tax payments, which indicates that they are accrued income taxes and meet definition of liabilities
	Derivative	A derivative instrument derives much of its value from an underlying product. Examples of derivatives include futures, options, forwards and swaps. For example, a forward contract can be derived from the spot currency market and the spot markets for borrowing and lending. In the past, derivative instruments tended to be restricted only to those products which could be derived from spot markets. However, today the term seems to be used for any product that can be derived from any other.
	Duration	Duration (Macaulay duration) measures the price volatility of fixed income securities. It is often used in the comparison of the interest rate risk between securities with different coupons and different maturities. It is the weighted average of the present value of all the cash flows associated with a fixed income security. It is expressed in years. The duration of a fixed income security is always shorter

		than its term to maturity, except in the case of zero coupon securities where they are the same.
	Foreign Institutional Investor	An institution established or incorporated outside India which proposes to make investment in India in securities; provided that a domestic asset management company or domestic portfolio manager who manages funds raised or collected or brought from outside India for investment in India on behalf of a sub-account, shall be deemed to be a Foreign Institutional Investor.
	Forward Contract	A forward contract is an agreement between two parties to buy or sell an agreed amount of a commodity or financial instrument at an agreed price, for delivery on an agreed future date. In contrast to a futures contract, a forward contract is not transferable or exchange tradable, its terms are not standardized and no margin is exchanged. The buyer of the forward contract is said to be long the contract and the seller is said to be short the contract.
	General provisions and loss reserves	Such reserves, if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, can be included in Tier II capital
	General risk	Risk that relates to overall market conditions while specific risk is risk that relates to the issuer of a particular security
	Hedging	Taking action to eliminate or reduce exposure to risk

	Held for Trading	Securities where the intention is to trade by taking advantage of short-term price / interest rate movements.
	Horizontal Disallowance	A disallowance of offsets to required capital used the BIS Method for assessing market risk for regulatory capital. In order to calculate the capital required for interest rate risk of a trading portfolio, the BIS Method allows offsets of long and short positions. Yet interest rate risk of instruments at different horizontal points of the yield curve are not perfectly correlated. Hence, the BIS Method requires that a portion of these offsets be disallowed.
	Hybrid debt capital instruments	In this category, fall a number of capital instruments, which combine certain characteristics of equity and certain characteristics of debt. Each has a particular feature, which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital.
	Interest rate risk	Risk that the financial value of assets or liabilities (or inflows/outflows) will be altered because of fluctuations in interest rates. For example, the risk that future investment may have to be made at lower rates and future borrowings at higher rates.
	Long Position	A long position refers to a position where gains arise from a rise in the value of the underlying.
	Market risk	Risk of loss arising from movements in market prices or rates away from the rates or prices set out in a transaction or agreement.
	Modified Duration	The modified duration or volatility of an interest

		bearing security is its Macaulay duration divided by one plus the coupon rate of the security. It represents the percentage change in a securities' price for a 100 basis points change in yield. It is generally accurate for only small changes in the yield. $MD = -\frac{dP}{dY} \cdot \frac{1}{P}$ where: MD = Modified duration. P = Gross price (i.e. clean price plus accrued interest). dP = Corresponding small change in price. dY = Small change in yield compounded with the frequency of the coupon payment.
	Mortgage-backed security	A bond-type security in which the collateral is provided by a pool of mortgages. Income from the underlying mortgages is used to meet interest and principal repayments.
	Mutual Fund	Mutual Fund is a mechanism for pooling the resources by issuing units to the investors and investing funds in securities in accordance with objectives as disclosed in offer document. A fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments.
	Net Interest Margin	Net interest margin is the net interest income divided by average interest earning assets
	Net NPA	Net NPA = Gross NPA – (Balance in Interest Suspense account + DICGC/ECGC claims received and held pending adjustment + Part payment received and kept in suspense account + Total provisions held)'

	Nostro accounts	Foreign currency settlement accounts that a bank maintains with its overseas correspondent banks. These accounts are assets of the domestic bank.
	Off-Balance Sheet exposures	Off-Balance Sheet exposures refer to the business activities of a bank that generally do not involve booking assets (loans) and taking deposits. Off-balance sheet activities normally generate fees, but produce liabilities or assets that are deferred or contingent and thus, do not appear on the institution's balance sheet until or unless they become actual assets or liabilities.
	Open position	It is the net difference between the amounts payable and amounts receivable in a particular instrument or commodity. It results from the existence of a net long or net short position in the particular instrument or commodity.
	Option	An option is a contract which grants the buyer the right, but not the obligation, to buy (call option) or sell (put option) an asset, commodity, currency or financial instrument at an agreed rate (exercise price) on or before an agreed date (expiry or settlement date). The buyer pays the seller an amount called the premium in exchange for this right. This premium is the price of the option.
	Risk	The possibility of an outcome not occurring as expected. It can be measured and is not the same as uncertainty, which is not measurable. In financial terms, risk refers to the possibility of financial loss. It can be classified as credit risk, market risk and operational risk.
	Risk Asset Ratio	A bank's risk asset ratio is the ratio of a bank's risk assets to its capital funds. Risk assets

		include assets other than highly rated government and government agency obligations and cash, for example, corporate bonds and loans. The capital funds include capital and undistributed reserves. The lower the risk asset ratio the better the bank's 'capital cushion'
	Risk Weights	Basel II sets out a risk-weighting schedule for measuring the credit risk of obligors. The risk weights are linked to ratings given to sovereigns, financial institutions and corporations by external credit rating agencies.
	Securitisation	The process whereby similar debt instruments/assets are pooled together and repackaged into marketable securities which can be sold to investors. The process of loan securitisation is used by banks to move their assets off the balance sheet in order to improve their capital asset ratios.
	Short position	A short position refers to a position where gains arise from a decline in the value of the underlying. It also refers to the sale of a security in which the seller does not have a long position.
	Specific risk	Within the framework of the BIS proposals on market risk, specific risk refers to the risk associated with a specific security, issuer or company, as opposed to the risk associated with a market or market sector (general risk).
	Subordinated debt	Refers to the status of the debt. In the event of the bankruptcy or liquidation of the debtor, subordinated debt only has a secondary claim on repayments, after other debt has been repaid.
	Tier one (or Tier I) capital	A term used to refer to one of the components

		of regulatory capital. It consists mainly of share capital and disclosed reserves (minus goodwill, if any). Tier I items are deemed to be of the highest quality because they are fully available to cover losses. The other categories of capital defined in Basel II are Tier II (or supplementary) capital and Tier III (or additional supplementary) capital.
	Tier two (or Tier II) capital	Refers to one of components of regulatory capital. Also known as supplementary capital, it consists of certain reserves and certain types of subordinated debt. Tier II items qualify as regulatory capital to the extent that they can be used to absorb losses arising from a bank's activities. Tier II's capital loss absorption capacity is lower than that of Tier I capital.
	Trading Book	A trading book or portfolio refers to the book of financial instruments held for the purpose of short-term trading, as opposed to securities that would be held as a long-term investment. The trading book refers to the assets that are held primarily for generating profit on short-term differences in prices/yields. The price risk is the prime concern of banks in trading book.
	Underwrite	Generally, to underwrite means to assume a risk for a fee. Its two most common contexts are: a) Securities: a dealer or investment bank agrees to purchase a new issue of securities from the issuer and distribute these securities to investors. The underwriter may be one person or part of an underwriting syndicate. Thus the issuer faces no risk of being left with unsold securities. b) Insurance: a person or company agrees to

		provide financial compensation against the risk of fire, theft, death, disability, etc., for a fee called a premium.
	Undisclosed Reserves	These reserves often serve as a cushion against unexpected losses, but they are less permanent in nature and cannot be considered as 'Core Capital'. Revaluation reserves arise from revaluation of assets that are undervalued on the bank's books, typically bank premises and marketable securities. The extent to which the revaluation reserves can be relied upon as a cushion for unexpected losses depends mainly upon the level of certainty that can be placed on estimates of the market values of the relevant assets, the subsequent deterioration in values under difficult market conditions or in a forced sale, potential for actual liquidation at those values, tax consequences of revaluation, etc
	Value at risk (VAR)	It is a method for calculating and controlling exposure to market risk. VAR is a single number (currency amount) which estimates the maximum expected loss of a portfolio over a given time horizon (the holding period) and at a given confidence level.
	Venture capital Fund	A fund with the purpose of investing in start-up businesses that is perceived to have excellent growth prospects but does not have access to capital markets.
	Vertical Disallowance	In the BIS Method for determining regulatory capital necessary to cushion market risk, a reversal of the offsets of a general risk charge of a long position by a short position in two or more securities in the same time band in the yield curve where the securities have differing

APPENDIX

Master Circular – Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of the New Capital Adequacy Framework (NCAF)

(As on June 30, 2008)



RESERVE BANK OF INDIA

MUMBAI

RBI/2008-09/68

DBOD.No.BP.BC. 11 /21.06.001/2008-09

July 1, 2008

All Commercial Banks
(excluding Local Area Banks and Regional Rural Banks)

Dear Sir,

Master Circular - Prudential Guidelines on Capital Adequacy and Market Discipline - Implementation of the New Capital Adequacy Framework (NCAF)

Please refer to the circulars DBOD.No.BP.BC.90/20.06.001/2006-07 dated April 27, 2007 and DBOD.No.BP.BC.66/21.06.001/2007-08 dated March 26, 2008, in terms of which the 'Guidelines on the implementation of NCAF' and 'Guidelines for Pillar 2 - Supervisory Review Process under the NCAF', respectively, were issued. In order to enable the banks to have access to all the existing instructions on the subject, in a single document, a Master Circular has been prepared, and is furnished in the Appendix. It incorporates the Pillar 2 guidelines and the amendments / clarifications issued on the subject till June 30, 2008. A glossary of some of the terms used in this circular has been provided in Annex - 15. This Circular has also been placed on the website of the Bank (www.rbi.org.in).

2. We advise that this Master Circular consolidates the modifications / clarifications issued vide circulars / mailbox clarifications listed in Annex - 16.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

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Master Circular on Prudential Guidelines on Capital Adequacy and Market Discipline - Implementation of New Capital Adequacy Framework

Part A : Guidelines on Minimum Capital Requirement

1. Introduction

1.1 With a view to adopting the Basle Committee on Banking Supervision (BCBS) framework on capital adequacy which takes into account the elements of credit risk in various types of assets in the balance sheet as well as off-balance sheet business and also to strengthen the capital base of banks, Reserve Bank of India decided in April 1992 to introduce a risk asset ratio system for banks (including foreign banks) in India as a capital adequacy measure. Essentially, under the above system the balance sheet assets, non-funded items and other off-balance sheet exposures are assigned prescribed risk weights and banks have to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures on an ongoing basis. Reserve Bank has issued guidelines to banks in June 2004 on maintenance of capital charge for market risks on the lines of 'Amendment to the Capital Accord to incorporate market risks' issued by the BCBS in 1996.

1.2 The BCBS released the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" on June 26, 2004. The Revised Framework was updated in November 2005 to include trading activities and the treatment of double default effects and a comprehensive version of the framework was issued in June 2006 incorporating the constituents of capital and the 1996 amendment to the Capital Accord to incorporate Market Risk. The Revised Framework seeks to arrive at significantly more risk-sensitive approaches to capital requirements. The Revised Framework provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and supervisors to select approaches that are most appropriate for their operations and financial markets.

2. Approach to implementation, Effective date and Parallel run

2.1 The Revised Framework consists of three-mutually reinforcing Pillars, viz. minimum capital requirements, supervisory review of capital adequacy, and market discipline. Under Pillar 1, the Framework offers three distinct options for computing capital requirement for credit risk and three other options for computing capital requirement for operational risk. These options for credit and operational risks are based on increasing risk sensitivity and allow banks to select an approach that is most appropriate to the stage of development of bank's operations. The options available for computing capital for credit risk are Standardised Approach, Foundation Internal Rating Based Approach and Advanced

Internal Rating Based Approach. The options available for computing capital for operational risk are Basic Indicator Approach, Standardised Approach and Advanced Measurement Approach.

2.2 Keeping in view Reserve Bank's goal to have consistency and harmony with international standards, it has been decided that all commercial banks in India (excluding Local Area Banks and Regional Rural Banks) shall adopt Standardised Approach (SA) for credit risk and Basic Indicator Approach (BIA) for operational risk. Banks shall continue to apply the Standardised Duration Approach (SDA) for computing capital requirement for market risks.

2.3 **Effective Date:** Foreign banks operating in India and Indian banks having operational presence outside India should migrate to the above selected approaches under the Revised Framework with effect from **March 31, 2008**. All other commercial banks (except Local Area Banks and Regional Rural Banks) are encouraged to migrate to these approaches under the Revised Framework in alignment with them but in any case not later than **March 31, 2009**.

2.4 **Parallel Run:** With a view to ensuring smooth transition to the Revised Framework and with a view to providing opportunity to banks to streamline their systems and strategies, banks were advised to have a parallel run of the revised Framework. The Boards of the banks should review the results of the parallel run on a quarterly basis. The broad elements which need to be covered during the parallel run are as under:

- i) Banks should apply the prudential guidelines on capital adequacy – both current guidelines and these guidelines on the Revised Framework – on an on-going basis and compute their Capital to Risk Weighted Assets Ratio (CRAR) under both the guidelines.
- ii) An analysis of the bank's CRAR under both the guidelines should be reported to the board at quarterly intervals.
- iii) A copy of the quarterly reports to the Board should be submitted to the Reserve Bank, one each to Department of Banking Supervision, Central Office and Department of Banking Operations and Development, Central Office. While reporting the above analysis to the board, banks should also furnish a comprehensive assessment of their compliance with the other requirements relevant under the Revised Framework, which will include the following, at the minimum:
 - a) Board approved policy on utilization of the credit risk mitigation techniques, and collateral management;
 - b) Board approved policy on disclosures;
 - c) Board approved policy on Internal Capital Adequacy Assessment Process (ICAAP) along with the capital requirement as per ICAAP;

- d) Adequacy of bank's MIS to meet the requirements under the New Cap Adequacy Framework, the initiatives taken for bridging gaps, if any, and the progress made in this regard;
- e) Impact of the various elements / portfolios on the bank's CRAR under the revised framework;
- f) Mechanism in place for validating the CRAR position computed as per the New Capital Adequacy Framework and the assessments / findings/ recommendations of these validation exercises;
- g) Action taken with respect to any advice / guidance / direction given by the Board in the past on the above aspects.

2.5 Migration to other approaches under the Revised Framework: Banks are required to obtain the prior approval of the Reserve Bank to migrate to the Internal Rating Based Approach (IRBA) for credit risk and the Standardised Approach (TSA) or the Advanced Measurement Approach (AMA) for operational risk. Banks that propose to migrate to these approaches are encouraged to undertake an objective and strict assessment of their compliance with the minimum requirements for entry and on-going use of those approaches as prescribed in the International Convergence of Capital Measurement and Capital Standards (comprehensive version of the Revised Framework published by the Basel Committee on Banking Supervision in June 2006 – available on the Bank for International Settlements website www.bis.org). These banks may also assess their compliance with the various processes relevant to these approaches. The above assessments would help these banks in preparing a realistic roadmap indicating the specific milestones, timeline, and plans for achieving smooth and meaningful migration to the advanced approaches. A separate communication in this regard will be issued to banks at a later date, specifying the pre-requisites and procedure for approaching the Reserve Bank for seeking its prior approval for such migration. Notwithstanding the above, all banks should migrate to Standardised Approach for credit risk and Basic Indicator Approach for operational risk on the effective date.

3. Scope of Application

The revised capital adequacy norms shall be applicable uniformly to all Commercial Banks (except Local Area Banks and Regional Rural Banks), both at the solo level (global position) as well as at the consolidated level. A Consolidated bank is defined as a group of entities where a licensed bank is the controlling entity. A consolidated bank will include all group entities under its control, except the exempted entities. In terms of guidelines on preparation of consolidated prudential reports issued vide circular DBOD. No.BP.BC.72/ 21.04.018/ 2001-02 dated February 25, 2003, a consolidated bank may exclude group companies which are engaged in insurance business and businesses not pertaining to financial

services. A consolidated bank should maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) as applicable to a bank on an ongoing basis.

4. **Capital funds**

4.1 **General**

4.1.1 Banks are required to maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) of 9 percent on an ongoing basis. The Reserve Bank will take into account the relevant risk factors and the internal capital adequacy assessments of each bank to ensure that the capital held by a bank is commensurate with the bank's overall risk profile. This would include, among others, the effectiveness of the bank's risk management systems in identifying, assessing / measuring, monitoring and managing various risks including interest rate risk in the banking book, liquidity risk, concentration risk and residual risk. Accordingly, the Reserve Bank will consider prescribing a higher level of minimum capital ratio for each bank under the Pillar 2 framework on the basis of their respective risk profiles and their risk management systems. Further, in terms of the Pillar 2 requirements of the New Capital Adequacy Framework, banks are expected to operate at a level well above the minimum requirement.

4.1.2 The minimum capital maintained by banks on implementation of the Revised Framework shall be subjected to a prudential floor¹, which shall be the higher of the following amounts:

- a) Minimum capital required to be maintained as per the Revised Framework;
- b) A specified per cent of the minimum capital required to be maintained as per the Basel I framework for credit and market risks. The specified per cent will progressively decline as indicated in Table 1.

Table 1 – Prudential floor

Financial year ending*	March 2008	March 2009	March 2010
Prudential Floor (as % of minimum capital requirement computed as per current (Basel I) framework for credit and market risks)	100	90	80
* The relevant periods shall be March 2009, 2010, and 2011 for banks implementing the Revised Framework with effect from March 31, 2009			

The adequacy and the need for the capital floors will be reviewed periodically on the basis of the quality and integrity of Basel II implementation in banks. In case the supervisory

¹ The need for continuing with the prudential floor will be reviewed periodically by the Reserve Bank.

assessments indicate satisfactory level and quality of compliance by banks, the capital floor may be dispensed with even before the above period.

4.1.3 Banks are encouraged to maintain, at both solo and consolidated level, a Tier 1 CRAR of at least 6 per cent. Banks which are below this level must achieve this ratio on or before March 31, 2010.

4.1.4 A bank should compute its Tier 1 CRAR and Total CRAR in the following manner:

$$\text{Tier 1 CRAR} = \frac{\text{Eligible Tier 1 capital funds}^2}{\text{Credit Risk RWA}^* + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

* RWA = Risk weighted Assets

$$\text{Total CRAR} = \frac{\text{Eligible total capital funds}^3}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

4.1.5 Capital funds are broadly classified as Tier 1 and Tier 2 capital. Elements of Tier 2 capital will be reckoned as capital funds up to a maximum of 100 per cent of Tier 1 capital, after making the deductions/ adjustments referred to in paragraph 4.4.

4.2 Elements of Tier 1 capital

4.2.1 For Indian banks, Tier 1 capital would include the following elements:

- i) Paid-up equity capital, statutory reserves, and other disclosed free reserves, if any;
- ii) Capital reserves representing surplus arising out of sale proceeds of assets;
- iii) Innovative perpetual debt instruments eligible for inclusion in Tier 1 capital, which comply with the regulatory requirements as specified in **Annex 1**;
- iv) Perpetual Non-Cumulative Preference Shares (PNCPS), which comply with the regulatory requirements as specified in **Annex – 2**; and
- v) Any other type of instrument generally notified by the Reserve Bank from time to time for inclusion in Tier 1 capital.

4.2.2 Foreign currency translation reserve arising consequent upon application of Accounting Standard 11 (revised 2003): 'The effects of changes in foreign exchange rates'; shall not be an eligible item of capital funds.

4.2.3 For foreign banks in India, Tier 1 capital would include the following elements:

- (i) Interest-free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

² Total Tier 1 capital funds, subject to prudential limits for Innovative Perpetual Debt Instruments *minus* deductions from Tier 1 capital

³ Total of eligible Tier 1 capital funds and eligible Tier 2 capital funds, subject to prudential limits for Innovative Tier 1 instruments, Upper Tier 2 instruments and subordinated debt instruments *minus* deductions from Tier 1 and Tier 2 capital

- (ii) Statutory reserves kept in Indian books.
- (iii) Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India.
- (iv) Capital reserve representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India.
- (v) Interest-free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books.
- (vi) Head Office borrowings in foreign currency by foreign banks operating in India for inclusion in Tier 1 capital which comply with the regulatory requirements as specified in Annex 1 and
- (vii) Any other item specifically allowed by the Reserve Bank from time to time for inclusion in Tier 1 capital.

4.2.4 Notes:

- (i) Foreign banks are required to furnish to Reserve Bank, an undertaking to the effect that the bank will not remit abroad the 'capital reserve' and 'remittable surplus retained in India' as long as they function in India to be eligible for including this item under Tier 1 capital.
- (ii) These funds may be retained in a separate account titled as 'Amount Retained in India for Meeting Capital to Risk-weighted Asset Ratio (CRAR) Requirements' under 'Capital Funds'.
- (iii) An auditor's certificate to the effect that these funds represent surplus remittable to Head Office once tax assessments are completed or tax appeals are decided and do not include funds in the nature of provisions towards tax or for any other contingency may also be furnished to Reserve Bank.
- (iv) The net credit balance, if any, in the inter-office account with Head Office / overseas branches will not be reckoned as capital funds. However, any debit balance in the Head Office account will have to be set-off against capital.

4.2.5 Limits on eligible Tier 1 capital

- (i) The Innovative perpetual debt instruments (IPDIs), eligible to be reckoned as Tier 1 capital, will be limited to 15 percent of total Tier 1 capital as on March 31 of the previous financial year. The above limit will be based on the amount of Tier 1 capital as on March 31 of the previous financial year, after deduction of goodwill, DTA and other intangible assets but before the deduction of investments, as required in paragraph 4.4.
- (ii) The outstanding amount of Tier 1 preference shares i.e Perpetual Non-Cumulative Preference Shares along with Innovative Tier 1 instruments shall not exceed 40 per cent of total Tier 1 capital at any point of time. The above limit will be

based on the amount of Tier 1 capital after deduction of goodwill and other intangible assets but before the deduction of investments as per para 4.4.6 below. Tier 1 preference shares issued in excess of the overall ceiling of 40 per cent, shall be eligible for inclusion under Upper Tier 2 capital, subject to limits prescribed for Tier 2 capital. However, investors' rights and obligations would remain unchanged.

(iii) Innovative instruments / PNCPs, in excess of the limit shall be eligible for inclusion under Tier 2, subject to limits prescribed for Tier 2 capital.

4.3 Elements of Tier 2 capital

4.3.1 Revaluation reserves

These reserves often serve as a cushion against unexpected losses, but they are less permanent in nature and cannot be considered as 'Core Capital'. Revaluation reserves arise from revaluation of assets that are undervalued on the bank's books, typically bank premises. The extent to which the revaluation reserves can be relied upon as a cushion for unexpected losses depends mainly upon the level of certainty that can be placed on estimates of the market values of the relevant assets, the subsequent deterioration in values under difficult market conditions or in a forced sale, potential for actual liquidation at those values, tax consequences of revaluation, etc. Therefore, it would be prudent to consider revaluation reserves at a discount of 55 percent while determining their value for inclusion in Tier 2 capital. Such reserves will have to be reflected on the face of the Balance Sheet as revaluation reserves.

4.3.2 General provisions and loss reserves

Such reserves, if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, can be included in Tier 2 capital. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier 2 capital. Banks are allowed to include the 'General Provisions on Standard Assets', Floating Provisions⁴ 'Provisions held for Country Exposures', and 'Investment Reserve Account' in Tier 2 capital. However, these four items will be admitted as Tier 2 capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

4.3.3 Hybrid debt capital instruments

In this category, fall a number of debt capital instruments, which combine certain

⁴ Floating Provisions held by banks, which is general in nature and not made against any identified assets may be treated as part of Tier 2, if such provisions are not netted off from GNPA's to arrive at disclosure of net NPAs.

characteristics of equity and certain characteristics of debt. Each has a particular feature, which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier 2 capital. Banks in India are allowed to recognise funds raised through debt capital instrument which has a combination of characteristics of both equity and debt, as Upper Tier 2 capital provided the instrument complies with the regulatory requirements specified in **Annex 3**. Indian Banks are also allowed to issue Perpetual Cumulative Preference Shares (PCPS), Redeemable Non-Cumulative Preference Shares (RNCPS) and Redeemable Cumulative Preference Shares (RCPS), as Upper Tier 2 Capital, subject to extant legal provisions as per guidelines contained in **Annex 4**.

4.3.4 Subordinated debt

To be eligible for inclusion in Tier 2 capital, the instrument should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses, and should not be redeemable at the initiative of the holder or without the consent of the Reserve Bank of India. They often carry a fixed maturity, and as they approach maturity, they should be subjected to progressive discount, for inclusion in Tier 2 capital. Instruments with an initial maturity of less than 5 years or with a remaining maturity of one year should not be included as part of Tier 2 capital. Subordinated debt instruments eligible to be reckoned as Tier 2 capital shall comply with the regulatory requirements specified in **Annex 5**.

4.3.5 Innovative Perpetual Debt Instruments (IPDI) and Perpetual Non-Cumulative Preference Shares (PNCPs)⁵

IPDI in excess of 15 per cent of Tier 1 capital {cf. Annexure I, Para 1(ii)} may be included in Tier 2, and PNCPs in excess of the overall ceiling of 40 per cent ceiling prescribed vide paragraph 4.2.5 {cf. Annexure 2, Para 1.1} may be included under Upper Tier 2 capital, subject to the limits prescribed for Tier 2 capital.

4.3.6 Any other type of instrument generally notified by the Reserve Bank from time to time for inclusion in Tier 2 capital.

4.3.7 Limits on Tier 2 Capital

Upper Tier 2 instruments along with other components of Tier 2 capital shall not exceed 100 per cent of Tier 1 capital. The above limit will be based on the amount of Tier 1 after

⁵ Vide SI No.1 of Annex to circular DBOD.BP.BC.No.67/21.06.001/2007-08 dated March 31, 2008

deduction of goodwill, DTA and other intangible assets but before deduction of investments.

4.3.8 Subordinated debt instruments eligible for inclusion in Lower Tier 2 capital will be limited to 50 percent of Tier 1 capital after all deductions.

4.4 Deductions from capital

4.4.1 Intangible assets and losses in the current period and those brought forward from previous periods should be deducted from Tier 1 capital.

4.4.2 The DTA computed as under should be deducted from Tier 1 capital:

- i) DTA associated with accumulated losses; **and**
- ii) The DTA (excluding DTA associated with accumulated losses), net of DTL. Where the DTL is in excess of the DTA (excluding DTA associated with accumulated losses), the excess shall neither be adjusted against item (i) nor added to Tier 1 capital.

4.4.3 Any **gain-on-sale** arising at the time of securitisation of standard assets, as defined in paragraph 5.16.1, **if recognised**, should be deducted entirely from Tier 1 capital. In terms of guidelines on securitisation of standard assets, banks are allowed to amortise the profit over the period of the securities issued by the SPV. The amount of profits thus recognised in the profit and loss account through the amortisation process need not be deducted.

4.4.4 Banks should not recognise minority interests that arise from consolidation of less than wholly owned banks, securities or other financial entities in consolidated capital to the extent specified below:

- i) The extent of minority interest in the capital of a less than wholly owned subsidiary which is in excess of the regulatory minimum for that entity.
- ii) In case the concerned subsidiary does not have a regulatory capital requirement, the deemed minimum capital requirement for that entity may be taken as 9 per cent of the risk weighted assets of that entity.

4.4.5 Securitisation exposures, as specified in paragraph 5.16.2, shall be deducted from regulatory capital and the deduction must be made 50 per cent from Tier 1 and 50 per cent from Tier 2, except where expressly provided otherwise. Deductions from capital may be calculated net of any specific provisions maintained against the relevant securitisation exposures.

4.4.6 In the case of investment in financial subsidiaries and associates, the treatment will be as under for the purpose of capital adequacy:

- (i) The entire investments in the paid up equity of the financial entities (including insurance entities), which are not consolidated for capital purposes with the bank, where such investment exceeds 30% of the paid up equity of such financial entities and entire investments in other instruments eligible for regulatory capital status in those entities shall be deducted, at 50 per cent

from Tier 1 and 50 per cent from Tier 2 capital. (For investments less than 30 per cent, please para 5.13.7)

- (ii) Banks should ensure that majority owned financial entities that are not consolidated for capital purposes and for which the investment in equity and other instruments eligible for regulatory capital status is deducted, meet their respective regulatory capital requirements. In case of any shortfall in the regulatory capital requirements in the de-consolidated entity, the shortfall shall be fully deducted at 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital.

4.4.7 An indicative list of institutions which may be deemed to be financial institutions for capital adequacy purposes is as under:

- o Banks,
- o Mutual funds,
- o Insurance companies,
- o Non-banking financial companies,
- o Housing finance companies,
- o Merchant banking companies,
- o Primary dealers.

4.4.8 A bank's aggregate investment in all types of instruments, eligible for capital status of investee banks / FIs / NBFCs / PDs as listed in paragraph 4.4.9 below, excluding those deducted in terms of paragraph 4.4.6, should not exceed 10 per cent of the investing bank's capital funds (Tier 1 plus Tier 2, after adjustments). Any investment in excess of this limit shall be deducted at 50 per cent from Tier 1 and 50 per cent from Tier 2 capital. Investments in equity or instruments eligible for capital status issued by **FIs / NBFCs / Primary Dealers** which are, within the aforesaid ceiling of 10 per cent and thus, are not deducted from capital funds, will attract a risk weight of 100 per cent or the risk weight as applicable to the ratings assigned to the relevant instruments, whichever is higher. As regards the treatment of investments in equity and other capital-eligible instruments of **scheduled banks**, within the aforesaid ceiling of 10 per cent, will be risk weighted as per paragraph 5.6.1. Further, in the case of **non-scheduled banks**, where CRAR has become negative, the investments in the capital-eligible instruments even within the aforesaid 10 per cent limit shall be fully deducted at 50 per cent from Tier 1 and 50 per cent from Tier 2 capital, as per paragraph 5.6.1.⁶

4.4.9 Banks' investment in the following instruments will be included in the prudential limit of 10 per cent referred to at paragraph 4.4.8 above.

- a) Equity shares;
- b) Perpetual Non-Cumulative Preference Shares

⁶ Vide Sl. No.2 in Annex to circular DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

- c) Innovative Perpetual Debt Instruments
- d) Upper Tier II Bonds
- e) Upper Tier II Preference Shares (PCPS/RNCPS/RCPS)
- f) Subordinated debt instruments;
- g) Any other instrument approved by the RBI as in the nature of capital.

4.4.10 The investments made by a banking subsidiary/associate in the equity or non equity regulatory-capital instruments issued by its parent bank, should be deducted from such subsidiary's regulatory capital at 50 per cent each from Tier 1 and Tier 2 capital, in its capital adequacy assessment on a solo basis.⁷ The regulatory treatment of investment by the non-banking financial subsidiaries / associates in the parent bank's regulatory capital would, however, be governed by the applicable regulatory capital norms of the respective regulators of such subsidiaries / associates.

5. Capital Charge for Credit Risk

5.1 General

Under the Standardised Approach, the rating assigned by the eligible external credit rating agencies will largely support the measure of credit risk. The Reserve Bank has identified the external credit rating agencies that meet the eligibility criteria specified under the revised Framework. Banks may rely upon the ratings assigned by the external credit rating agencies chosen by the Reserve Bank for assigning risk weights for capital adequacy purposes as per the mapping furnished in these guidelines.

5.2 Claims on Domestic Sovereigns

5.2.1 Both fund based and non fund based claims on the central government will attract a zero risk weight. Central Government guaranteed claims will attract a zero risk weight.

5.2.2 The Direct loan / credit / overdraft exposure, if any, of banks to the State Governments and the investment in State Government securities will attract zero risk weight. State Government guaranteed claims will attract 20 per cent risk weight⁸

5.2.3 The risk weight applicable to claims on central government exposures will also apply to the claims on the Reserve Bank of India, DICGC and Credit Guarantee Fund Trust for Small Industries (CGTSI). The claims on ECGC will attract a risk weight of 20 per cent.

⁷ Vide paragraph 2.2 of circular DBOD.No.BP.BC.88/21.06.001/2007-08 dated May 30, 2008

⁸ Vide Sl. No.3 in Annex to circular DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

5.2.4 The above risk weights for both direct claims and guarantee claims will be applicable as long as they are classified as 'standard'/ performing assets. Where these sovereign exposures are classified as non-performing, they would attract risk weights as applicable to NPAs, which are detailed in Paragraph 5.12.

5.3 Claims on Foreign Sovereigns

5.3.1 Claims on foreign sovereigns will attract risk weights as per the rating assigned⁹ to those sovereigns / sovereign claims by international rating agencies as follows:

Table 2: Claims on foreign sovereigns – Risk weights

S & P*/ FITCH ratings	AAA to AA	A	BBB	BB to B	Below B	Unrated
Moody's ratings	Aaa to Aa	A	Baa	Ba to B	Below B	Unrated
Risk weight	0 %	20 %	50 %	100 %	150 %	100 %

* Standard & Poor's

5.3.2 Claims denominated in domestic currency of the foreign sovereign met out of the resources in the same currency raised in the jurisdiction¹⁰ of that sovereign will, however, attract a risk weight of zero percent.

5.3.3 However, in case a Host Supervisor requires a more conservative treatment to such claims in the books of the foreign branches of the Indian banks, they should adopt the requirements prescribed by the Host Country supervisors for computing capital adequacy.

5.4 Claims on public sector entities (PSEs)

5.4.1 Claims on domestic public sector entities will be risk weighted in a manner similar to claims on Corporates.

5.4.2 Claims on foreign PSEs will be risk weighted as per the rating assigned by the international rating agencies as under:

⁹ For example: The risk weight assigned to an investment in US Treasury Bills by SBI branch in Paris, irrespective of the currency of funding, will be determined by the rating assigned to the Treasury Bills, as indicated in Table 2.

¹⁰ For example: The risk weight assigned to an investment in US Treasury Bills by SBI branch in New York will attract a zero per cent risk weight, irrespective of the rating of the claim, if the investment is funded from out of the USD denominated resources of SBI, New York. In case the SBI, New York, did not have any USD denominated resources, the risk weight will be determined by the rating assigned to the Treasury Bills, as

Table 3: Claims on foreign PSEs – Risk weights

S&P/ Fitch Ratings	AAA To AA	A	BBB to BB ¹¹	Below BB	Unrated
Moody's ratings	Aaa to Aa	A	Baa to Ba	Below Ba	Unrated
RW (%)	20	50	100	150	100

5.5 Claims on MDBs, BIS and IMF

Claims on the Bank for International Settlements (BIS), the International Monetary Fund (IMF) and the following eligible Multilateral Development Banks (MDBs) evaluated by the BCBS will be treated similar to claims on scheduled banks meeting the minimum capital adequacy requirements and assigned a uniform twenty percent risk weight :

- a) World Bank Group: IBRD and IFC,
- b) Asian Development Bank,
- c) African Development Bank,
- d) European Bank for Reconstruction & Development,
- e) Inter-American Development Bank,
- f) European Investment Bank,
- g) European Investment Fund,
- h) Nordic Investment Bank,
- i) Caribbean Development Bank,
- j) Islamic Development Bank and
- k) Council of Europe Development Bank.

Similarly, claims on the International Finance Facility for Immunization (IFFIm) will also attract a twenty per cent risk weight.

5.6 Claims on banks ¹²

5.6.1 The claims on banks incorporated in India and the branches of foreign banks in India, other than those deducted in terms of paragraph 4.4.6., 4.4.8 and 4.4.10 above, will be risk weighted as under:

indicated in Table 2 above.

¹¹ Vide Sl. No.4 of the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

¹² Vide Appendix -1 to Annex to circular DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

Table 4: Claims on banks incorporated in India and foreign bank branches in India

Level of CRAR (in%) of the investee bank (where available)	Risk Weights			
	All Scheduled Banks (Commercial, Regional Rural Banks, Local Area Banks and Co-Operative Banks)		All Non-Scheduled Banks (Commercial, Regional Rural Banks, Local Area Banks and Co-Operative Banks)	
	Investments within 10 % limit referred to in paragraph 4.4.8 above (in per cent)	All other claims (in per cent)	Investments within 10 per cent limit referred to in paragraph 4.4.8 above (in per cent)	All Other Claims (in per cent)
1	2	3	4	5
9 and above	Higher of 100 % or the risk weight as per the rating of the instrument or counterparty, whichever is higher	20	Higher of 100 % or the risk weight as per the rating of the instrument or counterparty, whichever is higher	100
6 to < 9	150	50	250	150
3 to < 6	250	100	350	250
0 to < 3	350	150	625	350
Negative	625	625	Full deduction*	625

* The deduction should be made @ 50% each, from Tier 1 and Tier 2 capital.

Notes:

- i) In the case of banks where no capital adequacy norms have been prescribed by the RBI, the lending / investing bank may calculate the CRAR of the cooperative bank concerned, notionally, by obtaining necessary information from the investee bank, using the capital adequacy norms as applicable to the commercial banks. In case, it is not found feasible to compute CRAR on such notional basis, the risk weight of 350 or 625 per cent, as per the risk perception of the investing bank, should be applied uniformly to the investing bank's entire exposure.
- ii) In case of banks where capital adequacy norms are not applicable at present, the matter of investments in their capital-eligible instruments would not arise for now. However, column No. 2 and 4 of the Table above will become applicable to them, if in future they issue any capital instruments where other banks are eligible to invest.

5.6.2 The claims on foreign banks will be risk weighted as under as per the ratings assigned by international rating agencies.

Table 5: Claims on foreign banks – Risk weights

S & P / FITCH ratings	AAA to AA	A	BBB	BB to B	Below B	Unrated
Moody's ratings	Aaa to Aa	A	Baa	Ba to B	Below B	Unrated
Risk weight	20 %	50 %	50 %	100 %	150 %	50 %

The exposures of the Indian branches of foreign banks, guaranteed / counter-guaranteed by the overseas Head Offices or the bank's branch in another country would amount to a claim on the parent foreign bank and would also attract the risk weights as per Table 5 above.¹³

5.6.3 However, the claims on a bank which are denominated in 'domestic'¹⁴ foreign currency met out of the resources in the same currency raised in that jurisdiction will be risk weighted at 20 per cent provided the bank complies with the minimum CRAR prescribed by the concerned bank regulator(s).

5.6.4 However, in case a Host Supervisor requires a more conservative treatment for such claims in the books of the foreign branches of the Indian banks, they should adopt the requirements prescribed by the Host supervisor for computing capital adequacy.

5.7 Claims on Primary Dealers

Claims on Primary Dealers shall be risk weighted in a manner similar to claims on corporates.

5.8 Claims on corporates

5.8.1 Claims on corporates¹⁵, including the exposures on Asset Finance companies,¹⁶ shall be risk weighted as per the ratings assigned by the rating agencies registered with the SEBI and chosen by the Reserve Bank of India. The following table indicates the risk weight applicable to claims on corporates. The standard risk weight for unrated claims on corporates up to the threshold level specified in paragraph 5.8.2 will be 100 per cent. No claim on an unrated corporate may be given a risk weight preferential to that assigned to its sovereign of incorporation.

Table 6: Part A – Long term claims on corporate – Risk weights

Domestic rating agencies	AAA	AA	A	BBB	BB & below	Unrated
Risk weight	20 %	30%	50 %	100 %	150%	100 %

¹³ Added in terms of the Mail Box clarification dated June 24, 2008.

¹⁴ For example: A Euro denominated claim of SBI branch in Paris on BNP Paribas, Paris which is funded from out of the Euro denominated deposits of SBI, Paris will attract a 20 per cent risk weight irrespective of the rating of the claim, provided BNP Paribas complies with the minimum CRAR stipulated by its regulator/supervisor in France. If BNP Paribas were breaching the minimum CRAR, the risk weight will be as indicated in Table 4 above.

¹⁵ Claims on corporates will include all fund based and non fund based exposures other than those which qualify for inclusion under 'sovereign', 'bank', 'regulatory retail', 'residential mortgage', 'non performing assets', specified category addressed separately in these guidelines.

¹⁶ Vide DBOD Mail Box clarification dated May 21, 2008

Table 6 : Part B - Short Term Claims on Corporate - Risk Weights¹⁷

Short Term Ratings				Risk Weights
CARE	CRISIL	Fitch	ICRA	
PR1+	P1+	F1+(ind)	A1+	20 %
PR1	P1	F1(ind)	A1	30 %
PR2	P2	F2(ind)	A2	50 %
PR3	P 3	F3 (ind)	A3	100 %
PR4 & PR5	P 4 & P5	F4/F5 (ind)	A4 / A5	150 %
Unrated	Unrated	Unrated	Unrated	100 %

5.8.2 The Reserve Bank may increase the standard risk weight for unrated claims where a higher risk weight is warranted by the overall default experience. As part of the supervisory review process, the Reserve Bank would also consider whether the credit quality of unrated corporate claims held by individual banks should warrant a standard risk weight higher than 100 per cent. To begin with, for the financial year 2008-09, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of Rs.50 crore will attract a risk weight of 150 per cent. With effect from April 1, 2009, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of Rs. 10 crore will attract a risk weight of 150 per cent. The threshold of Rs. 50 crore (and Rs. 10 crore) will be with reference to the aggregate exposure on a single counterparty for the bank as a whole.

5.8.3 With a view to reflect a higher element of inherent risk which may be latent in entities whose obligations have been subjected to re-structuring / re-scheduling either by the banks on their own or along with other bankers / creditors, the unrated standard / performing claims on these entities should be assigned a higher risk weight until satisfactory performance under the revised payment schedule has been established for one year from the date when the first payment of interest / principal falls due under the revised schedule. The applicable risk weights will be 125 per cent. If the claim is unrated and exceeds the limits laid down in para 5.8.2 above, the applicable risk weight will be 150 per cent.

5.8.4 The claims on non-resident corporates will be risk weighted as under as per the ratings assigned by international rating agencies. For the financial year 2008-09, all fresh sanctions or renewals in respect of unrated claims on non-resident corporates in excess of

¹⁷ Vide Sl. No.6 in the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

Rs.50 crore will attract a risk weight of 150 per cent. With effect from April 1, 2009, all fresh sanctions or renewals in respect of unrated claims on non-resident corporates in excess of Rs. 10 crore will attract a risk weight of 150 per cent. The threshold of Rs. 50 crore (and Rs. 10 crore) will be with reference to the aggregate exposure on a single counterparty for the bank as a whole.

Table 7: Claims on non-resident corporates – Risk weights

S&P/ Fitch Ratings	AAA to AA	A	<i>BBB to BB¹⁸</i>	Below BB	Unrated
Moody's ratings	Aaa to Aa	A	Baa to Ba	Below Ba	Unrated
RW (%)	20	50	100	150	100

5.9 Claims included in the regulatory retail portfolios

5.9.1 Claims (include both fund-based and non-fund based) that meet all the four criteria listed below in paragraph 5.9.3 may be considered as retail claims for regulatory capital purposes and included in a regulatory retail portfolio. Claims included in this portfolio shall be assigned a risk-weight of 75 per cent, except as provided in paragraph 5.12 below for non performing assets.

5.9.2 The following claims, both fund based and non fund based, shall be excluded from the regulatory retail portfolio:

- (a) Exposures by way of investments in securities (such as bonds and equities), whether listed or not;
- (b) Mortgage loans to the extent that they qualify for treatment as claims secured by residential property¹⁹ or claims secured by commercial real estate²⁰;
- (c) Loans and advances to bank's own staff which are fully covered by superannuation benefits and / or mortgage of flat/ house;
- (d) Consumer credit, including personal loans and credit card receivables;
- (e) Capital market exposures;
- (f) Venture capital funds.

5.9.3 Qualifying criteria

- (i) Orientation criterion - The exposure (both fund-based and non fund-based) is to an individual person or persons or to a small business; Person under this clause would

¹⁸ Vide SI. No.4 in the Annex to DBOD.No.BP.BC.21.06.001/2007-08 dated March 31, 2008.

¹⁹ Mortgage loans qualifying for treatment as 'claims secured by residential property' are defined in paragraph 5.10 below.

²⁰ As defined in paragraph 5.11.1 below.

mean any legal person capable of entering into contracts and would include but not be restricted to individual, HUF, partnership firm, trust, private limited companies, public limited companies, co-operative societies etc. Small business is one where the total average annual turnover is less than Rs. 50 crore. The turnover criterion will be linked to the average of the last three years in the case of existing entities; projected turnover in the case of new entities; and both actual and projected turnover for entities which are yet to complete three years.

(ii) Product criterion - The exposure (both fund-based and non fund-based) takes the form of any of the following: revolving credits and lines of credit (including overdrafts), term loans and leases (e.g. instalment loans and leases, student and educational loans) and small business facilities and commitments.

(iii) Granularity criterion - Banks must ensure that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75 per cent risk weight. One way of achieving this is that no aggregate exposure to one counterpart should exceed 0.2 per cent of the overall regulatory retail portfolio. '**Aggregate exposure**' means gross amount (i.e. not taking any benefit for credit risk mitigation into account) of all forms of debt exposures (e.g. loans or commitments) that individually satisfy the three other criteria. In addition, '*one counterpart*' means one or several entities that may be considered as a single beneficiary (e.g. in the case of a small business that is affiliated to another small business, the limit would apply to the bank's aggregated exposure on both businesses). While banks may appropriately use the group exposure concept for computing aggregate exposures, they should evolve adequate systems to ensure strict adherence with this criterion. NPAs under retail loans are to be excluded from the overall regulatory retail portfolio when assessing the granularity criterion for risk-weighting purposes.

(iv) Low value of individual exposures - The maximum aggregated retail exposure to one counterpart should not exceed the absolute threshold limit of Rs. 5 crore.

5.9.4 For the purpose of ascertaining compliance with the absolute threshold, exposure would mean sanctioned limit or the actual outstanding, whichever is higher, for all fund based and non-fund based facilities, including all forms of off-balance sheet exposures. In the case of term loans and EMI based facilities, where there is no scope for redrawing any portion of the sanctioned amounts, exposure shall mean the actual outstanding.

5.9.5 The RBI would evaluate at periodic intervals the risk weight assigned to the retail portfolio with reference to the default experience for these exposures. As part of the supervisory review process, the RBI would also consider whether the credit quality of

regulatory retail claims held by individual banks should warrant a standard risk weight higher than 75 per cent.

5.10 Claims secured by residential property

5.10.1 Lending to individuals meant for acquiring residential property which are fully secured by mortgages on the residential property that is or will be occupied by the borrower, or that is rented, shall be risk weighted as indicated below, provided the loan to value ratio (LTV) is not more than 75per cent, based on Board approved valuation policy. LTV ratio should be computed as a percentage with total outstanding in the account (viz. “principal + accrued interest + other charges pertaining to the loan” without any netting) in the numerator and the realisable value of the residential property mortgaged to the bank in the denominator.

Amount of loan	Risk weight
Up to Rs.30 lakh ²¹	50%
Rs. 30 lakh and above	75%

5.10.2 Lending for acquiring residential property, which meets the above criteria but have LTV ratio of more than 75 per cent, will attract a risk weight of 100 per cent.

5.10.3 All other claims secured by residential property would attract the higher of the risk weight applicable to the counterparty or to the purpose for which the bank has extended finance.

5.10.4 Loans / exposures to intermediaries for on-lending will not be eligible for inclusion under claims secured by residential property but will be treated as claims on corporates or claims included in the regulatory retail portfolio as the case may be.

5.10.5 Investments in mortgage backed securities (MBS) backed by exposures as at paragraph 5.10.1 above will be governed by the guidelines pertaining to securitisation exposures (c.f. paragraph 5.16 below).

5.11 Claims secured by commercial real estate

5.11.1 Claims secured by commercial real estate is defined as “fund based and non-fund based exposures secured by mortgages on commercial real estates (office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction etc.)” Exposures to entities for setting up Special

²¹ Vide circular DBOD.No.BP.BC.83/21.06.001/2007-08 dated May 14, 2008

Economic Zones (SEZs) or for acquiring units in SEZs which includes real estate would also be treated as commercial real estate exposure.

5.11.2 Claims secured by commercial real estate as defined above will attract a risk weight of 150 per cent.

5.11.3 Investments in mortgage backed securities (MBS) backed by exposures as at paragraph 5.11.1 above will be governed by the guidelines pertaining to securitisation exposures c.f. paragraph 5.16 below.

5.12 Non-performing assets (NPAs)

5.12.1 The unsecured portion of NPA (other than a qualifying residential mortgage loan which is addressed in paragraph 5.12.6), net of specific provisions (including partial write-offs), will be risk-weighted as follows:

- (i) 150 per cent risk weight when specific provisions are less than 20 per cent of the outstanding amount of the NPA ;
- (ii) 100 per cent risk weight when specific provisions are at least 20 per cent of the outstanding amount of the NPA ;
- (iii) 50 per cent risk weight when specific provisions are at least 50 per cent of the outstanding amount of the NPA

5.12.2 For the purpose of computing the level of specific provisions in NPAs for deciding the risk-weighting, all funded NPA exposures of a single counterparty (without netting the value of the eligible collateral) should be reckoned in the denominator.

5.12.3 For the purpose of defining the secured portion of the NPA, eligible collateral will be the same as recognised for credit risk mitigation purposes (paragraphs 7.3.5). Hence, other forms of collateral like land, buildings, plant, machinery, current assets, etc. will not be reckoned while computing the secured portion of NPAs for capital adequacy purposes.

5.12.4 In addition to the above, where a NPA is fully secured by the following forms of collateral that are not recognised for credit risk mitigation purposes, either independently or along with other eligible collateral a 100 per cent risk weight may apply, net of specific provisions, when provisions reach 15 per cent of the outstanding amount:

- (i) Land and building which are valued by an expert valuer and where the valuation is not more than three years old, and
- (ii) Plant and machinery in good working condition at a value not higher than the depreciated value as reflected in the audited balance sheet of the borrower, which is not older than eighteen months.

5.12.5 The above collaterals (mentioned in paragraph 5.12.4) will be recognized only where the bank is having clear title to realize the sale proceeds thereof and can appropriate

the same towards the amounts due to the bank. The bank's title to the collateral should be well documented. These forms of collaterals are not recognised anywhere else under the standardised approach.

5.12.6 Claims secured by residential property, as defined in paragraph 5.10.1, which are NPA will be risk weighted at 100 per cent net of specific provisions. If the specific provisions in such loans are at least 20 per cent but less than 50 per cent of the outstanding amount, the risk weight applicable to the loan net of specific provisions will be 75 per cent. If the specific provisions are 50 per cent or more the applicable risk weight will be 50 per cent.

5.13 Specified categories

5.13.1 Fund based and non-fund based claims on the following segments which are considered as high risk exposures will attract a higher risk weight of 150 per cent:

- a) Venture capital funds; and
- b) Commercial real estate.

5.13.2 Reserve Bank may, in due course, decide to apply a 150 per cent or higher risk weight reflecting the higher risks associated with any other claim that may be identified as a high risk exposure.

5.13.3 Consumer credit, including personal loans and credit card receivables but excluding educational loans, will attract a higher risk weight of 125 per cent or higher, if warranted by the external rating (or, the lack of it) of the counterparty. As gold and gold jewellery are eligible financial collateral, the counterparty exposure in respect of personal loans secured by gold and gold jewellery will be worked out under the comprehensive approach as per paragraph 7.3.4. The 'exposure value after risk mitigation' shall attract the risk weight of 125 per cent.²²

5.13.4 'Capital market exposures' will attract a 125 per cent risk weight or risk weight warranted by external rating (or lack of it) of the counterparty.

5.13.5 The claims on 'Non-deposit taking systemically important non-banking financial companies (NBFC-ND-SI), other than AFCs, will attract risk weight as furnished in the Table below:

²² Vide SI No.7 in the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

<u>Rated NBFC-ND-SI</u> (irrespective of the amount)	
- BBB and above	125%
- Below BBB	150%
<u>Unrated NBFC-ND-SI</u>	
- Below threshold	125%
- Above threshold	150%

5.13.6 All investments in the paid up equity of non-financial entities, which are not consolidated for capital purposes with the bank, shall be assigned a 125 per cent risk weight.

5.13.7 All Investments in the paid up equity of financial entities (other than banks, which are covered under paragraph 5.6), which are not consolidated for capital purposes with the bank, where such investment is upto 30 per cent of the equity of the investee entity, shall be assigned a 125 per cent risk weight or a risk weight warranted by the external rating (or the lack of it) of the counterparty, whichever is higher. The investment in paid up equity of financial entities, which are specifically exempted from 'capital market exposure', shall be assigned a 100 percent risk weight.

5.13.8 Bank's investments in the non-equity capital eligible instruments of other banks should be risk weighted as prescribed in paragraph 5.6.1

5.14 Other Assets

5.14.1 Loans and advances to bank's own staff which are fully covered by superannuation benefits and/or mortgage of flat/ house will attract a 20 per cent risk weight. Since flat / house is not an eligible collateral and since banks normally recover the dues by adjusting the superannuation benefits only at the time of cessation from service, the concessional risk weight shall be applied without any adjustment of the outstanding amount. In case a bank is holding eligible collateral in respect of amounts due from a staff member, the outstanding amount in respect of that staff member may be adjusted to the extent permissible, as indicated in paragraph 7 below.

5.14.2 Other loans and advances to bank's own staff will be eligible for inclusion under regulatory retail portfolio and will therefore attract a 75 per cent risk weight.

5.14.3 All other assets will attract a uniform risk weight of 100 per cent.

5.15 Off-balance sheet items

5.15.1 General

i) The total risk weighted off-balance sheet credit exposure is calculated as the sum of

the risk-weighted amount of the market related and non-market related off-balance sheet items. The risk-weighted amount of an off-balance sheet item that gives rise to credit exposure is generally calculated by means of a two-step process:

- (a) the notional amount of the transaction is converted into a credit equivalent amount, by multiplying the amount by the specified credit conversion factor or by applying the current exposure method, and
 - (b) the resulting credit equivalent amount is multiplied by the risk weight applicable to the counterparty or to the purpose for which the bank has extended finance or the type of asset, whichever is higher.
- ii) Where the off-balance sheet item is secured by eligible collateral or guarantee, the credit risk mitigation guidelines detailed in paragraph 7 may be applied.

5.15.2 Non-market-related off balance sheet items

- i) The credit equivalent amount in relation to a non-market related off-balance sheet item like, direct credit substitutes, trade and performance related contingent items and commitments with certain drawdown, other commitments, etc. will be determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor (CCF).
- ii) Where the non-market related off-balance sheet item is an undrawn or partially undrawn fund-based facility²³, the amount of undrawn commitment to be included in calculating the off-balance sheet non-market related credit exposures is the maximum unused portion of the commitment that could be drawn during the remaining period to maturity. Any drawn portion of a commitment forms a part of bank's on-balance sheet credit exposure.
- iii) In the case of irrevocable commitments to provide off-balance sheet facilities, the original maturity will be measured from the commencement of the commitment until the time the associated facility expires. For example an irrevocable commitment with an original maturity of 12 months, to issue a 6 month documentary letter of credit, is

²³ For example: (a) In the case of a cash credit facility for Rs.100 lakh (which is not unconditionally cancellable) where the drawn portion is Rs. 60 lakh, the undrawn portion of Rs. 40 lakh will attract a CCF of 20 per cent (since the CC facility is subject to review / renewal normally once a year). The credit equivalent amount of Rs. 8 lakh (20 % of Rs.40 lakh) will be assigned the appropriate risk weight as applicable to the counterparty / rating to arrive at the risk weighted asset for the undrawn portion. The drawn portion (Rs. 60 lakh) will attract a risk weight as applicable to the counterparty / rating.

(b) A TL of Rs. 700 cr is sanctioned for a large project which can be drawn down in stages over a three year period. The terms of sanction allow draw down in three stages – Rs. 150 cr in Stage I, Rs. 200 cr in Stage II and Rs. 350 cr in Stage III, where the borrower needs the bank's explicit approval for draw down under Stages II and III after completion of certain formalities. If the borrower has drawn already Rs. 50 cr under Stage I, then the undrawn portion would be computed with reference to Stage I alone i.e., it will be Rs.100 cr. If Stage I is scheduled to be completed within one year, the CCF will be 20% and if it is more than one year then the applicable CCF will be 50 per cent.

deemed to have an original maturity of 18 months. Irrevocable commitments to provide off-balance sheet facilities should be assigned the lower of the two applicable credit conversion factors. For example, an irrevocable commitment with an original maturity of 15 months (50 per cent - CCF) to issue a six month documentary letter of credit (20 per cent - CCF) would attract the lower of the CCF i.e., the CCF applicable to the documentary letter of credit viz. 20 per cent.

- iv) The credit conversion factors for non-market related off-balance sheet transactions are as under:

Table 8: Credit conversion factors – Non-market related off-balance sheet items²⁴

Sr. No.	Instruments	Credit Conversion Factor (%)
1.	Direct credit substitutes e.g. general guarantees of indebtedness (including standby L/Cs serving as financial guarantees for loans and securities, credit enhancements, liquidity facilities for securitisation transactions), and acceptances (including endorsements with the character of acceptance). <i>(i.e., the risk of loss depends on the credit worthiness of the counterparty or the party against whom a potential claim is acquired)</i>	100
2.	Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties, indemnities and standby letters of credit related to particular transaction).	50
3.	Short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralised by the underlying shipment) for both issuing bank and confirming bank.	20
4.	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the bank. <i>(These items are to be risk weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.)</i>	100
5.	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawdown. <i>(These items are to be risk weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.)</i>	100
6	Lending of banks' securities or posting of securities as collateral by banks, including instances where these arise out of repo style transactions (i.e., repurchase / reverse repurchase and securities lending / securities borrowing transactions)	100

²⁴ Pl. refer to item (a) of Sl.No.19 in the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dt. March 31, 2008

Sr. No.	Instruments	Credit Conversion Factor (%)
7.	Note issuance facilities and revolving / non-revolving underwriting facilities. ²⁵	50
8	Commitments with certain drawdown	100
9.	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of a) up to one year b) over one year. Similar commitments that are unconditionally cancellable at any time by the bank without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness	20 50 0
10.	Take-out Finance in the books of taking-over institution	
	(i) Unconditional take-out finance	100
	(ii) Conditional take-out finance	50

v) In regard to non-market related off-balance sheet items, the following transactions with non-bank counterparties will be treated as claims on banks:

- Guarantees issued by banks against the counter guarantees of other banks.
- Rediscounting of documentary bills discounted by other banks and bills²⁶ discounted by banks which have been accepted by another bank will be treated as a funded claim on a bank.

In all the above cases banks should be fully satisfied that the risk exposure is in fact on the other bank. If they are satisfied that the exposure is on the other bank they may assign these exposures the risk weight applicable to banks as detailed in paragraph 5.6.

5.15.3 Market related off-balance sheet items

i) In calculating the risk weighted off-balance sheet credit exposures arising from market related off-balance sheet items for capital adequacy purposes, the bank should include all its market related transactions held in the banking and trading book which give rise to off-balance sheet credit risk.

²⁵ Pl. refer to item (b) of Sl.No.19 of DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

²⁶ Pl. refer to Sl. No.8 in the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008.

- ii) The credit risk on market related off-balance sheet items is the cost to a bank of replacing the cash flow specified by the contract in the event of counterparty default. This would depend, among other things, upon the maturity of the contract and on the volatility of rates underlying the type of instrument.
- iii) Market related off-balance sheet items would include:
 - a) interest rate contracts – including single currency interest rate swaps, basis swaps, forward rate agreements, and interest rate futures;
 - b) foreign exchange contracts, including contracts involving gold, – includes cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options;
 - c) any other market related contracts specifically allowed by the Reserve Bank which give rise to credit risk.
- iv) Exemption from capital requirements is permitted for
 - a) foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and
 - b) instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments.
- v) The credit equivalent amount of a market related off-balance sheet item, whether held in the banking book or trading book must be determined by the current exposure method.

5.15.4 Current Exposure Method

- i) The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of current credit exposure and potential future credit exposure of these contracts.
- ii) Current credit exposure is defined as the sum of the positive mark-to-market value of these contracts. The Current Exposure Method requires periodical calculation of the current credit exposure by marking these contracts to market, thus capturing the current credit exposure.
- iii) Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.

Table 9 : Credit Conversion Factors for market related off-balance sheet items

Residual Maturity	Conversion Factor to be applied on Notional Principal Amount	
	Interest Rate Contract (in per cent)	Gold and Exchange Rate Contract (in per cent)
One year or less	0.25	1.0
Over one year to five years	0.5	5.0
Over 5 years	1.5	7.5

- iv) For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.
- v) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria, the add-on factor is subject to a floor of 0.5 per cent.
- vi) No potential future credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.
- vii) Potential future exposures should be based on effective rather than apparent notional amounts. In the event that the stated notional amount is leveraged or enhanced by the structure of the transaction, banks must use the effective notional amount when determining potential future exposure. For example, a stated notional amount of USD 1 million with payments based on an internal rate of two times the BPLR would have an effective notional amount of USD 2 million.

5.15.5 Failed transactions

- i) With regard to unsettled securities and foreign exchange transactions, banks are exposed to counterparty credit risk from trade date, irrespective of the booking or the accounting of the transaction. Banks are encouraged to develop, implement and improve systems for tracking and monitoring the credit risk exposure arising from unsettled transactions as appropriate for producing management information that facilitates action on a timely basis.
- ii) Banks must closely monitor securities and foreign exchange transactions that have failed, starting from the day they fail for producing management information that

facilitates action on a timely basis. Failed transactions give rise to risk of delayed settlement or delivery.

- iii) Failure of transactions settled through a delivery-versus-payment system (DvP), providing simultaneous exchanges of securities for cash, expose banks to a risk of loss on the difference between the transaction valued at the agreed settlement price and the transaction valued at current market price (i.e. positive current exposure). Failed transactions where cash is paid without receipt of the corresponding receivable (securities, foreign currencies, or gold,) or, conversely, deliverables were delivered without receipt of the corresponding cash payment (non-DvP, or free-delivery) expose banks to a risk of loss on the full amount of cash paid or deliverables delivered. Therefore, a capital charge is required for failed transactions and must be calculated as under. The following capital treatment is applicable to all failed transactions, including transactions through recognised clearing houses. Repurchase and reverse-repurchase agreements as well as securities lending and borrowing that have failed to settle are excluded from this capital treatment.
- iv) For DvP Transactions – If the payments have not yet taken place five business days after the settlement date, banks are required to calculate a **capital charge** by multiplying the positive current exposure of the transaction by the appropriate factor as under. In order to capture the information, banks will need to upgrade their information systems in order to track the number of days after the agreed settlement date and calculate the corresponding capital charge.

Number of working days after the agreed settlement date	Corresponding risk multiplier (in per cent)
From 5 to 15	9
From 16 to 30	50
From 31 to 45	75
46 or more	100

- v) For non-DvP transactions (free deliveries) after the first contractual payment / delivery leg, the bank that has made the payment will treat its exposure as a loan if the second leg has not been received by the end of the business day. If the dates when two payment legs are made are the same according to the time zones where each payment is made, it is deemed that they are settled on the same day. For example, if a bank in Tokyo transfers Yen on day X (Japan Standard Time) and receives corresponding US Dollar via CHIPS on day X (US Eastern Standard Time), the settlement is deemed to take place on the same value date. Banks shall compute the capital requirement using the counterparty risk weights prescribed in these guidelines. However, if five business days after the second contractual

payment / delivery date the second leg has not yet effectively taken place, the bank that has made the first payment leg will deduct from capital the full amount of the value transferred plus replacement cost, if any. This treatment will apply until the second payment / delivery leg is effectively made.

5.16 Securitisation Exposures

5.16.1 General

- i) A securitisation transaction, which meets the minimum requirements, listed in **Annex 6** (extracted from the 'Guidelines on Securitisation of Standard Assets', issued vide circular DBOD.No.BP.BC.60/ 21.04.048/ 2005-06 dated February 1, 2006), would qualify for the following prudential treatment of securitisation exposures for capital adequacy purposes. Banks' exposures to a securitisation transaction, referred to as securitisation exposures, can include, but are not restricted to the following: as investor, as credit enhancer, as liquidity provider, as underwriter, as provider of credit risk mitigants. Cash collaterals provided as credit enhancements shall also be treated as securitisation exposures. The terms used in this section with regard to securitisation shall be as defined in the above guidelines. Further, the following definitions shall be applicable:
 - a) A 'credit enhancing interest only strip (I/Os)' – an on-balance sheet exposure that is recorded by the originator, which (i) represents a valuation of cash flows related to future margin income to be derived from the underlying exposures, and (ii) is subordinated to the claims of other parties to the transaction in terms of priority of repayment.
 - b) 'Implicit support' – the support provided by a bank to a securitisation in excess of its predetermined contractual obligation.
 - c) A 'gain-on-sale' – any profit realised at the time of sale of the securitised assets to SPV.
- ii) Banks are required to hold regulatory capital against all of their securitisation exposures, including those arising from the provision of credit risk mitigants to a securitisation transaction, investments in asset-backed securities, retention of a subordinated tranche, and extension of a liquidity facility or credit enhancement, as set forth in the following paragraphs. Repurchased securitisation exposures must be treated as retained securitisation exposures. .
- iii) An originator in a securitisation transaction which does not meet the minimum requirements prescribed in the guidelines dated February 1, 2006 and therefore does not qualify for de-recognition shall hold capital against all of the exposures

associated with the securitisation transaction as if they had not been securitised²⁷. Additionally, the originator shall deduct any 'gain on sale' on such transaction from Tier 1 capital.

5.16.2 Deduction of securitisation exposures from capital funds

- i) When a bank is required to deduct a securitisation exposure from regulatory capital, the deduction must be made 50 per cent from Tier 1 and 50 per cent from Tier 2, except where expressly provided otherwise. Deductions from capital may be calculated net of any specific provisions maintained against the relevant securitisation exposures.
- ii) Credit enhancements, including credit enhancing I/Os (net of the gain-on-sale that shall be deducted from Tier 1 as specified below) and cash collaterals, which are required to be deducted must be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2.
- iii) Banks shall deduct from Tier 1 capital any "gain-on-sale", if permitted to be recognised.²⁸ However, in terms of guidelines on securitisation of standard assets, banks are allowed to amortise the profit over the period of the securities issued by the SPV. The amount of profit thus recognised in the P & L Account through amortisation, need not be deducted.
- iv) Any rated securitisation exposure with a long term rating of 'B+ and below' when not held by an originator, and a long term rating of 'BB+ and below' when held by the originator shall be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.
- v) Any unrated securitisation exposure, except an eligible liquidity facility as specified in paragraph 5.16.8 should be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 capital. In an unrated and ineligible liquidity facility, both the drawn and undrawn portions shall be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.
- vi) The holdings of securities devolved on the originator through underwriting should be sold to third parties within three-month period following the acquisition. In case of failure to off-load within the stipulated time limit, any holding in excess of 20 per cent

²⁷ For example: If in a securitisation transaction of Rs.100, the pool consists of 80 per cent of AAA securities, 10 per cent of BB securities and 10 per cent of unrated securities and the transaction does not meet the true sale criterion, then the originator will be deemed to be holding all the exposures in that transaction. Consequently, the AAA rated securities will attract a risk weight of 20 per cent and the face value of the BB rated securities and the unrated securities will be deducted. Thus the consequent impact on the capital will be Rs.21.44 (16*9 % + 20).

of the original amount of issue, including secondary market purchases, shall be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.

5.16.3 Implicit support

- i) The originator shall not provide any implicit support to investors in a securitisation transaction.
- ii) When a bank is deemed to have provided implicit support to a securitisation:
 - a) It must, at a minimum, hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised.
 - b) Additionally, the bank would need to deduct any gain-on-sale, as defined above, from Tier 1 capital.
 - c) Furthermore, in respect of securitisation transactions where the bank is deemed to have provided implicit support it is required to disclose publicly that (a) it has provided non-contractual support (b) the details of the implicit support and (c) the impact of the implicit support on the bank's regulatory capital.
- iii) Where a securitisation transaction contains a clean up call and the clean up call can be exercised by the originator in circumstances where exercise of the clean up call effectively provides credit enhancement, the clean up call shall be treated as implicit support and the concerned securitisation transaction will attract the above prescriptions.

5.16.4 Application of external ratings

The following operational criteria concerning the use of external credit assessments apply:

- i) A bank must apply external credit assessments from eligible external credit rating agencies consistently across a given type of securitisation exposure. Furthermore, a bank cannot use the credit assessments issued by one external credit rating agency for one or more tranches and those of another external credit rating agency for other positions (whether retained or purchased) within the same securitisation structure that may or may not be rated by the first external credit rating agency. Where two or more eligible external credit rating agencies can be used and these assess the credit risk of the same securitisation exposure differently, paragraphs 6.7 will apply.
- ii) If the CRM provider is not recognised as an eligible guarantor as defined in paragraph 7.5.5, the covered securitisation exposures should be treated as unrated.

²⁸ Vide item (c) of Sl.No.19 in the Annex to DBOD.No.BP.BC.21.06.001/2007-08 dated March 31, 2008

- iii) In the situation where a credit risk mitigant is not obtained by the SPV but rather applied to a specific securitisation exposure within a given structure (e.g. ABS tranche), the bank must treat the exposure as if it is unrated and then use the CRM treatment outlined in paragraph 7.
- iv) The other aspects of application of external credit assessments will be as per guidelines given in paragraph 6.

5.16.5 Risk weighted securitisation exposures

- i) Banks shall calculate the risk weighted amount of an on-balance sheet securitisation exposure by multiplying the principal amount (after deduction of specific provisions) of the exposures by the applicable risk weight.
- ii) The risk-weighted asset amount of a securitisation exposure is computed by multiplying the amount of the exposure by the appropriate risk weight determined in accordance with issue specific rating assigned to those exposures by the chosen external credit rating agencies as indicated in the following tables:

Table 10: Securitisation exposures – Risk weight mapping to long-term ratings

Domestic rating agencies	AAA	AA	A	BBB	BB	B and below or unrated
Risk weight for banks other than originators²⁹	20%	30%	50%	100%	350%	Deduction*
Risk weight for originator	20%	30%	50%	100%	Deduction*	

* governed by the provisions of paragraph 5.16.2

- iii) The risk-weighted asset amount of a securitisation exposure in respect of MBS backed by commercial real estate exposure, as defined in paragraph 5.11 above, is computed by multiplying the amount of the exposure by the appropriate risk weight determined in accordance with issue specific rating assigned to those exposures by the chosen external credit rating agencies as indicated in the following tables:

Table 11: Commercial real estate securitisation exposures – Risk weight mapping to long-term ratings

Domestic rating agencies	AAA	AA	A	BBB	BB	B and below or unrated
Risk weight for banks other than originators	50%	75%	100%	150%	400%	Deduction*
Risk weight for originator	50 %	75 %	100%	150%	Deduction*	

* governed by the provisions of paragraph 5.16.2

²⁹ Vide item (d) of Sl. No.19 in the Annex to DBOD.No.BP.BC.21.06.001/2007-08 dated March 31, 2008

- v) Banks are not permitted to invest in unrated securities issued by an SPV as a part of the securitisation transaction. However, securitisation exposures assumed by banks which may become unrated or may be deemed to be unrated, would be deducted for capital adequacy purposes in accordance with the provisions of paragraph 5.16.2.

5.16.6 Off-balance sheet securitisation exposures

- i) Banks shall calculate the risk weighted amount of a rated off-balance sheet securitisation exposure by multiplying the credit equivalent amount of the exposure by the applicable risk weight. The credit equivalent amount should be arrived at by multiplying the principal amount of the exposure (after deduction of specific provisions) with a 100 per cent CCF, unless otherwise specified.
- ii) If the off-balance sheet exposure is not rated, it must be deducted from capital, except an unrated eligible liquidity facility for which the treatment has been specified separately in paragraph 5.16.8.

5.16.7 Recognition of credit risk mitigants

- i) The treatment below applies to a bank that has obtained a credit risk mitigant on a securitisation exposure. Credit risk mitigant include guarantees and eligible collateral as specified in these guidelines. Collateral in this context refers to that used to hedge the credit risk of a securitisation exposure rather than for hedging the credit risk of the underlying exposures of the securitisation transaction.
- ii) When a bank other than the originator provides credit protection to a securitisation exposure, it must calculate a capital requirement on the covered exposure as if it were an investor in that securitisation. If a bank provides protection to an unrated credit enhancement, it must treat the credit protection provided as if it were directly holding the unrated credit enhancement.
- iii) Capital requirements for the guaranteed / protected portion will be calculated according to CRM methodology for the standardised approach as specified in paragraph 7 below. Eligible collateral is limited to that recognised under these guidelines in paragraph 7.3.5. For the purpose of setting regulatory capital against a maturity mismatch between the CRM and the exposure, the capital requirement will be determined in accordance with paragraphs 7.6. When the exposures being hedged have different maturities, the longest maturity must be used applying the methodology prescribed in paragraphs 7.6.3 & 7.6.4.

5.16.8 Liquidity facilities

- i) A liquidity facility will be considered as an 'eligible' facility only if it satisfies all minimum requirements prescribed in the guidelines issued on February 1, 2006. The rated liquidity facilities will be risk weighted or deducted as per the appropriate risk weight determined in accordance with the specific rating assigned to those exposures by the chosen ECAs as indicated in the tables presented above.
- ii) The unrated eligible liquidity facilities will be exempted from deductions and treated as follows.
 - a) The drawn and undrawn portions of an unrated eligible liquidity facility would attract a risk weight equal to the highest risk weight assigned to any of the underlying individual exposures covered by this facility.
 - b) The undrawn portion of an unrated eligible liquidity will attract the following credit conversion factors for calculating the credit equivalent amount: :
 - i) 20 per cent for facilities with an original maturity of one year or less, or
 - ii) 50 per cent for facilities with an original maturity of more than one year.

6. External credit assessments

6.1 Eligible Credit Rating Agencies

- 6.1.1 Reserve Bank has undertaken the detailed process of identifying the eligible credit rating agencies, whose ratings may be used by banks for assigning risk weights for credit risk. In line with the provisions of the Revised Framework, where the facility provided by the bank possesses rating assigned by an eligible credit rating agency, the risk weight of the claim will be based on this rating.
- 6.1.2 In accordance with the principles laid down in the Revised Framework, the Reserve Bank of India has decided that banks may use the ratings of the following domestic credit rating agencies (arranged in alphabetical order) for the purposes of risk weighting their claims for capital adequacy purposes:
 - a) Credit Analysis and Research Limited;
 - b) CRISIL Limited;
 - c) FITCH India; and
 - d) ICRA Limited.
- 6.1.2.1 The Reserve Bank of India has decided that banks may use the ratings of the following international credit rating agencies (arranged in alphabetical order) for the purposes of risk weighting their claims for capital adequacy purposes where specified:

- a) Fitch;
- b) Moodys; and
- c) Standard & Poor's

6.2 Scope of application of external ratings

6.2.1 Banks should use the chosen credit rating agencies and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. Banks will not be allowed to “cherry pick” the assessments provided by different credit rating agencies. If a bank has decided to use the ratings of some of the chosen credit rating agencies for a given type of claim, it can use only the ratings of those credit rating agencies, despite the fact that some of these claims may be rated by other chosen credit rating agencies whose ratings the bank has decided not to use. Banks shall not use one agency's rating for one corporate bond, while using another agency's rating for another exposure to the same counter-party, unless the respective exposures are rated by only one of the chosen credit rating agencies, whose ratings the bank has decided to use. External assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group.

6.2.2 Banks must disclose the names of the credit rating agencies that they use for the risk weighting of their assets, the risk weights associated with the particular rating grades as determined by Reserve Bank through the mapping process for each eligible credit rating agency as well as the aggregated risk weighted assets as required vide Table DF-5.

6.2.3 To be eligible for risk-weighting purposes, the external credit assessment must take into account and reflect the entire amount of credit risk exposure the bank has with regard to all payments owed to it. For example, if a bank is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with timely repayment of both principal and interest.

6.2.4 To be eligible for risk weighting purposes, the rating should be in force and confirmed from the monthly bulletin of the concerned rating agency. The rating agency should have reviewed the rating at least once during the previous 15 months.

6.2.5 An eligible credit assessment must be publicly available. In other words, a rating must be published in an accessible form and included in the external credit rating agency's transition matrix. Consequently, ratings that are made available only to the parties to a transaction do not satisfy this requirement.

6.2.6 For assets in the bank's portfolio that have contractual maturity less than or equal to one year, short term ratings accorded by the chosen credit rating agencies would be

relevant. For other assets which have a contractual maturity of more than one year, long term ratings accorded by the chosen credit rating agencies would be relevant.

6.2.7 Cash credit exposures tend to be generally rolled over and also tend to be drawn on an average for a major portion of the sanctioned limits. Hence, even though a cash credit exposure may be sanctioned for period of one year or less, these exposures should be reckoned as long term exposures and accordingly the long term ratings accorded by the chosen credit rating agencies will be relevant. Similarly, banks may use long-term ratings of a counterparty as a proxy for an unrated short- term exposure on the same counterparty subject to strict compliance with the requirements for use of multiple rating assessments and applicability of issue rating to issuer / other claims as indicated in paragraphs 6.4, 6.5, 6.7 and 6.8 below.

6.3 Mapping process

The Revised Framework recommends development of a mapping process to assign the ratings issued by eligible credit rating agencies to the risk weights available under the Standardised risk weighting framework. The mapping process is required to result in a risk weight assignment consistent with that of the level of credit risk. A mapping of the credit ratings awarded by the chosen domestic credit rating agencies has been furnished below in paragraphs 6.4.1 and 6.5.4, which should be used by banks in assigning risk weights to the various exposures.

6.4 Long term ratings

6.4.1 On the basis of the above factors as well as the data made available by the rating agencies, the ratings issued by the chosen domestic credit rating agencies have been mapped to the appropriate risk weights applicable as per the Standardised approach under the Revised Framework. The rating-risk weight mapping furnished in the Table below shall be adopted by all banks in India:

Table 12: Risk weight mapping of Long term Ratings of the chosen domestic rating agencies

Long term ratings of the chosen credit rating agencies operating in India	Standardised approach risk weights (in per cent)
AAA	20
AA	30
A	50
BBB	100
BB & below	150
Unrated	100

6.4.2 Where “+” or “-” notation is attached to the rating, the corresponding main rating category risk weight should be used. For example, A+ or A- would be considered to be in

the A rating category and assigned 50 per cent risk weight.

6.4.3 If an issuer has a long-term exposure with an external long term rating that warrants a risk weight of 150 per cent, all unrated claims on the same counter-party, whether short-term or long-term, should also receive a 150 per cent risk weight, unless the bank uses recognised credit risk mitigation techniques for such claims.

6.5 Short term ratings

6.5.1 For risk-weighting purposes, short-term ratings are deemed to be issue-specific. They can only be used to derive risk weights for claims arising from the rated facility. They cannot be generalised to other short-term claims. In no event can a short-term rating be used to support a risk weight for an unrated long-term claim. Short-term assessments may only be used for short-term claims against banks and corporates.

6.5.2 Notwithstanding the above restriction on using an issue specific short term rating for other short term exposures, the following broad principles will apply. The unrated short term claim on counterparty will attract a risk weight of at least one level higher than the risk weight applicable to the rated short term claim on that counter-party. If a short-term rated facility to counterparty attracts a 20 per cent or a 50 per cent risk-weight, unrated short-term claims to the same counter-party cannot attract a risk weight lower than 30 per cent or 100 per cent respectively.

6.5.3 Similarly, if an issuer has a short-term exposure with an external short term rating that warrants a risk weight of 150 per cent, all unrated claims on the same counter-party, whether long-term or short-term, should also receive a 150 per cent risk weight, unless the bank uses recognised credit risk mitigation techniques for such claims.

6.5.4 In respect of the issue specific short term ratings the following risk weight mapping shall be adopted by banks:

of the domestic rating agencies

Short Term Ratings				Risk Weights
CARE	CRISIL	Fitch	ICRA	
PR1+	P1+	F1+(ind)	A1+	20 %
PR1	P1	F1(ind)	A1	30 %
PR2	P2	F2(ind)	A2	50 %
PR3	P 3	F3 (ind)	A3	100 %
PR4 & PR5	P 4 & P5	F4/F5 (ind)	A4 / A5	150 %
Unrated	Unrated	Unrated	Unrated	100 %

6.5.5 Where “+” or “-” notation is attached to the rating, the corresponding main rating category risk weight should be used for PR2/ P2/ F2/ A2 and below, unless specified otherwise. For example, P2+ or P2- would be considered to be in the P2 rating category and assigned 50 per cent risk weight.

6.5.6 The above risk weight mapping of both long term and short term ratings of the chosen domestic rating agencies would be reviewed annually by the Reserve Bank.

6.6 Use of unsolicited ratings

A rating would be treated as solicited only if the issuer of the instrument has requested the credit rating agency for the rating and has accepted the rating assigned by the agency. As a general rule, banks should use only **solicited rating from the chosen credit rating agencies**. No ratings issued by the credit rating agencies on an unsolicited basis should be considered for risk weight calculation as per the Standardised Approach.

6.7 Use of multiple rating assessments

Banks shall be guided by the following in respect of exposures / obligors having multiple ratings from the chosen credit rating agencies chosen by the bank for the purpose of risk weight calculation:

- (i) If there is only one rating by a chosen credit rating agency for a particular claim, that rating would be used to determine the risk weight of the claim.
- (ii) If there are two ratings accorded by chosen credit rating agencies that map into different risk weights, the higher risk weight should be applied.
- (iii) If there are three or more ratings accorded by chosen credit rating agencies with different risk weights, the ratings corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights should be applied. i.e., the second lowest risk weight.

6.8 Applicability of issue rating to issuer/ other claims

Where a bank invests in a particular issue that has an issue specific rating by a chosen credit rating agency the risk weight of the claim will be based on this assessment. Where the bank's claim is not an investment in a specific assessed issue, the following general principles will apply:

- (i) In circumstances where the borrower has a specific assessment for an issued debt - but the bank's claim is not an investment in this particular debt - the rating applicable to the specific debt (where the rating maps into a risk weight lower than that which applies to an unrated claim) may be applied to the bank's unassessed claim only if this claim ranks *pari passu* or senior to the specific rated debt in all respects and the maturity of the unassessed

claim is not later than the maturity of the rated claim,³⁰ except where the rated claim is a short term obligation as specified in paragraph 6.5.2. If not, the rating applicable to the specific debt cannot be used and the unassessed claim will receive the risk weight for unrated claims.

- (ii) If either the issuer or single issue has been assigned a rating which maps into a risk weight equal to or higher than that which applies to unrated claims, a claim on the same counterparty, which is unrated by any chosen credit rating agency, will be assigned the same risk weight as is applicable to the rated exposure, if this claim ranks *pari passu* or junior to the rated exposure in all respects.
- (iii) Where a bank intends to extend an issuer or an issue specific rating assigned by a chosen credit rating agency to any other exposure which the bank has on the same counterparty and which meets the above criterion, it should be extended to the entire amount of credit risk exposure the bank has with regard to that exposure i.e., both principal and interest.
- (iv) With a view to avoiding any double counting of credit enhancement factors, no recognition of credit risk mitigation techniques should be taken into account if the credit enhancement is already reflected in the issue specific rating accorded by a chosen credit rating agency relied upon by the bank.
- (v) Where unrated exposures are risk weighted based on the rating of an equivalent exposure to that borrower, the general rule is that foreign currency ratings would be used only for exposures in foreign currency.

7. **Credit Risk Mitigation**

7.1 **General principles**

7.1.1 Banks use a number of techniques to mitigate the credit risks to which they are exposed. For example, exposures may be collateralised in whole or in part by cash or securities, deposits from the same counterparty, guarantee of a third party, etc. The revised approach to credit risk mitigation allows a wider range of credit risk mitigants to be recognised for regulatory capital purposes than is permitted under the 1988 Framework provided these techniques meet the requirements for legal certainty as described in paragraph 7.2 below. Credit risk mitigation approach as detailed in this section is applicable to the banking book exposures. This will also be applicable for calculation of the counterparty risk charges for OTC derivatives and repo-style transactions booked in the trading book.

7.1.2 The general principles applicable to use of credit risk mitigation techniques are as under:

- (i) No transaction in which Credit Risk Mitigation (CRM) techniques are used

³⁰ In a case where a short term claim on a counterparty is rated as P1+ and a long term claim on the same counterparty is rated as AAA, then a bank may assign a 30 per cent risk weight to an unrated short term claim and 20 per cent risk weight to an unrated long term claim on that counterparty where the seniority of the claim ranks *pari-passu* with the rated claims and the maturity of the unrated claim is not later than the rated claim. In a similar case where a short term claim is rated P1+ and a long term claim is rated A, the bank may assign 50 per cent risk weight to an unrated short term or long term claim.

should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.

- (ii) The effects of CRM will **not** be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM.
- (iii) Principal-only ratings will not be allowed within the CRM framework.
- (iv) While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; control of roll-off risks; and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile. Where these risks are not adequately controlled, Reserve Bank may impose additional capital charges or take other supervisory actions. The disclosure requirements prescribed in Table DF-6 (paragraph 10 – Market Discipline) must also be observed for banks to obtain capital relief in respect of any CRM techniques.

7.2 Legal Certainty

In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met. All documentation used in collateralised transactions and guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review, which should be well documented, to verify this. Such verification should have a well founded legal basis for reaching the conclusion about the binding nature and enforceability of the documents. Banks should also undertake such further review as necessary to ensure continuing enforceability.

7.3 Credit risk mitigation techniques - Collateralised transactions

7.3.1 A collateralised transaction is one in which:

- (i) banks have a credit exposure and that credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty. Here, "counterparty" is used to denote a party to whom a bank has an on- or off-balance sheet credit exposure.
- (ii) banks have a specific lien on the collateral and the requirements of legal certainty are met.

7.3.2 Overall framework and minimum conditions

The Revised Framework allows banks to adopt either the simple approach, which, similar to the 1988 Accord, substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collateralised portion of the exposure (generally subject to a 20 per cent floor), or the comprehensive approach, which allows fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral. Banks in India shall adopt the Comprehensive Approach, which allows fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral. Under this approach, banks, which take eligible financial collateral (e.g., cash or securities, more specifically defined below), are allowed to reduce their credit exposure to a counterparty when calculating their capital requirements to take account of the risk mitigating effect of the collateral. Credit risk mitigation is allowed only on an account-by-account basis, even within regulatory retail portfolio. However, before capital relief will be granted the standards set out below must be met:

- (i) In addition to the general requirements for legal certainty, the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore banks must take all steps necessary to fulfill those requirements under the law applicable to the bank's interest in the collateral for obtaining and maintaining an enforceable security interest, e.g. by registering it with a registrar.
- (ii) In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty - or by any related group entity - would provide little protection and so would be ineligible.
- (iii) Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.
- (iv) Where the collateral is held by a custodian, banks must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

7.3.3 A capital requirement will be applied to a bank on either side of the collateralised transaction: for example, both repos and reverse repos will be subject to capital requirements. Likewise, both sides of securities lending and borrowing transactions will be subject to explicit capital charges, as will the posting of securities in connection with a derivative exposure or other borrowing.

7.3.4 The comprehensive approach

- i) In the comprehensive approach, when taking collateral, banks will need to calculate their adjusted exposure to a counterparty for capital adequacy purposes in order to take account of the effects of that collateral. Banks are required to adjust both the amount of the exposure to the counterparty and the value of any collateral received in support of that counterparty to take account of possible future fluctuations in the value of either, occasioned by market movements. These adjustments are referred to as 'haircuts'. The application of haircuts will produce volatility adjusted amounts for both exposure and collateral. The volatility adjusted amount for the exposure will be higher than the exposure and the volatility adjusted amount for the collateral will be lower than the collateral, unless either side of the transaction is cash. In other words, the 'haircut' for the exposure will be a premium factor and the 'haircut' for the collateral will be a discount factor. It may be noted that the purpose underlying the application of haircut is to capture the market-related volatility inherent in the value of exposures as well as of the eligible financial collaterals. Since the value of credit exposures acquired by the banks in the course of their banking operations, would not be subject to market volatility, (since the loan disbursal / investment would be a "cash" transaction) though the value of eligible financial collateral would be, the haircut stipulated in Table-14 would apply in respect of credit transactions only to the eligible collateral but not to the credit exposure of the bank. On the other hand, exposures of banks, arising out of repo-style transactions would require upward adjustment for volatility, as the value of security sold/lent/pledged in the repo transaction, would be subject to market volatility. Hence, such exposures shall attract haircut.³¹
- ii) Additionally where the exposure and collateral are held in different currencies an additional downwards adjustment must be made to the volatility adjusted collateral amount to take account of possible future fluctuations in exchange rates.
- iii) Where the volatility-adjusted exposure amount is greater than the volatility-adjusted collateral amount (including any further adjustment for foreign exchange risk), banks shall calculate their risk-weighted assets as the difference between the two multiplied by the risk weight of the counterparty. The framework for performing calculations of capital requirement is indicated in paragraph 7.3.6.

³¹ Vide SI No.9 in the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

7.3.5 Eligible financial collateral

The following collateral instruments are eligible for recognition in the comprehensive approach:

- (i) Cash (as well as certificates of deposit or comparable instruments, including fixed deposit receipts, issued by the lending bank) on deposit with the bank which is incurring the counterparty exposure.
- (ii) Gold: Gold would include both bullion and jewellery. However, the value of the collateralised jewellery should be arrived at after notionally converting these to 99.99 purity.
- (iii) Securities issued by Central and State Governments
- (iv) Kisan Vikas Patra and National Savings Certificates provided no lock-in period is operational and if they can be encashed within the holding period.
- (v) Life insurance policies with a declared surrender value of an insurance company which is regulated by an insurance sector regulator.
- (vi) Debt securities rated by a chosen Credit Rating Agency in respect of which the banks should be sufficiently confident about the market liquidity³² where these are either:
 - a) Attracting 100 per cent or lesser risk weight i.e., rated at least BBB(-) when issued by public sector entities and other entities (including banks and Primary Dealers); or
 - b) Attracting 100 per cent or lesser risk weight i.e., rated at least PR3 / P3/F3/A3 for short-term debt instruments.
- vii) Debt securities not rated by a chosen Credit Rating Agency in respect of which the banks should be sufficiently confident about the market liquidity where these are:
 - a) issued by a bank; and
 - b) listed on a recognised exchange; and
 - c) classified as senior debt; and
 - d) all rated issues of the same seniority by the issuing bank are rated at least BBB(-) or PR3/P3/F3/A3 by a chosen Credit Rating Agency; and
 - e) the bank holding the securities as collateral has no information to suggest that the issue justifies a rating below BBB(-) or PR3/P3/F3/A3 (as applicable) and;
 - f) Banks should be sufficiently confident about the market liquidity of the security.
- viii) ³³Units of Mutual Funds regulated by the securities regulator of the jurisdiction of the bank's operation mutual funds where:
 - a) a price for the units is publicly quoted daily i.e., where the daily NAV

³² A debenture would meet the test of liquidity if it is traded on a recognised stock exchange(s) on at least 90 per cent of the trading days during the preceding 365 days. Further, liquidity can be evidenced in the trading during the previous one month in the recognised stock exchange if there are a minimum of 25 trades of marketable lots in securities of each issuer.

³³ Vide SI.No.11 in the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008.

- is available in public domain; and
- b) Mutual fund is limited to investing in the instruments listed in this paragraph.

7.3.6 Calculation of capital requirement

For a collateralised transaction, the exposure amount after risk mitigation is calculated as follows:

$$E^* = \max \{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\}$$

where:

- E^* = the exposure value after risk mitigation
 E = current value of the exposure for which the collateral qualifies as a risk mitigant
 H_e = haircut appropriate to the exposure
 C = the current value of the collateral received
 H_c = haircut appropriate to the collateral
 H_{fx} = haircut appropriate for currency mismatch between the collateral and exposure

The exposure amount after risk mitigation (i.e., E^*) will be multiplied by the risk weight of the counterparty to obtain the risk-weighted asset amount for the collateralised transaction. Illustrative examples calculating the effect of Credit Risk Mitigation is furnished in **Annex 8**³⁴

7.3.7 Haircuts

- i) In principle, banks have two ways of calculating the haircuts: (i) standard supervisory haircuts, using parameters set by the Basel Committee, and (ii) own-estimate haircuts, using banks' own internal estimates of market price volatility. Banks in India shall use only the standard supervisory haircuts for both the exposure as well as the collateral.
- ii) The Standard Supervisory Haircuts (assuming daily mark-to-market, daily re-margining and a 10 business-day holding period)³⁵, expressed as percentages, would be as furnished in Table 14.
- iii) The ratings indicated in Table – 14 represent the ratings assigned by the domestic rating agencies. In the case of exposures toward debt securities issued by foreign Central Governments and foreign corporates, the haircut may be based on ratings of the international rating agencies, as indicated in Table 15.
- iv) Sovereign will include Reserve Bank of India, DICGC and CGTSI, which are eligible for zero per cent risk weight.

³⁴ Vide Appendix – 2 to Annex of DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008.

³⁵ Holding period will be the time normally required by the bank to realise the value of the collateral.

- vi) Banks may apply a zero haircut for eligible collateral where it is a National Savings Certificate, Kisan Vikas Patras, surrender value of insurance policies and banks' own deposits.
- vi) The standard supervisory haircut for currency risk where exposure and collateral are denominated in different currencies is eight per cent (also based on a 10-business day holding period and daily mark-to-market)

Table – 14: Standard Supervisory Haircuts for Sovereign and other securities which constitute Exposure and Collateral

Sl. No.	Issue Rating for Debt securities	Residual Maturity (in years)	Haircut (in percentage)
A	Securities issued / guaranteed by the Government of India and issued by the State Governments (Sovereign securities)		
	i	< or = 1 year	0.5
		> 1 year and < or = 5 years	2
		> 5 years	4
B	Domestic debt securities other than those indicated at Item No. A above including the securities guaranteed by Indian State Governments		
	ii	< or = 1 year	1
		> 1 year and < or = 5 years	4
		> 5 years	8
	iii	< or = 1 year	2
		> 1 year and < or = 5 years	6
		> 5 years	12
	vi	Units of Mutual Funds	Highest haircut applicable to any of the above securities, in which the eligible mutual fund {cf. paragraph 7.3.5 (viii)} can invest
C	Cash in the same currency		0
D	Gold		15

Table – 15 : Standard Supervisory Haircut for Exposures and Collaterals which are obligations of foreign central sovereigns/foreign corporates

Issue rating for debt securities as assigned by international rating agencies	Residual Maturity	Sovereigns	Other Issues
AAA to AA / A-1	< = 1 year	0.5	1
	> 1 year and < or = 5 years	2	4
	> 5 years	4	8
A to BBB / A-2 / A-3 / P-3 and Unrated Bank Securities	< = 1 year	1	2
	> 1 year and < or = 5 years	3	6
	> 5 years	6	12

- vii) For transactions in which the banks' exposures are unrated or bank lends non-eligible instruments (i.e, non-investment grade corporate securities), the haircut to be applied on a exposure should be 25 per cent. (Since, at present, the repos are allowed only in the case of Government securities, the banks are not likely to have any exposure which will attract the provisions of this clause. However, this would be relevant, if in future, repos/security lending transactions are permitted in the case of unrated corporate securities).
- viii) Where the collateral is a basket of assets, the haircut on the basket will be,

$$H = \sum_i a_i H_i$$

where a_i is the weight of the asset (as measured by the amount/value of the asset in units of currency) in the basket and H_i , the haircut applicable to that asset.

ix) Adjustment for different holding periods

For some transactions, depending on the nature and frequency of the revaluation and remargining provisions, different holding periods (other than 10 business-days) are appropriate. The framework for collateral haircuts distinguishes between repo-style transactions (i.e. repo/reverse repos and securities lending/borrowing), "other capital-market-driven transactions" (i.e. OTC derivatives transactions and margin lending) and secured lending. In capital-market-driven transactions and repo-style transactions, the documentation contains remargining clauses; in secured lending transactions, it generally does not. In view of different holding periods, in the case of these transactions, the minimum holding period shall be taken as indicated below:

Transaction type	Minimum holding Period	Condition
Repo-style transaction	five business days	daily remargining
Other capital market transactions	ten business days	daily remargining
Secured lending	twenty business days	daily revaluation

The haircut for the transactions with other than 10 business-days minimum holding period, as indicated above, will have to be adjusted by scaling up/down the haircut for 10 business–days indicated in the Table-14, as per the formula given in paragraph 7.3.7 (xi) below.

x) Adjustment for non-daily mark-to-market or remargining

In case a transaction has margining frequency different from daily margining assumed, the applicable haircut for the transaction will also need to be adjusted by using the formula given in paragraph 7.3.7 (xi) below.

xi) Formula for adjustment for different holding periods and / or non-daily mark – to – market or remargining

Adjustment for the variation in holding period and margining / mark – to – market, as indicated in paragraph (ix) and (x) above will be done as per the following formula:

$$H = H_{10} \sqrt{\frac{N_R + (T_M - 1)}{10}}$$

where:

H = haircut;

H₁₀ = 10-business-day standard supervisory haircut for instrument

N_R = actual number of business days between remargining for capital market transactions or revaluation for secured transactions.

T_M = minimum holding period for the type of transaction

7.3.8 Capital Adequacy Framework for Repo-/Reverse Repo-style transactions.³⁶

The repo-style transactions also attract capital charge for Counterparty credit risk (CCR), in addition to the credit risk and market risk. The CCR is defined as the risk of default by the counterparty in a repo-style transaction, resulting in non-delivery of the security lent/pledged/sold or non-repayment of the cash.

³⁶ Vide SI No.13 in the Annex of DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

A. Treatment in the books of the borrower of funds

- i) Where a bank has borrowed funds by selling / lending or posting, as collateral, of securities, the 'Exposure' will be an off-balance sheet exposure equal to the 'market value' of the securities sold/lent as scaled up after applying appropriate haircut. For the purpose, the haircut as per Table 14 would be used as the basis which should be applied by using the formula in paragraph 7.3.7 (xi), to reflect minimum (prescribed) holding period of five business-days for repo-style transactions and the variations, if any, in the frequency of re-margining, from the daily margining assumed for the standard supervisory haircut. The 'off-balance sheet exposure' will be converted into 'on-balance sheet' equivalent by applying a credit conversion factor of 100 per cent., as per item 5 in Table 8 of the circular.
- ii) The amount of money received will be treated as collateral for the securities lent/sold/pledged. Since the collateral is cash, the haircut for it would be zero.
- iii) The credit equivalent amount arrived at (i) above, net of amount of cash collateral, will attract a risk weight as applicable to the counterparty.
- iv) As the securities will come back to the books of the borrowing bank after the repo period, it will continue to maintain the capital for the credit risk in the securities in the cases where the securities involved in repo are held under HTM category, and capital for market risk in cases where the securities are held under AFS/HFT categories. The capital charge for credit risk / specific risk would be determined according to the credit rating of the issuer of the security. In the case of Government securities, the capital charge for credit / specific risk will be 'zero'.

B. Treatment in the books of the lender of funds

- i) The amount lent will be treated as on-balance sheet/funded exposure on the counter party, collateralised by the securities accepted under the repo.
- ii) The exposure, being cash, will receive a zero haircut.
- iii) The collateral will be adjusted downwards/marked down as per applicable haircut.
- iv) The amount of exposure reduced by the adjusted amount of collateral, will receive a risk weight as applicable to the counterparty, as it is an on- balance sheet exposure.
- v) The lending bank will not maintain any capital charge for the security received by it as collateral during the repo period, since such collateral does not enter its balance sheet but is only held as a bailee.

7.4 Credit risk mitigation techniques – On-balance sheet netting

On-balance sheet netting is confined to loans/advances and deposits, where banks have legally enforceable netting arrangements, involving specific lien with proof of documentation. They may calculate capital requirements on the basis of net credit exposures subject to the following conditions:

Where a bank,

- a) has a well-founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt;
- b) is able at any time to determine the loans/advances and deposits with the same counterparty that are subject to the netting agreement; and
- c) monitors and controls the relevant exposures on a net basis,

it may use the net exposure of loans/advances and deposits as the basis for its capital adequacy calculation in accordance with the formula in paragraph 7.3.6. Loans/advances are treated as exposure and deposits as collateral. The haircuts will be zero except when a currency mismatch exists. All the requirements contained in paragraph 7.3.6 and 7.6 will also apply.

7.5 Credit risk mitigation techniques - Guarantees

7.5.1 Where guarantees are direct, explicit, irrevocable and unconditional banks may take account of such credit protection in calculating capital requirements.

7.5.2 A range of guarantors are recognised. As under the 1988 Accord, a substitution approach will be applied. Thus only guarantees issued by entities with a lower risk weight than the counterparty will lead to reduced capital charges since the protected portion of the counterparty exposure is assigned the risk weight of the guarantor, whereas the uncovered portion retains the risk weight of the underlying counterparty.

7.5.3 Detailed operational requirements for guarantees eligible for being treated as a CRM are as under:

7.5.4 Operational requirements for guarantees

- i) A guarantee (counter-guarantee) must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible. The guarantee must be irrevocable; there must be no clause in the contract that would allow the protection provider unilaterally to cancel the cover or that would increase the effective cost of cover as a result of deteriorating credit quality in the guaranteed exposure. The guarantee must also be unconditional; there should be no clause in the guarantee outside the direct control of the bank that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counterparty fails to make the payment(s) due.

- ii) All exposures will be risk weighted after taking into account risk mitigation available in the form of guarantees. When a guaranteed exposure is classified as non-performing, the guarantee will cease to be a credit risk mitigant and no adjustment would be permissible on account of credit risk mitigation in the form of guarantees. The entire outstanding, net of specific provision and net of realisable value of eligible collaterals / credit risk mitigants, will attract the appropriate risk weight.

7.5.5 Additional operational requirements for guarantees

In addition to the legal certainty requirements in paragraphs 7.2 above, in order for a guarantee to be recognised, the following conditions must be satisfied:

- i) On the qualifying default/non-payment of the counterparty, the bank is able in a timely manner to pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterparty for payment.
- ii) The guarantee is an explicitly documented obligation assumed by the guarantor.
- iii) Except as noted in the following sentence, the guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments etc. Where a guarantee covers payment of principal only, interests and other uncovered payments should be treated as an unsecured amount in accordance with paragraph 7.5.8.

7.5.6 Range of eligible guarantors (counter-guarantors)

Credit protection given by the following entities will be recognised:

- (i) Sovereigns, sovereign entities (including BIS, IMF, European Central Bank and European Community as well as those MDBs referred to in paragraph 5.5, ECGC and CGTSI), banks and primary dealers with a lower risk weight than the counterparty;
- (ii) other entities rated AA (-) or better. This would include guarantee cover provided by parent, subsidiary and affiliate companies when they have a lower risk weight than the obligor. The rating of the guarantor should be an entity rating which has factored in all the liabilities and commitments (including guarantees) of the entity.

7.5.7 Risk weights

The protected portion is assigned the risk weight of the protection provider. Exposures covered by State Government guarantees will attract a risk weight of 20 per cent. The uncovered portion of the exposure is assigned the risk weight of the underlying counterparty.

7.5.8 Proportional cover

Where the amount guaranteed, or against which credit protection is held, is less than the amount of the exposure, and the secured and unsecured portions are of equal seniority, i.e. the bank and the guarantor share losses on a pro-rata basis capital relief will be afforded on a proportional basis: i.e. the protected portion of the exposure will receive the treatment applicable to eligible guarantees, with the remainder treated as unsecured.

7.5.9 Currency mismatches

Where the credit protection is denominated in a currency different from that in which the exposure is denominated – i.e. there is a currency mismatch – the amount of the exposure deemed to be protected will be reduced by the application of a haircut H_{FX} , i.e.,

$$G_A = G \times (1 - H_{FX})$$

where:

G = nominal amount of the credit protection

H_{FX} = haircut appropriate for currency mismatch between the credit protection and underlying obligation.

Banks using the supervisory haircuts will apply a haircut of eight per cent for currency mismatch.

7.5.10 Sovereign guarantees and counter-guarantees

A claim may be covered by a guarantee that is indirectly counter-guaranteed by a sovereign. Such a claim may be treated as covered by a sovereign guarantee provided that:

- (i) the sovereign counter-guarantee covers all credit risk elements of the claim;
- (ii) both the original guarantee and the counter-guarantee meet all operational requirements for guarantees, except that the counter-guarantee need not be direct and explicit to the original claim; and
- (iii) the cover should be robust and no historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct sovereign guarantee.

7.6 Maturity Mismatch

7.6.1 For the purposes of calculating risk-weighted assets, a maturity mismatch occurs when the residual maturity of collateral is less than that of the underlying exposure. Where there is a maturity mismatch and the CRM has an original maturity of less than one year, the CRM is not recognised for capital purposes. In other cases where there is a maturity mismatch, partial recognition is given to the CRM for regulatory capital purposes as detailed below in paragraphs 7.6.2 to 7.6.4. In case of loans collateralised by the bank's own deposits, even if the tenor of such deposits is less than three months or deposits have maturity mismatch vis-à-vis the tenor of the loan, the provisions of paragraph 7.6.1 regarding derecognition of collateral would not be attracted provided an explicit consent of the depositor has been obtained from the depositor (i.e, borrower) 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.³⁷

7.6.2 Definition of maturity

The maturity of the underlying exposure and the maturity of the collateral should both be defined conservatively. The effective maturity of the underlying should be gauged as the longest possible remaining time before the counterparty is scheduled to fulfil its obligation, taking into account any applicable grace period. For the collateral, embedded options which may reduce the term of the collateral should be taken into account so that the shortest possible effective maturity is used. The maturity relevant here is the residual maturity.

7.6.3 Risk weights for maturity mismatches

As outlined in paragraph 7.6.1, collateral with maturity mismatches are only recognised when their original maturities are greater than or equal to one year. As a result, the maturity of collateral for exposures with original maturities of less than one year must be matched to be recognised. In all cases, collateral with maturity mismatches will no longer be recognised when they have a residual maturity of three months or less.

7.6.4 When there is a maturity mismatch with recognised credit risk mitigants (collateral, on-balance sheet netting and guarantees) the following adjustment will be applied.

$$Pa = P \times (t - 0.25) \div (T - 0.25)$$

where:

Pa = value of the credit protection adjusted for maturity mismatch

³⁷ Vide SI No.14 in the Annex to DBOD.No.BP.BC.67/21.06.01/2007-08 dated March 31, 2008

- P = credit protection (e.g. collateral amount, guarantee amount)
adjusted for any haircuts
- t = min (T, residual maturity of the credit protection arrangement)
expressed in years
- T = min (5, residual maturity of the exposure) expressed in years

7.7 Treatment of pools of CRM techniques

In the case where a bank has multiple CRM techniques covering a single exposure (e.g. a bank has both collateral and guarantee partially covering an exposure), the bank will be required to subdivide the exposure into portions covered by each type of CRM technique (e.g. portion covered by collateral, portion covered by guarantee) and the risk-weighted assets of each portion must be calculated separately. When credit protection provided by a single protection provider has differing maturities, they must be subdivided into separate protection as well.

8. Capital charge for Market Risk

8.1 Introduction

Market risk is defined as the risk of losses in on-balance sheet and off-balance sheet positions arising from movements in market prices. The market risk positions subject to capital charge requirement are:

- (i) The risks pertaining to interest rate related instruments and equities in the trading book; and
- (ii) Foreign exchange risk (including open position in precious metals) throughout the bank (both banking and trading books).

8.2 Scope and coverage of capital charge for market risks

8.2.1 These guidelines seek to address the issues involved in computing capital charges for interest rate related instruments in the trading book, equities in the trading book and foreign exchange risk (including gold and other precious metals) in both trading and banking books. Trading book for the purpose of capital adequacy will include:

- (i) Securities included under the Held for Trading category
- (ii) Securities included under the Available for Sale category
- (iii) Open gold position limits
- (iv) Open foreign exchange position limits
- (v) Trading positions in derivatives, and
- (vi) Derivatives entered into for hedging trading book exposures.

8.2.2 ³⁸Banks are required to manage the market risks in their books on an ongoing basis and ensure that the capital requirements for market risks are being maintained on a continuous basis, i.e. at the close of each business day. Banks are also required to maintain strict risk management systems to monitor and control intra-day exposures to market risks.

8.2.3 Capital for market risk would not be relevant for securities, which have already matured and remain unpaid. These securities will attract capital only for credit risk. On completion of 90 days delinquency, these will be treated on par with NPAs for deciding the appropriate risk weights for credit risk.

8.3 Measurement of capital charge for interest rate risk

8.3.1 This section describes the framework for measuring the risk of holding or taking positions in debt securities and other interest rate related instruments in the trading book.

8.3.2 The capital charge for interest rate related instruments would apply to current market value of these items in bank's trading book. Since banks are required to maintain capital for market risks on an ongoing basis, they are required to mark to market their trading positions on a daily basis. The current market value will be determined as per extant RBI guidelines on valuation of investments.

8.3.3 The minimum capital requirement is expressed in terms of two separately calculated charges, (i) "**specific risk**" charge for each security, which is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer, both for short (short position is not allowed in India except in derivatives) and long positions, and (ii) "**general market risk**" charge towards interest rate risk in the portfolio, where long and short positions (which is not allowed in India except in derivatives) in different securities or instruments can be offset.

8.3.4 For the debt securities held under AFS category, in view of the possible longer holding period and attendant higher specific risk, the banks shall hold total capital charge for market risk equal to greater of (a) or (b) below:

- a) Specific risk capital charge, computed notionally for the AFS securities treating them as held under HFT category (as computed according to Table 16: Part A/C/E, as applicable) plus the General Market Risk Capital Charge.
- b) Alternative total capital charge for the AFS category computed notionally treating them as held in the banking book (as computed in accordance with table 16: Part B/D/F, as applicable)

³⁸ Vide SI No.15 in the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

A. Specific Risk

8.3.5 The capital charge for specific risk is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer. The specific risk charges for various kinds of exposures would be applied as detailed below:

Sl.No.	Nature of debt securities / issuer	Table to be followed
a.	Central, State and Foreign Central Governments' <u>bonds</u> : (i) Held in HFT category (ii) Held in AFS category	Table 16 – Part A Table 16 – Par B
b.	<u>Banks' Bonds</u> : (i) Held in HFT category (ii) Held in AFS category	Table 16 – Part C Table 16 – Par D
c.	<u>Corporate Bonds and securitised debt</u> : (i) Held in HFT category (ii) Held in AFS category	Table 16 – Par E Table 16 – Part F

Table 16 – Part A

**Specific Risk Capital Charge for Sovereign securities issued by
Indian and foreign sovereigns – Held by banks under the HFT Category**

Sr. No.	Nature of Investment	Residual Maturity	Specific risk capital (as % of exposure)
A.	Indian Central Government and State Governments		
1.	Investment in Central and State Government Securities	All	0.00
2.	Investments in other approved securities guaranteed by Central Government	All	0.00
3.	Investments in other approved securities guaranteed by State Government	6 months or less	0.28
		More than 6 months and up to and including 24 months	1.13
		More than 24 months	1.80
4.	Investment in other securities where payment of interest and repayment of principal are guaranteed by Central Government	All	0.00
5.	Investments in other securities where payment of interest and repayment of principal are guaranteed by State Government.	6 months or less	0.28
		More than 6 months and up to and including 24 months	1.13
		More than 24 months	1.80
B.	Foreign Central Governments		
1.	AAA to AA	All	0.00
2.	A to BBB	6 months or less	0.28
		More than 6 months and up to and including 24 months	1.13
		More than 24 months	1.80
3.	BB to B	All	9.00
4.	Below B	All	13.50
5.	Unrated	All	13.50

Table 16 – Part B

**Alternative Total Capital Charge
for securities issued by Indian and foreign sovereigns
– Held by banks under the AFS Category**

Sr. No.	Nature of Investment	Residual Maturity	Specific risk capital (as % of exposure)
A.	Indian Central Government and State Governments		
1.	Investment in Central and State Government Securities	All	0.00
2.	Investments in other approved securities guaranteed by Central Government	All	0.00
3.	Investments in other approved securities guaranteed by State Government	All	1.80
4.	Investment in other securities where payment of interest and repayment of principal are guaranteed by Central Government	All	0.00
5.	Investments in other securities where payment of interest and repayment of principal are guaranteed by State Government.	All	1.80
B.	Foreign Central Governments		
1.	AAA to AA	All	0.00
2.	A	All	1.80
3.	BBB	All	4.50
4.	BB to B	All	9.00
5.	Below B	All	13.50
	Unrated	All	13.50

Table 16 – Part C
Specific risk capital charge for
bonds issued by banks – Held by banks under the HFT category

Level of CRAR (where available) (in per cent)	Residual maturity	Specific risk capital charge			
		All Scheduled Banks (Commercial, Co-Operative and Regional Rural Banks)		All Non-Scheduled Banks (Commercial, Co-Operative and Regional Rural Banks)	
		Investments within 10% limit referred to in para 4.4.8 (in per cent)	All other claims (in per cent)	Investments within 10% limit referred to in para 4.4.8 (in per cent)	All other claims (in per cent)
1	2	3	4	5	6
9 and above	6 months or less	1.40	0.28	1.40	1.40
	Greater than 6 months and up to and including 24 months	5.65	1.13	5.65	5.65
	Exceeding 24 months	9.00	1.80	9.00	9.00
6 to < 9	All maturities	13.50	4.50	22.50	13.50
3 to < 6	All maturities	22.50	9.00	31.50	22.50
0 to < 3	All maturities	31.50	13.50	56.25	31.50
Negative	All maturities	56.25	56.25	Full deduction	56.25

Notes:

- i) In the case of banks where no capital adequacy norms have been prescribed by the RBI, the lending / investing bank may calculate the CRAR of the bank concerned, notionally, by obtaining necessary information from the investee bank and using the capital adequacy norms as applicable to the commercial banks. In case, it is not found feasible to compute CRAR on such notional basis, the specific risk capital charge of 31.50 or 56.25 per cent, as per the risk perception of the investing bank, should be applied uniformly to the investing bank's entire exposure.
- ii) In case of banks where capital adequacy norms are not applicable at present, the matter of investments in their capital-eligible instruments would not arise for now. However, column Nos. 3 and 5 of the Table above will become applicable to them, if in future they issue any capital instruments where other banks are eligible to invest.

Table 16 – Part D

**Alternative Total Capital Charge
for bonds issued by banks – Held by banks under AFS category**
(subject to the conditions stipulated in paragraph 8.3.4)

Level of CRAR (where available) (in %)	Alternative Total Capital Charge			
	All Scheduled Banks (Commercial, Co-operative and Regional Rural Banks)		All Non-Scheduled Banks (Commercial, Co-operative and Regional Rural Banks)	
	Investments within 10 % limit referred to in para 4.4.8 above (in %)	All other claims (in%)	Investments within 10 % limit referred to in para 4.4.8 above (in %)	All other claims (in %)
1	2	3	4	5
9 and above	9.00	1.80	9.00	9.00
6 to < 9	13.50	4.50	22.50	13.50
3 to < 6	22.50	9.00	31.50	22.50
0 to < 3	31.50	13.50	50.00	31.50
Negative	56.25	56.25	Full deduction	56.25

Notes:

- i) In the case of banks where no capital adequacy norms have been prescribed by the RBI, the lending / investing bank may calculate the CRAR of the bank concerned, notionally, by obtaining necessary information from the investee bank and using the capital adequacy norms as applicable to the commercial banks. In case, it is not found feasible to compute CRAR on such notional basis, the specific risk capital charge of 31.50 or 56.25 per cent, as per the risk perception of the investing bank, should be applied uniformly to the investing bank's entire exposure.
- ii) In case of banks where capital adequacy norms are not applicable at present, the matter of investments in their capital-eligible instruments would not arise for now. However, column Nos. 2 and 4 of the Table above will become applicable to them, if in future they issue any capital instruments where other banks are eligible to invest.

Table 16 – Part E

**Specific Risk Capital Charge
for Corporate Bonds and Securitised Debt Instruments (SDIs)
(other than bank bonds) - Held by banks under HFT category**

*Rating by the ECAI	Residual maturity	Specific risk capital charge		
		Corporate Bonds (in %)	Securitisation exposures (in %)	Securitisation exposures (SDIs) relating to Commercial real estate exposures (in %)
1	2	3	4	5
AAA to BBB	6 months or less	0.28	0.28	0.56
	Greater than 6 months and up to and including 24 months	1.14	1.14	2.28
	Exceeding 24 months	1.80	1.80	3.60
BB	All maturities	13.50	31.50	36.00
B and Below	All maturities	13.50	Deduction	Deduction
Unrated (if permitted)	All maturities	13.50 @	Deduction	Deduction

* These ratings indicate the ratings assigned by Indian rating agencies/ECAIs or foreign rating agencies. In the case of foreign ECAIs, the rating symbols used here correspond to Standard and Poor. The modifiers "+" or "-" have been subsumed with the main rating category.

@ In case the amount invested is less than the threshold limit prescribed in para 5.8.2, the capital charge will be 9 per cent.

Table 16 - Part F

**Alternative Total Capital Charge
Corporate Bonds and Securitised Debt Instruments (SDIs)
(other than bank bonds) – Held by banks under AFS category**

(subject to the conditions stipulated in para 8.3.4)

# Rating by the ECAIs	Total capital charge		
	Corporate Bonds (in per cent)	Securitisation exposures(SDIs) (in per cent)	Securitisation exposures (SDIs) relating to Commercial real estate exposures (in per cent)
1	3	4	5
AAA	1.80	1.80	4.50
AA	2.70	2.70	6.75
A	4.50	4.50	9.00
BBB	9.00	9.00	13.50
BB	13.50	31.50 (Deduction in the case of originator)	36.00 (Deduction in the case of originator)
B and below	13.50	Deduction	Deduction
Un-rated (if permitted)	13.50	Deduction	Deduction

These ratings indicate the ratings assigned by Indian rating agencies/ECAIs or foreign rating agencies. In the case of foreign ECAIs the ratings symbols used here correspond to Standard and Poor. The modifiers "+" or "-" have been subsumed with the main rating category.

8.3.6 Banks shall, in addition to computing the counterparty credit risk (CCR) charge for OTC derivatives, as part of capital for credit risk as per the Standardised Approach covered in paragraph 5 above, also compute the specific risk charge for OTC derivatives in the trading book as required in terms of **Annex 8**.

B. General Market Risk

8.3.7 The capital requirements for general market risk are designed to capture the risk of loss arising from changes in market interest rates. The capital charge is the sum of four components:

- (i) the net short (short position is not allowed in India except in derivatives) or long position in the whole trading book;
- (ii) a small proportion of the matched positions in each time-band (the “vertical disallowance”);
- (iii) a larger proportion of the matched positions across different time-bands (the “horizontal disallowance”), and
- (iv) a net charge for positions in options, where appropriate.

8.3.8 Separate maturity ladders should be used for each currency and capital charges should be calculated for each currency separately and then summed with no offsetting between positions of opposite sign.³⁹ In the case of those currencies in which business is insignificant (where the turnover in the respective currency is less than 5 per cent of overall foreign exchange turnover), separate calculations for each currency are not required. The bank may, instead, slot within each appropriate time-band, the net long or short position for each currency. However, these individual net positions are to be summed within each time-band, irrespective of whether they are long or short positions, to produce a gross position figure. The gross positions in each time-band will be subject to the assumed change in yield set out in Table-18 with no further offsets.

8.3.9 The Basle Committee has suggested two broad methodologies for computation of capital charge for market risks. One is the standardised method and the other is the banks’ internal risk management models method. As banks in India are still in a nascent stage of developing internal risk management models, it has been decided that, to start with, banks may adopt the standardised method. Under the standardised method there are two principal methods of measuring market risk, a “maturity” method and a “duration” method. As “duration” method is a more accurate method of measuring interest rate risk, it has been decided to adopt standardised duration method to arrive at the capital charge. Accordingly, banks are required to measure the general market risk charge by calculating the price sensitivity (modified duration) of each position separately. Under this method, the mechanics are as follows:

- (i) first calculate the price sensitivity (modified duration) of each instrument;

³⁹ Sentence added, to ensure more clarity. The para 8.3.10 of the Circular dated April 27, 2007 has been brought here.

- (ii) next apply the assumed change in yield to the modified duration of each instrument between 0.6 and 1.0 percentage points depending on the maturity of the instrument (see **Table - 17 below**);
- (iii) slot the resulting capital charge measures into a maturity ladder with the fifteen time bands as set out in Table - 17;
- (iv) subject long and short positions (short position is not allowed in India except in derivatives) in each time band to a 5 per cent vertical disallowance designed to capture basis risk; and
- (v) carry forward the net positions in each time-band for horizontal offsetting subject to the disallowances set out in **Table - 18**.

Table 17 - Duration method – time bands and assumed changes in yield

Time Bands	Assumed Change in Yield	Time Bands	Assumed Change in Yield
Zone 1		Zone 3	
1 month or less	1.00	3.6 to 4.3 years	0.75
1 to 3 months	1.00	4.3 to 5.7 years	0.70
3 to 6 months	1.00	5.7 to 7.3 years	0.65
6 to 12 months	1.00	7.3 to 9.3 years	0.60
Zone 2		9.3 to 10.6 years	0.60
1.0 to 1.9 years	0.90	10.6 to 12 years	0.60
1.9 to 2.8 years	0.80	12 to 20 years	0.60
2.8 to 3.6 years	0.75	over 20 years	0.60

Table 18 - Horizontal Disallowances

Zones	Time band	Within the zones	Between adjacent zones	Between zones 1 and 3
Zone 1	1 month or less	40%	40%	100%
	1 to 3 months			
	3 to 6 months			
	6 to 12 months			
Zone 2	1.0 to 1.9 years	30%	40%	
	1.9 to 2.8 years			
	2.8 to 3.6 years			
Zone 3	3.6 to 4.3 years	30%	40%	
	4.3 to 5.7 years			
	5.7 to 7.3 years			
	7.3 to 9.3 years			
	9.3 to 10.6 years			
	10.6 to 12 years			
	12 to 20 years			
	over 20 years			

8.3.10 Interest rate derivatives

The measurement of capital charge for market risks should include all interest rate derivatives and off-balance sheet instruments in the trading book and derivatives entered into for hedging trading book exposures which would react to changes in the interest rates, like FRAs, interest rate positions etc. The details of measurement of capital charge for interest rate derivatives are furnished in **Annex 8**.

8.4 Measurement of capital charge for equity risk

8.4.1 The capital charge for equities would apply on their current market value in bank's trading book⁴⁰. Minimum capital requirement to cover the risk of holding or taking positions in equities in the trading book is set out below. This is applied to all instruments that exhibit market behaviour similar to equities but not to non-convertible preference shares (which are covered by the interest rate risk requirements described earlier). The instruments covered include equity shares, whether voting or non-voting, convertible securities that behave like equities, for example: units of mutual funds, and commitments to buy or sell equity.

Specific and general market risk

8.4.2 Capital charge for specific risk (akin to credit risk) will be 9 per cent and specific risk is computed on the banks' gross equity positions (i.e. the sum of all long equity positions and of all short equity positions – short equity position is, however, not allowed for banks in India). The general market risk charge will also be 9 per cent on the gross equity positions.

8.5 Measurement of capital charge for foreign exchange risk

The bank's net open position in each currency should be calculated by summing:⁴¹

- The net spot position (i.e. all asset items less all liability items, including accrued interest, denominated in the currency in question);
- The net forward position (i.e. all amounts to be received less all amounts to be paid under forward foreign exchange transactions, including currency futures and the principal on currency swaps not included in the spot position);
- Guarantees (and similar instruments) that are certain to be called and are likely to be irrecoverable;
- Net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting bank);
- Depending on particular accounting conventions in different countries, any other item representing a profit or loss in foreign currencies;
- The net delta-based equivalent of the total book of foreign currency options

⁴⁰ Vide Sl. No.17 in the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008.

⁴¹ The bullet points are added from the paragraph 718(xxii) of Basel II June 2006 document.

Foreign exchange open positions and gold open positions are at present risk-weighted at 100 per cent. Thus, capital charge for market risks in foreign exchange and gold open position is 9 per cent. These open positions, **limits or actual whichever is higher**, would continue to attract capital charge at 9 per cent. This capital charge is in addition to the capital charge for credit risk on the on-balance sheet and off-balance sheet items pertaining to foreign exchange and gold transactions.

8.6 Aggregation of the capital charge for market risks

As explained earlier capital charges for specific risk and general market risk are to be computed separately before aggregation. For computing the total capital charge for market risks, the calculations may be plotted in the following table:

Proforma

(Rs. in crore)

Risk Category	Capital charge
I. Interest Rate (a+b)	
a. General market risk	
i) Net position (parallel shift) ii) Horizontal disallowance (curvature) iii) Vertical disallowance (basis) iv) Options	
b. Specific risk	
II. Equity (a+b)	
a. General market risk	
b. Specific risk	
III. Foreign Exchange & Gold	
IV. Total capital charge for market risks (I+II+III)	

9. Capital Charge for Operational risk

9.1 Definition of operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

9.2 The measurement methodologies

9.2.1 The New Capital Adequacy Framework outlines three methods for calculating operational risk capital charges in a continuum of increasing sophistication and risk sensitivity: (i) the Basic Indicator Approach (BIA); (ii) the Standardised Approach (TSA); and (iii) Advanced Measurement Approaches (AMA).

9.2.2 Banks are encouraged to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices.

9.2.3 The New Capital Adequacy Framework provides that internationally active banks and banks with significant operational risk exposures are expected to use an approach that is more sophisticated than the Basic Indicator Approach and that is appropriate for the risk profile of the institution. However, to begin with, banks in India shall compute the capital requirements for operational risk under the Basic Indicator Approach. Reserve Bank will review the capital requirement produced by the Basic Indicator Approach for general credibility, especially in relation to a bank's peers and in the event that credibility is lacking, appropriate supervisory action under Pillar 2 will be considered.

9.3 The Basic Indicator Approach

9.3.1 Under the Basic Indicator Approach, banks must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted as alpha) of positive annual gross income. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average. If negative gross income distorts a bank's Pillar 1 capital charge, Reserve Bank will consider appropriate supervisory action under Pillar 2. The charge may be expressed as follows:

$$KBIA = [\sum (GI_{1...n} \times \alpha)] / n$$

Where:

KBIA = the capital charge under the Basic Indicator Approach

GI = annual gross income, where positive, over the previous three years

n = number of the previous three years for which gross income is positive

α = 15 per cent, which is set by the BCBS, relating the industry wide level of required capital to the industry wide level of the indicator.

9.3.2 Gross income is defined as "Net interest income" plus "net non-interest income". It is intended that this measure should:

- i) be gross of any provisions (e.g. for unpaid interest) and write-offs made during the year;
- ii) be gross of operating expenses, including fees paid to outsourcing service providers, *in addition to fees paid for services that are outsourced, fees received by banks that provide outsourcing services shall be included in the definition of gross income;*
- iii) exclude reversal during the year in respect of provisions and write-offs made during the previous year(s);
- iv) exclude income recognised from the disposal of items of movable and immovable property;
- v) exclude realised profits/losses from the sale of securities in the “*held to maturity*” category;
- vi) exclude income from legal settlements in favour of the bank;
- vii) exclude other extraordinary or irregular items of income and expenditure; and
- viii) exclude income derived from insurance activities (i.e. income derived by writing insurance policies) and insurance claims in favour of the bank.

9.3.3 Banks are advised to compute capital charge for operational risk under the Basic Indicator Approach as follows:

- a) Average of [Gross Income * alpha] for each of the last three financial years, excluding years of negative or zero gross income
- b) Gross income = *Net profit (+) Provisions & contingencies (+) operating expenses (Schedule 16) (–) items (iii) to (viii) of paragraph 9.3.2.*
- c) Alpha = 15 per cent

9.3.4 As a point of entry for capital calculation, no specific criteria for use of the Basic Indicator Approach are set out in the New Capital Adequacy Framework. Nevertheless, banks using this approach are encouraged to comply with the Committee’s guidance on *Sound Practices for the Management and Supervision of Operational Risk*, February 2003 and the Guidance Note on Management of Operational Risk issued by the Reserve Bank of India in October 2005.

Part – B : Supervisory Review and Evaluation Process (SREP)

10. Introduction to the SREP under Pillar 2

10.1 The New Capital Adequacy Framework (NCAF), based on the Basel II Framework evolved by the Basel Committee on Banking Supervision, has been adapted for India vide our Circular DBOD.No.BP.BC 90/ 20.06.001/ 2006-07 dated April 27, 2007. In terms of paragraph 2.4 (iii)(c) of the Annex to the aforesaid circular the banks were required to have a Board-approved policy on ICAAP and to assess the capital requirement as per ICAAP. It is presumed that the banks would have formulated the policy and also undertaken the capital adequacy assessment accordingly.

10.2 The Basel II Framework has three components or three Pillars. The Pillar 1 is the Minimum Capital Ratio while the Pillar 2 and Pillar 3 are the Supervisory Review Process (SRP) and Market Discipline, respectively. While the guidelines on the Pillar 1 and Pillar 3 were issued by the RBI vide the aforesaid circular, since consolidated in this Master Circular in Part A and Part C, respectively, the guidelines in regard to the SRP and the Internal Capital Adequacy Assessment Process (ICAAP) are furnished at paragraph 11 below. An illustrative outline of the format of the ICAAP document, to be submitted to the RBI, by the banks, is furnished at **Annex – 14**.

10.3 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 would require a well-defined internal assessment process within the banks through which they assure the RBI 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 RBI so that, when warranted, appropriate intervention could be made to either reduce the risk exposure of the bank or augment / restore its capital. Thus, ICAAP is an important component of the SRP.

10.4 The main aspects to be addressed under the SRP, and therefore, under the ICAAP, would include:

- (a) the risks that are not fully captured by the minimum capital ratio prescribed under Pillar 1;
- (b) the risks that are not at all taken into account by the Pillar 1; and
- (c) the factors external to the bank.

Since the capital adequacy ratio prescribed by the RBI under the Pillar 1 of the Framework

is only the regulatory **minimum** level, addressing only the three specified risks (viz., credit, market and operational risks), holding additional capital might be necessary for the banks, on account of both – the possibility of some under-estimation of risks under the Pillar 1 and the actual risk exposure of a bank vis-à-vis the quality of its risk management architecture. **Illustratively**, some of the risks that the banks are generally exposed to but which are not captured or not fully captured in the regulatory CRAR would include:

- (a) Interest rate risk in the banking book;
- (b) Credit concentration risk;
- (c) Liquidity risk;
- (d) Settlement risk;
- (e) Reputational risk;
- (f) Strategic risk;
- (g) Risk of under-estimation of credit risk under the Standardised approach;
- (h) “Model risk” i.e., the risk of under-estimation of credit risk under the IRB approaches;
- (i) Risk of weakness in the credit-risk mitigants;
- (j) Residual risk of securitisation, etc.

It is, therefore, only appropriate that the banks make their own assessment of their various risk exposures, through a well-defined internal process, and maintain an adequate capital cushion for such risks.

10.5 It is recognised that there is no one single approach for conducting the ICAAP and the market consensus in regard to the best practice for undertaking ICAAP is yet to emerge. The methodologies and techniques are still evolving particularly in regard to measurement of non-quantifiable risks, such as reputational and strategic risks. These guidelines, therefore, seek to provide only broad principles to be followed by the banks in developing their ICAAP.

10.6 The banks are advised to develop and put in place, with the approval of their Boards, an ICAAP commensurate with their size, level of complexity, risk profile and scope of operations. The ICAAP would be in addition to a bank’s calculation of regulatory capital requirements under Pillar 1 and must be operationalised with effect from March 31, 2008 by the foreign banks and the Indian banks with operational presence outside India, and from March 31, 2009 by all other commercial banks, excluding the Local Area Banks and Regional Rural banks.

10.7 The banks are advised to transmit to the RBI (i.e., to the CGM-in-Charge, Department of Banking Supervision, Reserve Bank of India, Central Office, Centre I, World

Trade Centre, Cuffe Parade, Colaba, Mumbai – 400 005) a copy of their Board-approved ICAAP document not later than June 30, 2008 or March 31, 2009, as applicable. The document should, *inter alia*, include the capital adequacy assessment and projections of capital requirement for the ensuing year, along with the plans and strategies for meeting the capital requirement. An illustrative outline of a format of the ICAAP document is furnished at **Annex – 14**, for guidance of the banks though the ICAAP documents of the banks could vary in length and format, in tune with their size, level of complexity, risk profile and scope of operations. The first ICAAP document was required to reach the RBI not later than June 30, 2008 or March 31, 2009, as applicable, and thereafter, before the end of March every year, covering the capital assessment and projections for the following financial year.

11. Guidelines for the SREP of the RBI and the ICAAP of the banks

11.1 The Background

11.1.1 While the Basel - I framework was confined to the prescription of only minimum capital requirements for banks, the Basel II framework expands this approach not only to capture certain additional risks in the minimum capital ratio but also includes two additional areas, namely, the Supervisory Review Process and Market Discipline through increased disclosure requirements for banks. Thus, the Basel II framework rests on the following three mutually-reinforcing pillars:

Pillar 1: Minimum Capital Requirements — which prescribes a risk-sensitive calculation of capital requirements that, for the first time, explicitly includes operational risk in addition to market and credit risk.

Pillar 2: Supervisory Review Process (SRP) — which envisages the establishment of suitable risk management systems in banks and their review by the supervisory authority.

Pillar 3: Market Discipline — which seeks to achieve increased transparency through expanded disclosure requirements for banks.

11.1.2. The Basel II document of the Basel Committee also lays down the following four key principles in regard to the SRP envisaged under Pillar 2:

Principle 1 : Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Principle 2 : Supervisors should review and evaluate the banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with the regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

Principle 3 : Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require the banks to hold capital in excess of the minimum.

Principle 4 : Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk

characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

11.1.3 It would be seen that the principles 1 and 3 relate to the supervisory expectations from the banks while the principles 2 and 4 deal with the role of the supervisors under Pillar 2. The Pillar 2 (Supervisory Review Process - SRP) requires banks to implement an internal process, called the Internal Capital Adequacy Assessment Process (ICAAP), for assessing their capital adequacy in relation to their risk profiles as well as a strategy for maintaining their capital levels. The Pillar 2 also requires the supervisory authorities to subject all banks to an evaluation process, hereafter called Supervisory Review and Evaluation Process (SREP), and to initiate such supervisory measures on that basis, as might be considered necessary. An analysis of the foregoing principles indicates that the following broad responsibilities have been cast on the banks and the supervisors:

Banks' responsibilities

- a) Banks should have in place a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels (Principle 1)
- b) Banks should operate above the minimum regulatory capital ratios (*Principle 3*)

Supervisors' responsibilities

- a) Supervisors should review and evaluate a bank's ICAAP. (Principle 2)
- b) Supervisors should take appropriate action if they are not satisfied with the results of this process. (Principle 2)
- c) Supervisors should review and evaluate a bank's compliance with the regulatory capital ratios. (Principle 2)
- d) Supervisors should have the ability to require banks to hold capital in excess of the minimum. (Principle 3)
- e) Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels. (Principle 4)
- f) Supervisors should require rapid remedial action if capital is not maintained or restored. (Principle 4)

11.1.4 Thus, the ICAAP and SREP are the two important components of Pillar 2 and could be broadly defined as follows:

The ICAAP comprises a bank's procedures and measures designed to ensure the following:

- a) An appropriate identification and measurement of risks;
- b) An appropriate level of internal capital in relation to the bank's risk profile; and
- c) Application and further development of suitable risk management systems in the bank.

The SREP consists of a review and evaluation process adopted by the supervisor, which covers all the processes and measures defined in the principles listed above. Essentially, these include the review and evaluation of the bank's ICAAP, conducting an independent assessment of the bank's risk profile, and if necessary, taking appropriate prudential measures and other supervisory actions.

11.1.5 These guidelines seek to provide broad guidance to the banks by outlining the manner in which the SREP would be carried out by the RBI, the expected scope and design of their ICAAP, and the expectations of the RBI from the banks in regard to implementation of the ICAAP.

11.2 Conduct of the SREP by the RBI

11.2.1 Capital helps protect individual banks from insolvency, thereby promoting safety and soundness in the overall banking system. Minimum regulatory capital requirements under Pillar 1 establish a threshold below which a sound bank's regulatory capital must not fall. Regulatory capital ratios permit some comparative analysis of capital adequacy across regulated banking entities because they are based on certain common methodology / assumptions. However, supervisors need to perform a more comprehensive assessment of capital adequacy that considers risks specific to a bank, conducting analyses that go beyond minimum regulatory capital requirements.

11.2.2 The RBI generally expects banks to hold capital above their minimum regulatory capital levels, commensurate with their individual risk profiles, to account for all material risks. Under the SREP, the RBI will assess the overall capital adequacy of a bank through a comprehensive evaluation that takes into account all relevant available information. In determining the extent to which banks should hold capital in excess of the regulatory minimum, the RBI would take into account the combined implications of a bank's compliance with regulatory minimum capital requirements, the quality and results of a bank's ICAAP, and supervisory assessment of the bank's risk management processes, control systems and other relevant information relating to the bank's risk profile and capital position.

11.2.3 The SREP of the banks would, thus, be conducted by the RBI periodically, generally, along with the RBI's Annual Financial Inspection (AFI) of the banks and in the light of the data in the off-site returns received from the banks in the RBI, in conjunction with the ICAAP document, which is required to be submitted every year by the banks to the RBI (Cf. Para 11.3.4 below). Through the SREP, the RBI would evaluate the adequacy and efficacy of the ICAAP of the banks and the capital requirements derived by them therefrom. While in the course of evaluation, there would be no attempt to reconcile the difference

between the regulatory minimum CRAR and the outcome of the ICAAP of a bank (as the risks covered under the two processes are different), the banks would be expected to demonstrate to the RBI that the ICAAP adopted by them is fully responsive to their size, level of complexity, scope & scale of operations and the resultant risk profile / exposures, and adequately captures their capital requirements. Such an evaluation of the effectiveness of the ICAAP would help the RBI in understanding the capital management processes and strategies adopted by the banks. If considered necessary, the SREP could also involve a dialogue between the bank's top management and the RBI from time to time. In addition to the periodic reviews, independent external experts may also be commissioned by the RBI, if deemed necessary, to perform *ad hoc* reviews and comment on specific aspects of the ICAAP process of a bank; the nature and extent of such a review shall be determined by the RBI.

11.2.4 Under the SREP, the RBI would also seek to determine whether a bank's overall capital remains adequate as the underlying conditions change. Generally, material increases in risk that are not otherwise mitigated should be accompanied by commensurate increases in capital. Conversely, reductions in overall capital (to a level still above regulatory minima) may be appropriate if the RBI's supervisory assessment leads it to a conclusion that risk has materially declined or that it has been appropriately mitigated. Based on such an assessment, the RBI could consider initiating appropriate supervisory measures to address its supervisory concerns. The measures could include requiring a modification or enhancement of the risk management and internal control processes of a bank, a reduction in risk exposures, or any other action as deemed necessary to address the identified supervisory concerns. These measures could also include the stipulation of a bank-specific minimum CRAR that could potentially be even higher, if so warranted by the facts and circumstances, than the regulatory minimum stipulated under the Pillar 1. In cases where the RBI decides to stipulate a CRAR at a level higher than the regulatory minimum, it would explain the rationale for doing so, to the bank concerned. However, such an add-on CRAR stipulation, though possible, is not expected to be an automatic or inevitable outcome of the SREP exercise, the prime objective being improvement in the risk management systems of the banks.

11.2.5 As and when the advanced approaches envisaged in the Basel II document are permitted to be adopted in India, the SREP would also assess the ongoing compliance by the banks with the eligibility criteria for adopting the advanced approaches.

11.3 The structural aspects of the ICAAP

11.3.1 This section outlines the broad parameters of the ICAAP that the banks are required to comply with in designing and implementing their ICAAP.

11.3.2 Every bank to have an ICAAP

Reckoning that the Basel II framework is applicable to all commercial banks (except the Local Area Banks and the Regional Rural Banks), both at the solo level (global position) as well as at the consolidated level, the ICAAP should be prepared, on a solo basis, at every tier for each banking entity within the banking group, as also at the level of the consolidated bank (i.e., a group of entities where the licensed bank is the controlling entity). This requirement would also apply to the foreign banks which have a branch presence in India and their ICAAP should cover their Indian operations only.

11.3.3 ICAAP to be a Board-approved process

The ultimate responsibility for designing and implementation of the ICAAP lies with the bank's board of directors of the bank and with the Chief Executive Officer in the case of the foreign banks with branch presence in India. The structure, design and contents of a bank's ICAAP should be approved by the board of directors to ensure that the ICAAP forms an integral part of the management process and decision making culture of the bank. Since a sound risk management process provides the basis for ensuring that a bank maintains adequate capital, the board of directors of a bank shall:

- a) set the tolerance level for risk;
- b) ensure that the senior management of the bank:
 - i. establishes a risk framework in order to assess and appropriately manage the various risk exposures of the bank;
 - ii. develops a system to monitor the bank's risk exposures and to relate them to the bank's capital and reserve funds;
 - iii. establishes a method to monitor the bank's compliance with internal policies, particularly in regard to risk management;
 - iv. effectively communicates all relevant policies and procedures throughout the bank;
- c) adopt and support strong internal controls;
- d) ensure that the bank has appropriate written policies and procedures in place;
- e) ensure that the bank has an appropriate strategic plan in place, which, as a *minimum*, shall duly outline
- f) the bank's current and future capital needs;
- g) the bank's anticipated capital expenditure; and
- h) the bank's desired level of capital.

11.3.4 Submission of the outcome of the ICAAP to the Board and the RBI

As the ICAAP is an ongoing process, a written record on the outcome of the ICAAP should be periodically submitted by the banks to their board of directors. Such written record of the internal assessment of its capital adequacy should include, *inter alia*, the risks identified, the manner in which those risks are monitored and managed, the impact of the bank's changing risk profile on the bank's capital position, details of stress tests/scenario analysis conducted and the resultant capital requirements. The reports shall be sufficiently detailed to allow the Board of Directors to evaluate the level and trend of material risk exposures, whether the bank maintains adequate capital against the risk exposures and in case of additional capital being needed, the plan for augmenting capital. The board of directors would be expected make timely adjustments to the strategic plan, as necessary.

Based on the outcome of the ICAAP as submitted to and approved by the Board, the ICAAP Document, in the format furnished at **Annex 14**, should be furnished to the RBI (i.e., to the CGM-in-Charge, Department of Banking Supervision, Central Office, Reserve Bank of India, World Trade Centre, Centre I, Colaba, Cuffe Parade, Mumbai – 400 005). To begin with, the Document, duly approved by the Board, should be sent to the RBI only once a year, for the year ending March 31, but the frequency of submission could be reviewed in due course. The first such submission was required to be for the year ending March 31, 2008 by the banks which migrated to Basel II framework from that date while the remaining banks would submit their first ICAAP Document for the year ending March 31, 2009, the date from which they would switch over to the Basel II framework. The document should reach the RBI latest by June 30, 2008 in respect of the first set of banks and by March 31, 2009 in respect of the second set of banks, and thereafter, by end of March every year.

11.3.5 Review of the ICAAP outcomes

The board of directors shall, at least once a year, assess and document whether the processes relating the ICAAP implemented by the bank successfully achieve the objectives envisaged by the board. The senior management should also receive and review the reports regularly to evaluate the sensitivity of the key assumptions and to assess the validity of the bank's estimated future capital requirements. In the light of such an assessment, appropriate changes in the ICAAP should be instituted to ensure that the underlying objectives are effectively achieved.

11.3.6 ICAAP to be an Integral part of the management and decision-making culture

The ICAAP should from an integral part of the management and decision-making culture of a bank. This integration could range from using the ICAAP to internally allocate capital to various business units, to having it play a role in the individual credit decision process and

pricing of products or more general business decisions such as expansion plans and budgets. The integration would also mean that ICAAP should enable the bank management to assess, on an ongoing basis, the risks that are inherent in their activities and material to the institution.

11.3.7 The Principle of proportionality

The implementation of ICAAP should be guided by the principle of proportionality. Though the banks are encouraged to migrate to and adopt progressively sophisticated approaches in designing their ICAAP, the RBI would expect the degree of sophistication adopted in the ICAAP in regard to risk measurement and management to be commensurate with the nature, scope, scale and the degree of complexity in the bank's business operations. The following paragraphs **illustratively** enumerate the broad approach which could be considered by the banks with varying levels of complexity in their operations, in formulating their ICAAP.

(A) In relation to a bank that defines its activities and risk management practices as **simple**, in carrying out its ICAAP, that bank could:

- a) identify and consider that bank's largest losses over the last 3 to 5 years and whether those losses are likely to recur;
- b) prepare a short list of the most significant risks to which that bank is exposed;
- c) consider how that bank would act, and the amount of capital that would be absorbed in the event that each of the risks identified were to materialise;
- d) consider how that bank's capital requirement might alter under the scenarios in (c) and how its capital requirement might alter in line with its business plans for the next 3 to 5 years; and
- e) document the ranges of capital required in the scenarios identified above and form an overall view on the amount and quality of capital which that bank should hold, ensuring that its senior management is involved in arriving at that view.

(B) In relation to a bank that define its activities and risk management practices as **moderately complex**, in carrying out its ICAAP, that bank could:

- a) having consulted the operational management in each major business line, prepare a comprehensive list of the major risks to which the business is exposed;
- b) estimate, with the aid of historical data, where available, the range and distribution of possible losses which might arise from each of those risks and consider using shock stress tests to provide risk estimates;
- c) consider the extent to which that bank's capital requirement adequately captures the risks identified in (a) and (b) above;

- d) for areas in which the capital requirement is either inadequate or does not address a risk, estimate the additional capital needed to protect that bank and its customers, in addition to any other risk mitigation action that bank plans to take;
- e) consider the risk that the bank's own analyses of capital adequacy may be inaccurate and that it may suffer from management weaknesses which affect the effectiveness of its risk management and mitigation;
- f) project that bank's business activities forward in detail for one year and in less detail for the next 3 to 5 years, and estimate how that bank's capital and capital requirement would alter, assuming that business develops as expected;
- g) assume that business does not develop as expected and consider how that bank's capital and capital requirement would alter and what that bank's reaction to a range of adverse economic scenarios might be;
- h) document the results obtained from the analyses in (b), (d), (f), and (g) above in a detailed report for that bank's top management / board of directors; and
- i) ensure that systems and processes are in place to review the accuracy of the estimates made in (b), (d), (f) and (g) (i.e., systems for back testing) vis-à-vis the performance / actuals.

(C) In relation to a bank that define its activities and risk management practices as **complex**, in carrying out its ICAAP, that bank could follow a proportional approach to that bank's ICAAP which should cover the issues identified at (a) to (d) in paragraph (B) above, but is likely also to involve the use of models, most of which will be integrated into its day-to-day management and operations.

Models of the kind referred to above may be linked so as to generate an overall estimate of the amount of capital that a bank considers appropriate to hold for its business needs. A bank may also link such models to generate information on the economic capital considered desirable for that bank. A model which a bank uses to generate its target amount of economic capital is known as an economic capital model (ECM). Economic capital is the target amount of capital which optimises the return for a bank's stakeholders for a desired level of risk. For example, a bank is likely to use value-at-risk (VaR) models for market risk, advanced modelling approaches for credit risk and, possibly, advanced measurement approaches for operational risk. A bank might also use economic scenario generators to model stochastically its business forecasts and risks. However, the advanced approaches envisaged in the Basel II Framework are not currently permitted by the RBI and the banks would need prior approval of the RBI for migrating to the advanced approaches.

Such a bank is also likely to be part of a group and to be operating internationally. There is likely to be centralised control over the models used throughout the group, the assumptions made and their overall calibration.

11.3.8 Regular independent review and validation

The ICAAP should be subject to regular and independent review through an internal or external audit process, separately from the SREP conducted by the RBI, to ensure that the ICAAP is comprehensive and proportionate to the nature, scope, scale and level of complexity of the bank's activities so that it accurately reflects the major sources of risk that the bank is exposed to. A bank shall ensure appropriate and effective internal control structures, particularly in regard to the risk management processes, in order to monitor the bank's continued compliance with internal policies and procedures. As a minimum, a bank shall conduct periodic reviews of its risk management processes, which should ensure:

- a) the integrity, accuracy, and reasonableness of the processes;
- b) the appropriateness of the bank's capital assessment process based on the nature, scope, scale and complexity of the bank's activities;
- c) the timely identification of any concentration risk;
- d) the accuracy and completeness of any data inputs into the bank's capital assessment process;
- e) the reasonableness and validity of any assumptions and scenarios used in the capital assessment process;
- f) that the bank conducts appropriate stress testing;

11.3.9 ICAAP to be a forward-looking process

The ICAAP should be forward looking in nature, and thus, should take into account the expected / estimated future developments such as strategic plans, macro economic factors, etc., including the likely future constraints in the availability and use of capital. As a minimum, the management of a bank shall develop and maintain an appropriate strategy that would ensure that the bank maintains adequate capital commensurate with the nature, scope, scale, complexity and risks inherent in the bank's on-balance-sheet and off-balance-sheet activities, and should demonstrate as to how the strategy dovetails with the macro-economic factors.

Thus, the banks shall have an explicit, Board-approved capital plan which should spell out the institution's objectives in regard to level of capital, the time horizon for achieving those objectives, and in broad terms, the capital planning process and the allocate responsibilities for that process. The plan shall outline:

- a) the bank's capital needs;
- b) the bank's anticipated capital utilisation;
- c) the bank's desired level of capital;
- d) limits related to capital;
- e) a general contingency plan for dealing with divergences and unexpected events.

11.3.10 ICAAP to be a risk-based process

The adequacy of a bank's capital is a function of its risk profile. Banks shall, therefore, set their capital targets which are consistent with their risk profile and operating environment. As a minimum, a bank shall have in place a sound ICAAP, which shall include all **material** risk exposures incurred by the bank. There are some types of risks (such as reputation risk and strategic risk) which are less readily quantifiable; for such risks, the focus of the ICAAP should be more on qualitative assessment, risk management and mitigation than on quantification of such risks. Banks' ICAAP document shall clearly indicate for which risks a quantitative measure is considered warranted, and for which risks a qualitative measure is considered to be the correct approach.

11.3.11 ICAAP to include stress tests and scenario analyses

As part of the ICAAP, the management of a bank shall, as a minimum, conduct relevant stress tests 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. The use of stress testing framework can provide a bank's management a better understanding of the bank's likely exposure in extreme circumstances. In this context, the attention is also invited to the RBI circular DBOD.No.BP.BC.101/21.04.103/2006-07 dated June 26, 2007 on stress testing wherein the banks were advised to put in place appropriate stress testing policies and stress test frameworks, incorporating "sensitivity tests" and "scenario tests", for the various risk factors, by September 30, 2007, on a trial / pilot basis and to operationalise formal stress testing frameworks from March 31, 2008. The banks are urged to take necessary measures for implementing an appropriate formal stress testing framework by the date specified which would also meet the stress testing requirements under the ICAAP of the banks.

11.3.12 Use of capital models for ICAAP

While the RBI does not expect the banks to use complex and sophisticated econometric models for internal assessment of their capital requirements, and there is no RBI-mandated requirement for adopting such models, the banks, with international presence, were required, in terms of paragraph 17 of our Circular DBOD.No.BP(SC).BC98/21.04.103/99 dated October 7, 1999, to develop suitable methodologies, by March 31, 2001, for estimating and maintaining economic capital. However, some of the banks which have relatively complex operations and are adequately equipped in this regard, may like to place reliance on such models as part of their ICAAP. While there is no single prescribed approach as to how a bank should develop its capital model, a bank adopting a model-based approach to its ICAAP shall be able to, *inter alia*, demonstrate:

- a) Well documented model specifications, including the methodology / mechanics and the assumptions underpinning the working of the model;
- b) The extent of reliance on the historical data in the model and the system of back testing to be carried out to assess the validity of the outputs of the model vis-à-vis the actual outcomes;
- c) A robust system for independent validation of the model inputs and outputs;
- d) A system of stress testing the model to establish that the model remains valid even under extreme conditions / assumptions;
- e) The level of confidence assigned to the model outputs and its linkage to the bank's business strategy;
- f) The adequacy of the requisite skills and resources within the banks to operate, maintain and develop the model.

11.4 Select operational aspects of the ICAAP

This Section outlines in somewhat greater detail the scope of the risk universe expected to be normally captured by the banks in their ICAAP.

11.4.1 Identifying and measuring material risks in ICAAP

The first objective of an ICAAP is to identify all material risks. Risks that can be reliably measured and quantified should be treated as rigorously as data and methods allow. The appropriate means and methods to measure and quantify those material risks are likely to vary across banks.

Some of the risks to which banks are exposed include credit risk, market risk, operational risk, interest rate risk in the banking book, credit concentration risk and liquidity risk (as briefly outlined below). The RBI has issued guidelines to the banks on asset liability management, management of country risk, credit risk, operational risk, etc., from time to time. A bank's risk management processes, including its **ICAAP, should, therefore, be consistent with this existing body of guidance**. However, certain other risks, such as reputational risk and business or strategic risk, may be equally important for a bank and, in such cases, should be given same consideration as the more formally defined risk types. For example, a bank may be engaged in businesses for which periodic fluctuations in activity levels, combined with relatively high fixed costs, have the potential to create unanticipated losses that must be supported by adequate capital. Additionally, a bank might be involved in strategic activities (such as expanding business lines or engaging in acquisitions) that introduce significant elements of risk and for which additional capital would be appropriate.

Additionally, if banks employ risk mitigation techniques, they should understand the risk to be mitigated and the potential effects of that mitigation, reckoning its enforceability and effectiveness, on the risk profile of the bank.

11.4.2 Credit risk: A bank should have the ability to assess credit risk at the portfolio level as well as at the exposure or counterparty level. Banks should be particularly attentive to identifying credit risk concentrations and ensuring that their effects are adequately assessed. This should include consideration of various types of dependence among exposures, incorporating the credit risk effects of extreme outcomes, stress events, and shocks to the assumptions made about the portfolio and exposure behavior. Banks should also carefully assess concentrations in counterparty credit exposures, including counterparty credit risk exposures emanating from trading in less liquid markets, and determine the effect that these might have on the bank's capital adequacy.

11.4.3 Market risk: A bank should be able to identify risks in trading activities resulting from a movement in market prices. This determination should consider factors such as illiquidity of instruments, concentrated positions, one-way markets, non-linear/deep out-of-the money positions, and the potential for significant shifts in correlations. Exercises that incorporate extreme events and shocks should also be tailored to capture key portfolio vulnerabilities to the relevant market developments.

11.4.4 Operational risk: A bank should be able to assess the potential risks resulting from inadequate or failed internal processes, people, and systems, as well as from events external to the bank. This assessment should include the effects of extreme events and shocks relating to operational risk. Events could include a sudden increase in failed processes across business units or a significant incidence of failed internal controls.

11.4.5 Interest rate risk in the banking book (IRRBB): A bank should identify the risks associated with the changing interest rates on its on-balance sheet and off-balance sheet exposures in the banking book from both, a short-term and long-term perspective. This might include the impact of changes due to parallel shocks, yield curve twists, yield curve inversions, changes in the relationships of rates (basis risk), and other relevant scenarios. The bank should be able to support its assumptions about the behavioral characteristics of its non-maturity deposits and other assets and liabilities, especially those exposures characterised by embedded optionality. Given the uncertainty in such assumptions, stress testing and scenario analysis should be used in the analysis of interest rate risks. While there could be several approaches to measurement of IRRBB, an **illustrative** approach for measurement of IRRBB is furnished at **Annex 9**. The banks would, however, be free to adopt any other variant of these approaches or entirely different methodology for computing / quantifying the IRRBB provided the technique is based on objective, verifiable and transparent methodology and criteria.

11.4.6 Credit concentration risk: A risk concentration is any single exposure or a group

of exposures with the potential to produce losses large enough (relative to a bank's capital, total assets, or overall risk level) to threaten a bank's health or ability to maintain its core operations. Risk concentrations have arguably been the single most important cause of major problems in banks. Concentration risk resulting from concentrated portfolios could be significant for most of the banks.

The following **qualitative criteria** could be adopted by the banks to demonstrate that the credit concentration risk is being adequately addressed:

- a) While assessing the exposure to concentration risk, a bank should keep in view that the calculations of Basel II framework are based on the assumption that a bank is well diversified.
- b) While the banks' single borrower exposures, the group borrower exposures and capital market exposures are regulated by the exposure norms prescribed by the RBI, there could be concentrations in these portfolios as well. In assessing the degree of credit concentration, therefore, a bank shall consider not only the foregoing exposures but also consider the degree of credit concentration in a particular economic sector or geographical area. The banks with operational concentration in a few geographical regions, by virtue of the pattern of their branch network, shall also consider the impact of adverse economic developments in that region, and their impact on the asset quality.
- c) The performance of specialised portfolios may, in some instances, also depend on key individuals / employees of the bank. Such a situation could exacerbate the concentration risk because the skills of those individuals, in part, limit the risk arising from a concentrated portfolio. The impact of such key employees / individuals on the concentration risk is likely to be correspondingly greater in smaller banks. In developing its stress tests and scenario analyses, a bank shall, therefore, also consider the impact of losing key personnel on its ability to operate normally, as well as the direct impact on its revenues.

As regards the **quantitative criteria** to be used to ensure that credit concentration risk is being adequately addressed, the credit concentration risk calculations shall be performed at the counterparty level (i.e., large exposures), at the portfolio level (i.e., sectoral and geographical concentrations) and at the asset class level (i.e., liability and assets concentrations). In this regard, a reference is invited to paragraph 3.2.2 (c) of the Annex to our Circular DBOD.No.BP.(SC).BC.98/ 21.04.103/ 99 dated October 7, 1999 regarding Risk Management System in Banks in terms of which certain prudential limits have been stipulated in regard to 'substantial exposures' of banks. As a prudent practice, the banks may like to ensure that their aggregate exposure (including non-funded exposures) to all 'large borrowers' does not exceed at any time, 800 per cent of their 'capital funds' (as defined for the purpose of extant exposure norms of the RBI). The 'large borrower' for this purpose could be taken to mean as one to whom the bank's aggregate exposure (funded as well as non-funded) exceeds 10 per cent of the bank's capital funds. The banks would also

be well advised to pay special attention to their industry-wise exposures where their exposure to a particular industry exceeds 10 per cent of their aggregate credit exposure (including investment exposure) to the industrial sector as a whole.

There could be several approaches to the measurement of credit concentration the banks' portfolio. One of the approaches commonly used for the purpose involves computation of Herfindahl-Hirshman Index (HHI). It may please be noted that the HHI as a measure of concentration risk is only one of the possible methods and the banks would be free to adopt any other appropriate method for the purpose, which has objective and transparent criteria for such measurement.

11.4.7 Liquidity risk: A bank should understand the risks resulting from its inability to meet its obligations as they come due, because of difficulty in liquidating assets (market liquidity risk) or in obtaining adequate funding (funding liquidity risk). This assessment should include analysis of sources and uses of funds, an understanding of the funding markets in which the bank operates, and an assessment of the efficacy of a contingency funding plan for events that could arise.

11.4.8 The risk factors discussed above should not be considered an exhaustive list of those affecting any given bank. All relevant factors that present a material source of risk to capital should be incorporated in a well-developed ICAAP. Furthermore, banks should be mindful of the capital adequacy effects of concentrations that may arise within each risk type.

11.4.9 Quantitative and qualitative approaches in ICAAP

(a) All measurements of risk incorporate both quantitative and qualitative elements, but to the extent possible, a quantitative approach should form the foundation of a bank's measurement framework. In some cases, quantitative tools can include the use of large historical databases; when data are more scarce, a bank may choose to rely more heavily on the use of stress testing and scenario analyses. Banks should understand when measuring risks that measurement error always exists, and in many cases the error is itself difficult to quantify. In general, an increase in uncertainty related to modeling and business complexity should result in a larger capital cushion.

(b) Quantitative approaches that focus on most likely outcomes for budgeting, forecasting, or performance measurement purposes may not be fully applicable for capital adequacy because the ICAAP should also take less likely events into account. Stress testing and scenario analysis can be effective in gauging the consequences of outcomes that are unlikely but would have a considerable impact on safety and soundness.

(c) To the extent that risks cannot be reliably measured with quantitative tools – for example, where measurements of risk are based on scarce data or unproven quantitative methods – qualitative tools, including experience and judgment, may be more heavily utilised. Banks should be cognisant that qualitative approaches have their own inherent biases and assumptions that affect risk assessment; accordingly, banks should recognise the biases and assumptions embedded in, and the limitations of, the qualitative approaches used.

11.4.10 Risk aggregation and diversification effects

(a) An effective ICAAP should assess the risks across the entire bank. A bank choosing to conduct risk aggregation among various risk types or business lines should understand the challenges in such aggregation. In addition, when aggregating risks, banks should ensure that any potential concentrations across more than one risk dimension are addressed, recognising that losses could arise in several risk dimensions at the same time, stemming from the same event or a common set of factors. For example, a localised natural disaster could generate losses from credit, market, and operational risks at the same time.

(b) In considering the possible effects of diversification, management should be systematic and rigorous in documenting decisions, and in identifying assumptions used in each level of risk aggregation. Assumptions about diversification should be supported by analysis and evidence. The bank should have systems capable of aggregating risks based on the bank's selected framework. For example, a bank calculating correlations within or among risk types should consider data quality and consistency, and the volatility of correlations over time and under stressed market conditions.

Part – C : Market Discipline

12. Guidelines for Market Discipline

12.1 General

12.1.1 The purpose of Market discipline (detailed in Pillar 3) in the Revised Framework is to complement the minimum capital requirements (detailed under Pillar 1) and the supervisory review process (detailed under Pillar 2). The aim is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution.

12.1.2 In principle, banks' disclosures should be consistent with how senior management and the Board of directors assess and manage the risks of the bank. Under Pillar 1, banks use specified approaches/ methodologies for measuring the various risks they face and the resulting capital requirements. It is believed that providing disclosures that are based on a common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and comprehensive disclosure framework that enhances comparability

12.2 Achieving appropriate disclosure

12.2.1 Market discipline can contribute to a safe and sound banking environment. Hence, non-compliance with the prescribed disclosure requirements would attract a penalty, including financial penalty. However, it is not intended that direct additional capital requirements would be a response to non-disclosure, except as indicated below.

12.2.2 In addition to the general intervention measures, the Revised Framework also anticipates a role for specific measures. Where disclosure is a qualifying criterion under Pillar 1 to obtain lower risk weightings and/or to apply specific methodologies, there would be a direct sanction (not being allowed to apply the lower risk weighting or the specific methodology).

12.3 Interaction with accounting disclosures

It is recognised that the Pillar 3 disclosure framework does not conflict with requirements under accounting standards, which are broader in scope. The BCBS has taken considerable efforts to see that the narrower focus of Pillar 3, which is aimed at disclosure of bank capital adequacy, does not conflict with the broader accounting requirements. The Reserve Bank will consider future modifications to the Market Discipline disclosures as necessary in light of its ongoing monitoring of this area and industry developments.

12.4 Scope and frequency of disclosures

12.4.1 Banks, including consolidated banks, should provide all Pillar 3 disclosures, both qualitative and quantitative, as at end March each year along with the annual financial statements. With a view to enhance the ease of access to the Pillar 3 disclosures, banks may make their annual disclosures both in their annual reports as well as their respective web sites. Banks with capital funds of Rs.100 crore or more should make interim disclosures on the quantitative aspects, on a stand alone basis, on their respective websites as at end September each year. Qualitative disclosures that provide a general summary of a bank's risk management objectives and policies, reporting system and definitions may be published only on an annual basis.

12.4.2 In recognition of the increased risk sensitivity of the Revised Framework and the general trend towards more frequent reporting in capital markets, all banks with capital funds of Rs. 500 crore or more, and their significant bank subsidiaries, must disclose their Tier 1 capital, total capital, total required capital and Tier 1 ratio and total capital adequacy ratio, on a quarterly basis on their respective websites.

12.4.3 The disclosure on the websites should be made in a web page titled "Basel II Disclosures" and the link to this page should be prominently provided on the home page of the bank's website. Each of these disclosures pertaining to a financial year should be available on the websites until disclosure of the third subsequent annual (March end) disclosure⁴² is made.

12.5 Validation

The disclosures in this manner should be subjected to adequate validation. For example, since information in the annual financial statements would generally be audited, the additional material published with such statements must be consistent with the audited statements. In addition, supplementary material (such as Management's Discussion and Analysis) that is published should also be subjected to sufficient scrutiny (e.g. internal control assessments, etc.) to satisfy the validation issue. If material is not published under a validation regime, for instance in a stand alone report or as a section on a website, then management should ensure that appropriate verification of the information takes place, in accordance with the general disclosure principle set out below. In the light of the above, Pillar 3 disclosures will not be required to be audited by an external auditor, unless specified.

⁴² For example: Disclosures for the financial year ending March 31, 2009 (i.e., June/ September/ December 2008 and March 2009) should be available until disclosure as on March 31, 2012.

12.6 Materiality

A bank should decide which disclosures are relevant for it based on the materiality concept. Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions. This definition is consistent with International Accounting Standards and with the national accounting framework. The Reserve Bank recognises the need for a qualitative judgment of whether, in light of the particular circumstances, a user of financial information would consider the item to be material (user test). The Reserve Bank does not consider it necessary to set specific thresholds for disclosure as the user test is a useful benchmark for achieving sufficient disclosure. However, with a view to facilitate smooth transition to greater disclosures as well as to promote greater comparability among the banks' Pillar 3 disclosures, the materiality thresholds have been prescribed for certain limited disclosures. Notwithstanding the above, banks are encouraged to apply the user test to these specific disclosures and where considered necessary make disclosures below the specified thresholds also.

12.7 Proprietary and confidential information

Proprietary information encompasses information (for example on products or systems), that if shared with competitors would render a bank's investment in these products/systems less valuable, and hence would undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship. This has an impact on what banks should reveal in terms of information about their customer base, as well as details on their internal arrangements, for instance methodologies used, parameter estimates, data etc. The Reserve Bank believes that the requirements set out below strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information.

12.8 General disclosure principle

Banks should have a formal disclosure policy approved by the Board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process. In addition, banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency.

12.9 Scope of application

Pillar 3 applies at the top consolidated level of the banking group to which the Framework applies (as indicated above under paragraph 3 Scope of Application). Disclosures related to individual banks within the groups would not generally be required to be made by the parent

bank. An exception to this arises in the disclosure of Total and Tier 1 Capital Ratios by the top consolidated entity where an analysis of significant bank subsidiaries within the group is appropriate, in order to recognise the need for these subsidiaries to comply with the Framework and other applicable limitations on the transfer of funds or capital within the group. Pillar 3 disclosures will be required to be made by the individual banks on a standalone basis when they are not the top consolidated entity in the banking group.

12.10 Effective date of disclosures

The first of the disclosures as per these guidelines shall be made as on the effective date viz. March 31, 2008 or 2009, as the case may be. Banks are, however, encouraged to make the Pillar 3 disclosures at an earlier date.

12.11 The disclosure requirements

The following sections set out in tabular form are the disclosure requirements under Pillar 3. Additional definitions and explanations are provided in a series of footnotes.

Table DF – 1 : Scope of Application

Qualitative Disclosures (a) The name of the top bank in the group to which the Framework applies. (b) An outline of differences in the basis of consolidation for accounting and regulatory purposes, with a brief description of the entities⁴³ within the group (i) that are fully consolidated;⁴⁴ (ii) that are pro-rata consolidated;⁴⁵ (iii) that are given a deduction treatment; and (iv) that are neither consolidated nor deducted (e.g. where the investment is risk-weighted).
Quantitative Disclosures (c) The aggregate amount of capital deficiencies⁴⁶ in all subsidiaries not included in the consolidation i.e. that are deducted and the name(s) of such subsidiaries. (d) The aggregate amounts (e.g. current book value) of the bank's total interests in insurance entities, which are risk-weighted⁴⁷ as well as their name, their country of incorporation or residence, the proportion of ownership interest and, if different, the proportion of voting power in these entities. In addition, indicate the quantitative impact on regulatory capital of using this method versus using the deduction.

⁴³ Entity = securities, insurance and other financial subsidiaries, commercial subsidiaries, significant minority equity investments in insurance, financial and commercial entities.

⁴⁴ viz. subsidiaries as in consolidated accounting, e.g. AS 21.

⁴⁵ viz. Joint ventures in consolidated accounting, e.g. AS 27.

⁴⁶ A capital deficiency is the amount by which actual capital is less than the regulatory capital requirement. Any deficiencies which have been deducted on a group level in addition to the investment in such subsidiaries are not to be included in the aggregate capital deficiency.

⁴⁷ See paragraph 3

Table DF – 2 : Capital Structure

Qualitative Disclosures (a) Summary information on the terms and conditions of the main features of all capital instruments, especially in the case of capital instruments eligible for inclusion in Tier 1 or in Upper Tier 2.
Quantitative Disclosures (b) The amount of Tier 1 capital, with separate disclosure of: • paid-up share capital; • reserves; • innovative instruments;⁴⁸ • other capital instruments; • amounts deducted from Tier 1 capital, including goodwill and investments. (c) The total amount of Tier 2 capital (net of deductions from Tier 2 capital). (d) Debt capital instruments eligible for inclusion in Upper Tier 2 capital • Total amount outstanding • Of which amount raised during the current year • Amount eligible to be reckoned as capital funds (e) Subordinated debt eligible for inclusion in Lower Tier 2 capital • Total amount outstanding • Of which amount raised during the current year • Amount eligible to be reckoned as capital funds (f) Other deductions from capital, if any. (g) Total eligible capital.

Table DF – 3 : Capital Adequacy

Qualitative disclosures (a) A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities.
Quantitative disclosures (b) Capital requirements for credit risk: • Portfolios subject to standardised approach • Securitisation exposures.
(c) Capital requirements for market risk: • Standardised duration approach; - Interest rate risk - Foreign exchange risk (including gold) - Equity risk
(d) Capital requirements for operational risk: • Basic indicator approach;
(e) Total and Tier 1 capital ratio: • For the top consolidated group; and • For significant bank subsidiaries (stand alone or sub-consolidated depending on how the Framework is applied).

⁴⁸ Innovative perpetual debt instruments (or head office borrowings of foreign banks eligible for similar treatment) and any other type of instrument that may be allowed from time to time.

12.12 Risk exposure and assessment

The risks to which banks are exposed and the techniques that banks use to identify, measure, monitor and control those risks are important factors market participants consider in their assessment of an institution. In this section, several key banking risks are considered: credit risk, market risk, and interest rate risk in the banking book and operational risk. Also included in this section are disclosures relating to credit risk mitigation and asset securitisation, both of which alter the risk profile of the institution. Where applicable, separate disclosures are set out for banks using different approaches to the assessment of regulatory capital.

12.13 General qualitative disclosure requirement

For each separate risk area (e.g. credit, market, operational, banking book interest rate risk) banks must describe their risk management objectives and policies, including:

- (i) strategies and processes;
- (ii) the structure and organisation of the relevant risk management function;
- (iii) the scope and nature of risk reporting and/or measurement systems;
- (iv) policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

Credit risk

General disclosures of credit risk provide market participants with a range of information about overall credit exposure and need not necessarily be based on information prepared for regulatory purposes. Disclosures on the capital assessment techniques give information on the specific nature of the exposures, the means of capital assessment and data to assess the reliability of the information disclosed.

Table DF – 4 : Credit Risk : General Disclosures for All Banks

Qualitative Disclosures (a) The general qualitative disclosure requirement (paragraph 10.13) with respect to credit risk, including: • Definitions of past due and impaired (for accounting purposes); • Discussion of the bank's credit risk management policy;
Quantitative Disclosures (b) Total gross credit risk exposures⁴⁹, Fund based and Non-fund based separately. (c) Geographic distribution of exposures⁵⁰, Fund based and Non-fund based separately • Overseas • Domestic (d) Industry⁵¹ type distribution of exposures, fund based and non-fund based separately (e) Residual contractual maturity breakdown of assets,⁵² (g) Amount of NPAs (Gross) • Substandard • Doubtful 1 • Doubtful 2 • Doubtful 3 • Loss (h) Net NPAs (i) NPA Ratios • Gross NPAs to gross advances • Net NPAs to net advances (j) Movement of NPAs (Gross) • Opening balance • Additions • Reductions • Closing balance (k) Movement of provisions for NPAs • Opening balance • Provisions made during the period • Write-off • Write-back of excess provisions • Closing balance (l) Amount of Non-Performing Investments (m) Amount of provisions held for non-performing investments (n) Movement of provisions for depreciation on investments • Opening balance • Provisions made during the period • Write-off • Write-back of excess provisions • Closing balance

⁴⁹ That is after accounting offsets in accordance with the applicable accounting regime and without taking into account the effects of credit risk mitigation techniques, e.g. collateral and netting.

⁵⁰ That is, on the same basis as adopted for Segment Reporting adopted for compliance with AS 17.

⁵¹ The industries break-up may be provided on the same lines as prescribed for DSB returns. If the exposure to any particular industry is more than 5 per cent of the gross credit exposure as computed under (b) above it should be disclosed separately.

⁵² Banks shall use the same maturity bands as used for reporting positions in the ALM returns.

Table DF – 5

Credit Risk: Disclosures for Portfolios Subject to the Standardised Approach

Qualitative Disclosures (a) For portfolios under the standardised approach: - Names of credit rating agencies used, plus reasons for any changes; - Types of exposure for which each agency is used; and - A description of the process used to transfer public issue ratings onto comparable assets in the banking book;
Quantitative Disclosures (b) For exposure⁵³ amounts after risk mitigation subject to the standardised approach, amount of a bank's outstandings (rated and unrated) in the following three major risk buckets as well as those that are deducted; - Below 100 % risk weight 100 % risk weight - More than 100 % risk weight - Deducted

Table DF – 6

Credit Risk Mitigation: Disclosures for Standardised Approaches⁵⁴

Qualitative Disclosures (a) The general qualitative disclosure requirement (paragraph 10.13) with respect to credit risk mitigation including: - policies and processes for collateral valuation and management; - a description of the main types of collateral taken by the bank; - the main types of guarantor counterparty and their creditworthiness; and - information about (market or credit) risk concentrations within the mitigation taken
Quantitative Disclosures (b) For disclosed credit risk portfolio under the standardised approach, the total exposure⁵⁵ that is covered by: eligible financial collateral; after the application of haircuts.

⁵³ As defined for disclosures in Table 4

⁵⁴ At a minimum, banks must give the disclosures in this Table in relation to credit risk mitigation that has been recognised for the purposes of reducing capital requirements under this Framework. Where relevant, banks are encouraged to give further information about mitigants that have not been recognised for that purpose.

⁵⁵ As defined for disclosures in Table DF-4 after application of haircuts for exposure

Table DF – 7 : Securitisation : Disclosure for Standardised Approach

Qualitative Disclosures (a) The general qualitative disclosure requirement (paragraph 10.13) with respect to securitisation, including a discussion of: - the bank's objectives in relation to securitisation activity, including the extent to which these activities transfer credit risk of the underlying securitised exposures away from the bank to other entities; - the roles played by the bank in the securitisation process⁵⁶ and an indication of the extent of the bank's involvement in each of them; and - the regulatory capital approach that the bank follows for its securitisation activities. (b) Summary of the bank's accounting policies for securitisation activities, including: - recognition of gain on sale; and - key assumptions for valuing retained interests, including any significant changes since the last reporting period and the impact of such changes; (c) Names of ECAs used for securitisations and the types of securitisation exposure for which each agency is used.
Quantitative Disclosures (d) The total outstanding exposures securitised by the bank and subject to the securitisation framework by exposure type.^{57,58} (e) For exposures securitised by the bank and subject to the securitisation framework:⁵⁹ - amount of impaired/past due assets securitised; and - losses recognised by the bank during the current period⁶⁰ broken down by exposure type. (f) Aggregate amount of securitisation exposures retained or purchased⁶¹ broken down by exposure type. (g) Aggregate amount of securitisation exposures retained or purchased broken down into a meaningful number of risk weight bands. Exposures that have been deducted entirely from Tier 1 capital, credit enhancing I/Os deducted from Total Capital, and other exposures deducted from total capital should be disclosed separately by type of underlying exposure type. (h) Summary of securitisation activity presenting a comparative position for two years, as a part of the Notes on Accounts to the balance sheet: - total number and book value of loan assets securitised – by type of underlying assets; - sale consideration received for the securitised assets and gain/loss on sale on account of securitisation; and - form and quantum (outstanding value) of services provided by way of credit enhancement, liquidity support, post-securitisation asset servicing, etc.

⁵⁶ For example: originator, investor, and servicer, provider of credit enhancement, liquidity provider, and swap provider.

⁵⁷ For example, credit cards, home equity, auto, etc.

⁵⁸ Securitisation transactions in which the originating bank does not retain any securitisation exposure should be shown separately but need only be reported for the year of inception.

⁵⁹ Where relevant, banks are encouraged to differentiate between exposures resulting from activities in which they act only as sponsors, and exposures that result from all other bank securitisation activities that are subject to the securitisation framework.

⁶⁰ For example, write-offs/provisions (if the assets remain on the bank's balance sheet) or write-downs of I/O strips and other residual interests.

⁶¹ Securitisation exposures, include, but are not restricted to, securities, liquidity facilities, other commitments and credit enhancements such as I/O strips, cash collateral accounts and other subordinated assets.

Table DF- 8 : Market Risk in Trading Book

Qualitative disclosures (a) The general qualitative disclosure requirement (paragraph 10.13) for market risk including the portfolios covered by the standardised approach.
Quantitative disclosures (b) The capital requirements for: • interest rate risk; • equity position risk; and • foreign exchange risk;

Table DF-9 : Operational Risk

Qualitative disclosures • In addition to the general qualitative disclosure requirement (paragraph 10.13), the approach(es) for operational risk capital assessment for which the bank qualifies.

Table DF- 10 : Interest Rate Risk in the Banking Book (IRRBB)

Qualitative Disclosures (a) The general qualitative disclosure requirement (paragraph 10.13), including the nature of IRRBB and key assumptions, including assumptions regarding loan prepayments and behaviour of non-maturity deposits, and frequency of IRRBB measurement.
Quantitative Disclosures (b) The increase (decline) in earnings and economic value (or relevant measure used by management) for upward and downward rate shocks according to management's method for measuring IRRBB, broken down by currency (where the turnover is more than 5% of the total turnover).

**Terms and Conditions Applicable to Innovative Perpetual Debt Instruments (IPDI)
to Qualify for Inclusion as Tier 1 Capital**

The Innovative Perpetual Debt Instruments (Innovative Instruments) that may be issued as bonds or debentures by Indian banks should meet the following terms and conditions to qualify for inclusion as Tier 1 Capital for capital adequacy purposes:

1. Terms of Issue of innovative instruments denominated in Indian Rupees

- i) Amount : The amount of innovative instruments to be raised may be decided by the Board of Directors of banks.
- ii) Limits: The total amount raised by a bank through innovative instruments shall not exceed 15 per cent of total Tier 1 capital. The eligible amount will be computed with reference to the amount of Tier 1 capital as on March 31 of the previous financial year, after deduction of goodwill, DTA and other intangible assets but before the deduction of investments, as required in paragraph 4.4. Innovative instruments in excess of the above limits shall be eligible for inclusion under Tier 2, subject to limits prescribed for Tier 2 capital. However, investors' rights and obligations would remain unchanged.
- iii) Maturity period : The innovative instruments shall be perpetual.
- iv) Rate of interest: The interest payable to the investors may be either at a fixed rate or at a floating rate referenced to a market determined rupee interest benchmark rate.
- v) Options : Innovative instruments shall not be issued with a 'put option'. However banks may issue the instruments with a call option subject to strict compliance with each of the following conditions:
 - a) Call option may be exercised after the instrument has run for at least ten years; and
 - b) Call option shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.
- vi) Step-up option : The issuing bank may have a step-up option which may be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. The step-up shall not be more than 100 bps. The limits on step-up apply to the all-in cost of the debt to the issuing banks.
- vii) Lock-In Clause :
 - (a) Innovative instruments shall be subjected to a lock-in clause in terms of which the issuing bank shall not be liable to pay interest, if

- i) the bank's CRAR is below the minimum regulatory requirement prescribed by RBI; OR
- ii) the impact of such payment results in bank's capital to risk assets ratio (CRAR) falling below or remaining below the minimum regulatory requirement prescribed by Reserve Bank of India;

(b) However, banks may pay interest with the prior approval of RBI when the impact of such payment may result in net loss or increase the net loss, provided the CRAR remains above the regulatory norm.

(c) The interest shall not be cumulative.

(d) All instances of invocation of the lock-in clause should be notified by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision of the Reserve Bank of India, Mumbai.

viii) Seniority of claim: The claims of the investors in innovative instruments shall be

- a) Superior to the claims of investors in equity shares; and
- b) Subordinated to the claims of all other creditors.

ix) Discount : The innovative instruments shall not be subjected to a progressive discount for capital adequacy purposes since these are perpetual.

x) Other conditions

- a) Innovative instruments should be fully paid-up, unsecured, and free of any restrictive clauses.
- b) Investment by FIIs in innovative instruments raised in Indian Rupees shall be outside the ECB limit for rupee denominated corporate debt, as fixed by the Govt. of India from time to time, for investment by FIIs in corporate debt instruments. Investment in these instruments by FIIs and NRIs shall be within an overall limit of 49 per cent and 24 per cent of the issue, respectively, subject to the investment by each FII not exceeding 10 per cent of the issue and investment by each NRI not exceeding five per cent of the issue.
- c) Banks should comply with the terms and conditions, if any, stipulated by SEBI / other regulatory authorities in regard to issue of the instruments.

2. Terms of issue of innovative instruments denominated in foreign currency

Banks may augment their capital funds through the issue of innovative instruments in foreign currency without seeking the prior approval of the Reserve Bank of India, subject to compliance with the undermentioned requirements:

- i) Innovative instruments issued in foreign currency should comply with all terms and conditions as applicable to the instruments issued in Indian Rupees.
- ii) Not more than 49 per cent of the eligible amount can be issued in foreign currency.

iii) Innovative instruments issued in foreign currency shall be outside the limits for foreign currency borrowings indicated below:

- a) The total amount of Upper Tier 2 Instruments issued in foreign currency shall not exceed 25 per cent of the unimpaired Tier 1 capital. This eligible amount will be computed with reference to the amount of Tier 1 capital as on March 31 of the previous financial year, after deduction of goodwill and other intangible assets but before the deduction of investments, as per para 4.4.6 of this Master Circular.
- b) This will be in addition to the existing limit for foreign currency borrowings by Authorised Dealers, stipulated in terms of Master Circular No. RBI/2006-07/24 dated July 1, 2006 on Risk Management and Inter-Bank Dealings.

3. Compliance with Reserve Requirements

The total amount raised by a bank through innovative instruments shall not be reckoned as liability for calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will not attract CRR / SLR requirements.

4. Reporting Requirements

Banks issuing innovative instruments shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the debt raised, including the terms of issue specified at para 1 above , together with a copy of the offer document soon after the issue is completed.

5. Investment in IPDIs issued by other banks/ FIs

- i) A bank's investment in innovative instruments issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent for cross holding of capital among banks/FIs prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004-05 dated 6th July 2004 and also subject to cross holding limits.
- ii) Bank's investments in innovative instruments issued by other banks will attract risk weight for capital adequacy purposes, as prescribed in paragraph 5.6 of this Master Circular.

6. Grant of advances against innovative instruments

Banks should not grant advances against the security of the innovative instruments issued by them.

7. Raising of innovative Instruments for inclusion as Tier 1 capital by foreign banks in India

Foreign banks in India may raise Head Office (HO) borrowings in foreign currency for inclusion as Tier 1 capital subject to the same terms and conditions as mentioned in items 1 to 5 above for Indian banks. In addition, the following terms and conditions would also be applicable:

- i) Maturity period : If the amount of innovative Tier 1 capital raised as Head Office borrowings shall be retained in India on a perpetual basis .
- ii) Rate of interest: Rate of interest on innovative Tier 1 capital raised as HO borrowings should not exceed the on-going market rate. Interest should be paid at half yearly rests.
- iii) Withholding tax: Interest payments to the HO will be subject to applicable withholding tax.
- iv) Documentation: The foreign bank raising innovative Tier 1 capital as HO borrowings should obtain a letter from its HO agreeing to give the loan for supplementing the capital base for the Indian operations of the foreign bank. The loan documentation should confirm that the loan given by HO shall be eligible for the same level of seniority of claim as the investors in innovative capital instruments issued by Indian banks. The loan agreement will be governed by and construed in accordance with the Indian law.
- v) Disclosure: The total eligible amount of HO borrowings shall be disclosed in the balance sheet under the head 'Innovative Tier 1 capital raised in the form of Head Office borrowings in foreign currency'.
- vi) Hedging : The total eligible amount of HO borrowing should remain fully swapped in Indian Rupees with the bank at all times.
- vii) Reporting and certification : Details regarding the total amount of innovative Tier 1 capital raised as HO borrowings, along with a certification to the effect that the borrowing is in accordance with these guidelines, should be advised to the Chief General Managers-in-Charge of the Department of Banking Operations & Development (International Banking Division), Department of External Investments & Operations and Foreign Exchange Department (Forex Markets Division), Reserve Bank of India, Mumbai.

Terms and Conditions Applicable to Perpetual Non-Cumulative Preference Shares (PNCPS) to Qualify for Inclusion as Tier I Capital

1. Terms of Issue

- i) Limits: The outstanding amount of Tier 1 Preference Shares along with Innovative Tier 1 instruments shall not exceed 40 per cent of total Tier 1 capital at any point of time. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill and other intangible assets but before the deduction of investments. Tier 1 Preference Shares issued in excess of the overall ceiling of 40 per cent, shall be eligible for inclusion under Upper Tier 2 capital, subject to limits prescribed for Tier 2 capital. However, investors' rights and obligations would remain unchanged.
- ii) Amount: The amount of PNCPS to be raised may be decided by the Board of Directors of banks.
- iii) Maturity: The PNCPS shall be perpetual.
- iv) Options:
 - (a) PNCPS shall not be issued with a 'put option' or 'step up option'.
 - (b) However, banks may issue the instruments with a call option at a particular date subject to following conditions :
 - (i) The call option on the instrument is permissible after the instrument has run for at least ten years; and
 - (ii) Call option shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.
- v) Classification in the Balance sheet: These instruments will be classified as capital and shown under 'Schedule I-Capital' of the Balance sheet.
- vi) Dividend: The rate of dividend payable to the investors may be either a fixed rate or a floating rate referenced to a market determined rupee interest benchmark rate
- vii) Payment of Dividend:
 - (a) The issuing bank shall pay dividend subject to availability of distributable surplus out of current year's earnings, and if
 - (i) the bank's CRAR is above the minimum regulatory requirement prescribed by RBI;
 - (ii) the impact of such payment does not result in bank's capital to risk weighted assets ratio (CRAR) falling below or remaining below the minimum regulatory requirement prescribed by Reserve Bank of India;
 - (iii) In the case of half yearly payment of dividends, the balance sheet as at the end of the previous year does not show any accumulated losses; and

- (iv) In the case of annual payment of dividends, the current year's balance sheet does not show any accumulated losses
- (b) The dividend shall not be cumulative. i.e., dividend missed in a year will not be paid in future years, even if adequate profit is available and the level of CRAR conforms to the regulatory minimum.
- (c) All instances of non-payment of dividend in consequence of conditions as at (a) above should be reported by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision, Central Office of the Reserve Bank of India, Mumbai.

viii) Seniority of claim: The claims of the investors in PNCPS shall be senior to the claims of investors in equity shares and subordinated to the claims of all other creditors and the depositors.

ix) Other conditions:

- (a) PNCPS should be fully paid-up, unsecured, and free of any restrictive clauses.
- (b) Investment by FIIs and NRIs shall be within an overall limit of 49 per cent and 24 per cent of the issue respectively, subject to the investment by each FII not exceeding 10 per cent of the issue, and investment by each NRI not exceeding five per cent of the issue. Investment by FIIs in these instruments shall be outside the ECB limit for rupee-denominated corporate debt, as fixed by Government of India from time to time. The overall non-resident holding of Preference Shares and equity shares in public sector banks will be subject to the statutory / regulatory limit.
- (c) Banks should comply with the terms and conditions, if any, stipulated by SEBI / other regulatory authorities in regard to issue of the instruments.

2. Compliance with Reserve Requirements

- (a) The funds collected by various branches of the bank or other banks for the issue and held pending finalisation of allotment of the Tier 1 Preference Shares will have to be taken into account for the purpose of calculating reserve requirements.
- (b) However, the total amount raised by the bank by issue of PNCPS shall not be reckoned as liability for calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will not attract CRR / SLR requirements.

3. Reporting Requirements

- i) Banks issuing PNCPS shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the capital raised, including the terms of issue specified at para 1 above together with a copy of the offer document soon after the issue is completed.
- ii) The issue-wise details of amount raised as PNCPS qualifying for Tier I capital by the bank from FIIs / NRIs are required to be reported within 30 days of the issue to the Chief General Manager, Reserve Bank of India, Foreign Exchange Department, Foreign Investment Division, Central Office, Mumbai 400 001 in the proforma given at the end of this **Annex**. The details of the secondary market sales / purchases by FIIs and the NRIs in these instruments on the floor of the stock exchange shall be reported by the custodians and designated banks, respectively, to the Reserve Bank of India through the soft copy of the LEC Returns, on a daily basis, as prescribed in Schedule 2 and 3 of the FEMA Notification No.20 dated 3rd May 2000, as amended from time to time.

4. Investment in perpetual non-cumulative Preference Shares issued by other banks/ FIIs

- (a) A bank's investment in PNCPS issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent of investing banks' capital funds as prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004-05 dated 6th July 2004.
- (b) Bank's investments in PNCPS issued by other banks / financial institutions will attract risk weight as provided in para 5.6.1 of this Master circular, for capital adequacy purposes.
- (c) A bank's investments in the PNCPS of other banks will be treated as exposure to capital market and be reckoned for the purpose of compliance with the prudential ceiling for capital market exposure as fixed by RBI.

5. Grant of advances against Tier 1 Preference Shares

Banks should not grant advances against the security of the PNCPS issued by them.

Reporting Format

(Cf. para 3(ii) of Annex – 2)

Details of Investments by FIIs and NRIs in Perpetual Non-Cumulative Preference Shares qualifying as Tier-I capital

- (a) Name of the bank :
- (b) Total issue size / amount raised (in Rupees) :
- (c) Date of issue :

FIIs			NRIs		
No of FIIs	Amount raised		No. of NRIs	Amount raised	
	in Rupees	as a percentage of the total issue size		in Rupees	as a percentage of the total issue size

It is certified that

- (i) the aggregate investment by all FIIs does not exceed 49 percent of the issue size and investment by no individual FII exceeds 10 percent of the issue size.
- (ii) It is certified that the aggregate investment by all NRIs does not exceed 24 percent of the issue size and investment by no individual NRI exceeds 5 percent of the issue size

Authorised Signatory
Date
Seal of the bank

**Terms and Conditions Applicable to Debt Capital Instruments to
Qualify for Inclusion as Upper Tier 2 Capital**

The debt capital instruments that may be issued as bonds / debentures by Indian banks should meet the following terms and conditions to qualify for inclusion as Upper Tier 2 Capital for capital adequacy purposes.

Terms of Issue of Upper Tier 2 Capital instruments in Indian Rupees

- i) Amount: The amount of Upper Tier 2 instruments to be raised may be decided by the Board of Directors of banks.
- ii) Limits: Upper Tier 2 instruments along with other components of Tier 2 capital shall not exceed 100 per cent of Tier 1 capital. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill, DTA and other intangible assets but before the deduction of investments, as required in paragraph 4.4.
- iii) Maturity Period: The Upper Tier 2 instruments should have a minimum maturity of 15 years.
- iv) Rate of interest: The interest payable to the investors may be either at a fixed rate or at a floating rate referenced to a market determined rupee interest benchmark rate.
- v) Options: Upper Tier 2 instruments shall not be issued with a 'put option'. However banks may issue the instruments with a call option subject to strict compliance with each of the following conditions:
 - a) Call option may be exercised only if the instrument has run for at least ten years;
 - b) Call option shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.
- vi) Step-up option: The issuing bank may have a step-up option which may be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. The step-up shall not be more than 100 bps. The limits on step-up apply to the all-in cost of the debt to the issuing banks.

vii) Lock-in-Clause

- a) Upper Tier 2 instruments shall be subjected to a lock-in clause in terms of which the issuing bank shall not be liable to pay either interest or principal, even at maturity, if
 - I. the bank's CRAR is below the minimum regulatory requirement prescribed by RBI; **OR**
 - II. the impact of such payment results in bank's capital to risk assets ratio (CRAR) falling below or remaining below the minimum regulatory requirement prescribed by Reserve Bank of India.
- b) However, banks may pay interest with the prior approval of RBI when the impact of such payment may result in net loss or increase the net loss provided CRAR remains above the regulatory norm.
- c) The interest amount due and remaining unpaid may be allowed to be paid in the later years in cash/ cheque subject to the bank complying with the above regulatory requirement.
- d) All instances of invocation of the lock-in clause should be notified by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision of the Reserve Bank of India, Mumbai.

viii) Seniority of claim: The claims of the investors in Upper Tier 2 instruments shall be

- a) Superior to the claims of investors in instruments eligible for inclusion in Tier 1 capital; and
- b) Subordinate to the claims of all other creditors.

ix) Discount: The Upper Tier 2 instruments shall be subjected to a progressive discount for capital adequacy purposes as in the case of long term subordinated debt over the last five years of their tenor. As they approach maturity these instruments should be subjected to progressive discount as indicated in the table below for being eligible for inclusion in Tier 2 capital.

Remaining Maturity of Instruments	Rate of Discount (per cent)
Less than one year	100
One year and more but less than two years	80
Two years and more but less than three years	60
Three years and more but less than four years	40
Four years and more but less than five years	20

x) Redemption: Upper Tier 2 instruments shall not be redeemable at the initiative of the holder. All redemptions shall be made only with the prior approval of the Reserve Bank of India (Department of Banking Operations & Development).

xi) Other conditions:

- a) Upper Tier 2 instruments should be fully paid-up, unsecured, and free of any restrictive clauses.
- b) Investment by FIIs in Upper Tier 2 Instruments raised in Indian Rupees shall be outside the limit for investment in corporate debt instruments, as fixed by the Govt. of India from time to time. However, investment by FIIs in these instruments will be subject to a separate ceiling of USD 500 million. In addition, NRIs shall also be eligible to invest in these instruments as per existing policy.
- c) Banks should comply with the terms and conditions, if any, stipulated by SEBI/other regulatory authorities in regard to issue of the instruments.

2. Terms of issue of Upper Tier 2 capital instruments in foreign currency

Banks may augment their capital funds through the issue of Upper Tier 2 Instruments in foreign currency without seeking the prior approval of the Reserve Bank of India, subject to compliance with the undermentioned requirements:

- i) Upper Tier 2 Instruments issued in foreign currency should comply with all terms and conditions applicable to instruments issued in Indian Rupees.
- ii) The total amount of Upper Tier 2 Instruments issued in foreign currency shall not exceed 25 per cent of the unimpaired Tier 1 capital. This eligible amount will be computed with reference to the amount of Tier 1 capital as on March 31 of the previous financial year, after deduction of goodwill and other intangible assets but before the deduction of investments, as per para 4.4.6 of this Master Circular.
- iii) This will be in addition to the existing limit for foreign currency borrowings by Authorised Dealers stipulated in terms of Master Circular No. RBI/2006-07/24 dated July 1, 2006 on Risk Management and Inter-Bank Dealings.

3. Compliance with Reserve Requirements

- I. The funds collected by various branches of the bank or other banks for the issue and held pending finalisation of allotment of the Upper Tier 2 Capital instruments will have to be taken into account for the purpose of calculating reserve requirements.
- II. The total amount raised by a bank through Upper Tier 2 instruments shall be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

4. Reporting Requirements

Banks issuing Upper Tier 2 instruments shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the debt raised, including the terms of issue specified at para 1 above, together with a copy of the offer document soon after the issue is completed.

5. Investment in Upper Tier 2 instruments issued by other banks/ FIs

- i) A bank's investment in Upper Tier 2 instruments issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent for cross holding of capital among banks/FIs prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004-05 dated 6th July 2004 and also subject to cross holding limits.
- ii) Bank's investments in Upper Tier 2 instruments issued by other banks/ financial institutions will attract risk weight as per para 5.6.1 of this Master Circular, for capital adequacy purposes.

6. Grant of advances against Upper Tier 2 instruments

Banks should not grant advances against the security of the Upper Tier 2 instruments issued by them.

7. Raising of Upper Tier 2 Instruments by Foreign Banks in India

Foreign banks in India may raise Head Office (HO) borrowings in foreign currency for inclusion as Upper Tier 2 capital subject to the same terms and conditions as mentioned in items 1 to 5 above for Indian banks. In addition, the following terms and conditions would also be applicable:

- 1) Maturity Period: If the amount of Upper Tier 2 capital raised as HO borrowings is in tranches, each tranche shall be retained in India for a minimum period of fifteen years.
- 2) Rate of interest: Rate of interest on Upper Tier 2 capital raised as HO borrowings should not exceed the on-going market rate. Interest should be paid at half yearly rests.
- 3) Withholding tax: Interest payments to the HO will be subject to applicable withholding tax.
- 4) Documentation: The foreign bank raising Upper Tier 2 capital as HO borrowings should obtain a letter from its HO agreeing to give the loan for supplementing the capital base for the Indian operations of the foreign bank. The loan documentation should confirm that the loan given by HO shall be eligible for the same level of seniority of claim as the investors in Upper Tier 2 debt capital instruments issued by Indian banks. The loan agreement will be governed by and construed in accordance with the Indian law.
- 5) Disclosure: The total eligible amount of HO borrowings shall be disclosed in the balance sheet under the head 'Upper Tier 2 capital raised in the form of Head Office borrowings in foreign currency'.
- 6) Hedging: The total eligible amount of HO borrowing should remain fully swapped in Indian Rupees with the bank at all times.
- 7) Reporting and certification: Details regarding the total amount of Upper Tier 2 capital raised as HO borrowings, along with a certification to the effect that the borrowing is in accordance with these guidelines, should be advised to the Chief General Managers-in-Charge of the Department of Banking Operations & Development (International Banking Division), Department of External Investments & Operations and Foreign Exchange Department (Forex Markets Division), Reserve Bank of India, Mumbai.

Terms and Conditions Applicable to Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable Cumulative Preference Shares (RCPS) to Qualify for Inclusion as Part of Upper Tier 2 Capital

1. Terms of Issue

i) Characteristics of the instruments:

- a. These instruments could be either perpetual (PCPS) or dated (RNCPS and RCPS) instruments with a fixed maturity of minimum 15 years.
- b. The perpetual instruments shall be cumulative. The dated instruments could be cumulative or non-cumulative

ii) Limits: The outstanding amount of these instruments along with other components of Tier 2 capital shall not exceed 100 per cent of Tier 1 capital at any point of time. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill and other intangible assets but before the deduction of investments.

iii) Amount: The amount to be raised may be decided by the Board of Directors of banks.

iv) Options:

- (i) These instruments shall not be issued with a 'put option'.
- (ii) However, banks may issue the instruments with a call option at a particular date subject to strict compliance with each of the following conditions:

- (a) The call option on the instrument is permissible after the instrument has run for at least ten years; and
- (b) Call option shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.

v) Step-up option: The issuing bank may have a step-up option which may be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. The step-up shall not be more than 100 bps. The limits on step-up apply to the all-in cost of the debt to the issuing banks.

vi) Classification in the balance sheet: These instruments will be classified as 'Borrowings' under Schedule 4 of the Balance Sheet under item No.I (i.e., Borrowings in India').

vii) Coupon: The coupon payable to the investors may be either at a fixed rate or at a floating rate referenced to a market determined rupee interest benchmark rate.

vii) Payment of coupon:

a) The coupon payable on these instruments will be treated as interest and accordingly debited to P& L Account. However, it will be payable only if

- I. The bank's CRAR is above the minimum regulatory requirement prescribed by RBI
- II. The impact of such payment does not result in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by RBI
- III. The bank does not have a net loss. For this purpose the Net Loss is defined as either (i) the accumulated loss at the end of the previous financial year / half year as the case may be; or (ii) the loss incurred during the current financial year.
- IV. In the case of PCPS and RCPS the unpaid coupon will be treated as a liability. The interest amount due and remaining unpaid may be allowed to be paid in later years subject to the bank complying with the above requirements.
- V. In the case of RNCPS, deferred coupon will not be paid in future years, even if adequate profit is available and the level of CRAR conforms to the regulatory minimum.

b) All instances of non-payment of interest should be notified by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision, Central Office of the Reserve Bank of India, Mumbai.

ix) Redemption / repayment:

- a) The RNCPS and RCPS shall not be redeemable at the initiative of the holder.
- b) Redemption of these instruments at maturity shall be made only with the prior approval of the Reserve Bank of India (Department of Banking Operations and Development), subject, *inter alia*, to the following conditions :
 - I. the bank's CRAR is above the minimum regulatory requirement prescribed by the RBI, and
 - II. the impact of such payment does not result in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by RBI.

1.10. Seniority of claim: The claims of the investors in these instruments shall be senior to the claims of investors in instruments eligible for inclusion in Tier 1 capital and subordinate to the claims of all other creditors including those in Lower Tier 2 and the depositors. Amongst the investors of various instruments included in Upper Tier 2, the claims shall rank *pari-passu* with each other.

1.11 Amortisation for the purpose of computing CRAR: The Redeemable Preference Shares (both cumulative and non-cumulative) shall be subjected to a progressive discount for capital adequacy purposes over the last five years of their tenor, as they approach maturity as indicated in the table below for being eligible for inclusion in Tier 2 capital.

Remaining Maturity of Instruments	Rate of Discount (%)
Less than one year	100
One year and more but less than two years	80
Two years and more but less than three years	60
Three years and more but less than four years	40
Four years and more but less than five years	20

1.12 Other conditions:

- a) These instruments should be fully paid-up, unsecured, and free of any restrictive clauses.
- b) Investment by FIIs and NRIs shall be within an overall limit of 49 per cent and 24 per cent of the issue respectively, subject to the investment by each FII not exceeding 10 per cent of the issue and investment by each NRI not exceeding 5 per cent of the issue. Investment by FIIs in these instruments shall be outside the ECB limit for rupee denominated corporate debt as fixed by Government of India from time to time. However, investment by FIIs in these instruments will be subject to separate ceiling of USD 500 million. The overall non-resident holding of Preference Shares and equity shares in public sector banks will be subject to the statutory / regulatory limit.
- c) Banks should comply with the terms and conditions, if any, stipulated by SEBI / other regulatory authorities in regard to issue of the instruments.

2. Compliance with Reserve Requirements

- a) The funds collected by various branches of the bank or other banks for the issue and held pending finalization of allotment of these instruments will have to be taken into account for the purpose of calculating reserve requirements.
- b) The total amount raised by a bank through the issue of these instruments shall be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR / SLR requirements.

3. Reporting Requirements

Banks issuing these instruments shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the debt raised, including the terms of issue specified at para 1 above ,together with a copy of the offer document soon after the issue is completed.

4. Investment in these instruments issued by other banks / FIs

- a) A bank's investment in these instruments issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent of investing banks' total capital funds prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004-05 dated 6th July 2004 and also subject to cross holding limits.
- b) Bank's investments in these instruments issued by other banks / financial institutions will attract risk weight for capital adequacy purposes as provided vide paragraph 5.6 of this Master Circular.

5. Grant of advances against these instruments

Banks should not grant advances against the security of these instruments issued by them.

**Terms and Conditions Applicable to Subordinated Debt to
Qualify for Inclusion as Lower Tier 2 Capital**

The Reserve Bank has given autonomy to Indian banks to raise rupee subordinated debt as Tier 2 capital, subject to strict compliance with the following terms and conditions. Foreign banks have also been given autonomy for raising subordinated debt in foreign currency through borrowings from Head Office for inclusion in Tier 2 capital, subject to strict compliance with the terms and conditions given in Part 2 of this **Annex**.

**PART 1 – Issue of Rupee-denominated subordinated debt by Indian banks,
which is eligible for inclusion in lower Tier 2 capital**

1. Terms of Issue of Bond

To be eligible for inclusion in Tier - II Capital, terms of issue of the bonds as subordinated debt instruments should be in conformity with the following:

- (i) Amount:: The amount of subordinated debt to be raised may be decided by the Board of Directors of the banks.
- (ii) Maturity period:
 - a) Subordinated debt instruments with an initial maturity period of less than 5 years, or with a remaining maturity of one year should not be included as part of Tier-II Capital. Further, they should be subjected to progressive discount as they approach maturity at the rates shown below:

Remaining Maturity of Instruments	Rate of Discount (%)
Less than one year	100
More than One year and less than Two years	80
More than Two years and less than Three years	60
More than Three years and less than Four years	40
More than Four years and less than Five years	20

- (b) The bonds should have a minimum maturity of 5 years. However if the bonds are issued in the last quarter of the year i.e. from 1st January to 31st March, they should have a minimum tenure of sixty three months.
- (iii) Rate of interest: The banks may issue Subordinated Tier 2 bonds at coupon rates decided by their Boards. ⁶²The instruments should be 'vanilla' with no special features like options etc.

⁶² Vide DBOD Mailbox clarification dated January 9, 2008

(iv) Other conditions:

- a) The instruments should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses and should not be redeemable at the initiative of the holder or without the consent of the RBI.
- b) Necessary permission from Foreign Exchange Department of the RBI should be obtained for issuing the instruments to NRIs/OCBs/FIIs.
- c) Banks should comply with the terms and conditions, if any, set by SEBI/other regulatory authorities in regard to issue of the instruments.
- d) In the case of foreign banks, rupee subordinated debt should be issued by the Head Office of the bank, through the Indian branch, after obtaining specific approval from Foreign Exchange Department, RBI.

2. Inclusion in Tier 2 capital

Subordinated debt instruments will be limited to 50 per cent of Tier-I Capital of the bank. These instruments, together with other components of Tier 2 capital, should not exceed 100 per cent of Tier 1 capital.

3. Grant of advances against bonds

Banks should not grant advances against the security of their own bonds.

4. Compliance with Reserve Requirements

The total amount of Subordinated Debt raised by the bank has to be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

5. Treatment of Investment in subordinated debt

Investments by banks in subordinated debt of other banks will be assigned risk weight as per para 5.6.1 of this Master Circular, for capital adequacy purpose. Also, the bank's aggregate investment in Tier 2 bonds issued by other banks and financial institutions shall be within the overall ceiling of 10 percent of the investing bank's total capital funds.. The capital for this purpose will be the same as that reckoned for the purpose of capital adequacy.

6. Subordinated Debt in foreign currency

Banks may take approval of RBI on a case-by-case basis, for issuing subordinated debt in foreign currency.

7. Reporting Requirements

The banks should submit a report to Reserve Bank of India giving details of the capital raised through subordinated-debt, such as, amount raised, maturity of the instrument, and rate of interest together with a copy of the offer document soon after the issue is completed.

Part 2 - Raising of Head Office borrowings in foreign currency by foreign banks operating in India for inclusion in Tier 2 Capital

1. Terms of borrowings:

Detailed guidelines on the standard requirements and conditions for Head Office borrowings in foreign currency raised by foreign banks operating in India for inclusion , as subordinated debt in Tier 2 capital are as indicated below:-

- i) Amount of borrowing : The total amount of HO borrowing in foreign currency will be at the discretion of the foreign bank. However, the amount eligible for inclusion in Tier 2 capital as subordinated debt will be subject to a maximum ceiling of 50 per cent of the Tier 1 capital maintained in India, and the applicable discount rate mentioned in paragraph 5 below. Further as per extant instructions, the total of Tier 2 capital should not exceed 100 per cent of Tier 1 capital.
- ii) Maturity period: Head Office borrowings should have a minimum initial maturity of 5 years. If the borrowing is in tranches, each tranche will have to be retained in India for a minimum period of five years. HO borrowings in the nature of perpetual subordinated debt, where there may be no final maturity date, will not be permitted.
- iii) Features: The HO borrowings should be fully paid up, i.e. the entire borrowing or each tranche of the borrowing should be available in full to the branch in India. It should be unsecured, subordinated to the claims of other creditors of the foreign bank in India, free of restrictive clauses and should not be redeemable at the instance of the HO.
- iv) Rate of discount: The HO borrowings will be subjected to progressive discount as they approach maturity at the rates indicated below:

Remaining maturity of borrowing	Rate of discount
More than 5 years	Not Applicable (the entire amount can be included as subordinated debt in Tier 2 capital subject to the ceiling mentioned in paragraph 2)
More than 4 years and less than 5 years	20%
More than 3 years and less than 4 years	40%
More than 2 years and less than 3 years	60%
More than 1 year and less than 2 years	80%
Less than 1 year	100% (No amount can be treated as subordinated debt for Tier 2 capital)

- v) Rate of interest: The rate of interest on HO borrowings should not exceed the on-going market rate. Interest should be paid at half yearly rests.

- vi) Withholding tax: The interest payments to the HO will be subject to applicable withholding tax.
- vii) Repayment: All repayments of the principal amount will be subject to prior approval of Reserve Bank of India, Department of Banking Operations and Development.
- viii) Documentation: The bank should obtain a letter from its HO agreeing to give the loan for supplementing the capital base for the Indian operations of the foreign bank. The loan documentation should confirm that the loan given by HO would be subordinated to the claims of all other creditors of the foreign bank in India. The loan agreement will be governed by, and construed in accordance with the Indian law. Prior approval of the RBI should be obtained in case of any material changes in the original terms of issue.

2. Disclosure

The total amount of HO borrowings may be disclosed in the balance sheet under the head 'Subordinated loan in the nature of long term borrowings in foreign currency from Head Office'.

3. Reserve Requirements

The total amount of HO borrowings is to be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

4. Hedging

The entire amount of HO borrowing should remain fully swapped with banks at all times. The swap should be in Indian rupees.

5. Reporting & Certification

Such borrowings done in compliance with the guidelines set out above would not require prior approval of Reserve Bank of India. However, information regarding the total amount of borrowing raised from Head Office under this Annex, along with a certification to the effect that the borrowing is as per the guidelines, should be advised to the Chief General Managers-in-Charge of the Department of Banking Operations & Development (International Banking Division), Department of External Investments & Operations and Foreign Exchange Department (Fore Markets Division), Reserve Bank of India, Mumbai.

Extracts from the 'Guidelines on Securitisation of Standard Assets' issued vide circular DBOD.No.BP.C.60/21.04.048/2005-06 dated February 1, 2006

“Scope

1. The regulatory framework provided in the guidelines covers securitisation of standard assets by banks, All India Term Lending and Refinancing Institutions, and Non Banking Financial Companies (including RNBCs). The reference to 'bank' in the guidelines would include all the above institutions.
2. Securitisation is a process by which assets are sold to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment. The cash flow from the underlying pool of assets is used to service the securities issued by the SPV. Securitisation thus follows a two-stage process. In the first stage there is sale of single asset or pooling and sale of pool of assets to a 'bankruptcy remote' special purpose vehicle (SPV) in return for an immediate cash payment and in the second stage repackaging and selling the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities.
3. Banks' exposures to a securitisation transaction are referred to as "securitisation exposures". Securitisation exposures include, but are not restricted to the following: exposures to securities issued by the SPV, credit enhancement facility, liquidity facility, underwriting facility, interest rate or currency swaps and cash collateral accounts. “

“Definition

5. The broad definitions of various terms used in these guidelines are furnished below. These terms have been supplemented as appropriate at various relevant portions of these guidelines.
 - (i) "Bankruptcy remote" means the unlikelihood of an entity being subjected to voluntary or involuntary bankruptcy proceedings, including by the originator or its creditors;
 - (ii) "credit enhancement" is provided to an SPV to cover the losses associated with the pool of assets. The rating given to the securities issued by the SPV (PTCs) by a rating agency will reflect the level of enhancement;
 - (iii) A "first loss facility" represents the first level of financial support to a SPV as part of the process in bringing the securities issued by the SPV to investment grade. The provider of the facility bears the bulk (or all) of the risks associated with the assets held by the SPV;
 - (iv) A "second loss facility" represents a credit enhancement providing a second (or subsequent) tier of protection to an SPV against potential losses;

- (v) "Liquidity facilities" enable SPVs to assure investors of timely payments. These include smoothening of timing differences between payment of interest and principal on pooled assets and payments due to investors;
- (vi) "Originator" refers to a bank that transfers from its balance sheet a single asset or a pool of assets to an SPV as a part of a securitisation transaction and would include other entities of the consolidated group to which the bank belongs.
- (vii) "Securitisation" means a process by which a single performing asset or a pool of performing assets are sold to a bankruptcy remote SPV and transferred from the balance sheet of the originator to the SPV in return for an immediate cash payment;
- (viii) "Service provider" means a bank that carries out on behalf of the SPV (a) administrative functions relating to the cash flows of the underlying exposure or pool of exposures of a securitization; (b) funds management; and (c) servicing the investors;
- (ix) "SPV" means any company, trust, or other entity constituted or established for a specific purpose - (a) activities of which are limited to those for accomplishing the purpose of the company, trust or other entity as the case may be; and (b) which is structured in a manner intended to isolate the corporation, trust or entity as the case may be, from the credit risk of an originator to make it bankruptcy remote;
- (x) "Underwriting" means the arrangement under which a bank agrees, before issue, to buy a specified quantity of securities in a new issue on a given date and at a given price if no other purchaser has come forward.

True Sale

6. For enabling the transferred assets to be removed from the balance sheet of the originator in a securitisation structure, the isolation of assets or 'true sale' from the originator to the SPV is an essential prerequisite. In case the assets are transferred to the SPV by the originator in full compliance with all the conditions of true sale given below, the transfer would be treated as a 'true sale' and originator will not be required to maintain any capital against the value of assets so transferred from the date of such transfer. The effective date of such transfer should be expressly indicated in the subsisting agreement. In the event of the transferred assets not meeting the "true-sale" criteria the assets would be deemed to be on the balance sheet of the originator and accordingly the originator would be required to maintain capital for those assets. The criteria of true-sale that have been prescribed below are illustrative but not exhaustive.

7. The criteria for "True Sale" of assets

7.1 The sale should result in immediate legal separation of the originator from the assets which are sold to the new owner viz. the SPV. The assets should stand completely isolated from the originator, after its transfer to the SPV, i.e., put beyond the originator's as well as their creditors' reach, even in the event of bankruptcy of the originator.

7.2 The originator should effectively transfer all risks / rewards and rights / obligations pertaining to the asset and shall not hold any beneficial interest in the asset after its sale to the SPV. An agreement entitling the originator to any surplus income on the securitised assets at the end of the life of the securities issued by the SPV would not be deemed as a

violation of the true sale criteria. The SPV should obtain the unfettered right to pledge, sell, transfer or exchange or otherwise dispose of the assets free of any restraining condition.

7.3 The originator shall not have any economic interest in the assets after its sale and the SPV shall have no recourse to the originator for any expenses or losses except those specifically permitted under these guidelines.

7.4 There shall be no obligation on the originator to re-purchase or fund the re-payment of the asset or any part of it or substitute assets held by SPV or provide additional assets to the SPV at any time except those arising out of breach of warranties or representations made at the time of sale. The originator should be able to demonstrate that a notice to this effect has been given to the SPV and that the SPV has acknowledged the absence of such obligation.

7.5 An option to repurchase fully performing assets at the end of the securitisation scheme where residual value of such assets has, in aggregate, fallen to less than 10% of the original amount sold to the SPV ("clean up calls") as allowed vide paragraph 10 can be retained by the originator.

7.6 The originator should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the scheme or investors.

7.7 The sale shall be only on cash basis and the consideration shall be received not later than at the time of transfer of assets to the SPV. The sale consideration should be market-based and arrived at in a transparent manner on an arm's length basis.

7.8 Provision of certain services (such as credit enhancement, liquidity facility, underwriting, asset-servicing, etc.) and assumption of consequent risks / obligations by the originators as specifically allowed in these guidelines would not detract from the 'true sale' nature of the transaction, provided such service obligations do not entail any residual credit risk on the assets securitized or any additional liability for them beyond the contractual performance obligations in respect of such services.

7.9 An opinion from the originating bank's Legal Counsel should be kept on record signifying that: (i) all rights, titles, interests and benefits in the assets have been transferred to SPV; (ii) originator is not liable to investors in any way with regard to these assets other than liability for certain permitted contractual obligations for example, credit enhancement / liquidity facility; and (iii) creditors of the originator do not have any right in any way with regard to these assets even in case of bankruptcy of the originator.

7.10 Any re-schedulement, restructuring or re-negotiation of the terms of the underlying agreement/s effected after the transfer of assets to the SPV, shall be binding on the SPV and not on the originator and shall be done only with the express consent of the investors, providers of credit enhancement and other service providers. This should be expressly provided in the sale transaction documents.

7.11 The transfer of assets from originator must not contravene the terms and conditions of any underlying agreement governing the assets and all necessary consents from obligors (including from third parties, where necessary) should have been obtained.

7.12 In case the originator also provides servicing of assets after securitisation, under an agreement with the SPV, and the payments / repayments from the borrowers are routed through it, it shall be under no obligation to remit funds to the SPV / investors unless and until these are received from the borrowers.

7.13 The originator should not be under any obligation to purchase the securities issued by the SPV and should not subscribe to their primary issue. The originator may, however,

purchase at market price only senior securities issued by the SPV if these are at least 'investment grade', for investment purposes. Such purchase, along with the securities that may devolve on account of underwriting commitments, should not exceed 10% of the original amount of the issue.

7.14 The originator shall not indulge in market-making or dealing in the securities issued by the SPV.

7.15 The securities issued by the SPV shall not have any put options. The securities may have a call option to address the pre-payment risk on the underlying assets.

CRITERIA TO BE MET BY SPV

8. SPV is a special purpose vehicle set up during the process of securitisation to which the beneficial interest in the securitised assets are sold / transferred on a without recourse basis. The SPV may be a partnership firm, a trust or a company. Any reference to SPV in these guidelines would also refer to the trust settled or declared by the SPV as a part of the process of securitisation. The SPV should meet the following criteria to enable the originator to treat the assets transferred by it to the SPV as a true sale and apply the prudential guidelines on capital adequacy and other aspects with regard to the securitisation exposures assumed by it.

8.1 Any transaction between the originator and the SPV should be strictly on arm's length basis. Further, it should be ensured that any transaction with the SPV should not intentionally provide for absorbing any future losses.

8.2 The SPV and the trustee should not resemble in name or imply any connection or relationship with the originator of the assets in its title or name.

8.3 The SPV should be entirely independent of the originator. The originator should not have any ownership, proprietary or beneficial interest in the SPV. The originator should not hold any share capital in the SPV.

8.4 The originator shall have only one representative, without veto power, on the board of the SPV provided the board has at least four members and independent directors are in majority.

8.5 The originator shall not exercise control, directly or indirectly, over the SPV and the trustees, and shall not settle the trust deed.

8.6 The SPV should be bankruptcy remote and non-discretionary.

8.7 The trust deed should lay down, in detail, the functions to be performed by the trustee, their rights and obligations as well as the rights and obligations of the investors in relation to the securitised assets. The Trust Deed should not provide for any discretion to the trustee as to the manner of disposal and management or application of the trust property. In order to protect their interests, investors should be empowered in the trust deed to change the trustee at any point of time.

8.8 The trustee should only perform trusteeship functions in relation to the SPV and should not undertake any other business with the SPV.

8.9 The originator shall not support the losses of the SPV except under the facilities explicitly permitted under these guidelines and shall also not be liable to meet the recurring expenses of the SPV.

8.10 The securities issued by the SPV shall compulsorily be rated by a rating agency registered with SEBI and such rating at any time shall not be more than 6 months old. The credit rating should be publicly available. For the purpose of rating and subsequent updation, the SPV should supply the necessary information to the rating agency in a timely manner. Commonality and conflict of interest, if any, between the SPV and the rating agency should also be disclosed.

8.11 The SPV should inform the investors in the securities issued by it that these securities are not insured and that they do not represent deposit liabilities of the originator, servicer or trustees.

8.12 A copy of the trust deed and the accounts and statement of affairs of the SPV should be made available to the RBI, if required to do so.

Special Features

9. Representations and Warranties

An originator that sells assets to SPV may make representations and warranties concerning those assets. Where the following conditions are met the originator will not be required to hold capital against such representations and warranties.

- (a) Any representation or warranty is provided only by way of a formal written agreement.
- (b) The originator undertakes appropriate due diligence before providing or accepting any representation or warranty.
- (c) The representation or warranty refers to an existing state of facts that is capable of being verified by the originator at the time the assets are sold.
- (d) The representation or warranty is not open-ended and, in particular, does not relate to the future creditworthiness of the assets, the performance of the SPV and / or the securities the SPV issues.
- (e) The exercise of a representation or warranty, requiring an originator to replace assets (or any parts of them) sold to a SPV, must be:
 - * undertaken within 120 days of the transfer of assets to the SPV; and
 - * conducted on the same terms and conditions as the original sale.
- (f) An originator that is required to pay damages for breach of representation or warranty can do so provided the agreement to pay damages meets the following conditions:
 - * the onus of proof for breach of representation or warranty remains at all times with the party so alleging;
 - * the party alleging the breach serves a written Notice of Claim on the originator, specifying the basis for the claim; and
 - * damages are limited to losses directly incurred as a result of the breach.
- (g) An originator should notify RBI (Department of Banking Supervision) of all instances where it has agreed to replace assets sold to SPV or pay damages arising out of any representation or warranty.

10. Re-purchase of Assets from SPVs

An option to repurchase fully performing assets at the end of the securitisation scheme where residual value of such assets has, in aggregate, fallen to less than 10% of the original amount sold to the SPV ("clean up calls") could be retained by the originator and would not be construed to constitute 'effective control', provided:

- (i) the purchase is conducted at arm's length, on market terms and conditions (including price / fee) and is subject to the originator's normal credit approval and review processes; and
- (ii) the exercise of the clean-up call is at its discretion.

POLICY ON PROVISION OF CREDIT ENHANCEMENT FACILITIES

11. Detailed Policy

Credit enhancement facilities include all arrangements provided to the SPV that could result in a bank absorbing losses of the SPV or its investors. Such facilities may be provided by both originators and third parties. A bank should hold capital against the credit risk assumed when it provides credit enhancement, either explicitly or implicitly, to a special purpose vehicle or its investors. The entity providing credit enhancement facilities should ensure that the following conditions are fulfilled. Where any of the conditions is not satisfied, the bank providing credit enhancement facility will be required to hold capital against the full value of the securitised assets as if they were held on its balance sheet.

11.1 Provision of the facility should be structured in a manner to keep it distinct from other facilities and documented separately from any other facility provided by the bank. The nature, purpose, extent of the facility and all required standards of performance should be clearly specified in a written agreement to be executed at the time of originating the transaction and disclosed in the offer document.

11.2 The facility is provided on an 'arm's length basis' on market terms and conditions, and subjected to the facility provider's normal credit approval and review process.

11.3 Payment of any fee or other income for the facility is not subordinated or subject to deferral or waiver.

11.4 The facility is limited to a specified amount and duration.

11.5 The duration of the facility is limited to the earlier of the dates on which:

- (i) the underlying assets are redeemed;
- (ii) all claims connected with the securities issued by the SPV are paid out; or
- (iii) the bank's obligations are otherwise terminated.

11.6 There should not be any recourse to the facility provider beyond the fixed contractual obligations. In particular, the facility provider should not bear any recurring expenses of the securitisation.

11.7 The facility provider has written opinions from its legal advisors that the terms of agreement protect it from any liability to the investors in the securitisation or to the SPV / trustee, except in relation to its contractual obligations pursuant to the agreement governing provision of the facility.

11.8 The SPV and / or investors in the securities issued by the SPV have the clear right to select an alternative party to provide the facility.

11.9 Credit enhancement facility should be provided only at the initiation of the securitisation transaction.

11.10 The amount of credit enhancement extended at the initiation of the securitisation transaction should be available to the SPV during the entire life of the securities issued by the SPV. The amount of credit enhancement shall be reduced only to the extent of draw downs to meet the contingencies arising out of losses accruing to the SPV or its investors. No portion of the credit enhancement shall be released to the provider during the life of the securities issued by the SPV.

11.11 Any utilization / draw down of the credit enhancement should be immediately written-off by debit to the profit and loss account.

11.12 When a first loss facility does not provide substantial cover a second loss facility might carry a disproportionate share of risk. In order to limit this possibility, a credit enhancement facility will be deemed to be a second loss facility only where:

- * it enjoys protection given by a substantial first loss facility;
- * it can be drawn on only after the first loss facility has been completely exhausted;
- * it covers only losses beyond those covered by the first loss facility; and
- * the provider of the first loss facility continues to meet its obligations.

If the second loss facility does not meet the above criteria, it will be treated as a first loss facility.

11.13 The first-loss facility would be considered substantial where it covers some multiple of historic losses or worst case losses estimated by simulation or other techniques. The second loss facility provider shall assess adequacy of first loss facility on an arm's length basis and shall review it periodically at least once in six months. The following factors may be reckoned while conducting the assessment as well as review:

- (i) the class and quality of assets held by the SPV;
- (ii) the history of default rates on the assets;
- (iii) the output of any statistical models used by banks to assess expected default rates on the assets;
- (iv) the types of activity in which the SPV is engaging in or is permitted to engage in;
- (v) the quality of the parties providing the first loss facility; and
- (vi) the opinions or rating letters provided by reputable rating agencies regarding the adequacy of first loss protection.

12. Treatment of credit enhancements provided by an originator

12.1 Treatment of First Loss Facility: The first loss credit enhancement provided by the originator shall be reduced from capital funds and the deduction shall be capped at the amount of capital that the bank would have been required to hold for the full value of the assets, had they not been securitised. The deduction shall be made 50% from Tier 1 and 50% from Tier 2 capital.

12.2 Treatment of Second Loss Facility: The second loss credit enhancement provided by the originator shall be reduced from capital funds to the full extent. The deduction shall be made 50% from Tier 1 and 50% from Tier 2 capital.

13. Treatment of credit enhancements provided by third party

13.1 Treatment of First Loss Facility: The first loss credit enhancement provided by third party service providers shall be reduced from capital to the full extent as mentioned in paragraph 12.1 above.

13.2 Treatment of Second Loss Facility: The second loss credit enhancement shall be treated as a direct credit substitute with a 100 per cent credit conversion factor and a 100 % risk weight covering the amount of the facility.

POLICY ON PROVISION OF LIQUIDITY FACILITIES

14. Detailed Policy on provision of liquidity support

A liquidity facility is provided to help smoothen the timing differences faced by the SPV between the receipt of cash flows from the underlying assets and the payments to be made to investors. A liquidity facility should meet the following conditions to guard against the possibility of the facility functioning as a form of credit enhancement and / or credit support. In case the facility fails to meet any of these conditions, it will be regarded as serving the economic purpose of credit enhancement and the liquidity facility provided by a third party shall be treated as a first loss facility and the liquidity facility provided by the originator shall be treated as a second loss facility.

14.1 All conditions specified in paragraphs 11.1 to 11.8 above.

14.2 The securitised assets are covered by a substantial first loss credit enhancement.

14.3 The documentation for the facility must clearly define the circumstances under which the facility may or may not be drawn on.

14.4 The facility should be capable of being drawn only where there is a sufficient level of non-defaulted assets to cover drawings, or the full amount of assets that may turn non-performing are covered by a substantial credit enhancement.

14.5 The facility shall not be drawn for the purpose of

- (a) providing credit enhancement;
- (b) covering losses of the SPV;
- (c) serving as a permanent revolving funding; and

(d) covering any losses incurred in the underlying pool of exposures prior to a draw down.

14.6 The liquidity facility should not be available for (a) meeting recurring expenses of securitisation; (b) funding acquisition of additional assets by the SPV; (c) funding the final scheduled repayment of investors and (d) funding breach of warranties.

14.7 Funding should be provided to SPV and not directly to the investors.

14.8 When the liquidity facility has been drawn the facility provider shall have a priority of claim over the future cash flows from the underlying assets, which will be senior to the claims of the senior most investor.

14.9 When the originator is providing the liquidity facility, an independent third party, other than the originator's group entities, should co-provide at least 25% of the liquidity facility that shall be drawn and repaid on a pro-rata basis. The originator must not be liable to meet any shortfall in liquidity support provided by the independent party. During the initial phase, a bank may provide the full amount of a liquidity facility on the basis that it will find an independent party to participate in the facility as provided above. The originator will have three months to locate such independent third party.

15. Treatment of liquidity facility

15.1 The commitment to provide liquidity facility, to the extent not drawn would be an off-balance sheet item and attract 100% credit conversion factor as well as 100 % risk weight. The extent to which the commitment becomes a funded facility, it would attract 100 % risk weight.

15.2 Since the liquidity facility is meant to smoothen temporary cash flow mismatches, the facility will remain drawn only for short periods. If the drawings under the facility are outstanding for more than 90 days it should be classified as NPA and fully provided for.

POLICY ON PROVISION OF UNDERWRITING FACILITIES

16. General Policy

An originator or a third-party service provider may act as an underwriter for the issue of securities by SPV and treat the facility as an underwriting facility for capital adequacy purposes subject to the following conditions. In case any of the conditions is not satisfied, the facility will be considered as a credit enhancement and treated as a first loss facility when provided by a third party and a second loss facility when provided by an originator.

16.1 All conditions specified in paragraphs 11.1 to 11.8 above.

16.2 The underwriting is exercisable only when the SPV cannot issue securities into the market at a price equal to or above the benchmark predetermined in the underwriting agreement.

16.3 The bank has the ability to withhold payment and to terminate the facility, if necessary, upon the occurrence of specified events(e.g. material adverse changes or defaults on assets above a specified level); and

16.4 There is a market for the type of securities underwritten.

17. Underwriting

17.1 Underwriting by an originator

An originator may underwrite only investment grade senior securities issued by the SPV. The holdings of securities devolved through underwriting should be sold to third parties within three-month period following the acquisition. During the stipulated time limit, the total outstanding amount of devolved securities will be subjected to a risk weight of 100 per cent. In case of failure to off-load within the stipulated time limit, any holding in excess of 10 per cent of the original amount of issue, including secondary market purchases, shall be deducted 50% from Tier 1 capital and 50% from Tier 2 capital.

17.2 Underwriting by third party service providers

A third party service provider may underwrite the securities issued by the SPV. The holdings of securities devolved through underwriting should be sold to third parties within three-month period following the acquisition. During the stipulated time limit, the total outstanding amount of devolved securities will be subjected to a risk weight of 100 per cent. In case of failure to off-load within the stipulated time limit, the total outstanding amount of devolved securities which are at least investment grade will attract a 100% risk weight and those which are below investment grade will be deducted from capital at 50% from Tier 1 and 50% from Tier 2.

POLICY ON PROVISION OF SERVICES

18. A servicing bank administers or services the securitised assets. Hence, it should not have any reputational obligation to support any losses incurred by the SPV and should be able to demonstrate this to the investors. A bank performing the role of a service provider for a proprietary or a third-party securitisation transaction should ensure that the following conditions are fulfilled. Where the following conditions are not met, the service provider may be deemed as providing liquidity facility to the SPV or investors and treated accordingly for capital adequacy purpose.

18.1 All conditions specified in paragraphs 11.1 to 11.8 above.

18.2 The service provider should be under no obligation to remit funds to the SPV or investors until it has received funds generated from the underlying assets except where it is the provider of an eligible liquidity facility.

18.3 The service provider shall hold in trust, on behalf of the investors, the cash flows arising from the underlying and should avoid co-mingling of these cash flows with their own cash flows.

19. PRUDENTIAL NORMS FOR INVESTMENT IN THE SECURITIES ISSUED BY SPV

19.1 As the securities issued by SPVs would be in the nature of non-SLR securities, banks' investment in these securities would attract all prudential norms applicable to non-SLR investments prescribed by RBI from time to time

19.2 Limits on investment in securities by the originator

The aggregate investment by the originator in securities issued by SPV would be as given in para 7.13.

19.3 Exposure norms for investment in the PTCs

The counterparty for the investor in the securities would not be the SPV but the underlying assets in respect of which the cash flows are expected from the obligors / borrowers. These should be taken into consideration when reckoning overall exposures to any particular borrower / borrower Group, industry or geographic area for the purpose of managing concentration risks and compliance with extant prudential exposure norms, wherever the obligors in the pool constitute 5% or more of the receivables in the pool or Rs.5 crore, whichever is lower.

19.4 Income recognition and provisioning norms for investors in the PTCs

As the securities are expected to be limited-tenor, interest bearing debt instruments, the income on the securities may normally be recognised on accrual basis. However, if the income (or even the redemption amount) on securities remains in arrears for more than 90 days, any future income should be recognised only on realisation and any unrealised income recognised on accrual basis should be reversed. In case of pendency of dues on the securities appropriate provisions for the diminution in value of the securities on account of such overdues should also be made, as already envisaged in the extant RBI norms for classification and valuation of investment by the banks.

20. ACCOUNTING TREATMENT OF THE SECURITISATION TRANSACTIONS

20.1 Accounting in the books of the originator

In terms of these guidelines banks can sell assets to SPV only on cash basis and the sale consideration should be received not later than the transfer of the asset to the SPV. Hence, any loss arising on account of the sale should be accounted accordingly and reflected in the Profit & Loss account for the period during which the sale is effected and any profit / premium arising on account of sale should be amortised over the life of the securities issued or to be issued by the SPV.

(i) In case the securitised assets qualify for derecognition from the books of the originator, the entire expenses incurred on the transaction, say, legal fees, etc., should be expensed at the time of the transaction and should not be deferred.

(ii) Where the securitised assets do not qualify for derecognition the sale consideration received shall be treated as a borrowing.

20.2 The accounting treatment of the securitisation transactions in the books of originators, SPV and investors in securities will be as per the guidance note issued by the ICAI with reference to those aspects not specifically covered in these guidelines. ”

Part – A

Illustrations on Credit Risk Mitigation (Loan- Exposures)

Calculation of Exposure amount for collateralised transactions:

$$E^* = \text{Max} \{ 0, [E \times (1 + H_e) - C \times (1 - H_c - H_{FX})] \}$$

Where,

E^* = Exposure value after risk mitigation

E = Current value of the exposure

H_e = Haircut appropriate to the exposure

C = Current value of the collateral received

H_c = Haircut appropriate to the collateral

H_{FX} = Haircut appropriate for currency mismatch between the collateral and exposure

Sly. No.	<u>Particulars</u>	<u>Case 1</u>	<u>Case 2</u>	<u>Case 3</u>	<u>Case 4</u>	<u>Case 5</u>
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1	Exposure	100	100	100	100	100
2	Maturity of the exposure	2	3	6	3	3
3	Nature of the exposure	Corporate Loan	Corporate Loan	Corporate Loan	Corporate Loan	Corporate Loan
4	Currency	INR	INR	USD	INR	INR
5	Exposure in rupees	100	100	4000 (Row 1 x exch. rate##)	100	100
6	Rating of exposure	BB	A	BBB-	AA	B-
	Applicable Risk weight	150	50	100@	30	150
7	Haircut for exposure*	0	0	0	0	0
8	Collateral	100	100	4000	2	100
9	Currency	INR	INR	INR	USD	INR
10	Collateral in Rs.	100	100	4000	80 (Row 1 x Exch. Rate)	100
11	Residual maturity of collateral (years)	2	3	6	3	5

⁶³ Vide SI N.18 in the Annex to DBOD.No.BP.BC.67/21.06.001/2007-08 dated March 31, 2008

12	Nature of collateral	Sovereign (Govt) Security	Bank Bonds	Corporate Bonds	Foreign Corporate Bonds	Units of Mutual Funds
13	Rating of Collateral	NA	Unrated	BBB	AAA (S & P)	AA
14	Haircut for collateral (%)	0.02	0.06	0.12	0.04	0.08
15	Haircut for currency mismatches (%) [cf. para 7.3.7 (vi) of circular]	0	0	0.08	0.08	0
16	Total Haircut on collateral [Row 10 x (row 14+15)]	2	6	800	9.6	8
17	Collateral after haircut (Row 10 - Row 16)	98	94	3200	70.4	92
18	Net Exposure (Row 5 – Row 17)	2	6	800	29.6	8
19	Risk weight (%)	150	50	100@	30	150
20	RWA (Row 18 x 19)	3	3	800	8.88	12

Exchange rate assumed to be 1 USD = Rs.40

Not applicable

@ In case of long term ratings, as per para 6.4.2 of the circular, where “+” or “-” notation is attached to the rating, the corresponding main rating category risk weight is to be used. Hence risk weight is 100 per cent.

(*) Haircut for exposure is taken as zero because the loans are not marked to market and hence are not volatile

Case 4 : Haircut applicable as per Table - 14

Case 5 : It is assumed that the Mutual Fund meets the criteria specified in paragraph 7.3.5(viii) and has investments in the securities all of which have residual maturity of more than five years are rated AA and above – which would attract a haircut of eight per cent in terms of Table 14 of the Circular.

Part - B

Illustrations on computation of capital charge for counterparty credit risk (CCR) – Repo Transactions

An illustration showing computation of total capital charge for a repo transaction comprising the capital charge for CCR and Credit/Market risk for the underlying security, under Basel-II is furnished below:

A. Particulars of a Repo Transaction:

Let us assume the following parameters of a hypothetical repo transaction:

Type of the Security	GOI security
Residual Maturity	5 years
Coupon	6 %
Current Market Value	Rs.1050
Cash borrowed	Rs.1000
Modified Duration of the security	4.5 years
Assumed frequency of margining	Daily
Haircut for security	2 % (Cf. Item A(i), Table 14 of the Circular)
Haircut on cash	Zero (Cf. Item C in Table 14 of the Circular)
Minimum holding period	5 business-days (Cf. para 7.3.7 (ix) of the Circular)
Change in yield for computing the capital charge for general market risk	0.7 % p.a. (Cf. Zone 3 in Table 17 of the Circular)

B. Computation of total capital charge comprising the capital charge for Counterparty Credit Risk (CCR) and Credit / Market risk for the underlying security

B.1 In the books of the borrower of funds (for the off-balance sheet exposure due to lending of the security under repo)

(In this case, the security lent is the exposure of the security lender while cash borrowed is the collateral)

Sl.No	Items	Particulars	Amount (in Rs.)
A.	Capital Charge for CCR		
1.	Exposure	MV of the security	1050
2.	CCF for Exposure	100 %	
3.	On-Balance Sheet Credit Equivalent	1050 * 100 %	1050
4.	Haircut	1.4 % @	
5.	Exposure adjusted for haircut as per Table 14 of the circular	1050 * 1.014	1064.70
6.	Collateral for the security lent	Cash	1000
7.	Haircut for exposure	0 %	
8.	Collateral adjusted for haircut	1000 * 1.00	1000
9.	Net Exposure (5- 8)	1064.70 - 1000	64.70
10.	Risk weight (for a Scheduled CRAR-compliant bank)	20 %	
11.	Risk weighted assets for CCR (9 x 10)	64.70 * 20 %	12.94
12.	Capital Charge for CCR (11 x 9%)	12.94 * 0.09	1.16
B.	Capital for Credit/ market Risk of the security		
1.	Capital for credit risk (if the security is held under HTM)	Credit risk	Zero (Being Govt. security)
2.	Capital for market risk (if the security is held under AFS / HFT)	Specific Risk	Zero (Being Govt. security)
		General Market Risk (4.5 * 0.7 % * 1050) {Modified duration * assumed yield change (%) * market value of security}	33.07
Total capital required (for CCR + credit risk + specific risk + general market risk)			34.23

@ The supervisory haircut of 2 per cent has been scaled down using the formula indicated in paragraph 7.3.7 of the circular.

B.2 In the books of the lender of funds (for the on-balance sheet exposure due to lending of funds under repo)

(In this case, the cash lent is the exposure and the security borrowed is collateral)

Sl.No	Items	Particulars	Amount (in Rs.)
A.	Capital Charge for CCR		
1.	Exposure	Cash	1000
2.	Haircut for exposure	0 %	
3.	<i>Exposure adjusted for haircut as per Table 14 of the circular</i>	$1000 * 1.00$	1000
4.	Collateral for the cash lent	Market value of the security	1050
5.	Haircut for collateral	1.4 % @	
6.	<i>Collateral adjusted for haircut</i>	$1050 * 0.986$	1035.30
7.	Net Exposure (3 - 6)	$\text{Max} \{ 1000 - 1035.30 \}$	0
8.	Risk weight (for a Scheduled CRAR-compliant bank)	20 %	
9.	Risk weighted assets for CCR (7 x 8)	$0 * 20 \%$	0
10.	Capital Charge for CCR	0	0
B.	Capital for Credit/ market Risk of the security		
1.	Capital for credit risk (if the security is held under HTM)	Credit Risk	Not applicable, as it is maintained by the borrower of funds
2.	Capital for market risk (if the security is held under AFS/HFT)	Specific Risk	Not applicable, as it is maintained by the borrower of funds
		General Market Risk	Not applicable, as it is maintained by the borrower of funds

@ The supervisory haircut of 2 per cent has been scaled down using the formula indicated in paragraph 7.3.7 of the circular.

Measurement of capital charge for market risks in respect of interest rate derivatives and options

A. Interest rate derivatives

The measurement system should include all interest rate derivatives and off-balance-sheet instruments in the trading book, which react to changes in interest rates, (e.g. forward rate agreements (FRAs), other forward contracts, bond futures, interest rate and cross-currency swaps and forward foreign exchange positions). Options can be treated in a variety of ways as described in para B.1 below. A summary of the rules for dealing with interest rate derivatives is set out in the Table at the end of this section.

1. Calculation of positions

The derivatives should be converted into positions in the relevant underlying and be subjected to specific and general market risk charges as described in the guidelines. In order to calculate the capital charge, the amounts reported should be the market value of the principal amount of the underlying or of the notional underlying. For instruments where the apparent notional amount differs from the effective notional amount, banks must use the effective notional amount.

(a) Futures and forward contracts, including forward rate agreements

These instruments are treated as a combination of a long and a short position in a notional government security. The maturity of a future or a FRA will be the period until delivery or exercise of the contract, plus - where applicable - the life of the underlying instrument. *For example, a long position in a June three-month interest rate future (taken in April) is to be reported as a long position in a government security with a maturity of five months and a short position in a government security with a maturity of two months.* Where a range of deliverable instruments may be delivered to fulfill the contract, the bank has flexibility to elect which deliverable security goes into the duration ladder but should take account of any conversion factor defined by the exchange.

(b) Swaps

Swaps will be treated as two notional positions in government securities with relevant maturities. *For example, an interest rate swap under which a bank is receiving floating rate interest and paying fixed will be treated as a long position in a floating rate instrument of maturity equivalent to the period until the next interest fixing and a short position in a fixed-*

rate instrument of maturity equivalent to the residual life of the swap. For swaps that pay or receive a fixed or floating interest rate against some other reference price, e.g. a stock index, the interest rate component should be slotted into the appropriate repricing maturity category, with the equity component being included in the equity framework.

Separate legs of cross-currency swaps are to be reported in the relevant maturity ladders for the currencies concerned.

2. Calculation of capital charges for derivatives under the standardised methodology

(a) Allowable offsetting of matched positions

Banks may exclude the following from the interest rate maturity framework altogether (for both specific and general market risk);

- Long and short positions (both actual and notional) in identical instruments with exactly the same issuer, coupon, currency and maturity.
- A matched position in a future or forward and its corresponding underlying may also be fully offset, (the leg representing the time to expiry of the future should however be reported) and thus excluded from the calculation.

When the future or the forward comprises a range of deliverable instruments, offsetting of positions in the future or forward contract and its underlying is only permissible in cases where there is a readily identifiable underlying security which is most profitable for the trader with a short position to deliver. The price of this security, sometimes called the "cheapest-to-deliver", and the price of the future or forward contract should in such cases move in close alignment.

No offsetting will be allowed between positions in different currencies; the separate legs of cross-currency swaps or forward foreign exchange deals are to be treated as notional positions in the relevant instruments and included in the appropriate calculation for each currency.

In addition, opposite positions in the same category of instruments can in certain circumstances be regarded as matched and allowed to offset fully. To qualify for this treatment the positions must relate to the same underlying instruments, be of the same nominal value and be denominated in the same currency. In addition:

- for futures: offsetting positions in the notional or underlying instruments to which the futures contract relates must be for identical products and mature within seven days of each other;

- for swaps and FRAs: the reference rate (for floating rate positions) must be identical and the coupon closely matched (i.e. within 15 basis points); and
- for swaps, FRAs and forwards: the next interest fixing date or, for fixed coupon positions or forwards, the residual maturity must correspond within the following limits:
 - o less than one month hence: same day;
 - o between one month and one year hence: within seven days;
 - o over one year hence: within thirty days.

Banks with large swap books may use alternative formulae for these swaps to calculate the positions to be included in the duration ladder. The method would be to calculate the sensitivity of the net present value implied by the change in yield used in the duration method and allocate these sensitivities into the time-bands set out in Table –17 in paragraph 8.3 of this Master Circular.

(b) Specific risk

Interest rate and currency swaps, FRAs, forward foreign exchange contracts and interest rate futures will not be subject to a specific risk charge. This exemption also applies to futures on an interest rate index (e.g. LIBOR). However, in the case of futures contracts where the underlying is a debt security, or an index representing a basket of debt securities, a specific risk charge will apply according to the credit risk of the issuer as set out in paragraphs above.

(c) General market risk

General market risk applies to positions in all derivative products in the same manner as for cash positions, subject only to an exemption for fully or very closely matched positions in identical instruments as defined in paragraphs above. The various categories of instruments should be slotted into the maturity ladder and treated according to the rules identified earlier.

Table - Summary of treatment of interest rate derivatives

Instrument	Specific risk charge	General Market risk charge
Exchange-traded future - Government debt security - Corporate debt security - Index on interest rates (e.g. MIBOR)	No Yes No	Yes, as two positions Yes, as two positions Yes, as two positions
OTC forward - Government debt security - Corporate debt security - Index on interest rates (e.g. MIBOR)	No Yes No	Yes, as two positions Yes, as two positions Yes, as two positions
FRAs, Swaps	No	Yes, as two positions
Forward Foreign Exchange	No	Yes, as one position in each currency
Options - Government debt security - Corporate debt security - Index on interest rates (e.g. MIBOR) - FRAs, Swaps	No Yes No No	

B. Treatment of Options

1. In recognition of the wide diversity of banks' activities in options and the difficulties of measuring price risk for options, alternative approaches are permissible as under:

- those banks which solely use purchased options⁶⁴ will be free to use the simplified approach described in Section I below;
- those banks which also write options will be expected to use one of the intermediate approaches as set out in Section II below.

2. In the **simplified approach**, the positions for the options and the associated underlying, cash or forward, are not subject to the standardised methodology but rather are "carved-out" and subject to separately calculated capital charges that incorporate both general market risk and specific risk. The risk numbers thus generated are then added to the capital charges for the relevant category, i.e. interest rate related instruments, equities, and foreign exchange as described in Paragraph 8.3 to 8.5 of this Master Circular. The *delta-plus method* uses the sensitivity parameters or "Greek letters" associated with options to measure their market risk and capital requirements. Under this method, the delta-equivalent

⁶⁴ Unless all their written option positions are hedged by perfectly matched long positions in exactly the same options, in which case no capital charge for market risk is required

position of each option becomes part of the standardised methodology set out in Paragraph 8.3 to 8.5 of this Master Circular with the delta-equivalent amount subject to the applicable general market risk charges. Separate capital charges are then applied to the gamma and Vega risks of the option positions. The **scenario approach** uses simulation techniques to calculate changes in the value of an options portfolio for changes in the level and volatility of its associated underlyings. Under this approach, the general market risk charge is determined by the scenario "grid" (i.e. the specified combination of underlying and volatility changes) that produces the largest loss. For the delta-plus method and the scenario approach the specific risk capital charges are determined separately by multiplying the delta-equivalent of each option by the specific risk weights set out in Paragraph 8.3 to 8.4 of this Master Circular.

I. Simplified approach

3. Banks which handle a limited range of purchased options only will be free to use the simplified approach set out in Table A below, for particular trades. As an example of how the calculation would work, if a holder of 100 shares currently valued at Rs.10 each holds an equivalent put option with a strike price of Rs.11, the capital charge would be: Rs.1,000 x 18 per cent (i.e. 9 per cent specific plus 9 per cent general market risk) = Rs.180, less the amount the option is in the money (Rs.11 – Rs.10) x 100 = Rs.100, i.e. the capital charge would be Rs.80. A similar methodology applies for options whose underlying is a foreign currency or an interest rate related instrument.

Table A - Simplified approach: capital charges

Position	Treatment
Long cash and Long put Or Short cash and Long call	The capital charge will be the market value of the underlying security ⁶⁵ multiplied by the sum of specific and general market risk charges ⁶⁶ for the underlying less the amount the option is in the money (if any) bounded at zero ⁶⁷

⁶⁵ In some cases such as foreign exchange, it may be unclear which side is the "underlying security"; this should be taken to be the asset which would be received if the option were exercised. In addition the nominal value should be used for items where the market value of the underlying instrument could be zero, e.g. caps and floors, swaptions etc.

⁶⁶ Some options (e.g. where the underlying is an interest rate or a currency) bear no specific risk, but specific risk will be present in the case of options on certain interest rate-related instruments (e.g. options on a corporate debt security or corporate bond index; see Section B for the relevant capital charges) and for options on equities and stock indices (see Section C). The charge under this measure for currency options will be 9 per cent.

⁶⁷ For options with a residual maturity of more than six months, the strike price should be compared with the forward, not current, price. A bank unable to do this must take the "in-the-money" amount to be zero.

Long call Or Long put	The capital charge will be the lesser of: (i) the market value of the underlying security multiplied by the sum of specific and general market risk charges ³ for the underlying (ii) the market value of the option ⁶⁸

II. Intermediate approaches

(a) Delta-plus method

4. Banks which write options will be allowed to include delta-weighted options positions within the standardised methodology set out in paragraph 8.3 to 8.5 of this Master Circular. Such options should be reported as a position equal to the market value of the underlying multiplied by the delta.

However, since delta does not sufficiently cover the risks associated with options positions, banks will also be required to measure gamma (which measures the rate of change of delta) and Vega (which measures the sensitivity of the value of an option with respect to a change in volatility) sensitivities in order to calculate the total capital charge. These sensitivities will be calculated according to an approved exchange model or to the bank's proprietary options pricing model subject to oversight by the Reserve Bank of India⁶⁹.

5. Delta-weighted positions with *debt securities or interest rates as the underlying* will be slotted into the interest rate time-bands, as set out in **Table 17** of paragraph 8.3 of this Master Circular, under the following procedure. A two-legged approach should be used as for other derivatives, requiring one entry at the time the underlying contract takes effect and a second at the time the underlying contract matures. For instance, a bought call option on a June three-month interest-rate future will in April be considered, on the basis of its delta-equivalent value, to be a long position with a maturity of five months and a short position with a maturity of two months⁷⁰. The written option will be similarly slotted as a long position with a maturity of two months and a short position with a maturity of five months. Floating rate instruments with caps or floors will be treated as a combination of floating rate securities and a series of European-style options. For example, the holder of a three-year floating rate bond indexed to six month LIBOR with a cap of 15 per cent will treat it as:

⁶⁸ Where the position does not fall within the trading book (i.e. options on certain foreign exchange or commodities positions not belonging to the trading book), it may be acceptable to use the book value instead.

⁶⁹ Reserve Bank of India may wish to require banks doing business in certain classes of exotic options (e.g. barriers, digitals) or in options "at-the-money" that are close to expiry to use either the scenario approach or the internal models alternative, both of which can accommodate more detailed revaluation approaches.

⁷⁰ Two-months call option on a bond future, where delivery of the bond takes place in September, would be considered in April as being long the bond and short a five-month deposit, both positions being delta-weighted.

(i) a debt security that reprices in six months; and

(ii) a series of five written call options on a FRA with a reference rate of 15 per cent, each with a negative sign at the time the underlying FRA takes effect and a positive sign at the time the underlying FRA matures⁷¹.

6. The capital charge for *options with equities as the underlying* will also be based on the delta-weighted positions which will be incorporated in the measure of market risk described in paragraph 8.4 of this Master Circular. For purposes of this calculation each national market is to be treated as a separate underlying. The capital charge for *options on foreign exchange and gold positions* will be based on the method set out in paragraph 8.5 of this Master Circular. For delta risk, the net delta-based equivalent of the foreign currency and gold options will be incorporated into the measurement of the exposure for the respective currency (or gold) position.

7. In addition to the above capital charges arising from delta risk, there will be further capital charges for *gamma* and for *Vega risk*. Banks using the delta-plus method will be required to calculate the gamma and Vega for each option position (including hedge positions) separately. The capital charges should be calculated in the following way:

(i) for **each individual option** a "gamma impact" should be calculated according to a Taylor series expansion as:

$$\text{Gamma impact} = \frac{1}{2} \times \text{Gamma} \times \text{VU}^2$$

where VU = Variation of the underlying of the option.

(ii) VU will be calculated as follows:

- for interest rate options if the underlying is a bond, the price sensitivity should be worked out as explained. An equivalent calculation should be carried out where the underlying is an interest rate.
- for options on equities and equity indices; which are not permitted at present, the market value of the underlying should be multiplied by 9 per cent⁷²;
- for foreign exchange and gold options: the market value of the underlying should be multiplied by 9 per cent;

(iii) For the purpose of this calculation the following positions should be treated as **the same underlying**:

⁷¹ The rules applying to closely-matched positions set out in paragraph 2 (a) of this Appendix will also apply in this respect.

⁷² The basic rules set out here for interest rate and equity options do not attempt to capture specific risk when calculating gamma capital charges. However, Reserve Bank may require specific banks to do so.

- for interest rates,⁷³ each time-band as set out in Table 17 of the guidelines;⁷⁴
- for equities and stock indices, each national market;
- for foreign currencies and gold, each currency pair and gold;

(iv) Each option on the same underlying will have a gamma impact that is either positive or negative. These individual gamma impacts will be summed, resulting in a net gamma impact for each underlying that is either positive or negative. Only those net gamma impacts that are negative will be included in the capital calculation.

(v) The total gamma capital charge will be the sum of the absolute value of the net negative gamma impacts as calculated above.

(vi) For **volatility risk**, banks will be required to calculate the capital charges by multiplying the sum of the Vegas for all options on the same underlying, as defined above, by a proportional shift in volatility of ± 25 per cent.

(vii) The **total capital charge** for Vega risk will be the sum of the absolute value of the individual capital charges that have been calculated for Vega risk.

(b) Scenario approach

8. More sophisticated banks will also have the right to base the market risk capital charge for options portfolios and associated hedging positions on *scenario matrix analysis*. This will be accomplished by specifying a fixed range of changes in the option portfolio's risk factors and calculating changes in the value of the option portfolio at various points along this "grid". For the purpose of calculating the capital charge, the bank will revalue the option portfolio using matrices for simultaneous changes in the option's underlying rate or price and in the volatility of that rate or price. A different matrix will be set up for each individual underlying as defined in paragraph 7 above. As an alternative, at the discretion of each national authority, banks which are significant traders in options for interest rate options will be permitted to base the calculation on a minimum of six sets of time-bands. When using this method, not more than three of the time-bands as defined in paragraph 8.3 of this Master Circular should be combined into any one set.

9. The options and related hedging positions will be evaluated over a specified range above and below the current value of the underlying. The range for interest rates is consistent with the assumed changes in yield in Table - 17 of paragraph 8.3 of this Master

⁷³ Positions have to be slotted into separate maturity ladders by currency.

⁷⁴ Banks using the duration method should use the time-bands as set out in Table 18 of the guidelines.

Circular. Those banks using the alternative method for interest rate options set out in paragraph 8 above should use, for each set of time-bands, the highest of the assumed changes in yield applicable to the group to which the time-bands belong.⁷⁵ The other ranges are ± 9 per cent for equities and ± 9 per cent for foreign exchange and gold. For all risk categories, at least seven observations (including the current observation) should be used to divide the range into equally spaced intervals.

10. The second dimension of the matrix entails a change in the volatility of the underlying rate or price. A single change in the volatility of the underlying rate or price equal to a shift in volatility of + 25 per cent and - 25 per cent is expected to be sufficient in most cases. As circumstances warrant, however, the Reserve Bank may choose to require that a different change in volatility be used and / or that intermediate points on the grid be calculated.

11. After calculating the matrix, each cell contains the net profit or loss of the option and the underlying hedge instrument. The capital charge for each underlying will then be calculated as the largest loss contained in the matrix.

12. In drawing up these intermediate approaches it has been sought to cover the major risks associated with options. In doing so, it is conscious that so far as specific risk is concerned, only the delta-related elements are captured; to capture other risks would necessitate a much more complex regime. On the other hand, in other areas the simplifying assumptions used have resulted in a relatively conservative treatment of certain options positions.

13. Besides the options risks mentioned above, the RBI is conscious of the other risks also associated with options, e.g. rho (rate of change of the value of the option with respect to the interest rate) and theta (rate of change of the value of the option with respect to time). While not proposing a measurement system for those risks at present, it expects banks undertaking significant options business at the very least to monitor such risks closely. Additionally, banks will be permitted to incorporate rho into their capital calculations for interest rate risk, if they wish to do so.

⁷⁵ If, for example, the time-bands 3 to 4 years, 4 to 5 years and 5 to 7 years are combined, the highest assumed change in yield of these three bands would be 0.75.

An Illustrative Approach for Measurement of Interest Rate Risk in the Banking Book (IRRBB) under Pillar II

The Basel-II Framework (Paras 739 and 762 to 764) require the banks to measure the interest rate risk in the banking book (IRRBB) and hold capital commensurate with it. If supervisors determine that banks are not holding capital commensurate with the level of interest rate risk, they must require the bank to reduce its risk, to hold a specific additional amount of capital or some combination of the two. To comply with the requirements of Pillar II relating to IRRBB, the guidelines on Pillar II issued by many regulators contain definite provisions indicating the approach adopted by the supervisors to assess the level of interest rate risk in the banking book and the action to be taken in case the level of interest rate risk found is significant.

In terms of para 764 of the Basel II framework, the banks can follow the indicative methodology prescribed in the supporting document "Principles for the Management and Supervision of Interest Rate Risk" issued by BCBS for assessment of sufficiency of capital for IRRBB.

2. The approach prescribed in the BCBS Paper on "Principles for the Management and Supervision of Interest Rate Risk"

The main components of the approach prescribed in the above mentioned supporting document are as under:

- a) The assessment should take into account both the earnings perspective and economic value perspective of interest rate risk.
- b) The impact on income or the economic value of equity should be calculated by applying a notional interest rate shock of 200 basis points.
- c) The usual methods followed in measuring the interest rate risk are :

a) Earnings perspective

Gap Analysis, simulation techniques and Internal Models based on VaR

b) Economic perspective

Gap analysis combined with duration gap analysis, simulation techniques and Internal Models based on VaR

3. Methods for measurement of the IRRBB

3.1 Impact on Earnings

The major methods used for computing the impact on earnings are the gap Analysis, Simulations and VaR based Techniques. Banks in India have been using the Gap Reports to assess the impact of adverse movements in the interest rate on income through gap

method. The banks may continue with the same. However, the banks may use the simulations also. The banks may calculate the impact on the earnings by gap analysis or any other method with the assumed change in yield on 200 bps over one year. However, no capital needs to be allocated for the impact on the earnings.

3.2 Impact of IRRBB on the Market Value of Equity (MVE)

The banks may use the Method indicated in the Basel Committee on Banking Supervision (BCBS) Paper "Principles for the Management and Supervision of Interest rate Risk" (July 2004) for computing the impact of the interest rate shock on the MVE.

3.2.1 Method indicated in the BCBS Paper on "Principles for the Management and Supervision of Interest Rate Risk"

The following steps are involved in this approach:

- a) The variables such as maturity/re-pricing date, coupon rate, frequency, principal amount for each item of asset/liability (for each category of asset / liability) are generated.
- b) The longs and shorts in each time band are offset.
- c) The resulting short and long positions are weighted by a factor that is designed to reflect the sensitivity of the positions in the different time bands to an assumed change in interest rates. These factors are based on an assumed parallel shift of 200 basis points throughout the time spectrum, and on a proxy of modified duration of positions situated at the middle of each time band and yielding 5 per cent.
- d) The resulting weighted positions are summed up, offsetting longs and shorts, leading to the net short- or long-weighted position.
- e) The weighted position is seen in relation to capital.

For details banks may refer to the captioned paper issued by BCBS. For the sake of convenience, Annex 3 and 4 of the Paper containing the framework and an example of the standardised framework are reproduced in **Annex 10 and Annex 11**.

3.2.2 Other techniques for Interest rate risk measurement

The banks can also follow different versions / variations of the above techniques or entirely different techniques to measure the IRRBB if they find them conceptually sound. In this context, Annex 1 and 2 of the BCBS paper referred to above provide broad details of interest rate risk measurement techniques and overview of some of the factors which the supervisory authorities might consider in obtaining and analysing the information on individual bank's exposures to interest rate risk. These Annexes are reproduced in **Annex 12 and Annex 13**, respectively.

4. Suggested approach for measuring the impact of IRRBB on capital

4.1 As per Basel II Framework, if the supervisor feels that the bank is not holding capital commensurate with the level of IRRBB, it may either require the bank to reduce the risk or allocate additional capital or a combination of the two.

4.2 The banks can decide, with the approval of the Board, on the appropriate level of interest rate risk in the banking book which they would like to carry keeping in view their capital level, interest rate management skills and the ability to re-balance the banking book portfolios quickly in case of adverse movement in the interest rates. In any case, a level of interest rate risk which generates a drop in the MVE of more than 20 per cent with an interest rate shock of 200 basis points, will be treated as excessive and such banks would normally be required by the RBI to hold additional capital against IRRBB as determined during the SREP. The banks which have IRRBB exposure equivalent to less than 20 per cent drop in the MVE may also be required to hold additional capital if the level of interest rate risk is considered, by the RBI, to be high in relation to their capital level or the quality of interest rate risk management framework obtaining in the bank. While the banks may on their own decide to hold additional capital towards IRRBB keeping in view the potential drop in their MVE, the IRR management skills and the ability to re-balance the portfolios quickly in case of adverse movement in the interest rates, the amount of exact capital add-on, if considered necessary, will be decided by the RBI as part of the SREP, in consultation with the bank.

5. Limit setting

The banks would be well advised to consider setting the internal limits for controlling their IRRBB. The following are some of the indicative ways for setting the limits:

- a) Internal limits could be fixed in terms of the maximum decline in earnings (as a percentage of the base-scenario income) or decline in capital (as a percentage of the base-scenario capital position) as a result of 200 or 300 basis point interest-rate shock.
- b) The limits could also be placed in terms of PV01 value (present value of a basis point) of the net position of the bank as a percentage of net worth/capital of the bank.

**Annex 3 to the BCBS Paper on Principles for
Management and Supervision of IRR, July 2004**

The Standardised Interest Rate Shock

1. To facilitate supervisors' monitoring of interest rate risk exposures across institutions, banks would have to provide the results of their internal measurement systems, expressed in terms of the change in economic value relative to capital, using a standardised interest rate shock. This annex gives the technical background to the selection of the standardised rate shock. In selecting the shock, the following guiding principles were followed:

- The rate shock should reflect a fairly uncommon and stressful rate environment;
- The magnitude of the rate shock should be significant enough to capture the effects of embedded options and convexity within bank assets and liabilities so that underlying risk may be revealed;
- The rate shock should be straightforward and practical to implement, and should be able to accommodate the diverse approaches inherent in single-rate-path simulation models and statistically driven value-at-risk models for banking book positions;
- The underlying methodology should provide relevant shocks for both G10 and material non-G10 currency exposures; and
- The underlying methodology should be adaptable for those non-G10 supervisors who wish to implement this approach in their own countries.

2. With these principles in mind, the proposed rate shock should in principle be determined by banks, based on the following:

- For exposures in G10 currencies, either:
 - (a) An upward and downward 200 basis point parallel rate shock; or
 - (b) 1st and 99th percentile of observed interest rate changes using a one-year (240 working days) holding period and a minimum five years of observations.
- For exposures in non-G10 currencies, either:
 - (a) A parallel rate shock substantially consistent with 1st and 99th percentile of observed interest rate changes using a one-year (240 working days) holding period and a minimum five years of observations for the particular non-G10 currency; or
 - (b) 1st and 99th percentile of observed interest rate changes using a one-year (240 working days) holding period and a minimum five years of observations.

3. In considering potential rate shocks, historical rate changes among a number of

G10 countries were analysed. A one-year holding period (240 business days) was selected both for practical purposes and in recognition that within a one-year period most institutions have the ability to restructure or hedge their positions to mitigate further losses in economic value should rates appear to be exceptionally volatile. Five years worth of rate change observations require a minimum of six years of historical data to calculate rate differences for a one-year holding period on a rolling basis. For example, the first observation from five years ago must look back to the rate environment six years ago to calculate the first rate change.

4. A five-year historical observation period (six years of data) was thought to be long enough to capture more recent and relevant interest rate cycles. That time period also appears to offer a reasonably manageable set of data for institutions that wish to incorporate such data into their statistically driven value-at-risk models or in their own evaluations of a suitable parallel rate shock for non-G10 currencies. In defining uncommon and stressful scenarios, rate shocks of a magnitude that would not be expected to be exceeded with a 99 percent confidence interval were considered adequate.

5. In evaluating the data for G10 shocks, rate moves at the 1st and 99th percentile were roughly comparable across most currencies, especially for longer maturities. A 200 basis point up and down rate shock appears to adequately cover volatilities across G10 currencies. The appropriateness of the proposed shock will need to be monitored on an ongoing basis, and recalibrated should the rate environment shift materially. Importantly, by calibrating the parallel shock to be roughly consistent with shocks that would be implemented through more sophisticated, statistically driven approaches using standard parameters (99 percent confidence interval, one-year holding period, five years of observations), this approach does not foreclose the use of more innovative risk measurement systems. It also allows institutions to use these parameters for calculating appropriate shocks themselves when they have material exposures outside G10 countries and for supervisors in emerging market and other non-G10 countries to derive simple shocks that are appropriate for their own countries.

6. The analysis so far has implicitly assumed that banks only carry interest rate risk in their home currency. However, many banks will be exposed to interest rate risk in more than one currency. In such cases, banks should carry out a similar analysis for each currency accounting for 5 per cent or more of either their banking book assets or liabilities, using an interest rate shock calculated according to one of the methodologies set out above. To ensure complete coverage of the banking book, remaining exposures should be aggregated and subjected to a 200 basis point shock.

7. The relative simplicity of a 200 basis point parallel rate shock has the disadvantage of ignoring exposures that might be revealed through scenarios that include yield curve twists, inversions, and other relevant scenarios. Such alternative scenarios are a necessary component of the overall management of interest rate risk as noted elsewhere in this paper. Supervisors will continue to expect institutions to perform multiple scenarios in evaluating their interest rate risk as appropriate to the level and nature of risk they are taking.

8. While more nuanced rate scenarios might tease out certain underlying risk characteristics, for the more modest objectives of supervisors in detecting institutions with significant levels of interest rate risk, a simple parallel shock is adequate. Such an approach also recognises the potential for spurious precision that occurs when undue attention to fine detail is placed on one aspect of a measurement system without recognition that assumptions employed for certain asset and liability categories, such as core deposits, are by necessity blunt and judgmental. Such judgmental aspects of an interest rate risk model often drive the resulting risk measure and conclusion, regardless of the detailed attention paid to other aspects of the risk measure.

**Annex 4 to the BCBS Paper on Principles for
Management and Supervision of IRR, July 2004**

An Example of a Standardised Framework

1. This annex contains an example setting out the methodology and calculation process in one version of a standardised framework. Other methodologies and calculation processes could be equally applicable in this context, depending on the circumstances of the bank concerned. Such a framework is intended for supervisory reporting purposes only, and is not intended to represent an adequate framework for internal risk management purposes.

A. Methodology

2. Positions on the bank's balance sheet would be slotted into the maturity approach according to the following principles:

- (a) All assets and liabilities belonging to the banking book and all OBS items belonging to the banking book which are sensitive to changes in interest rates (including all interest rate derivatives) are slotted into a maturity ladder comprising a number of time bands large enough to capture the nature of interest rate risk in a national banking market. Annex 2 discusses issues relating to the selection of appropriate time bands. Separate maturity ladders are to be used for each currency accounting for more than 5 per cent of either banking book assets or liabilities.
- (b) On-balance-sheet items are treated at book value.
- (c) Fixed-rate instruments are allocated according to the residual term to maturity and floating-rate instruments according to the residual term to the next repricing date.
- (d) Exposures which create practical processing problems because of their large number and relatively small individual amount (e.g. instalment or mortgage loans) may be allocated on the basis of statistically supported assessment methods.
- (e) Core deposits are slotted according to an assumed maturity of no longer than five years.
- (f) National supervisors will provide guidance on how other items with a behavioural maturity or repricing that differ from contractual maturity or repricing are to be slotted into the time band structure.
- (g) Derivatives are converted into positions in the relevant underlying. The amounts considered are the principal amount of the underlying or of the notional underlying.
- (h) Futures and forward contracts, including forward rate agreements (FRA), are treated as a combination of a long and a short position. The maturity of a future or a FRA will be the period until delivery or exercise of the contract, plus - where applicable - the life of the underlying instrument. For example, a long position in a June three-month interest rate future (taken in April) is to be reported as a long position with a maturity of five months and a short position with a maturity of two months.
- (i) Swaps are treated as two notional positions with relevant maturities. For example, an interest rate swap under which a bank is receiving floating-rate interest and paying fixed-rate interest will be treated as a long floating-rate position of maturity

equivalent to the period until the next interest fixing and a short fixed-rate position of maturity equivalent to the residual life of the swap. The separate legs of cross-currency swaps are to be treated in the relevant maturity ladders for the currencies concerned.

- (j) Options are considered according to the delta equivalent amount of the underlying or of the notional underlying.

B. Calculation process

3. The calculation process consists of five steps.
 - (a) The first step is to offset the longs and shorts in each time band, resulting in a single short or long position in each time band.
 - (b) The second step is to weight these resulting short and long positions by a factor that is designed to reflect the sensitivity of the positions in the different time bands to an assumed change in interest rates. The set of weighting factors for each time band is set out in Table 1 below. These factors are based on an assumed parallel shift of 200 basis points throughout the time spectrum, and on a proxy of modified duration of positions situated at the middle of each time band and yielding 5 per cent.
 - (c) The third step is to sum these resulting weighted positions, offsetting longs and shorts, leading to the net short- or long-weighted position of the banking book in the given currency.
 - (d) The fourth step is to calculate the weighted position of the whole banking book by summing the net short- and long-weighted positions calculated for different currencies.
 - (e) The fifth step is to relate the weighted position of the whole banking book to capital.

Table 1
Weighting factors per time band (second step in the calculation process)

Time band	Middle of time band	Proxy of modified duration	Assumed change in yield	Weighting factor
Up to 1 month	0.5 months	0.04 years	200 bp	0.08%
1 to 3 months	2 months	0.16 years	200 bp	0.32%
3 to 6 months	4.5 months	0.36 years	200 bp	0.72%
6 to 12 months	9 months	0.71 years	200 bp	1.43%
1 to 2 years	1.5 years	1.38 years	200 bp	2.77%
2 to 3 years	2.5 years	2.25 years	200 bp	4.49%
3 to 4 years	3.5 years	3.07 years	200 bp	6.14%
4 to 5 years	4.5 years	3.85 years	200 bp	7.71%
5 to 7 years	6 years	5.08 years	200 bp	10.15%
7 to 10 years	8.5 years	6.63 years	200 bp	13.26%
10 to 15 years	12.5 years	8.92 years	200 bp	17.84%
15 to 20 years	17.5 years	11.21 years	200 bp	22.43%
Over 20 years	22.5 years	13.01 years	200 bp	26.03%

**Annex 1 to the BCBS Paper on Principles for
Management and Supervision of IRR, July 2004**

Interest Rate Risk Measurement Techniques

1. This annex provides a brief overview of the various techniques used by banks to measure the exposure of earnings and of economic value to changes in interest rates. The variety of techniques ranges from calculations that rely on simple maturity and re-pricing tables, to static simulations based on current on- and off-balance-sheet positions, to highly sophisticated dynamic modelling techniques that incorporate assumptions about the behaviour of the bank and its customers in response to changes in the interest rate environment. Some of these general approaches can be used to measure interest rate risk exposure from both an earnings and an economic value perspective, while others are more typically associated with only one of these two perspectives. In addition, the methods vary in their ability to capture the different forms of interest rate exposure: the simplest methods are intended primarily to capture the risks arising from maturity and re-pricing mismatches, while the more sophisticated methods can more easily capture the full range of risk exposures.
2. As this discussion suggests, the various measurement approaches described below have their strengths and weaknesses in terms of providing accurate and reasonable measures of interest rate risk exposure. Ideally, a bank's interest rate risk measurement system would take into account the specific characteristics of each individual interest sensitive position, and would capture in detail the full range of potential movements in interest rates. In practice, however, measurement systems embody simplifications that move away from this ideal. For instance, in some approaches, positions may be aggregated into broad categories, rather than modelled separately, introducing a degree of measurement error into the estimation of their interest rate sensitivity. Similarly, the nature of interest rate movements that each approach can incorporate may be limited: in some cases, only a parallel shift of the yield curve may be assumed or less than perfect correlations between interest rates may not be taken into account. Finally, the various approaches differ in their ability to capture the optionality inherent in many positions and instruments. The discussion in the following sections will highlight the areas of simplification that typically characterise each of the major interest rate risk measurement techniques.

A. Re-pricing schedules

3. The simplest techniques for measuring a bank's interest rate risk exposure begin with a maturity/re-pricing schedule that distributes interest-sensitive assets, liabilities, and OBS positions into a certain number of predefined time bands according to their maturity (if fixed-rate) or time remaining to their next re-pricing (if floating-rate). Those assets and liabilities lacking definitive re-pricing intervals (e.g. sight deposits or savings accounts) or actual maturities that could vary from contractual maturities (e.g. mortgages with an option for early repayment) are assigned to re-pricing time bands according to the judgement and past experience of the bank.

I. Gap analysis

4. Simple maturity/re-pricing schedules can be used to generate simple indicators of the interest rate risk sensitivity of both earnings and economic value to changing interest rates. When this approach is used to assess the interest rate risk of current earnings, it is typically referred to as gap analysis. Gap analysis was one of the first methods developed to measure a bank's interest rate risk exposure, and continues to be widely used by banks. To evaluate earnings exposure, interest rate-sensitive liabilities in each time band are subtracted from the corresponding interest rate-sensitive assets to produce a re-pricing "gap" for that time band. This gap can be multiplied by an assumed change in interest rates to yield an approximation of the change in net interest income that would result from such an interest rate movement. The size of the interest rate movement used in the analysis can be based on a variety of factors, including historical experience, simulation of potential future interest rate movements, and the judgement of bank management.

5. A negative, or liability-sensitive, gap occurs when liabilities exceed assets (including OBS positions) in a given time band. This means that an increase in market interest rates could cause a decline in net interest income. Conversely, a positive, or asset-sensitive, gap implies that the bank's net interest income could decline as a result of a decrease in the level of interest rates.

6. These simple gap calculations can be augmented by information on the average coupon on assets and liabilities in each time band. This information can be used to place the results of the gap calculations in context. For instance, information on the average coupon rate could be used to calculate estimates of the level of net interest income arising from positions maturing or repricing within a given time band, which would then provide a "scale" to assess the changes in income implied by the gap analysis.

7. Although gap analysis is a very commonly used approach to assessing interest rate risk exposure, it has a number of shortcomings. First, gap analysis does not take account of

variation in the characteristics of different positions within a time band. In particular, all positions within a given time band are assumed to mature or re-price simultaneously, a simplification that is likely to have greater impact on the precision of the estimates as the degree of aggregation within a time band increases. Moreover, gap analysis ignores differences in spreads between interest rates that could arise as the level of market interest rates changes (basis risk). In addition, it does not take into account any changes in the timing of payments that might occur as a result of changes in the interest rate environment. Thus, it fails to account for differences in the sensitivity of income that may arise from option-related positions. For these reasons, gap analysis provides only a rough approximation of the actual change in net interest income which would result from the chosen change in the pattern of interest rates. Finally, most gap analyses fail to capture variability in non-interest revenue and expenses, a potentially important source of risk to current income.

II. Duration

8. A maturity/re-pricing schedule can also be used to evaluate the effects of changing interest rates on a bank's economic value by applying sensitivity weights to each time band. Typically, such weights are based on estimates of the duration of the assets and liabilities that fall into each time band. Duration is a measure of the percentage change in the economic value of a position that will occur given a small change in the level of interest rates.⁷⁶ It reflects the timing and size of cash flows that occur before the instrument's contractual maturity. Generally, the longer the maturity or next re-pricing date of the instrument and the smaller the payments that occur before maturity (e.g. coupon payments), the higher the duration (in absolute value). Higher duration implies that a given change in the level of interest rates will have a larger impact on economic value.

9. Duration-based weights can be used in combination with a maturity/re-pricing schedule to provide a rough approximation of the change in a bank's economic value that would occur given a particular change in the level of market interest rates. Specifically, an "average" duration is assumed for the positions that fall into each time band. The average durations are then multiplied by an assumed change in interest rates to construct a weight for each time band. In some cases, different weights are used for different positions that fall

⁷⁶ Modified duration - which is standard duration divided by $1 + r$, where r is the level of market interest rates - is an elasticity. As such, it reflects the percentage change in the economic value of the instrument for a given percentage change in $1 + r$. As with simple duration, it assumes a linear relationship between percentage changes in value and percentage changes in interest rates. The second form of duration relaxes this assumption, as well as the assumption that the timing of payments is fixed. Effective duration is the percentage change in the price of the relevant instrument for a basis point change in yield.

within a time band, reflecting broad differences in the coupon rates and maturities (for instance, one weight for assets, and another for liabilities). In addition, different interest rate changes are sometimes used for different time bands, generally to reflect differences in the volatility of interest rates along the yield curve. The weighted gaps are aggregated across time bands to produce an estimate of the change in economic value of the bank that would result from the assumed changes in interest rates.

10. Alternatively, an institution could estimate the effect of changing market rates by calculating the precise duration of each asset, liability, and OBS position and then deriving the net position for the bank based on these more accurate measures, rather than by applying an estimated average duration weight to all positions in a given time band. This would eliminate potential errors occurring when aggregating positions/cash flows. As another variation, risk weights could also be designed for each time band on the basis of actual percentage changes in market values of hypothetical instruments that would result from a specific scenario of changing market rates. That approach - which is sometimes referred to as effective duration - would better capture the non-linearity of price movements arising from significant changes in market interest rates and, thereby, would avoid an important limitation of duration.

11. Estimates derived from a standard duration approach may provide an acceptable approximation of a bank's exposure to changes in economic value for relatively non-complex banks. Such estimates, however, generally focus on just one form of interest rate risk exposure - repricing risk. As a result, they may not reflect interest rate risk arising, for instance, from changes in the relationship among interest rates within a time band (basis risk). In addition, because such approaches typically use an average duration for each time band, the estimates will not reflect differences in the actual sensitivity of positions that can arise from differences in coupon rates and the timing of payments. Finally, the simplifying assumptions that underlie the calculation of standard duration means that the risk of options may not be adequately captured.

B. Simulation approaches

12. Many banks (especially those using complex financial instruments or otherwise having complex risk profiles) employ more sophisticated interest rate risk measurement systems than those based on simple maturity/repricing schedules. These simulation techniques typically involve detailed assessments of the potential effects of changes in interest rates on earnings and economic value by simulating the future path of interest rates and their impact on cash flows.

13. In some sense, simulation techniques can be seen as an extension and refinement of the simple analysis based on maturity/repricing schedules. However, simulation

approaches typically involve a more detailed breakdown of various categories of on- and off balance-sheet positions, so that specific assumptions about the interest and principal payments and non-interest income and expense arising from each type of position can be incorporated. In addition, simulation techniques can incorporate more varied and refined changes in the interest rate environment, ranging from changes in the slope and shape of the yield curve to interest rate scenarios derived from Monte Carlo simulations.

I. Static simulation

14. In static simulations, the cash flows arising solely from the bank's current on- and off-balance-sheet positions are assessed. For assessing the exposure of earnings, simulations estimating the cash flows and resulting earnings streams over a specific period are conducted based on one or more assumed interest rate scenarios. Typically, although not always, these simulations entail relatively straightforward shifts or tilts of the yield curve, or changes of spreads between different interest rates. When the resulting cash flows are simulated over the entire expected lives of the bank's holdings and discounted back to their present values, an estimate of the change in the bank's economic value can be calculated.⁷⁷

II. Dynamic simulation

15. In a dynamic simulation approach, the simulation builds in more detailed assumptions about the future course of interest rates and the expected changes in a bank's business activity over that time. For instance, the simulation could involve assumptions about a bank's strategy for changing administered interest rates (on savings deposits, for example), about the behaviour of the bank's customers (e.g. withdrawals from sight and savings deposits), and/or about the future stream of business (new loans or other transactions) that the bank will encounter. Such simulations use these assumptions about future activities and reinvestment strategies to project expected cash flows and estimate dynamic earnings and economic value outcomes. These more sophisticated techniques allow for dynamic interaction of payments streams and interest rates, and better capture the effect of embedded or explicit options.

16. As with other approaches, the usefulness of simulation-based interest rate risk measurement techniques depends on the validity of the underlying assumptions and the accuracy of the basic methodology. The output of sophisticated simulations must be assessed largely in the light of the validity of the simulation's assumptions about future interest rates and the behaviour of the bank and its customers. One of the primary concerns

⁷⁷ The duration analysis described in the previous section can be viewed as a very simple form of static.

that arises is that such simulations do not become “black boxes” that lead to false confidence in the precision of the estimates.

C. Additional issues

17. One of the most difficult tasks when measuring interest rate risk is how to deal with those positions where behavioural maturity differs from contractual maturity (or where there is no stated contractual maturity). On the asset side of the balance sheet, such positions may include mortgages and mortgage-related securities, which can be subject to prepayment. In some countries, borrowers have the discretion to prepay their mortgages with little or no penalty, which creates uncertainty about the timing of the cash flows associated with these instruments. Although there is always some volatility in prepayments resulting from demographic factors (such as death, divorce, or job transfers) and macroeconomic conditions, most of the uncertainty surrounding prepayments arises from the response of borrowers to movements in interest rates. In general, declines in interest rates result in increasing levels of prepayments as borrowers refinance their loans at lower yields. In contrast, when interest rates rise unexpectedly, prepayment rates tend to slow, leaving the bank with a larger than anticipated volume of mortgages paying below current market rates.

18. On the liability side, such positions include so-called non-maturity deposits such as sight deposits and savings deposits, which can be withdrawn, often without penalty, at the discretion of the depositor. The treatment of such deposits is further complicated by the fact that the rates received by depositors tend not to move in close correlation with changes in the general level of market interest rates. In fact, banks can and do administer the rates on the accounts with the specific intention of managing the volume of deposits retained.

19. The treatment of positions with embedded options is an issue of special concern in measuring the exposure of both current earnings and economic value to interest rate changes. In addition, the issue arises across the full spectrum of approaches to interest rate measurement, from simple gap analysis to the most sophisticated simulation techniques. In the maturity/re-pricing schedule framework, banks typically make assumptions about the likely timing of payments and withdrawals on these positions and “spread” the balances across time bands accordingly. For instance, it might be assumed that certain percentages of a pool of 30-year mortgages prepay in given years during the life of the mortgages. As a result, a large share of the mortgage balances that would have been assigned to the time band containing 30-year instruments would be spread among nearer-term time bands. In a simulation framework, more sophisticated behavioural assumptions could be employed, such as the use of option-adjusted pricing models to better estimate the timing and magnitude of cash flows under different interest rate environments. In addition, simulations

can incorporate the bank's assumptions about its likely future treatment of administered interest rates on non-maturity deposits.

20. As with other elements of interest rate risk measurement, the quality of the estimates of interest rate risk exposure depends on the quality of the assumptions about the future cash flows on the positions with uncertain maturities. Banks typically look to the past behaviour of such positions for guidance about these assumptions. For instance, econometric or statistical analysis can be used to analyse the behaviour of a bank's holdings in response to past interest rate movements. Such analysis is particularly useful to assess the likely behaviour of non-maturity deposits, which can be influenced by bank-specific factors such as the nature of the bank's customers and local or regional market conditions. In the same vein, banks may use statistical prepayment models - either models developed internally by the bank or models purchased from outside developers - to generate expectations about mortgage-related cash flows. Finally, input from managerial and business units within the bank could have an important influence, since these areas may be aware of planned changes to business or repricing strategies that could affect the behaviour of the future cash flows of positions with uncertain maturities.

Annex 2 to the BCBS Paper on Principles for Management and Supervision of IRR, July 2004**Monitoring of interest rate risk by supervisory authorities**

1. This annex provides a brief overview of some of the factors that supervisory authorities might consider in obtaining and analysing information on individual banks' exposures to interest rate risk. As discussed in Section VII, supervisory authorities should obtain information sufficient to assess banks' exposures to interest rate risk in a timely fashion. Such information may be obtained through on-site examinations, through reports that are submitted by banks on a regular basis, or through other means.

2. While the precise information that is obtained will differ across supervisory authorities, one approach that some may adopt is a reporting framework that collects information on a bank's positions by remaining maturity or time to next re-pricing. Under such an approach, a bank would categorise its interest-sensitive assets, liabilities, and OBS positions into a series of re-pricing time bands or maturity categories. The two sections that follow discuss the considerations that a supervisor should take into account in specifying the number of time bands and the grouping of positions in the reporting framework. The final section of this annex describes some general approaches that supervisory authorities may wish to consider in analysing the information that is obtained through such a reporting framework.

A. Time bands

3. If a reporting framework is used in which information is collected by time to next re-pricing, the number and specific categories of time bands chosen should be sufficient to provide supervisors with a reasonable basis for identifying potentially significant re-pricing mismatches. The bands, however, could vary materially across countries, both in number and in range, depending on the lending and investing practices and experiences of banks in individual markets.

4. The usefulness of supervisory analysis crucially depends on the precision with which maturities of the positions and cash flows are recorded in the system. In analysing interest rate sensitivities, it is not enough to know when an instrument matures. Rather, the critical factor is when the instrument re-prices. Therefore, the emphasis of this section is on re-pricing rather than maturity. For cash flows whose re-pricing is unambiguous, the most precise approach is to use the exact re-pricing date. Any aggregation of positions/cash flows in time bands or zones necessarily implies a loss of information and a lower degree of precision. For this reason, the number of time bands in a re-pricing ladder framework

always reflects a decision regarding the necessary level of precision and the cost of pursuing greater accuracy. Supervisory authorities could use the re-pricing ladder in the standardised approach of the Market Risk Amendment as a starting point when developing a reporting framework that meets their particular needs. The breakdown can, of course, be modified by supervisors either in a general way or in a specific way for banks where the nature of business activities warrants or justifies a different reporting form.

B. Items

5. As with the time bands, the breakdown of assets and liabilities could differ among supervisors. A reporting system should include information for all rate-sensitive assets, liabilities, and OBS positions, and should also identify balances, by specific types of instruments, when those instruments have or may have materially different cash flow characteristics. Specific attention should be given to items whose behavioural re-pricings differ from contractual maturities, such as savings deposits and, in some countries, mortgage-related instruments. Further information on these issues is provided in Annex 1. If the volume of these positions is significant, they should be reported separately so as to facilitate an assessment of the underlying options risk in the bank's balance sheet structure.

6. The analysis of interest rate risk may be more difficult if a bank is engaged in trading activities. As a general rule, it is desirable for any measurement system to incorporate interest rate risk exposures arising from the full scope of a bank's activities, including both trading and non-trading sources. This does not preclude different measurement systems and risk management approaches being used for different activities; however, management should have an integrated view of interest rate risk across products and business lines. Supervisors may wish to permit banks that manage their interest rate risk exposures on an integrated basis to aggregate trading and non-trading positions in the overall reporting framework. However, it is important to recognise that in many countries different accounting rules may apply to the trading book and the traditional banking book. Under these accounting rules, losses in the trading book may not always be offset by profits in the banking book if the latter are unrealised. Furthermore, unlike the banking book, the composition of the trading portfolio changes significantly from week to week or even day to day because it is managed separately and according to a different (shorter) risk horizon than the banking book. This means that a hedge that is present on a given day may disappear a few days later. Supervisors should, therefore, review the risk management practices and information systems of banks that conduct material trading activities and should obtain the information necessary to ensure that interest rate risk in both trading and non-trading activities is properly managed and controlled.

C. Supervisory analysis

7. A reporting framework designed along these lines may provide supervisors with a flexible tool for analysing interest rate risk. Supervisors can use this basic information to perform their own assessments of a bank's exposure and risk profile.

8. Such assessments may provide insights regarding an institution's exposure to parallel shifts, or to a flattening, steepening, or inversion of the yield curve with rate changes of different magnitude based on either statistical probabilities or a worst-case analysis. For banks with important exposures in foreign currencies, analysis investigating different assumptions regarding correlations between interest rates in different currencies can be useful. With respect to instruments with behavioural maturities, supervisors may wish to assess assumptions that differ from those used by the institution.

9. The focus of supervisors' quantitative analysis can be the impact of interest rate changes on either current earnings or the economic value of the bank's portfolio. In conducting their analysis, information about average yields on assets and liabilities in each time band may be useful and supervisors may wish to collect such information in addition to pure position data.

10. Depending on their overall approach, supervisors may conduct their analysis of interest rate risk either on a case-by-case basis or as part of a broader system designed to identify outliers with apparently excessive risk-taking.

11. By conducting an assessment of interest rate risk using the proposed framework, supervisors may gain more insight into an institution's risk profile than with a reporting system that reduces the complexity of interest rate risk to a single number. In doing so, supervisors can become more familiar with the sensitivity of risk measures to changes in the underlying assumptions, and the evaluation process may produce as many insights as the quantitative result itself.

12. Regardless of the extent of a supervisor's own independent quantitative analysis, a bank's own interest rate risk measure, whether reported as part of a basic supervisory reporting system or reviewed as part of an individual assessment of a bank's risk management, is an important consideration in the supervisory process. Reviewing the results of a bank's internal model can be highly informative, but can also be a difficult process because of the multitude of important assumptions and modelling techniques which need to be made transparent to supervisors. To be most useful, the information received should indicate the contribution of principal elements of a bank's portfolio to the risk profile under different assumptions with respect to interest rate changes and the market response. Finally, any quantitative analysis should be supplemented by a review of internal

management reports in order to gain greater insights into management's evaluation and management of risks, its methods for measuring exposures, and factors not reflected in the information available in the limited reporting to supervisors.

An illustrative outline of the ICAAP Document

1. What is an ICAAP document?

The ICAAP Document would be a comprehensive Paper furnishing detailed information on the ongoing assessment of the bank's entire spectrum of risks, how the bank intends to mitigate those risks and how much current and future capital is necessary for the bank, reckoning other mitigating factors. The purpose of the ICAAP document is to apprise the Board of the bank on these aspects as also to explain to the RBI the bank's internal capital adequacy assessment process and the banks' approach to capital management. The ICAAP could also be based on the existing internal documentation of the bank.

The ICAAP document submitted to the RBI should be formally approved by the bank's Board. It is expected that the document would be prepared in a format that would be easily understood at the senior levels of management and would contain all the relevant information necessary for the bank and the RBI to make an informed judgment as to the appropriate capital level of the bank and its risk management approach. Where appropriate, technical information on risk measurement methodologies, capital models, if any, used and all other work carried out to validate the approach (e.g. board papers and minutes, internal or external reviews) could be furnished to the RBI as appendices to the ICAAP Document.

2. Contents

The ICAAP Document should contain the following sections:

- I. Executive Summary
- II. Background
- III. Summary of current and projected financial and capital positions
- IV. Capital Adequacy
- V. Key sensitivities and future scenarios
- VI. Aggregation and diversification
- VII. Testing and adoption of the ICAAP
- VIII. Use of the ICAAP within the bank

I. Executive Summary

The purpose of the Executive Summary is to present an overview of the ICAAP methodology and results. This overview would typically include:

- a) the purpose of the report and the regulated entities within a banking group that are covered by the ICAAP;
- b) the main findings of the ICAAP analysis:
 - i. how much and what composition of internal capital the bank considers it should hold as compared with the minimum CRAR requirement (CRAR) under 'Pillar 1' calculation, and
 - ii. the adequacy of the bank's risk management processes;
- c) a summary of the financial position of the bank, including the strategic position of the bank, its balance sheet strength, and future profitability;
- d) brief descriptions of the capital raising and dividend plan including how the bank intends to manage its capital in the days ahead and for what purposes;
- e) commentary on the most material risks to which the bank is exposed, why the level of risk is considered acceptable or, if it is not, what mitigating actions are planned;
- f) commentary on major issues where further analysis and decisions are required; and
- g) who has carried out the assessment, how it has been challenged / validated / stress tested, and who has approved it.

II. Background

This section would cover the relevant organisational and historical financial data for the bank. e.g., group structure (legal and operational), operating profit, profit before tax, profit after tax, dividends, shareholders funds, capital funds held vis-à-vis the regulatory requirements, customer deposits, deposits by banks, total assets, and any conclusions that can be drawn from trends in the data which may have implications for the bank's future.

III. Summary of current and projected financial and capital positions

This section would explain the present financial position of the bank and expected changes to the current business profile, the environment in which it expects to operate, its projected business plans (by appropriate lines of business), projected financial position, and future planned sources of capital.

The starting balance sheet used as reference and date as of which the assessment is carried out should be indicated.

The projected financial position could reckon both the projected capital available and projected capital requirements based on envisaged business plans. These might then provide a basis against which adverse scenarios might be compared.

IV. Capital adequacy

This section might start with a description of the bank's risk appetite, in quantitative terms, as approved by the bank's Board and used in the ICAAP. It would be necessary to clearly spell out in the document whether what is being presented represents the bank's view of the amount of capital required to meet minimum **regulatory needs** or whether represents the amount of capital that a bank believes it would need **to meet its business plans**. For instance, it should be clearly brought out whether the capital required is based on a particular credit rating desired by the bank or includes buffers for strategic purposes or seeks to minimise the chance of breaching regulatory requirements. Where economic capital models are used for internal capital assessment, the confidence level, time horizon, and description of the event to which the confidence level relates, should also be enumerated. Where scenario analyses or other means are used for capital assessment, then the basis / rationale for selecting the chosen severity of scenarios used, should also be included.

The section would then include a detailed review of the capital adequacy of the bank.

The information provided would include the following elements:

Timing

- the effective date of the ICAAP calculations together with details of any events between this date and the date of submission to the Board / RBI which would materially impact the ICAAP calculations together with their effects; and
- details of, and rationale for, the time period selected for which capital requirement has been assessed.

Risks analysed

- an identification of the major risks faced by the bank in each of the following categories:
 - a) credit risk
 - b) market risk
 - c) operational risk
 - d) liquidity risk
 - e) concentration risk
 - f) interest rate risk in the banking book
 - g) residual risk of securitisation
 - h) strategic risk
 - i) business risk
 - j) reputation risk
 - k) pension obligation risk
 - l) other residual risk; and
 - m) any other risks that might have been identified
- for each of these risks, an explanation of how the risk has been assessed and to the extent possible, the **quantitative results** of that assessment;

- where some of these risks have been highlighted in the report of the RBI's on-site inspection of the bank, an explanation of how the bank has mitigated these;
- where relevant, a comparison of the RBI-assessed CRAR during on-site inspection with the results of the CRAR calculations of the bank under the ICAAP;
- a clear articulation of the bank's risk appetite, in quantitative terms, by risk category and the extent of its consistency (its 'fit') with the overall assessment of bank's various risks; and
- where relevant, an explanation of any other methods, apart from capital, used by the bank to mitigate the risks.

Methodology and assumptions

A description of how assessments for each of the major risks have been approached and the main assumptions made.

For instance, banks may choose to base their ICAAP on the results of the CRAR calculation with the capital for additional risks (e.g. concentration risk, interest rate risk in the banking book, etc.) assessed separately and added to the Pillar 1 computations. Alternatively, banks could choose to base their ICAAP on internal models for all risks, including those covered under the CRAR (i.e. Credit, Market and Operational Risks).

The description here would make clear which risks are covered by which modelling or calculation approach. This would include details of the methodology and process used to calculate risks in each of the categories identified and reason for choosing the method used in each case.

Where the bank uses an internal model for the quantification of its risks, this section should explain for each of those models:

- the key assumptions and parameters within the capital modelling work and background information on the derivation of any key assumptions;
- how parameters have been chosen, including the historical period used and the calibration process;
- the limitations of the model;
- the sensitivity of the model to changes in those key assumptions or parameters chosen; and
- the validation work undertaken to ensure the continuing adequacy of the model.

Where stress tests or scenario analyses have been used to validate, supplement, or probe the results of other modelling approaches, then this section should provide:

- details of simulations to capture risks not well estimated by the bank's internal capital model (e.g. non-linear products, concentrations, illiquidity and shifts in correlations in a crisis period);

- details of the quantitative results of stress tests and scenario analyses the bank carried out and the confidence levels and key assumptions behind those analyses, including, the distribution of outcomes obtained for the main individual risk factors;
- details of the range of combined adverse scenarios which have been applied, how these were derived and the resulting capital requirements; and
- where applicable, details of any additional business-unit-specific or business-plan-specific stress tests selected.

Capital transferability

In case of banks with conglomerate structure, details of any restrictions on the management's ability to transfer capital into or out of the banking business(es) arising from, for example, by contractual, commercial, regulatory or statutory constraints that apply, should be furnished. Any restrictions applicable and flexibilities available for distribution of dividend by the entities in the Group could also be enumerated. In case of overseas banking subsidiaries of the banks, the regulatory restrictions would include the minimum regulatory capital level acceptable to the host-country regulator of the subsidiary, after declaration of dividend.

V. Key sensitivities and future scenarios

This section would explain how a bank would be affected by an economic recession or downswings in the business cycle or markets relevant to its activities. The RBI would like to be apprised as to how a bank would manage its business and capital so as to survive a recession while meeting the minimum regulatory standards. The analysis would include future financial projections for, say, three to five years based on business plans and solvency calculations.

For the purpose of this analysis, the severity of the recession reckoned should typically be one that occurs only once in a 25 year period. The time horizon would be from the day of the ICAAP calculation to at least the deepest part of the recession envisaged.

Typical scenarios would include:

- how an economic downturn would affect:
 - the bank's capital funds and future earnings; and
 - the bank's CRAR taking into account future changes in its projected balance sheet.
- In both cases, it would be helpful if these projections show separately the effects of management actions to change the bank's business strategy and the implementation of contingency plans.

- projections of the future CRAR would include the effect of changes in the credit quality of the bank's credit risk counterparties (including migration in their ratings during a recession) and the bank's capital and its credit risk capital requirement;
- an assessment by the bank of any other capital planning actions to enable it to continue to meet its regulatory capital requirements throughout a recession such as new capital injections from related companies or new share issues;
- This section would also explain which key macroeconomic factors are being stressed, and how those have been identified as drivers of the bank's earnings. The bank would also explain how the macroeconomic factors affect the key parameters of the internal model by demonstrating, for instance, how the relationship between the two has been established.

Management Actions

This section would elaborate on the management actions assumed in deriving the ICAAP, in particular:

- the quantitative impact of management actions – sensitivity testing of key management actions and revised ICAAP figures with management actions excluded.
- evidence of management actions implemented in the past during similar periods of economic stress.

VI. Aggregation and diversification

This section would describe how the results of the various separate risk assessments are brought together and an overall view taken on capital adequacy. At a technical level, this would, therefore, require some method to be used to combine the various risks using some appropriate quantitative techniques. At the broader level, the overall reasonableness of the detailed quantification approaches might be compared with the results of an analysis of capital planning and a view taken by senior management as to the overall level of capital that is considered appropriate.

- In enumerating the process of technical aggregation, the following aspects could be covered:
 - i) any allowance made for diversification, including any assumed correlations within risks and between risks and how such correlations have been assessed, including in stressed conditions;
 - ii) the justification for any credit taken for diversification benefits between legal entities, and the justification for the free movement of capital, if any assumed, between them in times of financial stress;
 - iii) the impact of diversification benefits with management actions excluded. It might be helpful to work out revised ICAAP figures with all correlations set to '1' i.e., no diversification; and similar figures with all correlations set to '0' i.e. assuming all risks are independent i.e., full diversification.
- As regards the overall assessment, this should describe how the bank has arrived at its overall assessment of the capital it needs taking into account such matters as:

- i) the inherent uncertainty in any modelling approach;
- ii) weaknesses in the bank's risk management procedures, systems or controls;
- iii) the differences between regulatory capital and internal capital; and
- iv) the differing purposes that capital serves: shareholder returns, rating objectives for the bank as a whole or for certain debt instruments the bank has issued, avoidance of regulatory intervention, protection against uncertain events, depositor protection, working capital, capital held for strategic acquisitions, etc.

VII. Testing and adoption of the ICAAP

This section would describe the extent of challenging and testing that the ICAAP has been subjected to. It would thus include the testing and control processes applied to the ICAAP models and calculations. It should also describe the process of review of the test results by the senior management or the Board and the approval of the results by them. A copy of any relevant report placed before the senior management or the Board of the bank in this regard, along with their response, could be attached to the ICAAP Document sent to the RBI.

Details of the reliance placed on any external service providers or consultants in the testing process, for instance, for generating economic scenarios, could also be detailed here.

In addition, a copy of any report obtained from an external reviewer or internal audit should also be sent to the RBI.

VIII. Use of the ICAAP within the bank

This section would contain information to demonstrate the extent to which the concept of capital management is embedded within the bank, including the extent and use of capital modelling or scenario analyses and stress testing within the bank's capital management policy. For instance, use of ICAAP in setting pricing and charges and the level and nature of future business, could be an indicator in this regard.

This section could also include a statement of the bank's actual operating philosophy on capital management and how this fits in to the ICAAP Document submitted. For instance, differences in risk appetite used in preparing the ICAAP Document vis-à-vis that used for business decisions might be discussed.

Lastly, the banks may also furnish the details of any anticipated future refinements envisaged in the ICAAP (highlighting those aspects which are work-in-progress) apart from any other information that the bank believes would be helpful to the RBI in reviewing the ICAAP Document.

ANNEX – 15

(Cf. para 1 of the covering circular)

GLOSSARY

Asset	An asset is anything of value that is owned by a person or business
Available for Sale	The securities available for sale are those securities where the intention of the bank is neither to trade nor to hold till maturity. These securities are valued at the fair value which is determined by reference to the best available source of current market quotations or other data relative to current value.
Balance Sheet	A balance sheet is a financial statement of the assets and liabilities of a trading concern, recorded at a particular point in time.
Banking Book	The banking book comprises assets and liabilities, which are contracted basically on account of relationship or for steady income and statutory obligations and are generally held till maturity.
Basel Capital Accord	The Basel Capital Accord is an Agreement concluded among country representatives in 1988 to develop standardised risk-based capital requirements for banks across countries. The Accord was replaced with a new capital adequacy framework (Basel II), published in June 2004. Basel II is based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face. These three pillars are: ▪ minimum capital requirements, which seek to refine the present measurement framework ▪ supervisory review of an institution's capital adequacy and internal assessment process; ▪ market discipline through effective disclosure to encourage safe and sound banking practices
Basel Committee on Banking Supervision	The Basel Committee is a committee of bank supervisors consisting of members from each of the G10 countries. The Committee is a forum for discussion on the handling of specific supervisory problems. It coordinates the sharing of supervisory responsibilities among national authorities in respect of banks' foreign establishments with the aim of ensuring effective supervision of banks' activities worldwide.
Basic Indicator Approach	An operational risk measurement technique permitted under Basel II. The approach sets a charge for operational risk as a fixed percentage ("alpha factor") of a single indicator. The indicator serves as a proxy for the bank's risk exposure.
Basis Risk	The risk that the interest rate of different assets, liabilities and off-balance sheet items may change in different magnitude is termed as basis risk.
Capital	Capital refers to the funds (e.g., money, loans, equity, etc.) which are available to carry on a business, make an investment, and generate future revenue. Capital also refers to physical assets which can be used to generate future returns.

Capital adequacy	A measure of the adequacy of an entity's capital resources in relation to its current liabilities and also in relation to the risks associated with its assets. An appropriate level of capital adequacy ensures that the entity has sufficient capital to support its activities and that its net worth is sufficient to absorb adverse changes in the value of its assets without becoming insolvent. For example, under BIS (Bank for International Settlements) rules, banks are required to maintain a certain level of capital against their risk-adjusted assets.
Capital reserves	That portion of a company's profits not paid out as dividends to shareholders. They are also known as undistributable reserves.
Convertible Bond	A bond giving the investor the option to convert the bond into equity at a fixed conversion price or as per a pre-determined pricing formula.
Core Capital	Tier 1 capital is generally referred to as Core Capital
Credit risk	Risk that a party to a contractual agreement or transaction will be unable to meet their obligations or will default on commitments. Credit risk can be associated with almost any transaction or instrument such as swaps, repos, CDs, foreign exchange transactions, etc. Specific types of credit risk include sovereign risk, country risk, legal or force majeure risk, marginal risk and settlement risk.
Debentures	Bonds issued by a company bearing a fixed rate of interest usually payable half yearly on specific dates and principal amount repayable on a particular date on redemption of the debentures.
Deferred Tax Assets	Unabsorbed depreciation and carry forward of losses which can be set-off against future taxable income which is considered as timing differences result in deferred tax assets. The deferred Tax Assets are accounted as per the Accounting Standard 22. Deferred Tax Assets have an effect of decreasing future income tax payments, which indicates that they are prepaid income taxes and meet definition of assets. Whereas deferred tax liabilities have an effect of increasing future year's income tax payments, which indicates that they are accrued income taxes and meet definition of liabilities
Delta (Δ)	The delta of an option / a portfolio of options is the rate of change in the value of the option / portfolio with respect to change in the price of the asset(s) underlying the option(s).
Derivative	A derivative instrument derives much of its value from an underlying product. Examples of derivatives include futures, options, forwards and swaps. For example, a forward contract can be derived from the spot currency market and the spot markets for borrowing and lending. In the past, derivative instruments tended to be restricted only to those products which could be derived from spot markets. However, today the term seems to be used for any product that can be derived from any other.
Duration	Duration (Macaulay duration) measures the price volatility of fixed income securities. It is often used in the comparison of the interest rate risk between securities with different coupons and different maturities. It is the weighted average of the present value of all the cash flows associated with a fixed income security. It is expressed in years. The duration of a fixed income security is always shorter than its term to maturity, except in the case of zero coupon securities where they are the same.
Foreign Institutional Investor	An institution established or incorporated outside India which proposes to make investment in India in securities; provided that a domestic asset management company or domestic portfolio manager who manages funds raised or collected or brought from outside India for investment in India on behalf of a sub-account, shall be deemed to be a Foreign Institutional Investor.

Forward Contract	A forward contract is an agreement between two parties to buy or sell an agreed amount of a commodity or financial instrument at an agreed price, for delivery on an agreed future date. In contrast to a futures contract, a forward contract is not transferable or exchange tradable, its terms are not standardized and no margin is exchanged. The buyer of the forward contract is said to be long the contract and the seller is said to be short the contract.
Gamma(Γ)	The gamma of an option / portfolio of options is the rate of change of the option's / portfolio's delta with respect to the change in the price of the asset(s) underlying the option (s).
General provisions & loss reserves	Such reserves, if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, can be included in Tier 2 capital.
General market risk	Risk that relates to overall market conditions while specific risk is risk that relates to the issuer of a particular security
Hedging	Taking action to eliminate or reduce exposure to risk
Held for Trading	Securities where the intention is to trade by taking advantage of short-term price / interest rate movements.
Horizontal Disallowance	A disallowance of offsets to required capital used the BIS Method for assessing market risk for regulatory capital. In order to calculate the capital required for interest rate risk of a trading portfolio, the BIS Method allows offsets of long and short positions. Yet interest rate risk of instruments at different horizontal points of the yield curve are not perfectly correlated. Hence, the BIS Method requires that a portion of these offsets be disallowed.
Hybrid debt capital instruments	In this category, fall a number of capital instruments, which combine certain characteristics of equity and certain characteristics of debt. Each has a particular feature, which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier 2 capital.
Interest rate risk	Risk that the financial value of assets or liabilities (or inflows/outflows) will be altered because of fluctuations in interest rates. For example, the risk that future investment may have to be made at lower rates and future borrowings at higher rates.
Long Position	A long position refers to a position where gains arise from a rise in the value of the underlying.
Market risk	Risk of loss arising from movements in market prices or rates away from the rates or prices set out in a transaction or agreement.
Modified Duration	The modified duration or volatility of an interest bearing security is its Macaulay duration divided by one plus the coupon rate of the security. It represents the percentage change in a securities' price for a 100 basis points change in yield. It is generally accurate for only small changes in the yield. $MD = - \frac{dP}{dY} \cdot \frac{1}{P}$ where: MD = Modified duration P = Gross price (i.e. clean price plus accrued interest). dP = Corresponding small change in price. dY = Small change in yield compounded with the frequency of the coupon payment.

Mortgage-backed security	A bond-type security in which the collateral is provided by a pool of mortgages. Income from the underlying mortgages is used to meet interest and principal repayments.
Mutual Fund	Mutual Fund is a mechanism for pooling the resources by issuing units to the investors and investing funds in securities in accordance with objectives as disclosed in offer document. A fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments.
Net Interest Margin	Net interest margin is the net interest income divided by average interest earning assets
Net NPA	Net NPA = Gross NPA – (Balance in Interest Suspense account + DICGC/ECGC claims received and held pending adjustment + Part payment received and kept in suspense account + Total provisions held)'
Nostro accounts	Foreign currency settlement accounts that a bank maintains with its overseas correspondent banks. These accounts are assets of the domestic bank.
Off-Balance Sheet exposures	Off-Balance Sheet exposures refer to the business activities of a bank that generally do not involve booking assets (loans) and taking deposits. Off-balance sheet activities normally generate fees, but produce liabilities or assets that are deferred or contingent and thus, do not appear on the institution's balance sheet until or unless they become actual assets or liabilities.
Open position	It is the net difference between the amounts payable and amounts receivable in a particular instrument or commodity. It results from the existence of a net long or net short position in the particular instrument or commodity.
Option	An option is a contract which grants the buyer the right, but not the obligation, to buy (call option) or sell (put option) an asset, commodity, currency or financial instrument at an agreed rate (exercise price) on or before an agreed date (expiry or settlement date). The buyer pays the seller an amount called the premium in exchange for this right. This premium is the price of the option.
Rho(ρ)	Rho of an option / a portfolio of options is the rate of change in the value of an option / portfolio with respect to change in the level of interest rates.
Risk	The possibility of an outcome not occurring as expected. It can be measured and is not the same as uncertainty, which is not measurable. In financial terms, risk refers to the possibility of financial loss. It can be classified as credit risk, market risk and operational risk.
Risk Asset Ratio	A bank's risk asset ratio is the ratio of a bank's risk assets to its capital funds. Risk assets include assets other than highly rated government and government agency obligations and cash, for example, corporate bonds and loans. The capital funds include capital and undistributed reserves. The lower the risk asset ratio the better the bank's 'capital cushion'
Risk Weights	Basel II sets out a risk-weighting schedule for measuring the credit risk of obligors. The risk weights are linked to ratings given to sovereigns, financial institutions and corporations by external credit rating agencies.
Securitisation	The process whereby similar debt instruments/assets are pooled together and repackaged into marketable securities which can be sold to investors. The process of loan securitisation is used by banks to move their assets off the balance sheet in order to improve their capital asset ratios.
Short position	A short position refers to a position where gains arise from a decline in the value of the underlying. It also refers to the sale of a security in which the seller does not have a long position.
Specific risk	Within the framework of the BIS proposals on market risk, specific risk refers to the risk associated with a specific security, issuer or company, as opposed to the risk associated with a market or market sector (general risk).

Subordinated debt	Refers to the status of the debt. In the event of the bankruptcy or liquidation of the debtor, subordinated debt only has a secondary claim on repayments, after other debt has been repaid.
Theta(θ)	The theta of an option / a portfolio of options is the rate of change in the value of the option / portfolio with respect to passage of time, with all else remaining the same. It is also called the "time decay" of the option.
Tier one (or Tier 1) capital	A term used to refer to one of the components of regulatory capital. It consists mainly of share capital and disclosed reserves (minus goodwill, if any). Tier 1 items are deemed to be of the highest quality because they are fully available to cover losses. The other categories of capital defined in Basel II are Tier 2 (or supplementary) capital and Tier 2 (or additional supplementary) capital.
Tier two (or Tier 2) capital	Refers to one of components of regulatory capital. Also known as supplementary capital, it consists of certain reserves and certain types of subordinated debt. Tier 2 items qualify as regulatory capital to the extent that they can be used to absorb losses arising from a bank's activities. Tier 2's capital loss absorption capacity is lower than that of Tier 1 capital.
Trading Book	A trading book or portfolio refers to the book of financial instruments held for the purpose of short-term trading, as opposed to securities that would be held as a long-term investment. The trading book refers to the assets that are held primarily for generating profit on short-term differences in prices/yields. The price risk is the prime concern of banks in trading book.
Underwrite	Generally, to underwrite means to assume a risk for a fee. Its two most common contexts are: a) Securities: a dealer or investment bank agrees to purchase a new issue of securities from the issuer and distribute these securities to investors. The underwriter may be one person or part of an underwriting syndicate. Thus the issuer faces no risk of being left with unsold securities. b) Insurance: a person or company agrees to provide financial compensation against the risk of fire, theft, death, disability, etc., for a fee called a premium.
Value at risk (VAR)	It is a method for calculating and controlling exposure to market risk. VAR is a single number (currency amount) which estimates the maximum expected loss of a portfolio over a given time horizon (the holding period) and at a given confidence level.
Vega (v)	The Vega of an option / a portfolio of options is the rate of change in the value of the option / portfolio with respect to volatility of the asset(s) underlying the option(s).
Venture capital Fund	A fund with the purpose of investing in start-up businesses that is perceived to have excellent growth prospects but does not have access to capital markets.
Vertical Disallowance	In the BIS Method for determining regulatory capital necessary to cushion market risk, a reversal of the offsets of a general risk charge of a long position by a short position in two or more securities in the same time band in the yield curve where the securities have differing credit risks.

ANNEX - 16

(Cf. para 2 of the covering circular)

List of circulars consolidated in the Master Circular
(The original circular DBOD.No.BP.BC.90/20.06.001/2006-07 dated April 27, 2007

Sl. No	Circular No.	para / provision of the circular consolidated	Subject	Para No. of the Master Circular
1	DBOD.NO.BP.B C.42/21.01.002/2007-08 dated Oct 29, 2007	Annex Para 1.1	Guidelines for issuing Preference Shares as part of Regulatory Capital	4.2.5 (ii) and (iii)
2	-- do --	Para 1	-- do --	4.3.3
3	DBOD.No.67/20.06.001 /2007-08 dated March 31, 2008	Sl.No.1 of Annex	Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of NCAF - Amendments	4.3.5
4	DBOD.No.BP.B C.88/21.06.001/2007-08 dated May 30, 2008	2.2	Capital Adequacy Norms – Treatment of Banks' investments in Subsidiaries/ Associates and of the Subsidiaries'/ Associates' Investments in Parent Banks	4.4.10
5	DBOD.No.67/20.06.001 /2007-08 dated March 31, 2008	Sl. No.3 of Annex	Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of NCAF - Amendments	5.2.2
6	-- do --	Sl. No. 4 of Annex	-- do --	5.4.2, 5.8.1 Tables
7	-- do --	Sl. No 5 of Annex	-- do --	5.6.1
8	Mail Box Clarification dated May 21, 2008		Claims on banks – Exposures of the Indian branches of foreign bank guaranteed/counter-guaranteed by HOs/Overseas branches	5.6.2
9	Mail Box Clarification dated May 21, 2008		Risk weights and provisioning norms - AFCs	5.8.1
10	DBOD.No.67/20.06.001 /2007-08 dated March 31, 2008	Sl. No. 6 Annex.	Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of NCAF - Amendments	5.8.1 Table 6: Part - B
11	Mail box clarification dated May 21, 2008		Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation	7.3.7 (ii) Table 14 (D)
12	DBOD.No.BP.B C.83/21.06.001/2007-08 dated May 14, 2008	Para 2	Claims secured by Residential Property – Change in limits for Risk Weights	5.10
13	DBOD.No.67/20.06.001 /2007-08 dated March 31, 2008	Sl.No 7 in the Annex	Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of NCAF - Amendments	5.13.3

14	Mail Box clarification dated May 21, 2008		Risk weights and provisioning norms – AFCs	5.13.5
15	DBOD.No.67/20.06.001 /2007-08 dated March 31, 2008	Sl. No. 8 Annex	Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of NCAF - Amendments	5.15.2 (v).
16	-- do --	Sl. No. 9 Annex	-- do --	7.3.4 (i)
17	-- do --	Sl. No. 11 Annex	-- do --	Existing paragraph 7.3.5 (viii) relating to 'equity' index dropped
18	-- do --	Sl. No. 12 Annex	-- do --	7.3.7
19	-- do --	Sl. No.13 of Annex	-- do --	7.3.8
20	-- do --	Sl. No. 14 Annex	-- do --	7.6.1
21	-- do --	Sl. No. 15 Annex	-- do --	Existing para 8.2.2 deleted
22	-- do --	Sl. No. 16 Annex	-- do --	8.3
23	-- do --	Sl. No. 17 Annex	-- do --	8.4.1
24	DBOD.No.BP.B C.66 /21.06.001/ 2007-08 dated March 31, 2008	Entire circular	Supervisory Review Process under the New Capital Adequacy Framework guidelines for Pillar 2	10.0, 11 and Annexures 9 to 14
25	DBOD.No.67/20.06.001 /2007-08 dated March 31, 2008	SI No. 18 Annex	Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of NCAF - Amendments	Annex – 7

RBI/2008-09/29

DBS. CO.FrMC. BC. No. 15 /23.04.001/2008-09

July 01, 2008

The Chief Executives of all commercial banks (Excluding RRBs), and Financial Institutions

Dear Sir,

Frauds – Classification and Reporting

Please refer to our letter DBS. FrMC. BC. No.1 /23.04.001/2007-08 dated July 02, 2007 forwarding the Master Circular on 'Frauds – Classification and Reporting'. It may be noted that the Master Circular consolidates and updates all the instructions issued during the year since the date of the last Master Circular dated July 2, 2007. The Master circular also incorporates instructions contained in certain clarifications issued by RBI to banks during the course of the year. The Master Circular has been updated as on June 30, 2008 and has been placed on the web-site of the Reserve Bank of India (www.rbi.org.in).

Yours faithfully

(P.K.Panda)
Chief General Manager

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FRAUD MONITORING RETURNS

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1. INTRODUCTION

- 1.1 Incidence of frauds, dacoities, robberies, etc., in banks is a matter of concern. While the primary responsibility for preventing frauds lies with banks themselves, the Reserve Bank of India (RBI) has been advising banks from time to time about the major fraud prone areas and the safeguards necessary for prevention of frauds. The Reserve Bank has also been circulating to banks, the details of frauds of an ingenious nature, not reported earlier so that banks could introduce necessary safeguards / preventive measures by way of appropriate procedures and internal checks. Banks are also being advised about the details of unscrupulous borrowers and related parties who have perpetrated frauds on banks so that banks could exercise caution while dealing with them. To facilitate this ongoing process, it is essential that banks report to RBI complete information about frauds and the follow-up action taken thereon. Banks may, therefore, adopt the reporting system for frauds as prescribed in following paragraphs.
- 1.2 A reference is invited to paragraph 5.2.4, as regards reporting of frauds involving Rs. 1.00 crore and above to special committee of the Board.
- 1.3 It has been observed that frauds are, at times, detected in banks long after their perpetration. Sometimes, fraud reports are also submitted to RBI with considerable delay and without complete information. On some occasions, RBI comes to know about frauds involving large amounts only through press reports. Banks should, therefore, ensure that the reporting system is suitably streamlined so that frauds are reported without any delay. Banks must fix staff accountability in respect of delays in reporting fraud cases to RBI.
- 1.4 Delay in reporting of frauds and the consequent delay in alerting other banks about the modus operandi and issue of caution advices against unscrupulous borrowers could result in similar frauds being perpetrated elsewhere. Banks may, therefore, strictly adhere to the timeframe fixed in this circular for reporting fraud cases to RBI failing which banks would be liable for penal action prescribed under Section 47(A) of the Banking Regulation Act, 1949.
- 1.5 A software package on 'Frauds Reporting and Monitoring System' was supplied to banks in June 2003 and subsequent revisions carried out in the above package were advised to banks vide RBI Circular DBS.FGV(F) No. 8897/23.10.001/2005-06 dated December 20, 2005. Banks are required to send the returns and data, as prescribed, in soft copy only (except in case of FMR-1 return which is required to be submitted both in hard and soft copies) to RBI Central Office as well as the concerned Regional Office of the Department of Banking Supervision under whose jurisdiction the bank's Head Office is situated.
- 1.6 Banks should specifically nominate an official of the rank of General Manager who will be responsible for submitting all the returns referred to in this circular.

2. CLASSIFICATION OF FRAUDS

- 2.1 In order to have uniformity in reporting, frauds have been classified as under, based mainly on the provisions of the Indian Penal Code:
- (a) Misappropriation and criminal breach of trust.
 - (b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
 - (c) Unauthorised credit facilities extended for reward or for illegal gratification.
 - (d) Negligence and cash shortages.
 - (e) Cheating and forgery.
 - (f) Irregularities in foreign exchange transactions.
 - (g) Any other type of fraud not coming under the specific heads as above.
- 2.2 Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (d) and (f) above are to be reported as fraud if the intention to cheat/defraud is suspected/ proved. However, the following cases where fraudulent intention is not suspected/proved at the time of detection will be treated as fraud and reported accordingly:
- (a) cases of cash shortage more than Rs. 10,000/-, and
 - (b) cases of cash shortage more than Rs.5,000/- if detected by management / auditor/ inspecting officer and not reported on the day of occurrence by the persons handling cash.
- 2.3 To ensure uniformity and to avoid duplication, frauds involving forged instruments may be reported only by the paying banker and not by the collecting banker. However, in the case of collection of an instrument which is genuine but the amount is collected fraudulently by a person who is not the true owner, the collecting bank, which is defrauded, will have to file fraud report with the RBI. In case of collection of instrument where the amount has been credited before realisation and subsequently the instrument is found to be fake/forged and returned by the paying bank, it is the collecting bank who has to file FMR-1 with the RBI as they are at loss by parting the amount before realisation of the instrument.
- 2.4 Banks (other than foreign banks) having overseas branches/offices should report all frauds perpetrated at such branches/offices also to RBI as per the format and procedure detailed under Paragraph 3 below.
- 2.5 Cases of theft, burglary, dacoity and robbery should not be reported as fraud. Such cases may be reported separately as detailed in paragraph 7.

3. REPORTING OF FRAUDS TO RESERVE BANK OF INDIA

3.1 Frauds involving Rs. 1 lakh and above

- 3.1.1 Fraud reports should be submitted in all cases of fraud of Rs. 1 lakh and above perpetrated through misrepresentation, breach of trust, manipulation of books of account, fraudulent encashment of instruments like cheques, drafts and bills of exchange, unauthorised handling of securities charged to the bank, misfeasance, embezzlement, misappropriation of funds, conversion of property, cheating, shortages, irregularities, etc.
- 3.1.2 Fraud reports should also be submitted in cases where central investigating agencies have initiated criminal proceedings suo motto and/or where the Reserve Bank has directed that they be reported as frauds.
- 3.1.3 Banks may also report frauds perpetrated in their subsidiaries and affiliates/joint ventures. Such frauds should, however, not be included in the report on outstanding frauds and the quarterly progress reports referred to in paragraph 4 below.
- 3.1.4 The fraud reports in soft copy format involving all categories of frauds and hard copy format involving frauds of Rs. 5 lakh and above should be sent to the Central Office (CO) as also the concerned Regional Office of RBI, Department of Banking Supervision, under whose jurisdiction the Head Office of the bank falls, in the format given in FMR – 1, within three weeks from the date of detection. However, fraud reports in hard copy format involving frauds of Rs. 1.00 lakh and above and less than Rs. 5.00 lakh should be sent to the concerned Regional Office of RBI, Department of Banking Supervision only.

3.2 Frauds committed by unscrupulous borrowers

- 3.2.1 It is observed that a large number of frauds are committed by unscrupulous borrowers including companies, partnership firms/proprietary concerns and/or their directors/partners by various methods including the following:
 - (i) Fraudulent discount of instruments or kite flying in clearing effects.
 - (ii) Fraudulent removal of pledged stocks/disposing of hypothecated stocks without the bank's knowledge/inflating the value of stocks in the stock statements and drawing excess bank finance.
 - (iii) Diversion of funds outside the borrowing units, lack of interest or criminal neglect on the part of borrowers, their partners, etc. and also due to managerial failure leading to the unit becoming sick and due to laxity in effective supervision over the operations in borrowal accounts on the part of the bank functionaries rendering the advance difficult to recover.

3.2.2 In respect of frauds in borrowal accounts, additional information as prescribed under Part B of FMR – 1 should also be furnished.

3.3 Frauds involving Rs. 100.00 lakh and above

In respect of frauds involving Rs. 100 lakh and above, in addition to the requirements given at paragraphs 3.1 and 3.2 above, banks may report the fraud by means of a D.O. letter addressed to the Chief General Manager in charge of the Department of Banking Supervision, RBI, Central Office, within a week of such frauds coming to the notice of the bank's Head Office. The letter may contain brief particulars of the fraud such as amount involved, nature of fraud, modus operandi in brief, name of the branch/office, names of parties involved (if they are proprietorship/ partnership concerns or private limited companies, the names of proprietors, partners and directors), names of officials involved, and whether the complaint has been lodged with the Police/CBI. A copy of the D.O. letter should also be endorsed to the Regional Office of RBI under whose jurisdiction the bank's branch, where the fraud has been perpetrated, is functioning.

3.4 Cases of attempted fraud

Cases of attempted fraud, where the likely loss would have been Rs. 100.00 lakh or more, had the fraud taken place, should be reported to the Central Office of the Reserve Bank, Department of Banking Supervision, indicating the modus operandi and how the fraud was detected. Such cases should not be included in the other returns to be submitted to RBI.

4. QUARTERLY RETURNS

4.1 Report on Frauds Outstanding

- 4.1.1 Banks should submit a copy each of the Quarterly Report on Frauds Outstanding in the format given in FMR – 2 to the Central Office and the Regional Office of the Reserve Bank under whose jurisdiction the Head Office of the bank falls within 15 days of the end of the quarter to which it relates. The data should be submitted in soft copy only. Banks which may not be having any fraud outstanding as at the end of a quarter should submit a *nil* report.
- 4.1.2 Part - A of the report covers details of frauds outstanding as at the end of the quarter. Parts B and C of the report give category-wise and perpetrator-wise details of frauds reported during the quarter respectively. The total number and amount of fraud cases reported during the quarter as shown in Parts B and C should tally with the totals of columns 4 and 5 in Part – A of the report.
- 4.1.3 Banks should furnish a certificate, as part of the above report, to the effect that all individual fraud cases of Rs. 1 lakh and above reported to the Reserve Bank in FMR – 1 during the quarter have also been put up to the bank's Board and have been incorporated in Part – A (columns 4 and 5) and Parts B and C of FMR – 2.
- 4.1.4 Closure of fraud cases :- Banks will report to the Frauds Monitoring Cell, RBI, Department of Banking Supervision (DBS), Central Office, Mumbai and the respective Regional offices of the

DBS, the details of fraud cases closed along with reasons for the closure where no further action was called for. Fraud cases closed during the quarter are required to be reported in quarterly return FMR 2.

Banks should report only such cases as closed where the actions as stated below are complete.

- a. The fraud cases pending with CBI/Police/Court are finally disposed of.
- b. The examination of staff accountability has been completed.
- c. The amount of fraud has been recovered or written off.
- d. Insurance claim wherever applicable has been settled.
- e. The bank has reviewed the systems and procedures, identified the causative factors and plugged the lacunae and the fact of which has been certified by the appropriate authority (Board / Audit Committee of the Board)

Banks should also pursue vigorously with CBI for final disposal of pending fraud cases especially where the banks have completed staff side action. Similarly, banks may vigorously follow up with the police authorities and/or court for final disposal of fraud cases.

4.2 Progress Report on Frauds

- 4.2.1 Banks should furnish case-wise quarterly progress reports on frauds involving Rs. 1.00 lakh and above in the format given in FMR – 3 to the Central Office of RBI, Department of Banking Supervision as well as the concerned Regional Office of the Department of Banking Supervision under whose jurisdiction the bank's Head Office is situated, within 15 days of the end of the quarter to which they relate.
- 4.2.2 In the case of frauds where there are no developments during a quarter, a list of such cases with a brief description including name of branch and date of reporting may be furnished in Part – B of FMR – 3.
- 4.2.3 Banks which do not have any fraud involving Rs. 1.00 lakh and above outstanding may submit a *nil* report.

5. REPORTS TO THE BOARD

5.1 Reporting of Frauds

- 5.1.1 Banks should ensure that all frauds of Rs. 1.00 lakh and above are reported to their Boards promptly on their detection.
- 5.1.2 Such reports should, among other things, take note of the failure on the part of the concerned branch officials and controlling authorities, and consider initiation of appropriate action against the officials responsible for the fraud.

5.2 Quarterly Review of Frauds

- 5.2.1 Information relating to frauds for the quarters ending March, June and September may be placed before the *Audit Committee of the Board of Directors* during the month following the quarter to which

it pertains, irrespective of whether or not these are required to be placed before the Board/Management Committee in terms of the Calendar of Reviews prescribed by RBI.

- 5.2.2 These should be accompanied by supplementary material analysing statistical information and details of each fraud so that the Audit Committee of the Board would have adequate material to contribute effectively in regard to the punitive or preventive aspects of frauds.
- 5.2.3 A separate review for the quarter ending December is not required in view of the Annual Review for the year-ending December prescribed below.
- 5.2.4 Banks are required to constitute a special committee for monitoring and follow up of cases of frauds involving amounts of Rs. 1.00 crore and above exclusively, while Audit Committee of the Board (ACB) may continue to monitor all the cases of frauds in general. The special committee should consist of CMD in case of public sector banks and MD in case of SBI/its Associates. In case of private sector banks, two members from ACB, two members from Board excluding RBI nominee.

The major functions of the special committee would be to monitor and review all the frauds of Rs. 1.00 crore and above so as to:

- Identify the systemic lacunae if any that facilitated perpetration of the fraud and put in place majors to plug the same:
- Identify the reasons for delay in detection, if any, reporting to top management of the bank and RBI:
- Monitor progress of CBI/Police investigation and recovery position:
- Ensure that staff accountability is examined at all levels in all the cases of frauds and staff side action, if required, is completed quickly without loss of time:
- Review the efficacy of the remedial action taken to prevent recurrence of frauds, such as strengthening of internal controls:
- Put on place other measures as may be considered relevant to strengthen preventive measures against frauds.

All the frauds involving an amount of Rs 1.00 crore and above should be monitored and reviewed by the Special Committee of the Board in case of all Indian commercial banks. The periodicity of the meetings of the Special Committee may be decided according to the number of cases involved. However, the Committee should meet and review as and when a fraud involving an amount of Rs 1.00 crore and above comes to light.

5.3 Annual Review of Frauds

- 5.3.1 Banks should conduct an annual review of the frauds and place a note before the Board of Directors/Local Advisory Board for information. The reviews for the year-ended December may be put up to the Board before the end of March the following year.

Such reviews need not be sent to RBI. These may be preserved for verification by the Reserve Bank's inspecting officers.

5.3.2 The main aspects which may be taken into account while making such a review may include the following:

- (a) Whether the systems in the bank are adequate to detect frauds, once they have taken place, within the shortest possible time.
- (b) Whether frauds are examined from staff angle and, wherever necessary, the cases are reported to the Vigilance Cell for further action in the case of public sector banks.
- (c) Whether deterrent punishment is meted out, wherever warranted, to the persons found responsible.
- (d) Whether frauds have taken place because of laxity in following the systems and procedures and, if so, whether effective action has been taken to ensure that the systems and procedures are scrupulously followed by the staff concerned.
- (e) Whether frauds are reported to local Police or CBI, as the case may be, for investigation, as per the guidelines issued in this regard to public sector banks by Government of India.

5.3.3 The annual reviews should also, among other things, include the following details:

- (a) Total number of frauds detected during the year and the amount involved as compared to the previous two years.
- (b) Analysis of frauds according to different categories detailed in Paragraph 2.1 and also the different business areas indicated in the Quarterly Report on Frauds Outstanding (vide FMR – 2).
- (c) Modus operandi of major frauds reported during the year along with their present position.
- (d) Detailed analyses of frauds of Rs. 1 lakh and above.
- (e) Estimated loss to the bank during the year on account of frauds, amount recovered and provisions made.
- (f) Number of cases (with amounts) where staff are involved and the action taken against staff.
- (g) Region-wise/Zone-wise/State-wise break-up of frauds and amount involved.
- (h) Time taken to detect frauds (number of cases detected within three months, six months and one year of their taking place).
- (i) Position with regard to frauds reported to CBI/Police.
- (j) Number of frauds where final action has been taken by the bank and cases disposed of.

- (k) Preventive/punitive steps taken by the bank during the year to reduce/minimise the incidence of frauds.

6. GUIDELINES FOR REPORTING FRAUDS TO POLICE/CBI

- 6.1 *Private sector banks* (including foreign banks operating in India) should follow the following guidelines for reporting of frauds such as unauthorised credit facilities extended by the bank for illegal gratification, negligence and cash shortages, cheating, forgery, etc. to the State Police authorities:
- (a) In dealing with cases of fraud/embezzlement, banks should not merely be actuated by the necessity of recovering expeditiously the amount involved, but should also be motivated by public interest and the need for ensuring that the guilty persons do not go unpunished.
 - (b) Therefore, as a general rule, the following cases should invariably be referred to the State Police:
 - i) Cases of fraud involving an amount of Rs. 1.00 lakh and above, committed by outsiders on their own and/or with the connivance of bank staff/officers.
 - ii) Cases of fraud committed by bank employees, when it involves bank funds exceeding Rs. 10,000/-.
 - (c) Fraud cases involving amounts of Rs 1.00 crore and above should also be reported to the Director, Serious Fraud Investigation Office (SFIO), Ministry of Company Affairs, Government of India. Second Floor, Paryavaran Bhavan, CGO Complex, Lodhi Road, New Delhi 110 003. Details of the fraud are to be reported to SFIO in FMR-1 Format.
- 6.2 *Public sector banks* should report fraud cases involving amount of Rs. 1 crore and above to CBI and those below Rs. 1 crore to local police, as detailed below:

Cases to be referred to CBI

- (a) Cases of Rs. 1.00 crore and above upto Rs. 5.00 crore
 - Where staff involvement is prima facie evident – CBI (Anti Corruption Branch)
 - Where staff involvement is prima facie not evident – CBI (Economic Offences Wing)
- (b) All cases involving more than Rs.5.00 crore – Banking Security and Fraud Cell of the respective centres, which is specialised cell of the Economic Offences Wing of the CBI for major bank fraud cases.

Cases to be referred to Local Police

Cases below Rs.1 crore – Local Police.

- i) Cases of financial frauds of the value of Rs.1.00 lakh and above, which involve outsiders (private parties) and bank staff, should be reported by the Regional Head of the bank concerned to a senior officer of the State CID/Economic Offences Wing of the State concerned.
- ii) For cases of financial frauds below the value of Rs.1.00 lakh but above Rs.10,000/- the cases should be reported to the local police station by the bank branch concerned.
- iii) All fraud cases of value below Rs.10,000 involving bank officials, should be referred to the Regional Head of the bank, who would scrutinize each case and direct the bank branch concerned on whether it should be reported to the local police station for further legal action.

6.3 Filing of Police complaint in case of fraudulent encashment of DDs/TTs/Pay orders/Cheques/Dividend warrants, etc.

- i) In case of frauds involving forged instruments, the *paying banker* has to file the police complaint (FIR) and not the collecting banker.
- ii) However, in case of collection of instrument which is genuine but the amount is collected fraudulently by a person who is not the owner, the *collecting bank* which is defrauded has to file a police complaint (FIR).
- iii) In case of collection of instruments where the amount has been credited before realisation and subsequently the instrument is found to be fake/forged and returned by the paying bank, it is the *collecting bank* that has to file a police complaint as they are at loss by paying the amount before realisation of the instrument.

7. REPORTING CASES OF THEFT, BURGLARY, DACOITY AND BANK ROBBERIES

7.1 Banks should arrange to report instances of bank robberies, dacoities, thefts and burglaries to the following authorities immediately on their occurrence by telegram/ fax / e-mail. The report should include details of modus operandi and other information as at columns 1 to 11 of FMR – 4.

- (a) Reserve Bank of India, Department of Banking Supervision, Central Office, Mumbai.
- (b) The concerned Regional Office of the Department of Banking Supervision, Reserve Bank of India under whose jurisdiction the Head Office of the bank falls.
- (c) The concerned Regional Office of the Department of Banking Supervision, Reserve Bank of India, under whose jurisdiction the affected bank branch is located.
- (d) The Security Adviser, Central Security Cell, Reserve Bank of India, Central Office Building, Mumbai – 400001.
- (e) Ministry of Finance, Department of Economic Affairs, (Banking Division), Government of India, New Delhi.

7.2 Banks should also submit to the Reserve Bank, Department of Banking Supervision, Central Office as well as the concerned Regional Office of the Reserve Bank under whose jurisdiction the bank's Head Office is

situated a quarterly consolidated statement in the format given in FMR – 4 covering all cases pertaining to the quarter. This may be submitted within 15 days of the end of the quarter to which it relates.

- 7.3 Banks which do not have any instances of theft, burglary, dacoity and / or robbery to report during the quarter, may submit a *nil* report.

FMR – 1

Report on Actual or Suspected Frauds in Banks

(Vide Paragraph 3)

Part A: Fraud Report

1. .	Name of the bank	
2. .	Fraud number ¹	
3. 3.	Details of the branch ²	
4.	(a) Name of the branch	
5.	(b) Branch type	
	(c) Place	
	(d) District	
	(e) State	
6. .	Name of the Principal party/account ³	
7. .a	Area of operation where the fraud has occurred ⁴	
9. .b	Whether fraud has occurred in a borrowal account ?	Yes/No
10. .a	Nature of fraud ⁵	
11. .b	Whether computer is used in committing the fraud?	
12. .c	If yes, details	
13. .	Total amount involved ⁶ (Rs. In lakh)	
14. .a	Date of occurrence ⁷	
b	Date of detection ⁸	

c	Reasons for delay, if any, in detecting the fraud	
d	Date on which reported to RBI ⁹	
e	Reasons for delay, if any, in reporting the fraud to RBI	
15. .a b	16. Brief history 17. modus operandi	
18. 0.	Fraud committed by	
a	Staff	Yes/No
b	Customers	Yes/No
c	Outsiders	Yes/No
19. 1.a	Whether the controlling office (Regional/Zonal) could detect the fraud by a scrutiny of control returns submitted by the branch	Yes/No
b	Whether there is need to improve the information system?	Yes/No
20. 2.a	Whether internal inspection/ audit (including concurrent audit) was conducted at the branch(es) during the period between the date of first occurrence of the fraud and its detection?	Yes/No*
b	If yes, why the fraud could not have been detected during such inspection/audit.	
c	What action has been taken for non-detection of the fraud during such inspection/audit	
21. 3.	Action taken/proposed to be taken	
a	Complaint with Police/CBI	
	i)Whether any complaint has been lodged with the Police/CBI?	Yes/No
	ii)If yes, name of office/ branch of CBI/ Police	

1	Date of reference	
2	Present position of the case	
3	Date of completion of Police/CBI investigation	
4	Date of submission of investigation report by Police/CBI	
	iii) If not reported to Police/CBI, reasons therefor	
b	Recovery suit with DRT/Court	
	i) Date of filing	
	ii) Present position	
c	Insurance claim	
	i) Whether any claim has been lodged with an insurance company	Yes/No
	ii) If not, reasons therefor	
d	Details of staff-side action	
	i) Whether any internal investigation has been/is proposed to be conducted	Yes/No
	ii) If yes, date of completion	
	iii) Whether any departmental enquiry has been/is proposed to be conducted	
	iv) If yes, give details as per format given below:	
	v) If not, reasons therefor	

No.	Name	Design.	Whether suspended/Dt. of suspension	Date of issue of charge sheet	Date of commencement of domestic inquiry	Date of completion of inquiry	Date of issue of final orders	Punishment awarded	Details of prosecution/conviction/acquittal, etc.

e	Steps taken/proposed to be taken to avoid such incidents	
22.4.	(a) Total amount recovered	
23.	i) Amount recovered from party/parties concerned	
	ii) From insurance	
	iii) From other sources	
	(b) Extent of loss to the bank	
	(c) Provision held	
	(d) Amount written off	
24.5.	Suggestions for consideration of RBI	

(a)

(b) * Mention the type/s of inspection / audit the branch is subjected to

Part B: Additional Information on Frauds in Borrowal Accounts

(c) (This part is required to be completed in respect of frauds in all borrowal accounts)

Sr. No.	Type of party	Name of party/account	Party Address

Borrowal accounts details:

Party Sr. No.	Name of party/account	Borrowal account Sr. No.	Nature of Account	Date of Sanction	Sanctioned limit	Balance outstanding

Borrowal account Director/proprietor details:

Name of party/account	Sr.No.	Name of Director/Proprietor	Address

Associate Concerns:

Name of party/account	Sr. No. Associate Concern	Name of Associate Concern	Address

Associate Concern Director/proprietor details:

Name of Associate Concern	Sr. No.	Name of Director	Address

(d)

FMR – 2

(f) **Quarterly Report on Frauds Outstanding**
(Vide Paragraph 4.1)

(g)

(h) Name of the bank _____

(i) Report for the quarter ended _____

Domestic Overseas

Part – A: Frauds Outstanding

(j)

(Amount in Rs. lakh)

(k) Category	Cases outstanding as at the end of the previous quarter		New cases reported during the current quarter		Cases closed during the current quarter		Cases outstanding as at the end of the quarter		Total amount recovered	Provision held for cases outstanding as at the end of the Qtr.	Amount Recovered during the current Qtr.	Amount Written off during the current quarter
	No.	Amount	No.	Amount	No.	Amount	No. (2+4-6)	Amount (3+5-7)	Amount	Amount	Amount	Amount
1	2	3	4	5	6	7	8	9	10	11	12	13
Cash												
Deposits												
(i) Savings												
(ii) Current												
(iii) Term												
Non-resident accounts												

(k) Category	Cases outstanding as at the end of the previous quarter		New cases reported during the current quarter		Cases closed during the current quarter		Cases outstanding as at the end of the quarter		Total amount recovered	Provision held for cases outstanding as at the end of the Qtr.	Amount Recovered during the current Qtr.	Amount Written off during the current quarter
	No.	Amount	No.	Amount	No.	Amount	No. (2+4-6)	Amount (3+5-7)	Amount	Amount	Amount	Amount
1	2	3	4	5	6	7	8	9	10	11	12	13
Advances (i) Cash credit (ii) Term Loans (iii) Bills (iv) Others												
25. Foreign exchange transactions												
26. Inter-branch accounts												
27. Cheques/Demand drafts, etc.												
28. Clearing, etc., accounts												
Off-balance sheet (i) Letters of credit (ii) Guarantees (iii) Co-acceptance (iv) Others												
Card / Internet - (i) Credit Cards												
(ii) ATM/Debit Cards												
(iii) Internet Banking												
(iv) Others												

(k) Category	Cases outstanding as at the end of the previous quarter		New cases reported during the current quarter		Cases closed during the current quarter		Cases outstanding as at the end of the quarter		Total amount recovered	Provision held for cases outstanding as at the end of the Qtr.	Amount Recovered during the current Qtr.	Amount Written off during the current quarter
	No.	Amount	No.	Amount	No.	Amount	No. (2+4-6)	Amount (3+5-7)	Amount	Amount	Amount	Amount
1	2	3	4	5	6	7	8	9	10	11	12	13
Total												

(l)

- (m) **Note:** For Indian banks with overseas offices/branches, the above figures relate to the domestic position. The figures in respect of overseas branches/offices may be shown in a separate sheet in the same format as above.

(n) **Part – B: Category-wise classification of frauds reported during the quarter** _____

(o)

(p) **Name of the bank** _____

(q)

(r) Category	(s) Misappropriation and criminal breach of trust		(t) Fraudulent encashment/ manipulation of books of account and conversion of property		(u) Unauthorised credit facility extended for illegal gratification		(v) Negligence and cash shortages		(w) Cheating and forgery		(x) Irregularities in foreign exchange transactions		(y) Others		(z) Total	
	(aa) o.	(bb) mt. A	(cc) o.	(dd) mt. A	(ee) o.	(ff) mt.	(gg) o.	(hh) mt.	(ii) o.	(jj) mt.	(kk) o.	(ll) mt. A	(mm) o.	(nn) mt.	(oo) o.	(pp) mt.
(qq) Less than Rs. 1 lakh	(rr)	(ss)	(tt)	(uu)	(vv)	(ww)	(xx)	(yy)	(zz)	(aaa)	(bbb)	(ccc)	(ddd)	(eee)	(fff)	(ggg)
(hhh) Rs. 1 lakh and above but less than Rs. 100 lakh	(iii)	(jjj)	(kkk)	(lll)	(mmm)	(nnn)	(ooo)	(ppp)	(qqq)	(rrr)	(sss)	(ttt)	(uuu)	(vvv)	(www)	(xxx)
(yyy) Rs. 100 lakh and above	(zzz)	(aaaa)	(bbbb)	(cccc)	(dddd)	(eeee)	(ffff)	(gggg)	(hhhh)	(iiii)	(jjjj)	(kkkk)	(llll)	(mmmm)	(nnnn)	(oooo)
(pppp) Total	(qqqq)	(rrrr)	(ssss)	(tttt)	(uuuu)	(vvvv)	(wwww)	(xxxx)	(yyyy)	(zzzz)	(aaaaa)	(bbbbb)	(ccccc)	(ddddd)	(eeee)	(fffff)

(ggggg)

(hhhhh) **Part – C: Perpetrator-wise classification of frauds reported during the quarter**

(iiiiii)

(jjjjj) Name of the bank _____

(kkkkk)

(lllll) (mmmmm) Category	(nnnnn) Staff		(ooooo) Customers		(ppppp) Outsiders		(qqqqq) Staff and Customers		(rrrrr) Staff and Outsiders		(sssss) Customers and Outsiders		(ttttt) Staff, Customers and Outsiders		(uuuuu) Total	
	(vvvvv) o.	(wwwww) mt.	(xxxxx) o.	(yyyyy) mt.	(zzzzz) o.	(aaaaa) mt.	(bbbbb) o.	(ccccc) mt.	(ddddd) o.	(eeeeee) mt.	(fffff) o.	(ggggg) mt.	(hhhhh) o.	(iiiiii) mt.	(jjjjj) o.	(kkkkk) mt.
(lllll) Less than Rs. 1 lakh	(mmmm)	(nnnnnn)	(ooooo)	(ppppp)	(qqqqq)	(rrrrr)	(sssss)	(ttttt)	(uuuuu)	(vvvvv)	(wwwww)	(xxxxx)	(yyyyy)	(zzzzz)	(aaaaa)	(bbbbb)
(ccccc)Rs. 1 lakh and above but less than Rs. 100 lakh	(ddddd)	(eeeeee)	(fffff)	(ggggg)	(hhhhh)	(iiiiii)	(jjjjj)	(kkkkk)	(lllll)	(mmmm)	(nnnnn)	(ooooo)	(ppppp)	(qqqqq)	(rrrrr)	(sssss)
(ttttt) Rs. 100 lakh and above	(uuuuu)	(vvvvvv)	(wwwww)	(xxxxxx)	(yyyyyy)	(zzzzzz)	(aaaaa)	(bbbbb)	(ccccc)	(ddddd)	(eeeeee)	(fffff)	(ggggg)	(hhhhh)	(iiiiii)	(jjjjj)
(kkkkkkk) Total	(lllllll)	(mmmmmm)	(nnnnnnn)	(oooooooo)	(pppppp)	(qqqqqq)	(rrrrrrr)	(sssssss)	(ttttttt)	(uuuuuuu)	(vvvvvvv)	(wwwwwww)	(xxxxxxxx)	(yyyyyyy)	(zzzzzzz)	(aaaaaaaa)

(bbbbbbbbb)

(cccccccc) **Note:** 1. The above category-wise classification is mostly based on various provisions of the Indian Penal Code.

(dddddddd) 2. All amounts may be furnished in Rs. lakh up to two decimals.

(eeeeeeee)

(ffffff) **Certificate**

(gggggggg)

(hhhhhhhh) Certified that all frauds of Rs. 1 lakh and above reported to the Reserve Bank during the last quarter have also been reported to the bank's Board

and have been incorporated in Part A (Columns 4 and 5) and Parts B and C above.

(iiiiiiii)

(jjjjjjjj)

(kkkkkkkk) Signature:

(|||||||) Name and Designation:
(mmmmmmmm)
(nnnnnnnn) Place:
(oooooooo) Date:

FMR – 3

Quarterly Progress Report on Frauds of Rs 1 lakh and above

(Vide Paragraph 4.2)

(pppppppppp) Name of the bank: _____

(qqqqqqqqqq) Statement for quarter ended _____

(rrrrrrrrrr)

(ssssssssss) **Part A: Summary information**

(ttttttttt)

(uuu)	(vvvvvvvvv)	(wwwwwwwww) Number	(xxxxxxx) Amount involved (Rs. In lakh)
(yyy)	(zzzzzzzzz) Cases outstanding	(aaaaaaaaa)	(bbbbbbbbbbb)
(ccc)	(ddddddddd) Cases where there is no progress (furnish case-wise details as per format at Part B below)	(eeeeeeeeeee)	(fffffffffff)
(ggg)	(hhhhhhhhh) Cases where there is progress (furnish case-wise details as per format at Part C below)	(iiiiiii)	(jjjjjjjjj)

(kkkkkkkkkk)

(lllllllll) **Part – B: Details of cases where there is no progress**

(mmmmmmmmmm)

(nnn) No.	(ooooooooo) Name of branch	(ppppppppp) Fraud No.	(qqqqqqqqq) Name of party/account	(rrrrrrrrr) Amount (sssssssss) (Rs. in lakh)
(ttttt)	(uuuuuuuuu)	(vvvvvvvvv)	(wwwwwwwww)	(xxxxxxx)
(yyy)	(zzzzzzzzz)	(aaaaaaaaa)	(bbbbbbbbbbb)	(ccccccccc)
(ddd)	(eeeeeeeeeee)	(fffffffffff)	(ggggggggggg)	(hhhhhhhhhhh)
(iiiiii)	(jjjjjjjjj)	(kkkkkkkkkkk)	(lllllllll)	(mmmmmmmmmm)
(nnnn)	(ooooooooo)	(ppppppppppp)	(qqqqqqqqqqq)	(rrrrrrrrrrr)
(ssss)	(ttttttttt)	(uuuuuuuuu)	(vvvvvvvvvvv)	(wwwwwwwwwww)
(xxxx)	(yyyyyyyyyyy)	(zzzzzzzzzzz)	(aaaaaaaaaaaaa)	(bbbbbbbbbbbbbb)
(cccc)	(ddddddddd)	(eeeeeeeeeee)	(fffffffffff)	(ggggggggggggg)
(hhhh)	(iiiiiii)	(jjjjjjjjjjj)	(kkkkkkkkkkkkk)	(lllllllllll)

(mm)	(nnnnnnnnnnnn)	(ooooooo)	(pppppppppppp)	(qqqqqqqqqqqq)

(rrrrrrrrrrrr)

(ssssssssssss) **Part – C: Case-wise details of progress**

(ttttttttttt)

(uuuuuuuuuuuu) **Name of party/account:**

(vvvvvvvvvvvv) **Name of branch/office:**

(wwwwwwwwwwww) **Amount involved**

(xxxxxxxxxxxx) **(Rs in lakh)**

(yyyyyyyyyyyyyy) **Fraud No :**

(zzzzzzzzzzzz)

1.	Date of first reporting	
2.a	29. Date of filing recovery suit with DRT/Court	
b	31. Present position	
3.	Recoveries made up to the end of the last quarter (Rs. in lakh)	
4.	34. Recoveries made during the quarter (Rs. In lakh)	
	36. a) From party/parties concerned	
	38. b) From insurance	
	40. c) From other sources	
5.	42. Total recoveries (3+4) (Rs. in lakh)	
6.	44. Loss to the bank (Rs in lakh)	
7.	46. Provision held (Rs in lakh)	
8.	47. Amount written off (Rs in lakh)	
9.	a) Date of reporting case to Police/ CBI	

	b) Date of completion of Police/CBI investigation									
	c) Date of submission of investigation report by Police/CBI									
10.	Details of staff-side action									
	No.	Name	Desgn.	Whether suspended/Dt. of suspension	Date of issue of charge sheet	Date of comment of domestic inquiry	Date of completion of inquiry	Date of issue of final orders	Punishment awarded	Details of prosecution/conviction/acquittal, etc.
	1.									
	2.									
	3.									
	4.									
11.	Other developments									
12.	Whether case closed during the quarter					Yes/No				
13.	Date of closure:									

FMR – 4

Report on Dacoities/Robberies/Theft/Burglaries

(Vide Paragraph 7)

(aaaaaaaaaaaaa)

(bbbbbbbbbbbbbb) Name of the bank _____

Report for the quarter ended _____

Name of branch	Address	State	District	Type of branch ¹⁰	Risk classification ¹¹	Whether a currency chest branch	Number of armed guards	Type of Case ¹²	Date and time of occurrence	Amount involved (Rs. In lakh)	Amount recovered (Rs. In lakh)	Insurance claim settled (Rs. In lakh)	Arrested	
													Staff	Robbers
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
48.	49.	50.	51.	52.										

Killed			Injured		Convicted		Compensation paid (Actual in Rs.)		Action taken	Crime No. and name of police station at which offence has been registered	Modus operandi
Staff	Robbers	Others	Staff	Others	Staff	Robbers	Staff	Others			
16	17	18	19	20	21	22	23	24	25	26	27
				53.							

(cccccccccccc)

Instructions for compiling the Fraud Report (FMR 1):

¹ Fraud number: This has been introduced with a view to facilitate computerisation and cross-reference. The number will be an alphanumeric field consisting of the following: four alphabets (to indicate name of bank), two digits for the year (02, 03, etc.), two digits for the quarter (01 for January – March quarter, etc.) and the final four digits being a distinctive running number for the fraud reported during the quarter.

² Name of the branch: In case the fraud relates to more than one branch, indicate the name of only one branch where the amount involved has been the highest and/or which is mainly involved in following up the fraud. The names of the other branches may be given in the brief history/modus operandi against item number 9.

³ Name of party: A distinctive name may be given to identify the fraud. In the case of frauds in borrowal accounts, name of the borrowers may be given. In the case of frauds committed by employees, the name(s) of the employee(s) could be used to identify the fraud. Where fraud has taken place, say, in clearing account/inter-branch account, and if it is not immediately possible to identify the involvement of any particular employee in the fraud, the same may be identified merely as "Fraud in clearing/inter-branch account".

⁴ Area of operation where the fraud has occurred: Indicate the relevant area out of those given in column 1 of statement FMR 2 (Part A) (Cash; Deposits (Savings/Current/Term); Non-resident accounts; Advances (Cash credit/Term Loans/Bills/Others); Foreign exchange transactions; Inter-branch accounts; Cheques/demand drafts, etc.; Clearing, etc. accounts; Off-balance sheet (Letters of credit/Guarantee/Co-acceptance/Others); Card/Internet - Credit Cards ; ATM/Debit Cards ; Internet Banking ; Others).

⁵ Nature of fraud: Select the number of the relevant category from the following which would best describe the nature of fraud:

- (1) Misappropriation and criminal breach of trust,
- (2) Fraudulent encashment through forged instruments/manipulation of books of account or through fictitious accounts and conversion of property,
- (3) Unauthorised credit facilities extended for reward or for illegal gratification,
- (4) Negligence and cash shortages,
- (5) Cheating and forgery,
- (6) Irregularities in foreign exchange transactions, (7) Others.

⁶ Total amount involved: Amounts should, at all places, be indicated in Rs. lakh up to two decimal places.

⁷ Date of occurrence: In case it is difficult to indicate the exact date of occurrence of fraud (for instance, if pilferages have taken place over a period of time, or if the precise date of a borrower's specific action, subsequently deemed to be fraudulent, is not ascertainable), a notional date may be indicated which is the earliest likely date on which the person is likely to have committed the fraud (say, January 1, 2002, for a fraud which may have been committed anytime during the year 2002). The specific details, such as the period over which the fraud has occurred, may be given in the history/modus operandi.

⁸ Date of detection: If a precise date is not available (as in the case of a fraud detected during the course of an inspection/audit or in the case of a fraud being reported such on the directions of the Reserve Bank), a notional date on which the same may be said to have been recognised as fraud may be indicated.

⁹ Date of reporting to RBI: The date of reporting shall uniformly be the date of sending the detailed fraud report in form FMR 1 to the RBI and not any date of fax or DO letter that may have preceded it.

* Banks have to categorically mention the nature of audit the branch is subjected to viz, concurrent audit, internal inspection, etc.

¹⁰ Rural/Semi-urban/Urban/Metropolitan

¹¹ High/Normal/Low

¹² Dacoity/Robbery/Theft/Burglary

**RBI/2008-09/25
FMD. MSRG. No.22/02.08.003/2008-09**

**July 1, 2008
Ashadha 10, 1930 (S)**

**The Chairmen/Chief Executives of
all Scheduled Commercial Banks (excluding RRBs) /
Co-operative Banks / Primary Dealers**

Dear Sir,

Master Circular on Call/Notice Money Market Operations

As you are aware, the Reserve Bank of India has, from time to time, issued a number of guidelines/instructions/directives to banks in regard to matters relating to call/notice money market. To enable eligible institutions to have current instructions at one place, a Master Circular incorporating all the existing guidelines/instructions/directives on the subject has been prepared. It may be noted that this Master Circular consolidates and updates all the instructions/guidelines contained in the circulars issued up to June 30, 2008, in so far as they relate to operations of eligible institutions in the call/notice money markets. This Master Circular has been placed on the RBI website at www.mastercirculars.rbi.org.in.

Yours faithfully,

**(Chandan Sinha)
Chief General Manager**

**Master Circular
on
Call/Notice Money Market Operations**

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1. Introduction
2. Participants
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4. Interest Rate
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6. Documentation
7. Reporting requirement
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 - I. List of institutions permitted in Call/Notice Money Market
 - II. Reporting Format
 - III. Definitions
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Master Circular on Call/Notice Money Market Operations

1. Introduction

1.1 The money market is a market for short-term financial assets that are close substitutes of money. The most important feature of a money market instrument is that it is liquid and can be turned over quickly at low cost and provides an avenue for equilibrating the short-term surplus funds of lenders and the requirements of borrowers. The call/notice money market forms an important segment of the Indian Money Market. Under call money market, funds are transacted on overnight basis and under notice money market, funds are transacted for the period between 2 days and 14 days.

2. Participants

2.1 Participants in call/notice money market currently include banks (excluding RRBs) and Primary Dealers (PDs), both as borrowers and lenders (Annex I).

3. Prudential Limits

3.1 The prudential limits in respect of both outstanding borrowing and lending transactions in call/notice money market for banks and PDs are as follows:-

Table 1: Prudential Limits for Transactions in Call/Notice Money Market

Sr. No.	Participant	Borrowing	Lending
1	Scheduled Commercial Banks	On a fortnightly average basis, borrowing outstanding should not exceed 100 per cent of capital funds (i.e., sum of Tier I and Tier II capital) of latest audited balance sheet. However, banks are allowed to borrow a maximum of 125 per cent of their capital funds on any day, during a fortnight.	On a fortnightly average basis, lending outstanding should not exceed 25 per cent of their capital funds; however, banks are allowed to lend a maximum of 50 per cent of their capital funds on any day, during a fortnight.
2	Co-operative Banks	Borrowings outstanding by State Co-operative Banks/District Central Co-operative Banks/Urban Co-op. Banks in call/notice money market on a daily basis should not exceed 2.0 per cent of their aggregate deposits as at end March of the previous financial year.	No Limit.
3	Primary Dealers (PDs)	PDs are allowed to borrow, on average in a reporting fortnight, up to 200 per cent of their net owned funds (NOF) as at end-March of the previous financial year.	PDs are allowed to lend in call/notice money market, on average in a reporting fortnight, up to 25 per cent of their NOF.

3.2 Non-bank institutions are not permitted in the call/notice money market with effect from August 6, 2005.

4. Interest Rate

4.1 Eligible participants are free to decide on interest rates in call/notice money market.

4.2 Calculation of interest payable would be based on FIMMDA's (Fixed Income Money Market and Derivatives Association of India) Handbook of Market Practices.

5. Dealing Session

5.1 Deals in the call/notice money market can be done upto 5.00 pm on weekdays and 2.30 pm on Saturdays or as specified by RBI from time to time.

6. Documentation

6.1 Eligible participants may adopt the documentation suggested by FIMMDA from time to time.

7. Reporting Requirement

7.1 All dealings in call/notice money on screen-based negotiated quote-driven system (NDS-CALL) launched since September 18, 2006 do not require separate reporting. It is mandatory for all Negotiated Dealing System (NDS) members to report their call/notice money market deals (other than those done on NDS-CALL) on NDS. Deals should be reported within 15 minutes on NDS, irrespective of the size of the deal or whether the counterparty is a member of the NDS or not. In case there is repeated non-reporting of deals by an NDS member, it will be considered whether non-reported deals by that member should be treated as invalid.

7.2 The reporting time on NDS is upto 5.00 pm on weekdays and 2.30 pm on Saturdays or as decided by RBI from time to time.

7.3 With the stabilisation of reporting of call/notice money transactions over NDS as also to reduce reporting burden, the practice of reporting of call/notice/term money transactions by fax to RBI has been discontinued with effect from December 11, 2004. However, deals between non-NDS members will continue to be reported to the Financial Markets Department (FMD) of RBI by fax as hitherto (Annex II).

7.4 In case the situation so warrants, Reserve Bank may call for information in respect of money market transactions of eligible participants by fax.

8. Annexes

Annex I

I. List of Institutions Permitted to Participate in the Call/Notice Money Market both as Lenders and Borrowers

- a) All Scheduled Commercial Banks (excluding RRBs).
- b) All Co-operative Banks other than Land Development Banks.
- c) All Primary Dealers (PDs).

Annex - II

Daily Return on Call/Notice/Term Money Market Transactions

To
The Chief General Manager,
Financial Markets Department,
23rd Floor NCOB, RBI,
Mumbai-400001
Fax-91-22-22630981

Name of the Bank/Institution : _____

Code No.(As specified by RBI) : _____

Date : _____

		Borrowed			Lent		
		Amount (Rs. crore)	Range of Interest Rates (% p.a.)	Weighted Average Interest Rates (% p.a.)	Amount (Rs. crore)	Range of Interest Rates (% p.a.)	Weighted Average Interest Rates (% p.a.)
1.	Call Money (Overnight)						
2.	Notice Money (2-14 Days)						
(a)	Transacted on the day						
(b)	Outstanding * (including day's transactions)						
3.	Term Money @						
(a)	Transacted on the day						
	(15 Days-1 Month)						
	(1 Month-3 Months)						
	(3 Months-6 Months)						
	(6 Months-1 Year)						
(b)	Outstanding * (Including day's transactions) Amount Borrowed				Amount Lent		
	(15 Days-1 Month)						
	(1 Month-3 Months)						
	(3 Months-6 Months)						
	(6 Months-1 Year)						

*In case of outstandings, rates need not be given.

@ Where applicable.

Authorised Signatories

Phone No. :

Annex III**Definitions**

In these guidelines, unless the context otherwise requires:

1. "Call Money" means deals in overnight funds
2. "Notice Money" means deals in funds for 2 - 14 days
3. "Fortnight" shall be on a reporting Friday basis and mean the period from Saturday to the second following Friday, both days inclusive
4. "Bank" or "banking company" means a banking company as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949 (10 of 1949) or a "corresponding new bank", "State Bank of India" or "subsidiary bank" as defined in clause (da), clause (nc) and clause (nd) respectively thereof and includes a "co-operative bank" as defined in clause (cci) of Section 5 read with Section 56 of that Act
5. "Scheduled bank" means a bank included in the Second Schedule of the Reserve Bank of India Act, 1934
6. "Primary Dealer" means a financial institution which holds a valid letter of authorisation as a Primary Dealer issued by the Reserve Bank, in terms of the "Guidelines for Primary Dealers in Government Securities Market" dated March 29, 1995, as amended from time to time
7. "Capital Funds" means the sum of the Tier I and Tier II capital as disclosed in the latest audited balance sheet of the entity.

9. Appendix

List of Circulars

Sr. No.	Circular Number	Subject
1.	CPC.BC.103/279A-90 dated.12-4-1990	Access to the Call Money Market
2.	Ref.DBOD.No.Dir.BC.97/C.347-90 dated April 18, 1990	
3.	CPC.BC.111/279A-91 dated.12-4-1991	Call/Notice Money and Bills Rediscounting Market.
4.	CPC.BC.144/07.01.279/94-95 dated.17-4-1995	Widening Access to Call/Notice Money Market
5.	Ref.DBOD.No.FSC.BC.68/24.91.001-95 dated June 27, 1995	
6.	CPC.BC.162/07.01.279/96-97 dated April 15, 1997	Money Market - Routing of Transactions through DFHI
7.	CPC.BC.165/07.01.279/97-98 dated. April 21, 1997	Money Market - Routing of Transactions through Primary Dealers
8.	CPC.BC.175/07.01.279/97-98 dated April 29, 1998	Money Market
9.	CPC.BC.185/07.01.279/98-99 dated April 20, 1999	Measures for Developing the Money Market - Call/Notice Money Market
10.	Ref.No.MPD.2785/279A(MM)/98-99 dated April 24, 1999	Call/Notice Money and Bills Rediscounting Markets - Routing of Transaction
11.	CPC.BC.190/07.01.279/99-2000 dated October 29, 1999	Money Market
12.	CPC.BC.196/07.01.279/99-2000 dated April 27, 2000	Money Market
13.	Ref.No.MPD.3513/279A(MM)/1999-2000 dated April 28, 2000	Call/Notice Money and Bills Rediscounting Markets - Routing of Transactions - Extract from the Statement on Monetary and Credit Policy for the Year 2000-01 dated April 27, 2000
14.	MPD.BC.201/07.01.279/2000-01 dated October 10, 2000	Permission to non-banks to lend in the call money market
15.	MPD.BC.206/07.01.279/2000-01 dated April 19, 2000	Moving towards Pure Inter-bank Call Money Market
16.	DS.PCB.CIR.40/13.01.00/2000-01 dated April 19, 2001	Operations in call/notice money market
17.	MPD.2991/03.09.01/2000-01 dated April 21, 2001	Participation in Call/Notice Money Market
18.	MPD.3173/03.09.01/2000-01 dated May 8, 2001	Participation in Call/Notice Money Market
19.	Ref.DBOD.No.FSC.BC.125/24.92.001/2000-01 dated May 25, 2001	Permission to participate in Call/Notice/Term Money Market and Bills Rediscounting Scheme - Primary Dealers
20.	MPD.BC.214/07.01.279/2001-02 dated April 29, 2002	Money Market - Moving towards Pure Inter-bank Call Money Market
21.	DS.PCB.CIR.52/13.01.00/2001-02 dated June 24, 2002	Reporting of Call Money Transactions
22.	MPD.217/07.01.279/2001-02 dated June 27, 2002	Reliance on Call/Notice Money Market: Prudential Norm
23.	MPD.220/07.01.279/2002-03 dated July 31, 2002	Access to Call/Notice Money Market for Primary Dealers: Prudential Norms.
24.	MPD.222/07.01.279/2002-03 dated October 29, 2002	Money Market
25.	MPD.225/07.01.279/2002-03 dated November 14, 2002	Reliance on Call/Notice Money Market: Prudential Norm
26.	MPD.226/07.01.279/2002-03 dated December	Reliance on Call/Notice Money Market: Prudential Norm

	11, 2002	
27.	DBOD.FSC.BC.85/24.91.001/2002-03 dated March 26, 2003	Permission to participate in Call/Notice Money Market and Bills Rediscounting Scheme - Private Sector Mutual Funds
28.	DBOD.FSC.BC.86/24.91.001/2002-03 dated March 26, 2003	Permission to participate in Call/Notice/Term Money Market and Bills Rediscounting Scheme - Primary Dealers
29.	MPD.BC.230/07.01.279/2002-03 dated April 29, 2002	Money Market - Moving towards Pure Inter-bank Call Money Market
30.	MPD.BC.234/07.01.279/2002-03 dated April 29, 2003	Participation of Non-bank Entities in Call/Notice Money Market
31.	MPD.BC.235/07.01.279/2002-03 dated April 29, 2003	Reporting of Call/Notice Money Market Transactions on NDS Platform.
32.	MPD.BC.241/07.01.279/2003-04 dated November 3, 2003	Money Market - Moving towards Pure Inter-bank Call/Notice Money Market
33.	MPD.BC.244/07.01.279/2003-04 dated November 5, 2003	Primary Dealers' Access to Call/Notice Money Market
34.	MPD.BC.242/07.01.279/2003-04 dated November 5, 2003	Moving towards Pure Inter-bank Call/Notice Money Market
35.	MPD.BC.250/07.01.279/2003-04 dated May 25, 2004	Moving towards Pure Inter-bank Call/Notice Money Market
36.	MPD.BC.253/07.01.279/2004-05 dated July 3, 2005.	Master Circular on Call/Notice Money Market Operations
37.	MPD.BC.259/07.01.279/2004-05 dated October 26, 2004.	Moving towards Pure Inter-bank Call/Notice Money Market
38.	MPD.BC.260/07.01.279/2004-05 dated December 10, 2004.	Reporting of Call/Notice Money Market Transactions.
39.	MPD.BC.265/07.01.279/2004-05 dated April 29, 2005.	Call/Notice Money Market – Review of Benchmark.
40.	MPD.BC.266/07.01.279/2004-05 dated April 29, 2005.	Participation in Call/Notice Money Market.

RBI/2008-09/26
DBOD No.DL.BC.1/20.16.003/2008-09

July 1, 2008

- i) All scheduled commercial banks (excluding RRBs and LABs) and
- ii) All India Notified Financial Institutions

Dear Sirs,

Master Circular on Wilful Defaulters

As you are aware, the Reserve Bank of India has, from time to time, issued a number of circulars to banks and financial institutions (FIs) containing instructions on matters relating to wilful defaulters. In order to enable the banks/FIs to have all the existing instructions on the subject at one place, this Master Circular has been prepared. The Master Circular incorporates all the instructions/ guidelines issued on cases of wilful default, which are operational as on date. The Master Circular has also been placed on the RBI web-site (<http://www.rbi.org.in>).

Yours faithfully,

(Vinay Baijal)
Chief General Manager

Master Circular on 'Wilful Defaulters'

Purpose:

To put in place a system to disseminate credit information pertaining to wilful defaulters for cautioning banks and financial institutions so as to ensure that further bank finance is not made available to them.

Application:

To all scheduled commercial banks (excluding RRBs and LABs) and All India Notified Financial Institutions.

Structure :

1.	Introduction	
2.	Guidelines issued on wilful defaulters on May 30, 2002	
	2.1	Definition of Wilful Default
	2.2	Diversion and siphoning of funds
	2.3	Cut-off limits
	2.4	End-use of Funds
	2.5	Penal measures
	2.6	Guarantees furnished by group companies
	2.7	Role of Auditors
	2.8	Role of Internal Audit / Inspection
	2.9	Reporting to RBI / CIBIL
3.	Grievances Redressal Mechanism	
4.	Criminal Action against Wilful Defaulters	
	4.1	J P C recommendations
	4.2	Monitoring of End Use
	4.3	Criminal Action by Banks / FIs
5.	Reporting names of Directors	
	5.1	Need for Ensuring Accuracy
	5.2	Position regarding Independent & Nominee Directors
	5.3	Government Undertakings
6.	Annex 1 - Reporting Format Annex 2 - List of Circulars consolidated	

1. Introduction

Pursuant to the instructions of the Central Vigilance Commission for collection of information on wilful defaults of Rs.25 lakhs and above by RBI and dissemination to the reporting banks and FIs, a scheme was framed by RBI with effect from 1st April 1999 under which the banks and notified All India Financial Institutions were required to submit to RBI the details of the wilful defaulters. Wilful default broadly covered the following:

- a) Deliberate non-payment of the dues despite adequate cash flow and good networth;
- b) Siphoning off of funds to the detriment of the defaulting unit;
- c) Assets financed either not been purchased or been sold and proceeds have misutilised;
- d) Misrepresentation / falsification of records;
- e) Disposal / removal of securities without bank's knowledge;
- f) Fraudulent transactions by the borrower.

Accordingly, banks and FIs started reporting all cases of wilful defaults, which occurred or were detected after 31st March 1999 on a quarterly basis. It covered all non-performing borrowal accounts with outstandings (funded facilities and such non-funded facilities which are converted into funded facilities) aggregating Rs.25 lakhs and above identified as wilful default by a Committee of higher functionaries headed by the Executive Director and consisting of two GMs/DGMs. Banks/FIs were advised that they should examine all cases of wilful defaults of Rs 1.00 crore and above for filing of suits and also consider criminal action wherever instances of cheating/fraud by the defaulting borrowers were detected. In case of consortium/multiple lending, banks and FIs were advised that they report wilful defaults to other participating/financing banks also. Cases of wilful defaults at overseas branches were required be reported if such disclosure is permitted under the laws of the host country.

2. Guidelines issued on wilful defaulters

Further, considering the concerns expressed over the persistence of wilful default in the financial system in the 8th Report of the Parliament's Standing Committee on Finance on Financial Institutions, the Reserve Bank of India, in consultation with the Government of India, constituted in May 2001 a Working Group on Wilful Defaulters (WGWD) under the Chairmanship of Shri S. S. Kohli, the then Chairman of the Indian Banks' Association, for examining some of the recommendations of the Committee. The Group submitted its report in November 2001. The recommendations of the

WGWD were further examined by an In House Working Group constituted by the Reserve Bank. Accordingly, the Scheme was further revised by RBI on May 30, 2002.

The above scheme was in addition to the **Scheme of Disclosure of Information on Defaulting Borrowers of banks and FIs** introduced in April 1994, vide RBI Circular DBOD.No.BC/CIS/47/20.16.002/94 dated 23 April 1994.

2.1 Definition of wilful default

The term "wilful default" has been redefined in supersession of the earlier definition as under:

A "wilful default" would be deemed to have occurred if any of the following events is noted :-

- (a) The unit has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations.
- (b) The unit has defaulted in meeting its payment / repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
- (c) The unit has defaulted in meeting its payment / repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.
- (d) The unit has defaulted in meeting its payment / repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank/lender.

2.2 Diversion and siphoning of funds

The terms "diversion of funds" and "siphoning of funds" should construe to mean the following:-

2.2.1 Diversion of funds, referred to at para 2.1(b) above, would be construed to include any one of the undernoted occurrences:

- (a) utilisation of short-term working capital funds for long-term purposes not in conformity with the terms of sanction;
- (b) deploying borrowed funds for purposes / activities or creation of assets other than those for which the loan was sanctioned;
- (c) transferring funds to the subsidiaries / Group companies or other corporates by whatever modalities;

- (d) routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender;
- (e) investment in other companies by way of acquiring equities / debt instruments without approval of lenders;
- (f) shortfall in deployment of funds vis-à-vis the amounts disbursed / drawn and the difference not being accounted for.

2.2.2 Siphoning of funds, referred to at para 2.1(c) above, should be construed to occur if any funds borrowed from banks / FIs are utilised for purposes un-related to the operations of the borrower, to the detriment of the financial health of the entity or of the lender. The decision as to whether a particular instance amounts to siphoning of funds would have to be a judgement of the lenders based on objective facts and circumstances of the case.

The identification of the wilful default should be made keeping in view the track record of the borrowers and should not be decided on the basis of isolated transactions/incidents. The default to be categorised as wilful must be intentional, deliberate and calculated.

2.3 Cut-off limits

While the penal measures indicated at para 2.5 below would normally be attracted by all the borrowers identified as wilful defaulters or the promoters involved in diversion / siphoning of funds, keeping in view the present limit of Rs. 25 lakh fixed by the Central Vigilance Commission for reporting of cases of wilful default by the banks/FIs to RBI, any wilful defaulter with an outstanding balance of Rs. 25 lakh or more, would attract the penal measures stipulated at para 2.5 below. This limit of Rs. 25 lakh may also be applied for the purpose of taking cognisance of the instances of 'siphoning' / 'diversion' of funds.

2.4 End-use of Funds

In cases of project financing, the banks / FIs seek to ensure end use of funds by, *inter alia*, obtaining certification from the Chartered Accountants for the purpose. In case of short-term corporate / clean loans, such an approach ought to be supplemented by 'due diligence' on the part of lenders themselves, and to the extent possible, such loans should be limited to only those borrowers whose integrity and reliability are above board. The banks and FIs, therefore, should not depend entirely on the certificates issued by the Chartered Accountants but strengthen their internal controls and the credit risk management system to enhance the quality of their loan portfolio. Needless to say, ensuring end-use of funds by the banks and the FIs should form a

part of their loan policy document for which appropriate measures should be put in place. The following are some of the **illustrative measures** that could be taken by the lenders for monitoring and ensuring end-use of funds:

- (a) Meaningful scrutiny of quarterly progress reports / operating statements / balance sheets of the borrowers;
- (b) Regular inspection of borrowers' assets charged to the lenders as security;
- (c) Periodical scrutiny of borrowers' books of accounts and the no-lien accounts maintained with other banks;
- (d) Periodical visits to the assisted units;
- (e) System of periodical stock audit, in case of working capital finance;
- (f) Periodical comprehensive management audit of the 'Credit' function of the lenders, so as to identify the systemic-weaknesses in the credit-administration.

(It may be kept in mind that this list of measures is only illustrative and by no means exhaustive.)

2.5 Penal measures

In order to prevent the access to the capital markets by the wilful defaulters, a copy of the list of wilful defaulters (non-suit filed accounts) and list of wilful defaulters (suit-filed accounts) are forwarded to SEBI by RBI and Credit Information Bureau (India) Ltd. (CIBIL) respectively.

The following measures should be initiated by the banks and FIs against the wilful defaulters identified as per the definition indicated at paragraph 2.1 above:

- a) No additional facilities should be granted by any bank / FI to the listed wilful defaulters. In addition, the **entrepreneurs / promoters of companies** where banks / FIs have identified siphoning / diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions should be debarred from institutional finance from the scheduled commercial banks, Development Financial Institutions, Government owned NBFCs, investment institutions etc. for floating new ventures for a period of 5 years from the date the name of the wilful defaulter is published in the list of wilful defaulters by the RBI.
- b) The legal process, wherever warranted, against the borrowers / guarantors and foreclosure of recovery of dues should be initiated expeditiously. The lenders may initiate criminal proceedings against wilful defaulters, wherever necessary.
- c) Wherever possible, the banks and FIs should adopt a proactive approach for a change of management of the wilfully defaulting borrower unit.

- d) A covenant in the loan agreements, with the companies in which the banks / notified FIs have significant stake, should be incorporated by the banks / FIs to the effect that the borrowing company should not induct a person who is a promoter or director on the Board of a company which has been identified as a wilful defaulter as per the definition at paragraph 2.1 above and that in case, such a person is found to be on the Board of the borrower company, it would take expeditious and effective steps for removal of the person from its Board.

It would be imperative on the part of the banks and FIs to put in place a transparent mechanism for the entire process so that the penal provisions are not misused and the scope of such discretionary powers are kept to the barest minimum. It should also be ensured that a solitary or isolated instance is not made the basis for imposing the penal action.

2.6 Guarantees furnished by group companies

While dealing with wilful default of a single borrowing company in a Group, the banks / FIs should consider the track record of the **individual company**, with reference to its repayment performance to its lenders. However, in cases where a letter of comfort and / or the guarantees furnished by the companies within the Group on behalf of the wilfully defaulting units are not honoured when invoked by the banks / FIs, such Group companies should also be reckoned as wilful defaulters.

2.7 Role of auditors

In case any falsification of accounts on the part of the borrowers is observed by the banks / FIs, and if it is observed that the auditors were negligent or deficient in conducting the audit, they should lodge a formal complaint against the auditors of the borrowers with the Institute of Chartered Accountants of India (ICAI) to enable the ICAI to examine and fix accountability of the auditors.

With a view to monitoring the end-use of funds, if the lenders desire a specific certification from the borrowers' auditors regarding diversion / siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. To facilitate such certification by the auditors the banks and FIs will also need to ensure that appropriate covenants in the loan agreements are incorporated to enable award of such a mandate by the lenders to the borrowers / auditors.

2.8 Role of Internal Audit / Inspection

The aspect of diversion of funds by the borrowers should be adequately looked into while conducting internal audit/inspection of their offices/branches and periodical reviews on cases of wilful defaults should be submitted to the Audit Committee of the bank.

2.9 Reporting to RBI / CIBIL

Bank/FIs should submit the list of suit-filed accounts of wilful defaulters of Rs.25 lakh and above as at end-March, June, September and December every year to Credit Information Bureau (India) Ltd. (CIBIL) and/or any other credit information company which has obtained / would obtain certificate of registration from RBI in terms of Section 5 of the Credit Information Companies (Regulation) Act, 2005 and of which it is a member. Banks/FIs should, however, submit the quarterly list of wilful defaulters where suits have not been filed only to RBI in the format given in Annex 1.

Explanation

In this connection, it is clarified that banks need not report cases where

- (i) outstanding amount falls below Rs.25 lakh and
- (ii) in respect of cases where banks have agreed for a compromise settlement and the borrower has fully paid the compromised amount.

3. Grievances Redressal Mechanism

Banks/FIs should take the following measures in identifying and reporting instances of wilful default:

- (i) With a view to imparting more objectivity in identifying cases of wilful default, decisions to classify the borrower as wilful defaulter should be entrusted to a Committee of higher functionaries headed by the Executive Director and consisting of two GMs/DGMs as decided by the Board of the concerned bank/FI.
- (ii) The decision taken on classification of wilful defaulters should be well documented and supported by requisite evidence. The decision should clearly spell out the reasons for which the borrower has been declared as wilful defaulter vis-à-vis RBI guidelines.
- (iii) The borrower should thereafter be suitably advised about the proposal to classify him as wilful defaulter along with the reasons therefor. The concerned borrower should be provided reasonable time (say 15 days) for making representation against such decision, if he so desires, to a Grievance Redressal Committee headed by the Chairman and Managing Director and consisting of two other senior officials.

- (iv) Further, the above Grievance Redressal Committee should also give a hearing to the borrower if he represents that he has been wrongly classified as wilful defaulter.
- (v) A final declaration as 'wilful defaulter' should be made after a view is taken by the Committee on the representation and the borrower should be suitably advised.

4. Criminal Action against Wilful Defaulters

4.1 J.P.C. Recommendations

Reserve Bank examined, the issues relating to restraining wilful defaults in consultation with the Standing Technical Advisory Committee on Financial Regulation in the context of the following recommendations of the JPC and in particular, on the need for initiating criminal action against concerned borrowers, viz.

- a. It is essential that offences of breach of trust or cheating construed to have been committed in the case of loans should be clearly defined under the existing statutes governing the banks, providing for criminal action in all cases where the borrowers divert the funds with malafide intentions.
- b. It is essential that banks closely monitor the end-use of funds and obtain certificates from the borrowers certifying that the funds have been used for the purpose for which these were obtained.
- c. Wrong certification should attract criminal action against the borrower.

4.2 Monitoring of End Use

Banks / FIs should closely monitor the end-use of funds and obtain certificates from borrowers certifying that the funds are utilised for the purpose for which they were obtained. In case of wrong certification by the borrowers, banks / FIs may consider appropriate legal proceedings, including criminal action wherever necessary, against the borrowers.

4.3 Criminal Action by Banks / FIs

It is essential to recognise that there is scope even under the existing legislations to initiate criminal action against wilful defaulters depending upon the facts and circumstances of the case under the provisions of Sections 403 and 415 of the Indian Penal Code (IPC) 1860. Banks / FIs are, therefore, advised to seriously and promptly consider initiating criminal action against wilful defaulters or wrong certification by borrowers, wherever considered necessary, based on the facts and circumstances of each case under the above provisions of the IPC to comply with our instructions and the recommendations of JPC.

It should also be ensured that the penal provisions are used effectively and determinedly but after careful consideration and due caution. Towards this end, banks / FIs are advised to put in place a transparent mechanism, with the approval of their Board, for initiating criminal proceedings based on the facts of individual case.

5. Reporting names of Directors

5.1 Need for Ensuring Accuracy

RBI / CIBIL disseminate information on non-suit filed and suit filed accounts respectively, as reported to them by the banks / FIs and responsibility for reporting correct information and also accuracy of facts and figures rests with the concerned banks and financial institutions. Therefore, banks and financial institutions should take immediate steps to up-date their records and ensure that the names of current directors are reported. In addition to reporting the names of current directors, it is necessary to furnish information about directors who were associated with the company at the time the account was classified as defaulter, to put the other banks and financial institutions on guard. Banks and FIs may also ensure the facts about directors, wherever possible, by cross-checking with Registrar of Companies.

5.2 Position regarding Independent and Nominee directors

Professional Directors who associate with companies for their expert knowledge act as independent directors. Such independent directors apart from receiving director's remuneration do not have any material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of Board may affect their independent judgment. As a guiding principle of disclosure, no material fact should be suppressed while disclosing the names of a company that is a defaulter and the names of all directors should be published. However, while doing so, a suitable distinguishing remark should be made clarifying that the concerned person was an independent director. Similarly the names of directors who are nominees of government or financial institutions should also be reported but a suitable remark 'nominee director' should be incorporated.

Therefore, against the names of Independent Directors and Nominee Directors, they should indicate the abbreviations "Ind" and "Nom" respectively in brackets to distinguish them from other directors.

5.3 Government Undertakings

In the case of Government undertakings, it should be ensured that the names of directors are not to be reported. Instead, a legend "Government of ----- undertaking" should be added.

ANNEX

Format for submission of data on cases of wilful default (non-suit filed accounts) of Rs.25 lakh & above to RBI on quarterly basis:

The banks/FIs are required to use the following structure (with the same field names) while submitting data of wilful defaulters (non-suit filed accounts) in floppy diskettes to RBI on quarterly basis:

Field	Field Name	Type	Width	Description	Remarks
1	SCTG	Numeric	1	Category of bank/FI	Number 1/2/4/6/8 should be fed 1 SBI and its associate banks 2 Nationalised banks 4 Foreign banks 6 Private Sector Banks 8 Financial Institutions
2	BKNM	Character	40	Name of bank/FI	Name of the bank/FI
3	BKBR	Character	30	Branch name	Name of the branch
4	STATE	Character	15	Name of state	Name of state in which branch is situated
5	SRNO	Numeric	4	Serial No.	Serial No.
6	PRTY	Character	45	Name of Party	The legal name
7	REGADDR	Character	96	Registered address	Registered Office address
8	OSAMT	Numeric	6	Outstanding amount in Rs. lakhs (Rounded off)	
9	SUIT	Character	4	Suit filed or not	Type 'SUIT' in case suit is filed. For other cases this field should be kept blank.
10	OTHER_BK	Character	40	Name of other banks/ FIs	The names of other banks/FIs from whom the party has availed credit facility should be indicated. The names may be fed in abbreviated form e.g. BOB for Bank of Baroda, SBI for State Bank of India etc.

11	DIR1	Character	40	Name of director	(a) Full name of Director should be indicated. (b) In case of Government companies the legend "Govt. of _____ undertaking" alone should be mentioned. (c) Against the names of nominee directors of banks/ FIs/ Central Govt./ State Govt., abbreviation 'Nom' should be indicated in the brackets. (d) Against the name of independent directors, abbreviation 'Ind' should be indicated in the brackets. (e) In the case of Directors who held office at the time the account of the borrower entity was classified as defaulter, but are no longer on its Board, the symbol @ should be indicated in brackets against their names.
12	DIR2	Character	40	Name of director	--- do ---
13	DIR3	Character	40	Name of director	--- do ---
14	DIR4	Character	40	Name of director	--- do ---
15	DIR5	Character	40	Name of director	--- do ---
16	DIR6	Character	40	Name of director	--- do ---
17	DIR7	Character	40	Name of director	--- do ---
18	DIR8	Character	40	Name of director	--- do ---
19	DIR9	Character	40	Name of director	--- do ---
20	DIR10	Character	40	Name of director	--- do ---
21	DIR11	Character	40	Name of director	--- do ---
22	DIR12	Character	40	Name of director	--- do ---
23	DIR13	Character	40	Name of director	--- do ---
24	DIR14	Character	40	Name of director	--- do ---
	Total bytes		841		

(1) If total numbers of directors exceed 14, the name of additional directors may be entered in blank spaces available in the other directors' columns.

(2) The data / information should be submitted in the above format **in 3.5" floppy diskette as .dbf file only**. While submitting the floppy diskette, the banks/FIs should ensure that:

- the floppy is readable and is not corrupted / virus-affected.
- the floppy is labeled properly indicating name of the bank, name of the list and period to which the list belongs, and the name of list indicated on label and in the letter are same.
- the name and width of each of the fields and order of the fields is strictly as per the above format.
- records with outstanding amount of less than Rs.25 lakh have not been included.
- no suit-filed account has been included.
- use of following types of words have been avoided (as the fields can not be properly indexed) : 'M/s', 'Mr', 'Shri' etc.
- the words 'Mrs', 'Smt', 'Dr' etc. have been fed at the end of name of the person, if applicable.
- Except for field "SUIT" and some of the fields from DIR1 To DIR 14, as applicable, information is completely filled in and columns are not kept blank.

(3) In case of 'Nil' data, there is no need to send any floppy and the position can be conveyed through a letter/fax.

(4) A certificate signed by a sufficiently senior official stating that 'the list of wilful defaulters has been correctly compiled after duly verifying the details thereof and RBI's instructions in this regard have been strictly followed' is sent along with the floppy.

ANNEX 2
List of Circulars consolidated by the Master Circular

Sr. No.	Circular No.	Date	Subject	Para No.
1.	DBOD.No.DL(W).BC.12/20.16.002(1)/98-99	20.02.1999	Collection and Dissemination of Information on Cases of Wilful Default of Rs.25 lakh and above	1
2.	DBOD.No.DL.BC.46/20.16.002/98-99	10.05.1999	Disclosure of information regarding defaulting borrowers - Lists of Defaulters/ Suit filed accounts and Data on Wilful Default	Annex
3.	DBOD.No.DL(W).BC.161/20.16.002/99-2000	01.04.2000	Collection and Dissemination of information on defaulting borrowers of banks and Financial Institutions	5 and Annex
4.	DBOD.No.DL.BC.54 / 20.16.001/2001-02	22.12.2001	Collection and dissemination of information on defaulters	5
5.	DBOD.No.DL(W).BC110 /20.16.003(1)/ 2001-02	30.05.2002	Wilful defaulters and action thereagainst	2, 2.1 to 2.8
6.	DBOD.No.DL.BC.111 / 20.16.001/ 2001-02	04.06.2002	Submission of Credit Information to Credit Information Bureau (CIB)	2.9
7.	DBOD.No.DL(W).BC 58 / 20.16.003/2002-03	11.01.2003	Wilful defaulters and Diversion of funds - Action thereagainst	2.1, 2.2
8.	DBOD.No.DL.BC. 7 / 20.16.003/2003-04	29.07.2003	Wilful Defaulters and action thereagainst	3
9.	DBOD.No.DL.BC.94/20.16.003/2003-04	17.06.2004	Annual Policy Statement: 2004-05 - Wilful Defaulters – Clarification on Process	3
10.	DBOD.No.DL.BC.16 / 20.16.003/2004-05	23.07.2004	Checking of wilful defaults and measures against Wilful Defaulters	4
11.	DBOD.No.DL.(W).BC.87 / 20.16.003/2004-05	28.05.2008	Wilful Defaulters and action thereagainst	2.1
12.	Mail-Box Clarification	17.04.2008	Reporting of accounts under compromise settlement	2.9

**RBI / 2008-09/39
DBOD.FSD.BC.6/ 24.01.011/ 2008-09**

**July 1, 2008
Ashadha 10, 1930 (Saka)**

**All Scheduled Commercial Banks /NBFCs
(excluding RRBs)**

Dear Sir

Master Circular on Credit Card Operations of banks

Please refer to the Master Circular No. DBOD.FSD.BC.17/24.01.011/2007-08 dated July 2, 2007 on credit card operations of banks consolidating the instructions/guidelines issued to banks till June 30, 2007. The Master Circular has been suitably updated by incorporating instructions issued upto June 30, 2008. The Master Circular has also been put on the RBI website (<http://www.rbi.org.in>). A copy of the Master Circular is enclosed. All the credit card issuing banks/NBFCs should adhere to these guidelines strictly.

Yours faithfully

**(P.Vijaya Bhaskar)
Chief General Manager**

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Master Circular on Credit Card Operations of banks

A. Purpose

To provide a framework of rules/regulations/standards/practices to the credit card issuing banks/NBFCs for their credit card business and ensure that the same are in alignment with the best customer practices. Banks should adopt adequate safeguards and implement the following guidelines in order to ensure that their credit card operations are run on sound, prudent and customer friendly manner.

B. Classification

A statutory guideline issued by the RBI

C. Previous guidelines consolidated

This Master Circular consolidates the instructions contained in the circulars listed in the Appendix.

D. Scope of Application

To all Scheduled Commercial Banks (excluding RRBs) / NBFCs that engage in credit card business directly or through their subsidiaries or affiliated companies controlled by them

Structure

1. Introduction
 - 1.1 Background
 - 1.2 Basic features of credit cards
 - 1.3 Types of credit cards
 - 1.4 Fair Practices Code
2. Issue of cards
3. Interest rates and other charges
4. Wrongful billing
5. Use of DSAs/ DMAs and other agents
6. Protection of customers rights
 - 6.1 Right to privacy
 - 6.2 Customer confidentiality
 - 6.3 Fair practices in debt collection
7. Redressal of Grievances
8. Internal control and monitoring systems
9. Fraud Control
10. Right to impose penalty

Annex- Most Important Terms and Conditions

Appendix – List of circulars consolidated

1.0 Introduction

1.1 Background

1.1.1 This circular is aimed at providing general guidance to banks/NBFCs on their credit card operations, and the systems and controls expected of them in managing their credit card business. It also sets out the best practices that they should aim to achieve.

1.1.2 Experience has shown that the quality of banks' credit card portfolios mirrors the economic environment in which they operate. Very often, there is a strong correlation between an economic downturn and deterioration in the quality of such portfolios. The deterioration may become even more serious if banks have relaxed their credit underwriting criteria and risk management standards as a result of intense competition in the market. It is therefore important for banks to maintain prudent policies and practices for managing the risks of their credit card business which are relevant to the market environment that they operate in.

1.1.3 To facilitate a better understanding of the credit card operations, the basic features of credit cards and their associated operations are highlighted in the sub-sections below.

1.2 Basic features of credit cards

1.2.1 The term "credit card" usually/generally refers to a plastic card assigned to a cardholder, usually with a credit limit, that can be used to purchase goods and services on credit or obtain cash advances.

1.2.2 Credit cards allow cardholders to pay for purchases made over a period of time, and to carry a balance from one billing cycle to the next. Credit card purchases normally become payable after a free credit period, during which no interest or finance charge is imposed. Interest is charged on the unpaid balance after the payment is due. Cardholders may pay the entire amount due and save on the interest that would otherwise be charged. Alternatively, they have the option of paying any amount, as long as it is higher than the minimum amount due, and carrying forward the balance.

1.2.3 A credit card scheme typically involves the following parties:

- Cardholders - persons who are authorized to use credit cards for the payment of goods and services;
- Card issuers - institutions which issue credit cards;
- Merchants - entities which agree to accept credit cards for payment of goods and services;
- Merchant acquirers – Banks/NBFCs which enter into agreements with merchants to process their credit card transactions; and
- Credit card associations - organisations that license card issuers to issue credit cards under their trademark, e.g. Visa and MasterCard, and provide settlement services for their members (i.e. card issuers and merchant acquirers).

1.2.4 Credit card schemes normally operate at an international level too, meaning that cardholders belonging to card issuers in one country can make purchases at the place of business of merchants in another country.

1.2.5 The focus of this circular is on the operations, risks and controls associated with credit card schemes of which banks (or their subsidiaries or affiliated companies under their control) are either the card issuer or the merchant acquirer.

1.3 Types of credit cards

1.3.1 Credit cards can be broadly categorised into two types:

General purpose cards and private label cards: The former are issued under the trademark of credit card associations (VISA and Mastercard) and accepted by many merchants while the latter are only accepted by specific retailers (e.g. a departmental store).

Banks in India can undertake credit card business either departmentally or through a subsidiary company set up for the purpose. They can also undertake domestic credit card business by entering into tie-up arrangement with one of the banks already having arrangements for issue of credit cards.

Prior approval of the Reserve Bank is not necessary for banks desirous of undertaking credit card business either independently or in tie-up arrangement with other card issuing banks. Banks can do so with the approval of their Boards. However, only banks with networth of Rs.100 crore and above should undertake credit card business. Banks desirous of setting up separate subsidiaries for undertaking credit card business would, however, require prior approval of the Reserve Bank. Banks should adopt adequate safeguards and implement the guidelines enunciated in this circular in order to ensure that their credit card operations are run on sound, prudent and customer friendly manner.

1.3.2 Most of the card issuing banks in India offer general purpose credit cards. These cards are normally categorised by banks as platinum, gold or classic to differentiate the services offered on each card and the income eligibility criteria. Banks may, at the request of a cardholder, issue a supplementary card (also referred to as 'add-on cards') to another individual who is usually an immediate family member of the cardholder.

1.3.3 It is quite common for banks to partner with business corporations or non-profit making organisations (e.g. charitable or professional bodies) to issue co-branded cards. However they need to undertake due diligence on the non-bank entity to protect themselves against the reputation risk to which they are exposed to in such an arrangement. NBFCs, which desire to enter into a co-branding arrangement for issue of credit cards with banks, may be guided by the instructions contained in circular No. DNBS(PD) CC No.83/03.10.27/2006-07 dated December 04, 2006

1.3.4 Banks may also issue corporate credit cards to the employees of their corporate customers.

1.3.5 The types of credit cards mentioned above are illustrative and not exhaustive. Banks may, from time to time, introduce new credit card products to satisfy customer needs and cater to the changes in market conditions.

1.4 Fair Practices Code

Each bank must have a well documented policy and a Fair Practices Code for credit card operations. The Banking Codes and Standards of India(BCSBI) has released a “Code of Bank’s Commitment to Customers”(Code) in July 2006 as also a Guidance Note in December 2006, which have been adopted by most of the banks with the approval of their Boards. Such of the banks which have subscribed to the BCSBI Code may incorporate the principles contained in BCSBI Code for evolving their Fair Practices Code for credit card operations, in lieu of IBA Fair Practices Code for credit card operations. The banks’ Fair Practices Code, should at a minimum, incorporate the relevant guidelines contained in this Master Circular. Banks/NBFCs should also widely disseminate the contents of this Master Circular, including through their websites.

2. Issue of cards

- a. Banks/NBFCs should independently assess the credit risk while issuing cards to persons, especially to students and others with no independent financial means. Add-on cards i.e. those that are subsidiary to the principal card, may be issued with the clear understanding that the liability will be that of the principal cardholder.
- b. As holding several credit cards enhances the total credit available to any consumer, banks/NBFCs should assess the credit limit for a credit card customer having regard to the limits enjoyed by the cardholder from other banks on the basis of self declaration/ credit information.
- c. The card issuing banks/NBFCs would be solely responsible for fulfillment of all KYC requirements, even where DSAs / DMAs or other agents solicit business on their behalf.
- d. While issuing cards, the terms and conditions for issue and usage of a credit card should be mentioned in clear and simple language (preferably in English, Hindi and the local language) comprehensible to a card user. The Most Important Terms and Conditions (MITCs) termed as standard set of conditions, as given in the Annex, should be highlighted and advertised/ sent separately to the prospective customer/ customers at all the stages i.e. during marketing, at the time of application, at the acceptance stage (welcome kit) and in important subsequent communications.

3. Interest rates and other charges

Credit card dues are in the nature of non-priority sector personal loans and as such banks are free to determine the rate of interest on credit card dues without reference to their BPLR and regardless of the size in terms of paragraph No. 2.4.1(iii) of the Master Circular on Interest rates on advances dated July 1, 2008 . Further, the banks/NBFCs have to adhere to the following guidelines relating to interest rates and other charges on credit cards

- a. Card issuers should ensure that there is no delay in dispatching bills and the customer has sufficient number of days (at least one fortnight) for making payment before the interest starts getting charged.
- b. Card issuers should quote Annualized Percentage Rates (APR) on card products (separately for retail purchase and for cash advance, if different). The method of calculation of APR should be given with a couple of examples for better comprehension. The APR charged and the annual fee should be shown with equal prominence. The late payment charges, including the method of calculation of such charges and the number of days, should be prominently indicated. The manner in which the outstanding unpaid amount will be included for calculation of interest should also be specifically shown with prominence in all monthly statements. Even where the minimum amount indicated to keep the card valid has been paid, it should be indicated in bold letters that the interest will be charged on the amount due after the due date of payment. These aspects may be shown in the Welcome Kit in addition to being shown in the monthly statement. *A legend/notice to the effect that " Making only the minimum payment every month would result in the repayment stretching over ----- years with consequent interest payment on your outstanding balance" should be prominently displayed in all the monthly statements so as to caution the customers about the pitfalls in paying only the minimum amount due.*
- c. The banks /NBFCs should not levy any charge that was not explicitly indicated to the credit card holder at the time of issue of the card and getting his / her consent. However, this would not be applicable to charges like service taxes, etc. which may subsequently be levied by the Government or any other statutory authority.
- d. The terms and conditions for payment of credit card dues, including the minimum payment due, should be stipulated so as to ensure that there is no negative amortization.
- e. Changes in charges (other than interest) may be made only with prospective effect giving notice of at least one month. If a credit card holder desires to surrender his credit card on account of any change in credit card charges to his disadvantage, he may be permitted to do so without the bank levying any extra charge for such closure.

4. Wrongful billing

- a. The card issuing bank/NBFC should ensure that wrong bills are not raised and issued to customers. In case, a customer protests any bill, the bank/NBFC should provide explanation and, if necessary, documentary evidence to the customer within a maximum period of sixty days with a spirit to amicably redress the grievances.
- b. In order to obviate frequent complaints of delayed billing, the credit card issuing bank/NBFC may consider providing bills and statements of accounts online, with suitable security built therefor.

5. Use of DSAs / DMAs and other agents

- a. When banks /NBFCs outsource the various credit card operations, they have to be extremely careful that the appointment of such service providers does not compromise with the quality of the customer service and the banks'/NBFCs' ability to manage credit, liquidity and operational risks. In the choice of the service provider, the banks/NBFCs have to be guided by the need to

ensure confidentiality of the customer's records, respect customer privacy, and adhere to fair practices in debt collection.

b. In terms of the BCSBI's Code of Bank's Commitment to Customers, banks which have subscribed to the Code are required to prescribe a Code of Conduct for their Direct Sales Agents(DSAs) whose services are engaged by banks for marketing their products/services. Banks should ensure that the DSAs engaged by them for marketing their credit card products scrupulously adhere to the banks'/NBFCs' own Code of Conduct for Credit Card operations which should be displayed on the individual bank's/NBFC's website and be available easily to any credit card holder.

c. The bank/NBFC should have a system of random checks and mystery shopping to ensure that their agents have been properly briefed and trained in order to handle with care and caution their responsibilities, particularly in the aspects included in these guidelines like soliciting customers, hours for calling, privacy of customer information, conveying the correct terms and conditions of the product on offer, etc.

6. Protection of Customer Rights

Customer's rights in relation to credit card operations primarily relate to personal privacy, clarity relating to rights and obligations, preservation of customer records, maintaining confidentiality of customer information and fair practices in debt collection. The card issuing bank/NBFC would be responsible as the principal for all acts of omission or commission of their agents (DSAs / DMAs and recovery agents).

6.1 Right to privacy

a. Unsolicited cards should not be issued. In case, an unsolicited card is issued and activated without the consent of the recipient and the latter is billed for the same, the card issuing bank shall not only reverse the charges forthwith, but also pay a penalty without demur to the recipient amounting to twice the value of the charges reversed.

b. Unsolicited loans or other credit facilities should not be offered to the credit card customers. In case, an unsolicited credit facility is extended without the consent of the recipient and the latter objects to the same, the credit sanctioning bank/NBFC shall not only withdraw the credit limit, but also be liable to pay such penalty as may be considered appropriate.

c. The card issuing bank/NBFC should not unilaterally upgrade credit cards and enhance credit limits. Prior consent of the borrower should invariably be taken whenever there are any change/s in terms and conditions.

d. The card issuing bank/NBFC should maintain a Do Not Call Registry (DNCR) containing the phone numbers (both cell phones and land phones) of customers as well as non-customers (non-constituents) who have informed the bank/NBFC that they do not wish to receive unsolicited calls / SMS for marketing of its credit card products. Since the DNCR would have been already set up by the banks, they should give wide publicity to the arrangement.

e. The intimation for including an individual's telephone number in the Do Not Call Registry (DNCR) should be facilitated through a website maintained by the bank/NBFC or on the basis of a letter received from such a person addressed to the bank/NBFC.

- f. The card issuing bank /NBFC should introduce a system whereby the DSAs/ DMAs as well as its Call Centers have to first submit to the bank/NBFC a list of numbers they intend to call for marketing purposes. The bank/NBFC should then refer to the Do Not Call Registry (DNCR) and only those numbers which do not figure in the Registry should be cleared for calling.
- g. The numbers cleared by the card issuing bank/NBFC for calling should only be accessed. The bank/NBFC would be held responsible if a Do Not Call Number (DNCN) is called on by its DSAs / DMAs or Call Centre/s.
- h. The card issuing bank/NBFC should ensure that the Do Not Call Registry (DNCR) numbers are not passed on to any unauthorised person/s or misused in any manner.
- i. Banks/NBFCs/ their agents should not resort to invasion of privacy viz., persistently bothering the card holders at odd hours, violation of "do not call" code etc.
- j. The Telecom Regulatory Authority of India (TRAI) has framed the Telecom Unsolicited Commercial Communications (UCC) Regulations 2007 for curbing UCC. The Regulation envisages 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 Private Do Not Call List will include telephone numbers and other details of all such subscribers. The telephone numbers and area code from this Private Do Not Call 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) and thus the NDNC will have the telephone numbers of all the subscribers all over India who have opted not to receive any UCC. Telemarketers will have to register in the NDNC Registry. The telemarketers 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. The Telecom Unsolicited Commercial Communications(UCC) Regulations, 2007 have been notified in the Gazette on June 6, 2007.

The Department of Telecommunications (DoT) has issued relevant guidelines for telemarketers alongwith the registration procedure and these guidelines have made it mandatory for telemarketers to register themselves with DoT or any other agency authorized by DoT and also specified that the telemarketers shall comply with the Guidelines and Orders/Directions issued by DoT and Orders/Directions/Regulations issued by TRAI on Unsolicited Commercial Communications(UCC). For the effective implementation of the UCC Regulations, TRAI has mandated that the telemarketers have to register themselves with the DoT, Ministry of Communication and Information Technology, Government of India failing which their telecom services may face disconnection. The Telecom Service Providers have been directed to disconnect the telephone connections provided to the telemarketers in case of violation of the UCC Regulations by them.

Keeping in view the above aspects, banks are required to implement the following instructions:

- (i) Banks should not engage Telemarketers (DSAs/DMAs) who do not have a valid registration certificate from DoT, Govt. of India, as telemarketers.

(ii) 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.

(iii) Banks should ensure that all Telemarketers(DSAs/DMAs) presently engaged by them register themselves with DoT as telemarketers.

(iv) As per the laid down procedure, the telemarketer(DSAs/DMAs) shall get automatically registered with NDNC Registry while they register themselves with DoT.

(v) As IBA will be the co-ordinating agency at the industry level to ensure compliance with the requirements of TRAI regulations, banks are advised to actively cooperate with IBA in this regard.

Further, 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, will be required to give the details of the telephone numbers used by them for telemarketing.

6.2 Customer confidentiality

a. The card issuing bank/NBFC should not reveal any information relating to customers obtained at the time of opening the account or issuing the credit card to any other person or organization without obtaining their specific consent, as regards the purpose/s for which the information will be used and the organizations with whom the information will be shared. Banks/NBFCs should satisfy themselves, based on specific legal advice, that the information being sought from them is not of such nature as will violate the provisions of the laws relating to secrecy in the transactions. Banks/NBFCs would be solely responsible for the correctness or otherwise of the data provided for the purpose.

b. In case of providing information relating to credit history / repayment record of the card holder to a credit information company (specifically authorized by RBI), the bank/NBFC may explicitly bring to the notice of the customer that such information is being provided in terms of the Credit Information Companies (Regulation) Act, 2005.

c. Before reporting default status of a credit card holder to the Credit Information Bureau of India Ltd. (CIBIL) or any other credit information Company authorized by RBI, banks/NBFCs should ensure that they adhere to a procedure, duly approved by their Board, including issuing of sufficient notice to such card holder about the intention to report him/ her as defaulter to the Credit Information Company. The procedure should also cover the notice period for such reporting as also the period within which such report will be withdrawn in the event the customer settles his dues after having been reported as defaulter. Banks /NBFCs should be particularly careful in the case of cards where there are pending disputes. The disclosure/ release of information, particularly about the default, should be made only after the dispute is settled as far as possible. In all cases, a well laid down procedure should be transparently followed. These procedures should also be transparently made known as part of MITCs.

d. The disclosure to the DSAs / recovery agents should also be limited to the extent that will enable them to discharge their duties. Personal information provided by the card holder but not required for recovery purposes should not be released by the card issuing bank/NBFC. The card issuing bank /NBFCs should ensure that the DSAs / DMAs do not transfer or misuse any customer information during marketing of credit card products.

6.3 Fair Practices in debt collection

(a) In the matter of recovery of dues, banks should ensure that they, as also their agents, adhere to the extant instructions on Fair Practice Code for lenders (circular DBOD.Leg.No.BC.104/09.07.007/2002-03 dated May 5, 2003) as also BCSBI's Code of Bank's Commitment to Customers(those banks which have subscribed to the BCSBI Code). In case banks have their own code for collection of dues, they should, at the minimum, incorporate all the terms of BCSBI's Code referred above.

(b) In particular, in regard to appointment of third party agencies for debt collection, it is essential that such agents refrain from action that could damage the integrity and reputation of the bank/NBFC and that they observe strict customer confidentiality. All letters issued by recovery agents must contain the name and address of a responsible senior officer of the card issuing bank whom the customer can contact at his location.

(c) Banks /NBFCs / their agents should not resort to intimidation or harassment of any kind, either verbal or physical, against any person in their debt collection efforts, including acts intended to humiliate publicly or intrude the privacy of the credit card holders' family members, referees and friends, making threatening and anonymous calls or making false and misleading representations.

(d) The banks should also ensure to comply with the guidelines in respect of engagement of recovery agents (circular No. DBOD.No.Leg.BC.75 /09.07.005/2007-08 dated April 24, 2008) issued by RBI. These guidelines inter-alia cover aspects relating to i) engagement of Recovery Agents including verification of antecedents of their employees by agents, (ii) incentives to recovery agents – banks to ensure that contracts with the recovery agents do not induce adoption of uncivilized, unlawful and questionable behaviour or recovery process, (iii) methods followed by recovery agents, (iv) training to recovery agents , (v) taking possession of property mortgaged /hypothecated to banks, (vi) use of forum of Lok Adalats, (vii) complaints against the bank/recovery agents and (viii) periodical review of the recovery agents' mechanism.

7. Redressal of Grievances

a. Generally, a time limit of 60 (sixty) days may be given to the customers for preferring their complaints / grievances.

b. The card issuing bank /NBFC should constitute Grievance Redressal machinery within the bank/NBFC and give wide publicity about it through electronic and print media. The name and contact number of designated grievance redressal officer of the bank /NBFC should be mentioned on the credit card bills. The designated officer should ensure that genuine grievances of credit card subscribers are redressed promptly without involving delay.

c. The grievance redressal procedure of the bank/NBFC and the time frame fixed for responding to the complaints should be placed on the bank's website. The name, designation, address and contact number of important executives as well as the Grievance Redressal Officer of the bank/NBFC may be displayed on the website. There should be a system of acknowledging customers' complaints for follow up, such as complaint number / docket number, even if the complaints are received on phone.

d. If a complainant does not get satisfactory response from the bank/NBFC which is a subsidiary of a bank within a maximum period of thirty (30) days from the date of his lodging the complaint, he will have the option to approach the Office of the concerned Banking Ombudsman for redressal of his grievance/s. The bank/NBFC which is a subsidiary of a bank shall be liable to compensate the complainant for the loss of his time, expenses, financial loss as well as for the harassment and mental anguish suffered by him for the fault of the bank and where the grievance has not been redressed in time.

8. Internal control and monitoring systems

With a view to ensuring that the quality of customer service is ensured on an on-going basis in banks/NBFCs, the Standing Committee on Customer Service in each bank/NBFC should review on a monthly basis the credit card operations including reports of defaulters to the CIBIL, credit card related complaints and take measures to improve the services and ensure the orderly growth in the credit card operations. Banks should put up detailed quarterly analysis of credit card related complaints to their Top Management. Card issuing banks should have in place a suitable monitoring mechanism to randomly check the genuineness of merchant transactions.

9. Fraud Control

Banks/NBFCs should set up internal control systems to combat frauds and actively participate in fraud prevention committees/ task forces which formulate laws to prevent frauds and take proactive fraud control and enforcement measures.

10. Right to impose penalty

Reserve Bank of India reserves the right to impose any penalty on a bank/NBFC under the provisions of the Banking Regulation Act, 1949/the Reserve Bank of India Act, 1934, respectively for violation of any of these guidelines.

1. Most Important Terms and Conditions (MITCs)

(a) Fees and Charges

- i) Joining fees for primary card holder and for add-on card holder
- ii) Annual membership fees for primary and add-on card holder
- iii) Cash advance fee
- iv) Service charges levied for certain transactions
- v) Interest free (grace) period - *illustrated with examples*
- vi) Finance charges for both revolving credit and cash advances
- vii) Overdue interest charges - to be given on monthly & annualised basis
- viii) Charges in case of default

(b) Drawal limits

- i) Credit limit
- ii) Available credit limit
- iii) Cash withdrawal limit

(c) Billing

- i) Billing statements—periodicity and mode of sending
- ii) Minimum amount payable
- iii) Method of payment
- iv) Billing disputes resolution
- v) Contact particulars of 24 hour call centers of card issuer
- vi) Grievances redressal escalation—contact particulars of officers to be contacted
- vii) Complete postal address of card issuing bank
- viii) Toll free number for customer care services

(d) Default and circumstances

- i) Procedure including notice period for reporting a card holder as defaulter
- ii) Procedure for withdrawal of default report and the period within which the default report would be withdrawn after settlement of dues
- iii) Recovery procedure in case of default
- iv) Recovery of dues in case of death/ permanent incapacitation of cardholder
- v) Available insurance cover for card holder and date of activation of policy

(e) Termination / revocation of card membership

- i) Procedure for surrender of card by card holder - due notice

(f) Loss/theft/misuse of card

- i) Procedure to be followed in case of loss/ theft/ misuse of card-mode of intimation to card issuer

ii) Liability of card holder in case of (i) above

(g) Disclosure

i) Type of information relating to card holder to be disclosed with and without approval of card holder

2. Disclosure of MITCs - Items to be disclosed in stages :

- i) During marketing - Item no: a
- ii) At application - Item nos: *all items from a to g*
- iii) Welcome Kit - Item nos: all items from a to g
- iv) On billing - Item nos: a, b and c,
- v) On an ongoing basis, any change of the terms and conditions

Note :

(i) The font size of MITC should be minimum Arial-12

(ii) The normal terms and conditions communicated by the card issuer to the card holder at different stages will continue as hitherto.

APPENDIX

List of Circulars consolidated by the Master Circular

No	Circular No.	Date	Subject
1.	RBI/2007-2008/296 DBOD.No.Leg.BC.75/09.07.005/2007-08	April 24, 2008	Recovery Agents engaged by banks
2.	RBI/2007 -2008/163 DBOD.FSD.BC.35/24.01.011/2007-08	October 19, 2007	Unsolicited Commercial Communications – National Do Not Call Registry
3.	RBI/2007-2008/78 DBOD.FSD.BC.19/24.01.011/2007-08	July 3, 2007	Unsolicited Commercial Communications – National Do Not Call Registry
4.	RBI/2007-2008/32 DBOD.FSD.BC.17/24.01.011/2007-08	July 2, 2007	Master Circular on Credit Card Operations of banks
5.	RBI 2005-06/ 211 DBOD. FSD. BC. No. 49/24.01.011/ 2005-06	November 21, 2005	Credit Card Operations by banks
6.	DBOD.Leg.BC.104/09.07.007/2002-03	May 5, 2003	Guidelines on Fair Practice Codes for Lenders
7.	DBOD.No.FSC.BC.120/24.01.011/2000-01	May 12, 2001	Credit Card Business of banks

RBI/ 2008-09/67
DBOD. No.DIR. (HSG). BC.10 /08.12.01/2008--09

July 1, 2008
10 Ashadha,1930 (Saka)

**All Scheduled Commercial Banks
(excluding RRBs)**

Dear Sir,

**Master Circular on
HOUSING FINANCE**

As you are aware, in order to have all current instructions on the subject at one place, the Reserve Bank of India had issued a Master Circular DBOD.DIR(Hsg.)No.02/08.12.01/2007-08 dated July 2, 2007 on the captioned subject, which is now updated up to 30th June 2008. It may be noted that the Master Circular consolidates and updates all the instructions contained in the circulars listed in the Appendix, in so far they relate to providing bank finance to the housing sector. This Master Circular also incorporates instructions contained in certain clarifications issued by RBI to banks during the course of the year. The Master Circular has also been placed on the RBI web-site (<http://www.rbi.org.in>). A copy of the revised Master Circular is enclosed.

Yours faithfully,

(P. Vijaya Bhaskar)
Chief General Manager

Master Circular
HOUSING FINANCE
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MASTER CIRCULAR ON HOUSING FINANCE

Purpose

To consolidate the framework of rules/regulations and clarifications on Housing Finance issued by Reserve Bank of India from time to time.

Classification

A statutory directive issued by the Reserve Bank in exercise of the powers conferred by Sections 21 and 35 A of the Banking Regulation Act, 1949.

Previous instructions consolidated

This Master Circular consolidates and updates all the instructions contained in the Circulars listed in the Appendix and clarifications issued during the year.

Scope of Application

Applicable to all Scheduled Commercial Banks, excluding Regional Rural Banks.

Structure

1. Introduction
2. Direct Housing Finance
3. Indirect Housing Finance
4. Housing Loans Under Priority Sector
5. RBI Refinance
6. Construction Activities Eligible For Bank Credit
7. Construction Activities Not Eligible For Bank Credit
8. Reporting
9. Home Loan Account Scheme (HLAS) for NHB
10. Banks' Exposure to Real Estate Sector
11. Risk Weight on Housing Finance
12. Delhi High Court Order on Unauthorized Construction
13. Terms and Conditions for Banks Investments in Mortgage Backed Securities (MBS)
- 14 Annex : Financial assistance granted by scheduled commercial banks under the category 'Housing Finance' as on Sept. 30 /Mar.31
- 15 Appendix: Housing Finance circulars

1. INTRODUCTION

In pursuance of National Housing Policy of Central Government, Reserve Bank of India has been facilitating the flow of credit to housing sector. During recent period the housing has emerged as one of the sectors attracting a large quantum of bank finance. Therefore, the current focus of RBI's regulation is to ensure orderly growth of housing loan portfolios of banks.

1.1. National Housing Policy

1.1.1 As a part of the strategy to overcome the colossal housing shortage, the Central Government adopted a comprehensive National Housing Policy which, among other things, envisaged.

- (i) development of a viable and accessible institutional system for the provision of housing finance;
- (ii) establishing a system where housing boards and development authorities would concentrate on acquisition and development of land and infrastructure; and
- (iii) creation of conditions in which access to institutional finance is made easier and affordable for individuals for construction/buying of houses/flats. This may include outright purchase of houses/flats constructed by or under the aegis of public agencies.

Banks with their vast branch network throughout the length and breadth of the country, occupy a very strategic position in the financial system and were required to play an important role in providing credit to the housing sector in consonance with the National Housing Policy.

1.1.2 Housing Finance Allocation

Keeping in view the objectives of National Housing Finance Policy, RBI was announcing minimum housing finance allocation annually on the basis of the growth of deposits recorded during the previous year till the year 2002-03. Banks could deploy their funds under the housing finance allocation in any of the three categories, i.e.

- (i) direct finance,
- (ii) indirect finance,
- (iii) investment in bonds of NHB/HUDCO, or combination thereof.

2. DIRECT HOUSING FINANCE

2.1 Direct Housing Finance refers to the finance provided to individuals or groups of individuals including co-operative societies.

2.2 Banks are free to evolve their own guidelines with the approval of their Boards on aspects such as security, margin, age of dwelling units, repayment schedule, etc.

2.3 Other Guidelines

The following types of bank finance may be included under Direct Housing Finance:

- (i) Bank finance extended to a person who is already owning a house in town/village where he resides, for buying/ constructing a second house in the same or other town/ village for the purpose of self occupation.
- (ii) Bank finance extended for purchase of a house by a borrower who proposes to let it out on rental basis on account of his posting outside the headquarters or because he has been provided accommodation by his employer.
- (iii) Bank finance extended to a person who proposes to buy an old house where he is presently residing as a tenant.
- (iv) Bank finance granted only for purchase of a plot, provided a declaration is obtained from the borrower that he intends to construct a house on the said plot, with the help of bank finance or otherwise, within such period as may be laid down by the banks themselves
- (v) Supplementary finance
 - (a) Banks may consider requests for additional finance within the overall ceiling for carrying out alterations/ additions/repairs to the house/flat already financed by them.
 - (b) In the case of individuals who might have raised funds for construction/ acquisition of accommodation from other sources and need supplementary finance, banks may extend such finance after obtaining *pari passu* or second mortgage charge over the property mortgaged in favour of other lenders and/or against such other security, as they may deem appropriate.

3. INDIRECT HOUSING FINANCE

3.1 General

Banks should ensure that their indirect housing finance is channeled by way of term loans to housing finance institutions, housing boards, other public housing agencies, etc., primarily for augmenting the supply of serviced land and constructed units. It should also be ensured that the supply of plots/houses is time bound and public agencies do

not utilise the bank loans merely for acquisition of land. Similarly, serviced plots should be sold by these agencies to co-operative societies, professional developers and individuals with a stipulation that the houses should be constructed thereon within a reasonable time, not exceeding three years. For this purpose, the banks may take advantage of various guidelines issued by NHB for augmenting the supply of serviced land and constructed units.

3.2 Lending to Housing Intermediary Agencies

3.2.1 Lending to Housing Finance Institutions

- (i) Banks may grant term loans to housing finance institutions taking into account (long-term) debt-equity ratio, track record, recovery performance and other relevant factors.
- (ii) In terms of NHB guidelines, housing finance companies' total borrowings, whether by way of deposits, issue of debentures/ bonds, loans and advances from banks or from financial institutions including any loans obtained from NHB, should not exceed 16 times of their net owned funds (i.e. paid-up capital and free reserves less accumulated balance of loss, deferred revenue expenditure and intangible assets).
- (iii) All housing finance companies registered with NHB are eligible to apply for refinance from NHB and will be eligible subject to the refinance policy. The quantum of term loan to be sanctioned to them will not be linked to net owned fund as NHB has already prescribed the above referred ceiling on total borrowing of housing finance companies. A list of housing finance companies registered with NHB may be obtained by the banks directly from NHB or download from www.nhb.org.in.

3.2.2 Lending to Housing Boards and Other Agencies

Banks may extend term loans to state level housing boards and other public agencies. However, in order to develop a healthy housing finance system, while doing so, the banks must not only keep in view the past performance of these agencies in the matter of recovery from the beneficiaries but they should also stipulate that the Boards will ensure prompt and regular recovery of loan installments from the beneficiaries.

3.2.3 Financing of Land Acquisition

In view of the need to increase the availability of land and house sites for increasing the housing stock in the country, banks may extend finance to public agencies and not private builders for acquisition and development of land, provided it is a part of the complete project, including development of infrastructure such as water systems, drainage, roads, provision of electricity, etc. Such credit may be extended by way of term loans. The project should be completed as early as possible and, in any case, within three years, so as to ensure quick re-cycling of bank funds for optimum results. If the project covers construction of houses, credit extended therefor in respect of individual beneficiaries should be on the same terms and conditions as stipulated for direct finance.

3.2.4 Terms and Conditions for Lending to Housing Intermediary Agencies

- (i) In order to enhance the flow of resources to housing sector, term loans may be granted by banks to housing intermediary agencies against the direct loans sanctioned/ proposed to be sanctioned by the latter, irrespective of the per borrower size of the loan extended by these agencies and such term loans would be reckoned for the purpose of achievement of their housing finance allocation.
- (ii) Banks can grant term loans to housing intermediary agencies against the direct loans sanctioned/proposed to be sanctioned by them to Non-Resident Indians also. However, banks should ensure that housing finance intermediary agencies being financed by them, are authorised by RBI to grant housing loans to NRIs as all housing finance intermediaries are not authorised by RBI to provide housing finance to NRIs. Further, such finance granted by banks to housing finance intermediary agencies against the latter's on-lending to NRIs will not be treated as housing finance for the purpose of scheme of yearly allocation of housing finance applicable to banks.
- (iii) Banks have freedom to charge interest rates to housing intermediary agencies without reference to Benchmark Prime Lending Rates (BPLR)

3.3 Term Loans to Private Builders

3.3.1 In view of the important role played by professional builders as providers of construction services in the housing field, especially where land is acquired and developed by State Housing Boards and other public agencies, commercial banks may extend credit to private builders on commercial terms by way of loans linked to each

specific project. However, the banks are not permitted to extend fund based or non-fund based facilities to private builders for acquisition of land even as part of a housing project. The period of credit for loans extended by banks to private builders may be decided by banks themselves based on their commercial judgement subject to usual safeguards and after obtaining such security, as banks may deem appropriate. Such credit may be extended to builders of repute, employing professionally qualified personnel. It should be ensured, through close monitoring, that no part of such funds is used for any speculation in land.

Care should also be taken to see that prices charged from the ultimate beneficiaries do not include any speculative element, that is, prices should be based only on the documented price of land, the actual cost of construction and a reasonable profit margin.

3.3.2 It is advised that banks adhere to the National Building Code (NBC) formulated by the Bureau of Indian Standards (BIS) in view of the importance of safety of buildings especially against natural disasters. Banks' may consider this aspect for incorporation in their loan policies.

4. HOUSING LOANS UNDER PRIORITY SECTOR

Banks may refer to the Master Circular on Lending to Priority Sectors issued by Rural Planning and Credit Department.

5. RBI REFINANCE

Finance provided by the banks would not be eligible for refinance from Reserve Bank.

6. CONSTRUCTION ACTIVITIES ELIGIBLE FOR BANK CREDIT AS FINANCE

The following types of bank credit will be eligible for being treated as housing finance.

- (i) Loans to individuals for purchase/construction of dwelling unit per family and loans given for repairs to the damaged dwelling units of families
- (ii) Finance provided for construction of residential houses to be constructed by public housing agencies like HUDCO, Housing Boards, local bodies, individuals, co-operative societies, employers, priority being accorded for financing construction of houses meant for economically weaker sections, low income group and middle income group.
- (iii) Finance for construction of educational, health, social, cultural or other institutions/centers, which are part of a housing project and which are necessary for the development of settlements or townships;

- (iv) Finance for shopping complexes, markets and such other centers catering to the day to day needs of the residents of the housing colonies and forming part of a housing project and
- (v) Finance for construction meant for improving the conditions in slum areas for which credit may be extended directly to the slum-dwellers on the guarantee of the Government, or indirectly to them through the State Governments.
- (vi) Bank credit given for slum improvement schemes to be implemented by Slum Clearance Boards and other public agencies;
- (vii) Finance provided to –
 - (a) the bodies constituted for undertaking repairs to houses, and
 - (b) the owners of building/house/flat, whether occupied by themselves or by tenants, to meet the need-based requirements for their repairs/additions, after satisfying themselves regarding the estimated cost (for which requisite certificate should be obtained from an Engineer/Architect, wherever necessary) and obtaining such security as deemed appropriate;
- (viii) Housing finance provided by banks for which refinance is availed of from National Housing Bank (NHB);
- (ix) Investment in the guarantee/non-guaranteed bonds and debentures of NHB/HUDCO in the primary market, provided investment in non-guaranteed bonds is made only if guaranteed bonds are not available.

7. CONSTRUCTION ACTIVITIES NOT ELIGIBLE FOR BANK CREDIT

7.1 Banks should not grant finance for construction of buildings meant purely for Government/Semi-Government offices, including Municipal and Panchayat offices. However, banks may grant loans for activities, which will be refinanced by institutions like NABARD.

7.2 Projects undertaken by public sector entities which are not corporate bodies (i.e. public sector undertakings which are not registered under Companies Act or which are not Corporations established under the relevant statute) may not be financed by banks. Even in respect of projects undertaken by corporate bodies, as defined above, banks should satisfy themselves that the project is run on commercial lines and that bank finance is not in lieu of or to substitute budgetary resources envisaged for the project. The loan could, however, supplement budgetary resources if such supplementing was contemplated in the project design. Thus, in the case of a housing project, where the

project is run on commercial lines, and the Government is interested in promoting the project either for the benefit of the weaker sections of the society or otherwise, and a part of the project cost is met by the Government through subsidies made available and/or contributions to the capital of the institutions taking up the project, the bank finance should be restricted to an amount arrived at after reducing from the total project cost the amount of subsidy/capital contribution receivable from the Government and any other resources proposed to be made available by the Government.

7.3 Banks had, in the past, sanctioned term loans to Corporations set up by Government like State Police Housing Corporation, for construction of residential quarters for allotment to employees where the loans were envisaged to be repaid out of budgetary allocations. As these projects cannot be considered to be run on commercial lines, it would not be in order for banks to grant loans to such projects.

8. REPORTING

Banks should compile the data relating to Housing Finance at half-yearly intervals on the lines of format given in Annex and keep it ready for being made available to the bank's internal inspectors/RBI's inspectors.

9. HOME LOAN ACCOUNT SCHEME (HLAS) OF NHB

9.1 Foreclosure of Loans obtained from Other Sources

9.1.1 Under the HLAS, a member of HLAS is eligible for a loan after subscription to the scheme for a minimum period of 5 years. The member has to declare while joining the scheme/availing loan that he/ she does not own a house/flat. However, a member may acquire a house or a flat from a public agency/co-operative/ private builder by obtaining a loan from a bank at the normal rate of interest or from friends and relatives or through a hire-purchase scheme of Housing Board/ Development Authority. Thereafter, when the member becomes eligible for a loan under HLAS, he/she may approach the bank for such a loan to repay the loan(s) raised earlier from other sources.

9.1.2 There is no objection to bank loans under HLAS being utilised for foreclosing loans secured earlier from other sources, as a special case.

9.2 Classification of Deposits/Loans under HLAS

Under HLAS, the participating bank is required to accept deposits on behalf of NHB and make use of these deposits by way of refinance under any scheme approved by NHB from time to time. The surplus funds, if any, not so utilised (i.e. excess of deposits over refinance) can either be remitted by the participating bank to NHB or retained by it, subject to compliance with the statutory reserve requirements as under:

- (i) The deposits under the HLA Scheme are on a recurring basis; and they should be treated as ‘time’ liabilities, subject to reserve requirements under Section 42(1) of the Reserve Bank of India Act, 1934 as also under Section 24 of the Banking Regulation Act, 1949 and included under item II (a) (ii) of Form ‘A’.
- (ii) In terms of sub-clause (ii) of clause (c) of the Explanation to Sub-Section (1) of Section 42 of the RBI Act, as amended by clause 3 of the Second Schedule to the National Housing Bank Act, 1987, ‘liabilities’ will not include any loan taken from NHB. Hence, the deposits utilised as refinance from NHB should be deducted from the total deposits received under the HLA Scheme while including the amount under item II (a) (ii) of Form ‘A’.

10. BANK'S EXPOSURE TO REAL ESTATE SECTOR

While the development of real estate is welcome, there is a need for the banks to curb the excessively risk lending by exercising selectivity and strengthening the loan approval process. Banks should ensure that the borrowers should have obtained prior permission from government./local governments./other statutory authorities for the project, wherever required. While the proposals could be sanctioned in normal course, the disbursements should be made only after the borrower has obtained requisite clearances from the government authorities.

11. RISK WEIGHT ON HOUSING FINANCE

Banks extending housing loans to individuals against the mortgage of residential housing properties were required to assign risk weight of 75% on such loans which were fully secured by mortgage of residential properties and investments in Mortgage Backed Securities (MBS) of Housing Finance Companies (HFCs), recognized and supervised by NHB. In view of the fact that banks have been advised from time to time to tighten their credit administration in this area in particular it has been decided to reduce the risk weight on the residential housing loans to individuals from the existing 75% to 50% as given below :

LTV Ratio	Sanctioned Amount of loan	Risk weight
LTV Ratio = or < 75%	Up to Rs. 30.00 lakh	50%
LTV Ratio = or < 75%	Above Rs. 30.00 lakh	75%
LTV Ratio > 75%	Irrespective of the amount	100% (unchanged)

Similarly, the risk weight for banks' investment in mortgage backed securities, which are backed by housing loans which would now qualify for 50% risk weight, and are issued by the housing finance companies regulated by the National Housing Banks is also reduced from 75% to 50%. In all other cases, it will be 100%. However the risk weight for

commercial real estate exposure has been raised to 125% on July 26, 2005 and further to 150% on May 25, 2006.

12. DELHI HIGH COURT ORDER ON UNAUTHORISED CONSTRUCTION

The Monitoring Committee constituted by the Hon'ble High Court of Delhi regarding Unauthorised Construction, Misuse of Properties and Encroachment on Public Land, has issued the following directions for immediate compliance by the banks/ Financial Institutions.

A. Housing Loan for building construction

- i) In cases where the applicant owns a plot/land and approaches the banks/FIs for a credit facility to construct a house, a copy of the plan sanctioned by the competent authority in the name of a person applying for such credit facility must be obtained by the Banks/FIs before sanctioning the home loan.
- ii) An affidavit-cum-undertaking must be obtained from the person applying for such credit facility that he shall not violate the sanctioned plan, construction shall be strictly as per the sanctioned plan and it shall be the sole responsibility of the executant to obtain completion certificate within 3 months of completion of construction, failing which the bank shall have the power and the authority to recall the entire loan with interest, costs and other usual bank charges.
- iii) An Architect appointed by the bank must also certify at various stages of construction of building that the construction of the building is strictly as per sanctioned plan and shall also certify at a particular point of time that the completion certificate of the building issued by the competent authority has been obtained.

B. Housing Loan of purchase of constructed property/ built up property

- i) In cases where the applicant approaches the bank/FIs for a credit facility to purchase the built up house/flat, it should be mandatory for him to declare by way of an affidavit-cum-undertaking that the built up property has been constructed as per the sanctioned plan and/or building bye-laws and as far as possible has a completion certificate also.
- ii) An Architect appointed by the bank must also certify before disbursement of the loan that the built up property is strictly as per sanctioned plan and/or building bye-laws.

C. Unauthorised colonies

No loan should be given in respect of those properties which fall in the category of unauthorized colonies unless and until they have been regularized and development and other charges paid.

D. Commercial Property

No loan should also be given in respect of properties meant for residential use but which the applicant intends to use for commercial purposes and declares so while applying for loan.

13. TERMS AND CONDITIONS FOR BANKS' INVESTMENT IN MORTGAGE BACKED SECURITIES (MBS)

13.1 Banks' investments in MBS should satisfy the following terms and conditions:

- (i) The right, title, and interest of an HFC in securitised housing loans and receivables there under should irrevocably be assigned in favour of a Special Purpose Vehicle (SPV) / Trust.
- (ii) Mortgaged securities underlying the securitised housing loans should be held exclusively on behalf of and for the benefit of the investors by the SPV/Trust.
- (iii) The SPV or Trust should be entitled to the receivables under the securitised loans with an arrangement for distribution of the same to the investors as per the terms of the issue of MBS. Such an arrangement may provide for appointment of the originating HFC as the servicing and paying agent. However, the originating HFC participating in a securitisation transaction as a seller, manager, servicer or provider of credit enhancement of liquidity facilities.
 - (a) shall not own any share capital in the SPV or be the beneficiary of the Trust used as a vehicle for the purchase and securitisation of assets. Share capital for this purpose shall include all classes of common and preferred share capital,
 - (b) shall not name the SPV in such manner as to imply any connection with the bank,
 - (c) shall not have any directors, officers, or employees on the board of the SPV unless the board is made of at least three members and where there is a majority of independent directors. In addition, the official (s) representing the bank will not have veto powers,
 - (d) shall not directly or indirectly control the SPV, or

- (e) shall not support any losses arising from the securitisation transaction or by investors involved in it or bear any of the recurring expenses of the transaction.
- (iv) The loans to be securitised should be loans advanced to individuals for acquiring /constructing residential houses which should have been mortgaged to the HFC by way of exclusive first charge.
- (v) The loans to be securitised should be accorded an investment grade credit rating by any of the credit rating agencies at the time of assignment to the SPV.
- (vi) The investors should be entitled to call upon the issuer-SPV-to take steps for recovery in the event of default and distribute the net proceeds to the investors as per the terms of issue of MBS.
- (vii) The SPV undertaking the issue of MBS should not be engaged in any business other than the business of issue and administration of MBS of individual housing loans.
- (viii) The SPV or Trustees appointed to manage the issue of MBS should have to be governed by the provisions of Indian Trust Act, 1882.

13.2 If the issue of MBS is in accordance with the terms and conditions stated in above paragraph and includes irrevocable transfer of risk and reward of housing loan assets to the Special Purpose Vehicle (SPV) / Trust, investment in such MBS by any bank would not be reckoned as an exposure on the HFC originating the securitised housing loan. However, it would be treated as an exposure on the underlying assets of the SPV/ Trust.

[illegible]

[illegible]

II. LENDING THROUGH AGENCIES/INSTITUTIONS (INDIRECT LENDING)

		Disbursed during half-year		Outstanding at the end of half-year	
No.	Item	No.of A/cs.	Amount	No.of A/cs.	Amount
1.	2.	3.	4.	5.	6.
20.	Total (21+22+23+24+25+26)				
21.	HUDCO				
22.	State Housing Boards				
23.	Other State-level Agencies				
24.	Housing Finance Institutions (other than HDFC)				
25.	HDFC				
26.	Others				
	Of which for SC/ST				
30.	Total (31+32+33+34+35+36)				
31.	HUDCO				
32.	State Housing Boards				
33.	Other State-level Agencies				
34.	Housing Finance Institutions(other than HDFC)				
35.	HDFC				
36.	Others				
40.	Sub-Total(10+20)				
41.	Sub-Total(11+13+30)				

III. INVESTMENTS IN BONDS/DEBENTURES

No.	Item	Disbursed during half-year		Outstanding at the end of half-year	
		No.of A/cs.	Amount	No. of A/cs.	Amount
1.	2.	3.	4.	5.	6.
50.	Total (60+70+80+90)	X		X	
	Guaranteed Bonds/Debentures	X	X	X	X
60.	National Housing Bank	X		X	
70.	HUDCO	X		X	
	Other Bonds (i.e. not carrying any guarantee)	X	X	X	X
80.	National Housing Bank	X		X	
90.	HUDCO	X		X	
100.	Grand Total (40+50)				

Instructions for Compiling the Statement

1. This statement should invariably be prepared horizontally on paper of foolscap (32 cms x 21 cms), to facilitate computerised processing of the data. Further, the column numbers and item numbers should not be changed.
2. Data in Blocks I & II should be furnished for all-India and each State/Union Territory separately and in Block III for all-India only.
3. Amounts shown in Block I should be inclusive of housing loans in respect of which refinance from the National Housing Bank has been drawn.
4. Housing loans to banks' own employees should not be classified under the category 'Housing Finance' and should also not be included in this statement.
5. Loans to co-operative housing societies should be included under items 11 & 13 in Block I, only if the number of SC/ST members is more than 50% of the total membership.
6. Rural - Places with population upto 10,000
Semi urban - Places with population over 10,000 and upto 1,00,000
7. 'Other State-level Agencies' at items 23 & 33 include, for example, rural/urban housing corporations, slum clearance boards, etc.
8. 'Others' at items 26 & 36 include city improvement trusts, city development authorities, local bodies, construction companies/builders, land developers, etc.

Appendix

Master circular HOUSING FINANCE List of Circulars consolidated in the Master Circular

No.	Circular No.	Date	Subject
1	DBOD.BP.BC.83/ 21.06.001/ 2007-08	14.05.08	Risk weight on Residential Housing Loans
2	DBOD.Dir.(Hsg.)No.27/ 08.12.01/2007-08	22.08.07	Discontinuance of quarterly statement on housing finance disbursements
3	DBOD.BP.BC.02/ 08.12..01/ 2007-08	02.07.07	Master Circular on Housing Finance
4	DBOD.BP.BC.92/ 21.01.002/ 2006-07	03.05.07	Risk weight on Residential Housing Loans
5	DBOD.Dir.BC.No.43/ 21.01.002/2006-07	17.11.06	Housing Loans- Orders of the Delhi High Court – Writ Petition by Kalyan Sanstha Welfare Organisation against Union of India and Others – Implementation of Directions
6	DBOD.BP.BC.1711/08.12.1 4/2005-06	12.06.06	Adherence to National Building Code (NBC) Specifications necessary for lending institutes
7	DBOD.BP.BC.84/21.01. 002/ 2005-06	25.5.06	Risk weight on Exposures to Commercial Real Estate
8	DBOD. No.BP.BC.65/ /08.12.01/2005-06	01.3.06	Banks' Exposures to Real Estate Sector
9	DBOD.BP.BC.20/21.01. 002/ 2005-06	26.7.05	Risk weight on Exposures to Commercial Real Estate
10	DBOD.BP.BC.61/ 21.01.002/ 2004-05	23.12.04	Mid-Term Review of the Annual Policy Statement for the year 2004-05-Risk Weight on housing loans and consumer credit
11	RPCD. No. Plan. BC. 64/ 04.09.01/ 2004-05	15.12.04	Priority Sector Lending- Investment in special bonds issued by specified institutions
12	RPCD.PLNFS.BC.No. 44/ 06.11.01/ 2004-05	26.10.04	Priority Sector Lending-Housing Loan: Enhancement of Ceiling
13	DBOD(IECS).No.4/ 03.27.25/ 2004-05	03.07.04	Freedom granted to banks to lay down the period within which the borrowers are required to construct the house on the plot purchased
14	IECD. No. 14/ 01.01.43/ 2003-04	30.06.04	Merger of functions of IECD with other departments
15	RPCD. No. PLNFS. BC. 92/ 06.11.01/ 2002-03	29.04.03	Priority Sector Advances – Loans for Housing
16	RPCD.No.PLNFS.BC. 30/06.11.01/ 2002-03	29.10.02	Priority Sector Advances-Repairs to damaged houses in Rural and other areas
17	DBOD.No.BP.BC.106/ 21.01.002/ 2001-02	14.05.02	Risk Weight on Housing Finance and Mortgage Backed Securities
18	IECD.No.(HF)5/03:27:25/ 99-2000	29.10.99	Housing Finance – Modification in Loan Size
19	IECD.No.(HF)12/ 03.27.25/98-99	15.01.99	Terms and Conditions Governing Direct Finance for Purchase of Old House

20	IECD.No.(HF) 40/03.27.25/97-98	16.04.98	Terms and Conditions Governing Direct Housing Loans - Review of Parameters
21	IECD.No.HF.37/ 03.27.25/97-98	27.02.98	Submission of Half-yearly Housing Finance Statements – Discontinuance
22	IECD.No.HF. 22/03.27.25/97-98	06.12.97	Housing Finance – Modification in Loan Size
23	RPCD. No. PLNFS. BC. 37/ 06.11.01/ 97-98	21.10.97	Priority Sector Advances- Loans for Housing
24	IECD.No.5/03.27.25/97-98	30.08.97	Quantum of Bank Finance to Housing Finance Companies Entitled to Draw Refinance from National Housing Bank (NHB)
25	IECD.No.CMD. 8/03:27:25/95-96	27.09.95	Sanction of Term Loans for Housing Projects Involving Budgetary Support from Government - Non-Permissibility of
26	IECD.No.1/03.27.25/94-95	11.07.94	Direct Housing Finance
27	DBOD.No.BP.BC.88/60-90	05.04.90	Home Loan Account Scheme (HLAS) of National Housing Bank - Foreclosure of Loans Obtained from Other Sources
28	IECD.No.CMD.IV. 24/HF(P)- 89/90	30.03.90	Housing Finance
29	DBOD.No.BP.1074/BP.60- 90	23.03.90	Housing Finance - Designation of Specific Branches
30	DBOD.No.BP.1022/BP.60- 90	15.03.90	Housing Finance - Designation of Specific Branches
31	DBOD. No. Ret.BC. 75/ C.96-90	13.02.90	The Reserve Bank of India Scheduled Banks Regulation, 1951- Classification of Deposits Accepted under the Home Loan Account Scheme of the National Housing Bank
32	IECD.No.CAD.IV. 223/(HF- P)- 88/89	02.11.88	Housing Finance – Modifications on the basis of the recommendations of the Study Group on Housing Finance Institutions
33	DBOD.No.CAS.BC. 70/C.446(HF-P)-81	05.06.81	Housing Finance - Revised Guidelines (General)
34	DBOD.No.CAS.BC.71/ C.446(HF-P)-79	31.05.79	Housing Finance - Recommendations of the Working Group to Examine the Role of Banking System in Providing Finance for Housing Scheme



HOUSING FINANCE

(updated upto June 30, 2008)



**Department of Banking Operations and
Development
Reserve Bank of India
Central Office
Mumbai**

RBI/ 2008-09/72
DBOD. AML. BC. No. 12 /14 .01.001/2008-09

July 1, 2008

The Chairman/CEOs of all Scheduled Commercial Banks (Excluding RRBs) /
all Financial Institutions

Dear Sir,

Master Circular – Know Your Customer (KYC) norms /
Anti-Money Laundering (AML) standards/
Combating of Financing of Terrorism (CFT)/Obligation of banks under PMLA, 2002

Reserve Bank of India has issued regulatory guidelines on Know Your Customer (KYC) norms / Anti Money Laundering (AML) Standards / Combating of Financing of Terrorism (CFT) from time to time. This Master Circular consolidates all the guidelines issued by Reserve Bank of India on KYC/AML/CFT norms up to June 30, 2008.

2. This Master Circular has been placed on the RBI website (<http://www.rbi.org.in>).

Yours faithfully,

(Vinay Baijal)
Chief General Manager



Know Your Customer(KYC) norms/Anti Money Laundering (AML) Standards/Combating of Financing of Terrorism/Obligations of Banks under Prevention of Money Laundering Act, (PMLA), 2002

(Updated upto June 30, 2008)

Department of Banking Operations and Development



**RESERVE BANK OF INDIA
Central Office
Mumbai**

The Master Circular can also be viewed and be downloaded from RBI Website

www.rbi.org.in

Master Circular on Know Your Customer (KYC) norms/Anti-Money Laundering (AML) standards/Combating of Financing of Terrorism (CFT)/Obligation of banks under Prevention of Money Laundering Act, (PMLA), 2002

Purpose

Banks were advised to follow certain customer identification procedure for opening of accounts and monitoring transactions of a suspicious nature for the purpose of reporting it to appropriate authority. These 'Know Your Customer' guidelines have been revisited in the context of the Recommendations made by the Financial Action Task Force (FATF) on Anti Money Laundering (AML) standards and on Combating Financing of Terrorism (CFT). Detailed guidelines based on the Recommendations of the Financial Action Task Force and the paper issued on Customer Due Diligence (CDD) for banks by the Basel Committee on Banking Supervision, with indicative suggestions wherever considered necessary, have been issued. Banks have been advised to ensure that a proper policy framework on 'Know Your Customer' and Anti-Money Laundering measures with the approval of the Board is formulated and put in place.

2. This Master Circular aims at consolidating all the instructions/guidelines issued by RBI on Know Your Customer (KYC) norms/Anti-Money Laundering (AML) standards. The Master Circular has been placed on the RBI website (<http://www.rbi.org.in>).

Previous instructions

A list of circulars issued in this regard is given in Annex – III.

Application

i) The instructions, contained in the master circular, are applicable to all Financial Institutions and all the scheduled commercial banks excluding RRBs. The said guidelines shall also apply to the branches and majority owned subsidiaries located abroad, especially, in countries which do not or insufficiently apply the FATF Recommendations, to the extent local laws permit. When local applicable laws and regulations prohibit implementation of these guidelines, the same should be brought to the notice of Reserve Bank. In case there is a variance in KYC/AML standards prescribed by the Reserve Bank and the host country regulators, branches/overseas subsidiaries of banks are required to adopt the more stringent regulation of the two.

ii) These guidelines are issued under Section 35A of the Banking Regulation Act, 1949 and Rule 7 of Prevention of Money-Laundering (Maintenance of Records of the Nature and Value of Transactions, the Procedure and Manner of Maintaining and Time for Furnishing Information and Verification and Maintenance of Records of the Identity of the Clients of the Banking Companies, Financial Institutions and Intermediaries) Rules, 2005. Any contravention thereof or non-compliance shall attract penalties under Banking Regulation Act.

iii) This Master Circular consolidates all the circulars issued on the subject up to June 30, 2008.

Structure

1. Introduction

1.1 KYC/AML/CFT

1.2 Definition of Customer

2. Guidelines

2.1 General

2.2 KYC Policy

2.3 Customer Acceptance Policy

2.4 Customer Identification Procedure

2.5 Customer Identification Requirements – Indicative guidelines

2.6 KYC guidelines for small deposit accounts

2.7 Monitoring of transactions

2.8 Closure of Accounts

2.9 Risk Management

2.10 Introduction of new technology – credit/debit/smart/gift cards

2.11 Combating Financing of Terrorism

2.12 Correspondent Banking

2.13 Wire Transfers

2.14 Principal Officer

2.15 Maintenance of records of transactions/Information to be preserved/ Maintenance and preservation of records/Cash and Suspicious transactions reporting to Financial Intelligence Unit-India (FIU-IND)

2.16 Cash and Suspicious Transaction Report

2.17 Customer Education/ Training of Employees /Hiring of Employees

3. Annex

3.1 Annex - I - Indicative List of documents required for opening of accounts

3.2 Annex – II – List of reporting formats

3.3 Annex – III – List of circulars superseded by the Master Circular

1 Introduction

1.1 Know Your Customer (KYC)/Anti-Money Laundering (AML) / Combating of Financing of Terrorism (CFT)

The objective of KYC/AML/CFT guidelines is to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. KYC procedures also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently.

1.2 Definition of Customer

For the purpose of KYC policy, a 'Customer' is defined as :

- a person or entity that maintains an account and/or has a business relationship with the bank;
- one on whose behalf the account is maintained (i.e. the beneficial owner);
- beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and
- any person or entity connected with a financial transaction which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

2. Guidelines

2.1 General

i) Banks should keep in mind that the information collected from the customer for the purpose of opening of account is to be treated as confidential and details thereof are not to be divulged for cross selling or any other like purposes. Banks should, therefore, ensure that information sought from the customer is relevant to the perceived risk, is not intrusive, and is in conformity with the guidelines issued in this regard. Any other information from the customer should be sought separately with his/her consent and after opening the account.

ii) Banks should ensure that any remittance of funds by way of demand draft, mail/telegraphic transfer or any other mode and issue of travellers' cheques for value of Rupees fifty thousand and above is effected by debit to the customer's account or against cheques and not against cash payment.

iii) Banks should ensure that the provisions of Foreign Contribution (Regulation) Act, 1976, as amended from time to time, wherever applicable are strictly adhered to.

2.2 KYC Policy

Banks should frame their KYC policies incorporating the following four key elements:

- a) Customer Acceptance Policy;
- b) Customer Identification Procedures;
- c) Monitoring of Transactions; and
- d) Risk Management.

2.3 Customer Acceptance Policy (CAP)

a) Every bank should develop a clear Customer Acceptance Policy laying down explicit criteria for acceptance of customers. The Customer Acceptance Policy must ensure that explicit guidelines are in place on the following aspects of customer relationship in the bank.

- (i) No account is opened in anonymous or fictitious/ benami name(s);

- (ii) Parameters of risk perception are clearly defined in terms of the nature of business activity, location of customer and his clients, mode of payments, volume of turnover, social and financial status etc. to enable categorisation of customers into low, medium and high risk (banks may choose any suitable nomenclature viz. level I, level II and level III). Customers requiring very high level of monitoring, e.g. Politically Exposed Persons (PEPs) may, if considered necessary, be categorised even higher;
- (iii) Documentation requirements and other information to be collected in respect of different categories of customers depending on perceived risk and keeping in mind the requirements of PML Act, 2002 and instructions/guidelines issued by Reserve Bank from time to time;
- (iv) Not to open an account or close an existing account where the bank is unable to apply appropriate customer due diligence measures i.e. bank is unable to verify the identity and /or obtain documents required as per the risk categorisation due to non cooperation of the customer or non reliability of the data/information furnished to the bank. It is, however, necessary to have suitable built in safeguards to avoid harassment of the customer. For example, decision by a bank to close an account should be taken at a reasonably high level after giving due notice to the customer explaining the reasons for such a decision;
- (v) Circumstances, in which a customer is permitted to act on behalf of another person/entity, should be clearly spelt out in conformity with the established law and practice of banking as there could be occasions when an account is operated by a mandate holder or where an account is opened by an intermediary in fiduciary capacity and
- (vi) Necessary checks before opening a new account so as to ensure that the identity of the customer does not match with any person with known criminal background or with banned entities such as individual terrorists or terrorist organisations etc.

b) Banks should prepare a profile for each new customer based on risk categorisation. The customer profile may contain information relating to customer's identity, social/financial status, nature of business activity, information about his clients' business and their location etc. The nature and extent of due diligence will depend on the risk perceived by the bank. However, while preparing customer profile banks should take care to seek only such information from the customer, which is relevant to the risk category and is not intrusive. The customer profile is a confidential document and details contained therein should not be divulged for cross selling or any other purposes.

c) For the purpose of risk categorisation, individuals (other than High Net Worth) and entities whose identities and sources of wealth can be easily identified and transactions in whose accounts by and large conform to the known profile, may be categorised as low risk. Illustrative examples of low risk customers could be salaried employees whose salary structures are well defined, people belonging to lower economic strata of the society whose accounts show small balances and low turnover, Government Departments and Government owned companies, regulators and statutory bodies etc. In such cases, the policy may require that only the basic requirements of verifying the identity and location of the customer are to be met. Customers that are likely to pose a higher than average risk to the bank should be categorised as medium or high risk depending on customer's background, nature and location of activity, country of origin, sources of funds and his client profile etc. Banks should apply enhanced due diligence measures based on the risk assessment, thereby requiring intensive 'due diligence' for higher risk customers, especially those for whom the sources of funds are not clear. Examples of customers requiring higher due diligence include (a) non-resident customers; (b) high net worth individuals; (c) trusts, charities, NGOs and organizations receiving donations; (d) companies having close family shareholding or beneficial ownership; (e) firms with 'sleeping partners'; (f) politically exposed persons (PEPs) of foreign origin; (g) non-face to face customers and (h) those with dubious reputation as per public information available etc.

d) It is important to bear in mind that the adoption of customer acceptance policy and its implementation should not become too restrictive and must not result in denial of banking services to general public, especially to those, who are financially or socially disadvantaged.

2.4 Customer Identification Procedure (CIP)

a) The policy approved by the Board of banks should clearly spell out the Customer Identification Procedure to be carried out at different stages i.e. while establishing a banking relationship; carrying out a financial transaction or when the bank has a doubt about the authenticity/veracity or the adequacy of the previously obtained customer identification data. Customer identification means identifying the customer and verifying his/her identity by using reliable, independent source documents, data or information. Banks need to obtain sufficient information necessary to establish, to their satisfaction, the identity of each new customer, whether regular or occasional, and the purpose of the intended nature of banking relationship. Being satisfied means that the bank must be able to satisfy the competent authorities that due diligence was observed based on the risk profile of the customer in compliance with the extant guidelines in place. Such risk based approach is considered necessary to avoid disproportionate cost to banks and a burdensome regime for the customers. Besides risk perception, the nature of information/documents required would also depend on the type of customer (individual, corporate etc.). For customers that are natural persons, the banks should obtain sufficient identification data to verify the identity of the customer, his address/location, and also his recent photograph. For customers that are legal persons or entities, the bank should (i) verify the legal status of the legal person/entity through proper and relevant documents; (ii) verify that any person purporting to act on behalf of the legal person/entity is so authorised and identify and verify the identity of that person; (iii) understand the ownership and control structure of the customer and determine who are the natural persons who ultimately control the legal person. Customer identification requirements in respect of a few typical cases, especially, legal persons requiring an extra element of caution are given in paragraph 2.5 below for guidance of banks. Banks may, however, frame their own internal guidelines based on their experience of dealing with such persons/entities, normal bankers' prudence and the legal requirements as per established practices. If the bank decides to accept such accounts in terms of the Customer Acceptance Policy, the bank

should take reasonable measures to identify the beneficial owner(s) and verify his/her/their identity in a manner so that it is satisfied that it knows who the beneficial owner(s) is/are.

b) It has been observed that some close relatives, e.g. wife, son, daughter and parents etc. who live with their husband, father/mother and son, as the case may be, are finding it difficult to open account in some banks as the utility bills required for address verification are not in their name. It is clarified, that in such cases, 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 use any supplementary evidence such as a letter received through post for further verification of the address. While issuing operational instructions to the branches on the subject, banks should keep in mind the spirit of instructions issued by the Reserve Bank and avoid undue hardships to individuals who are, otherwise, classified as low risk customers.

c) Banks should introduce a system of periodical updation of customer identification data (including photograph/s) after the account is opened. The periodicity of such updation should not be less than once in five years in case of low risk category customers and not less than once in two years in case of high and medium risk categories.

d) An indicative list of the nature and type of documents/information that may be relied upon for customer identification is given in Annex-I to this Master Circular. It is clarified that permanent correct address, as referred to in Annex-I, means the address at which a person usually resides and can be taken as the address as mentioned in a utility bill or any other document accepted by the bank for verification of the address of the customer.

e) It has been brought to our notice that the said indicative list furnished in Annex – I, is being treated by some banks as an exhaustive list as a result of which a section of public is being denied access to banking services. Banks are, therefore, advised to take a review of their extant internal instructions in this regard.

2.5 Customer Identification Requirements – Indicative Guidelines

i) Trust/Nominee or Fiduciary Accounts

There exists the possibility that trust/nominee or fiduciary accounts can be used to circumvent the customer identification procedures. Banks should determine whether the customer is acting on behalf of another person as trustee/nominee or any other intermediary. If so, banks should insist on receipt of satisfactory evidence of the identity of the intermediaries and of the persons on whose behalf they are acting, as also obtain details of the nature of the trust or other arrangements in place. While opening an account for a trust, banks should take reasonable precautions to verify the identity of the trustees and the settlors of trust (including any person settling assets into the trust), grantors, protectors, beneficiaries and signatories. Beneficiaries should be identified when they are defined. In the case of a 'foundation', steps should be taken to verify the founder managers/ directors and the beneficiaries, if defined.

ii) Accounts of companies and firms

Banks need to be vigilant against business entities being used by individuals as a 'front' for maintaining accounts with banks. Banks should examine the control structure of the entity, determine the source of funds and identify the natural persons who have a controlling interest and who comprise the management. These requirements may be moderated according to the risk perception e.g. in the case of a public company it will not be necessary to identify all the shareholders.

iii) Client accounts opened by professional intermediaries

When the bank has knowledge or reason to believe that the client account opened by a professional intermediary is on behalf of a single client, that client must be identified. Banks may hold 'pooled' accounts managed by professional intermediaries on behalf of entities like mutual funds, pension funds or other types of funds. Banks also maintain 'pooled' accounts managed by lawyers/chartered accountants or stockbrokers for funds held 'on deposit' or 'in escrow' for a range of clients. Where funds held by the intermediaries are not co-mingled at the bank and there are 'sub-accounts', each of them attributable to a beneficial owner, all the

beneficial owners must be identified. Where such funds are co-mingled at the bank, the bank should still look through to the beneficial owners. Where the banks rely on the 'customer due diligence' (CDD) done by an intermediary, they should satisfy themselves that the intermediary is regulated and supervised and has adequate systems in place to comply with the KYC requirements. It should be understood that the ultimate responsibility for knowing the customer lies with the bank.

iv) Accounts of Politically Exposed Persons (PEPs) resident outside India

Politically exposed persons are individuals who are or have been entrusted with prominent public functions in a foreign country, e.g., Heads of States or of Governments, senior politicians, senior government/judicial/military officers, senior executives of state-owned corporations, important political party officials, etc. Banks should gather sufficient information on any person/customer of this category intending to establish a relationship and check all the information available on the person in the public domain. Banks should verify the identity of the person and seek information about the sources of funds before accepting the PEP as a customer. The decision to open an account for a PEP should be taken at a senior level which should be clearly spelt out in Customer Acceptance Policy. Banks should also subject such accounts to enhanced monitoring on an ongoing basis. The above norms may also be applied to the accounts of the family members or close relatives of PEPs.

v) Accounts of non-face-to-face customers

With the introduction of telephone and electronic banking, increasingly accounts are being opened by banks for customers without the need for the customer to visit the bank branch. In the case of non-face-to-face customers, apart from applying the usual customer identification procedures, there must be specific and adequate procedures to mitigate the higher risk involved. Certification of all the documents presented should be insisted upon and, if necessary, additional documents may be called for. In such cases, banks may also require the first payment to be effected through the customer's account with another bank which, in turn, adheres to similar KYC standards. In the case of cross-border customers, there is the additional difficulty of matching the customer with the documentation and the bank may have

to rely on third party certification/introduction. In such cases, it must be ensured that the third party is a regulated and supervised entity and has adequate KYC systems in place.

2.6 Small Deposit Accounts

(i) Although flexibility in the requirements of documents of identity and proof of address has been provided in the above mentioned KYC guidelines, it has been observed that a large number of persons, especially, those belonging to low income group both in urban and rural areas are not able to produce such documents to satisfy the bank about their identity and address. This would lead to their inability to access the banking services and result in their financial exclusion. Accordingly, the KYC procedure also provides for opening accounts for those persons who intend to keep balances not exceeding Rupees Fifty Thousand (Rs. 50,000/-) in all their accounts taken together and the total credit in all the accounts taken together is not expected to exceed Rupees One Lakh (Rs. 1,00,000/-) in a year. In such cases, if a person who wants to open an account and is not able to produce documents mentioned in Annex I of this master circular, banks should open an account for him, subject to:

Introduction from another account holder who has been subjected to full KYC procedure. The introducer's account with the bank should be at least six months old and should show satisfactory transactions. Photograph of the customer who proposes to open the account and also his address need to be certified by the introducer,

or

any other evidence as to the identity and address of the customer to the satisfaction of the bank.

ii) While opening accounts as described above, the customer should be made aware that if at any point of time, the balances in all his/her accounts with the bank (taken together) exceeds Rupees Fifty Thousand (Rs. 50,000/-) or total credit in the account exceeds Rupees One Lakh (Rs. 1,00,000/-) in a year, no further transactions will be permitted until the full KYC

procedure is completed. In order not to inconvenience the customer, the bank must notify the customer when the balance reaches Rupees Forty Thousand (Rs. 40,000/-) or the total credit in a year reaches Rupees Eighty thousand (Rs. 80,000/-) that appropriate documents for conducting the KYC must be submitted otherwise operations in the account will be stopped.

2.7 Monitoring of Transactions

Ongoing monitoring is an essential element of effective KYC procedures. Banks can effectively control and reduce their risk only if they have an understanding of the normal and reasonable activity of the customer so that they have the means of identifying transactions that fall outside the regular pattern of activity. However, the extent of monitoring will depend on the risk sensitivity of the account. Banks should pay special attention to all complex, unusually large transactions and all unusual patterns which have no apparent economic or visible lawful purpose. Banks may prescribe threshold limits for a particular category of accounts and pay particular attention to the transactions which exceed these limits. Transactions that involve large amounts of cash inconsistent with the normal and expected activity of the customer should particularly attract the attention of the bank. Very high account turnover inconsistent with the size of the balance maintained may indicate that funds are being 'washed' through the account. High-risk accounts have to be subjected to intensified monitoring. Every bank should set key indicators for such accounts, taking note of the background of the customer, such as the country of origin, sources of funds, the type of transactions involved and other risk factors. Banks should put in place a system of periodical review of risk categorization of accounts and the need for applying enhanced due diligence measures. Such review of risk categorisation of customers should be carried out at a periodicity of **not less** than once in six months.

2.8 Closure of accounts

Where the bank is unable to apply appropriate KYC measures due to non-furnishing of information and /or non-cooperation by the customer, the bank should consider closing the account or terminating the banking/business relationship after issuing due notice to the customer explaining the reasons for taking such a decision. Such decisions need to be taken at a reasonably senior level.

2.9 Risk Management

a) The Board of Directors of the bank should ensure that an effective KYC programme is put in place by establishing appropriate procedures and ensuring their effective implementation. It should cover proper management oversight, systems and controls, segregation of duties, training and other related matters. Responsibility should be explicitly allocated within the bank for ensuring that the bank's policies and procedures are implemented effectively. Banks should, in consultation with their boards, devise procedures for creating risk profiles of their existing and new customers and apply various anti money laundering measures keeping in view the risks involved in a transaction, account or banking/business relationship.

b) Banks' internal audit and compliance functions have an important role in evaluating and ensuring adherence to the KYC policies and procedures. As a general rule, the compliance function should provide an independent evaluation of the bank's own policies and procedures, including legal and regulatory requirements. Banks should ensure that their audit machinery is staffed adequately with individuals who are well-versed in such policies and procedures. Concurrent/ Internal Auditors should specifically check and verify the application of KYC procedures at the branches and comment on the lapses observed in this regard. The compliance in this regard should be put up before the Audit Committee of the Board on quarterly intervals.

2.10 Introduction of New Technologies – Credit cards/debit cards/ smart cards/gift cards

Banks should pay special attention to any money laundering threats that may arise from new or developing technologies including internet banking that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes. Many banks are engaged in the business of issuing a variety of Electronic Cards that are used by customers for buying goods and services, drawing cash from ATMs, and can be used for electronic transfer of funds. Further, marketing of these cards is generally done through the services of agents. Banks should ensure that appropriate KYC procedures are duly applied before issuing the cards to the customers. It is also desirable that agents are also subjected to KYC measures.

2.11 Combating financing of terrorism

a) In terms of PMLA Rules, suspicious transaction should include *inter alia* transactions which give rise to a reasonable ground of suspicion that these may involve financing of the activities relating to terrorism. Banks are, therefore, advised to develop suitable mechanism through appropriate policy framework for enhanced monitoring of accounts suspected of having terrorist links and swift identification of the transactions and making suitable reports to the Financial Intelligence Unit – India (FIU-IND) on priority.

b) As and when list of individuals and entities, approved by Security Council Committee established pursuant to various United Nations' Security Council Resolutions (UNSCRs), are received from Government of India, Reserve Bank circulates these to all banks and financial institutions. Banks/Financial Institutions should ensure to update the consolidated list of individuals and entities as circulated by Reserve Bank. Further, the updated list of such individuals/entities can be accessed in the United Nations website at <http://www.un.org/sc/committees/1267/consolist.shtml>. Banks are advised that before opening any new account it should be ensured that the name/s of the proposed customer does not appear in the list. Further, 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 RBI and FIU-IND.

2.12 Correspondent Banking

a) Correspondent banking is the provision of banking services by one bank (the “correspondent bank”) to another bank (the “respondent bank”). These services may include cash/funds management, international wire transfers, drawing arrangements for demand drafts and mail transfers, payable-through-accounts, cheques clearing etc. Banks should gather sufficient information to understand fully the nature of the business of the correspondent/respondent bank. Information on the other bank’s management, major business activities, level of AML/CFT compliance, purpose of opening the account, identity of any third party entities that will use the correspondent banking services, and regulatory/supervisory framework in the correspondent’s/respondent’s country may be of special relevance. Similarly, banks should try to ascertain from publicly available information whether the other bank has been subject to any money laundering or terrorist financing investigation or regulatory action. While it is desirable that such relationships should be established only with the approval of the Board, in case the Boards of some banks wish to delegate the power to an administrative authority, they may delegate the power to a committee headed by the Chairman/CEO of the bank while laying down clear parameters for approving such relationships. Proposals approved by the Committee should invariably be put up to the Board at its next meeting for post facto approval. The responsibilities of each bank with whom correspondent banking relationship is established should be clearly documented. In the case of payable-through-accounts, the correspondent bank should be satisfied that the respondent bank has verified the identity of the customers having direct access to the accounts and is undertaking ongoing 'due diligence' on them. The correspondent bank should also ensure that the respondent bank is able to provide the relevant customer identification data immediately on request.

b) Correspondent relationship with a “Shell Bank”

Banks should refuse to enter into a correspondent relationship with a “shell bank” (i.e. a bank which is incorporated in a country where it has no physical presence and is unaffiliated to any regulated financial group). Shell banks are not permitted to operate in India. Banks should also guard against establishing relationships with respondent foreign financial institutions that permit their accounts to be used by shell banks. Banks should be extremely cautious while continuing relationships with respondent banks located in countries with poor KYC standards and countries identified as 'non-cooperative' in the fight against money laundering and terrorist financing. Banks should ensure that their respondent banks have anti money laundering policies and procedures in place and apply enhanced 'due diligence' procedures for transactions carried out through the correspondent accounts.

2.13 Wire Transfers

Banks use wire transfers as an expeditious method for transferring funds between bank accounts. Wire transfers include transactions occurring within the national boundaries of a country or from one country to another. As wire transfers do not involve actual movement of currency, they are considered as a rapid and secure method for transferring value from one location to another.

i) The salient features of a wire transfer transaction are as under :

- a) Wire transfer is a transaction carried out on behalf of an originator person (both natural and legal) through a bank by electronic means with a view to making an amount of money available to a beneficiary person at a bank. The originator and the beneficiary may be the same person.
- b) Cross-border transfer means any wire transfer where the originator and the beneficiary bank or financial institution are located in different countries. It may include any chain of wire transfers that has at least one cross-border element.
- c) Domestic wire transfer means any wire transfer where the originator and receiver are located in the same country. It may also include a chain of wire transfers that takes

place entirely within the borders of a single country even though the system used to effect the wire transfer may be located in another country.

- d) The originator is the account holder, or where there is no account, the person (natural or legal) that places the order with the bank to perform the wire transfer.

ii) Wire transfer is an instantaneous and most preferred route for transfer of funds across the globe and hence, there is a need for preventing terrorists and other criminals from having unfettered access to wire transfers for moving their funds and for detecting any misuse when it occurs. This can be achieved if basic information on the originator of wire transfers is immediately available to appropriate law enforcement and/or prosecutorial authorities in order to assist them in detecting, investigating, prosecuting terrorists or other criminals and tracing their assets. The information can be used by Financial Intelligence Unit - India (FIU-IND) for analysing suspicious or unusual activity and disseminating it as necessary. The originator information can also be put to use by the beneficiary bank to facilitate identification and reporting of suspicious transactions to FIU-IND. Owing to the potential terrorist financing threat posed by small wire transfers, the objective is to be in a position to trace all wire transfers with minimum threshold limits. Accordingly, banks must ensure that all wire transfers are accompanied by the following information :

(A) Cross-border wire transfers

- a) All cross-border wire transfers must be accompanied by accurate and meaningful originator information.
- b) Information accompanying cross-border wire transfers must contain the name and address of the originator and where an account exists, the number of that account. In the absence of an account, a unique reference number, as prevalent in the country concerned, must be included.
- c) Where several individual transfers from a single originator are bundled in a batch file for transmission to beneficiaries in another country, they may be exempted from including full originator information, provided they include the originator's account number or unique reference number as at (b) above.

(B) Domestic wire transfers

- a) Information accompanying all domestic wire transfers of Rs. 50000/- (Rupees Fifty Thousand) and above must include complete originator information i.e. name, address and account number etc., unless full originator information can be made available to the beneficiary bank by other means.
- b) If a bank has reason to believe that a customer is intentionally structuring wire transfers to below Rs. 50000/- (Rupees Fifty Thousand) to several beneficiaries in order to avoid reporting or monitoring, the bank must insist on complete customer identification before effecting the transfer. In case of non-cooperation from the customer, efforts should be made to establish his identity and Suspicious Transaction Report (STR) should be made to FIU-IND.
- c) When a credit or debit card is used to effect money transfer, necessary information as (a) above should be included in the message.

(iii) Exemptions

Interbank transfers and settlements where both the originator and beneficiary are banks or financial institutions would be exempted from the above requirements.

(iv) Role of Ordering, Intermediary and Beneficiary banks**(a) Ordering bank**

An ordering bank is the one that originates a wire transfer as per the order placed by its customer. The ordering bank must ensure that qualifying wire transfers contain complete originator information. The bank must also verify and preserve the information at least for a period of ten years.

(b) Intermediary bank

For both cross-border and domestic wire transfers, a bank processing an intermediary element of a chain of wire transfers must ensure that all originator information accompanying a wire transfer is retained with the transfer. Where technical limitations prevent full originator information accompanying a cross-border wire transfer from remaining with a related domestic wire transfer, a record must be kept at least for ten years (as required under Prevention of Money Laundering Act, 2002) by the receiving intermediary bank of all the information received from the ordering bank.

(c) Beneficiary bank

A beneficiary bank should have effective risk-based procedures in place to identify wire transfers lacking complete originator information. The lack of complete originator information may be considered as a factor in assessing whether a wire transfer or related transactions are suspicious and whether they should be reported to the Financial Intelligence Unit-India. The beneficiary bank should also take up the matter with the ordering bank if a transaction is not accompanied by detailed information of the fund remitter. If the ordering bank fails to furnish information on the remitter, the beneficiary bank should consider restricting or even terminating its business relationship with the ordering bank.

2.14 Principal Officer

a) Banks should appoint a senior management officer to be designated as Principal Officer. Principal Officer shall be located at the head/corporate office of the bank and shall be responsible for monitoring and reporting of all transactions and sharing of information as required under the law. He will maintain close liaison with enforcement agencies, banks and any other institution which are involved in the fight against money laundering and combating financing of terrorism.

b) The Principal Officer will be responsible for timely submission of CTR, STR and reporting of counterfeit notes to FIU-IND.

2.15 Maintenance of records of transactions/Information to be preserved / Maintenance and preservation of records/Cash and Suspicious transactions reporting to Financial Intelligence Unit-India (FIU-IND)

Government of India, Ministry of Finance, Department of Revenue, vide its notification dated July 1, 2005 in the Gazette of India, has notified the Rules under the Prevention of Money Laundering Act (PMLA), 2002. In terms of the said Rules, the provisions of PMLA, 2002 came into effect from July 1, 2005. Section 12 of the PMLA, 2002 casts certain obligations on the banking companies in regard to preservation and reporting of customer account information. Banks are, therefore, advised to go through the provisions of PMLA, 2002 and the Rules notified there under and take all steps considered necessary to ensure compliance with the requirements of Section 12 of the Act *ibid*.

(i) Maintenance of records of transactions

Banks should introduce a system of maintaining proper record of transactions prescribed under Rule 3, as mentioned below:

- a)** all cash transactions of the value of more than Rupees Ten Lakh or its equivalent in foreign currency;
- b)** all series of cash transactions integrally connected to each other which have been valued below Rupees Ten Lakh or its equivalent in foreign currency where such series of transactions have taken place within a month and the aggregate value of such transactions exceeds Rupees Ten Lakh;
- c)** all cash transactions where forged or counterfeit currency notes or bank notes have been used as genuine and where any forgery of a valuable security or a document has taken place facilitating the transaction;
- d)** all suspicious transactions whether or not made in cash and by way of as mentioned in the Rules.

e) Explanation - Integrally connected cash transactions referred to at (b) above

The following transactions have taken place in a branch during the month of April , 2008:

Date	Mode	Dr (in Rs.)	Cr (in Rs.)	Balance (in Rs.) BF - 8,00,000.00
02/04/2008	Cash	5,00,000.00	3,00,000.00	6,00,000.00
07/04/2008	Cash	40,000.00	2,00,000.00	7,60,000.00
08/04/2008	Cash	4,70,000.00	1,00,000.00	3,90,000.00
Monthly summation		10,10,000.00	6,00,000.00	

f) As per above clarification, the debit transactions in the above example are integrally connected cash transactions because total cash debits during the calendar month exceeds Rs. 10 lakhs. However, the bank should report only the debit transaction taken place on 02/04 & 08/04/2008. The debit transaction dated 07/04/2008 should not be separately reported by the bank, which is less than Rs.50,000/-.

g) All the credit transactions in the above example would not be treated as integrally connected, as the sum total of the credit transactions during the month does not exceed Rs.10 lakh and hence credit transaction dated 02, 07 & 08/04/2008 should not be reported by banks.

(ii) Information to be preserved

Banks are required to maintain the following information in respect of transactions referred to in Rule 3:

- a)** the nature of the transactions;
- b)** the amount of the transaction and the currency in which it was denominated;
- c)** the date on which the transaction was conducted; and
- d)** the parties to the transaction.

(iii) Maintenance and Preservation of records

a) Banks are required to maintain the records containing information in respect of transactions referred to in Rule 3 above. Banks should take appropriate steps to evolve a system for proper maintenance and preservation of account information in a manner that allows data to be retrieved easily and quickly whenever required or when requested by the competent authorities. Further, banks should maintain for at least ten years from the date of cessation of transaction between the bank and the client, all necessary records of transactions, both domestic or international, which will permit reconstruction of individual transactions (including the amounts and types of currency involved if any) so as to provide, if necessary, evidence for prosecution of persons involved in criminal activity.

b) Banks should ensure that records pertaining to the identification of the customer and his address (e.g. copies of documents like passports, identity cards, driving licenses, PAN, card, utility bills etc.) obtained while opening the account and during the course of business relationship, are properly preserved for at least ten years after the business relationship is ended. The identification records and transaction data should be made available to the competent authorities upon request.

c) In paragraph 2.7 of this Master Circular, banks have been advised to pay special attention to all complex, unusual large transactions and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. It is further clarified that the background including all documents/office records/memorandums pertaining to such transactions and purpose thereof should, as far as possible, be examined and the findings at branch as well as Principal Officer level should be properly recorded. Such records and related documents should be made available to help auditors in their day-to-day work relating to scrutiny of transactions and also to Reserve Bank/other relevant authorities. These records are required to be preserved for ten years as is required under PMLA, 2002.

(iv) Reporting to Financial Intelligence Unit-India

a) In terms of the PMLA rules, banks are required to report information relating to cash and suspicious transactions to the Director, Financial Intelligence Unit-India (FIU-IND) in respect of transactions referred to in Rule 3 at the following address:

Director, FIU-IND,
Financial Intelligence Unit-India,
6th Floor, Hotel Samrat,
Chanakyapuri,
New Delhi-110021.

Website - <http://fiuindia.gov.in/>

b) Banks should carefully go through all the reporting formats. There are altogether eight reporting formats, as detailed in Annex II, viz. i) Cash Transactions Report (CTR); ii) Summary of CTR iii) Electronic File Structure-CTR; iv) Suspicious Transactions Report (STR); v) Electronic File Structure-STR; vi) Counterfeit Currency Report (CCR); vii) Summary of CCR and viii) Electronic File Structure-CCR. The reporting formats contain detailed guidelines on the compilation and manner/procedure of submission of the reports to FIU-IND. It would be necessary for banks to initiate urgent steps to ensure electronic filing of all types of reports to FIU-IND. The related hardware and technical requirement for preparing reports in an electronic format, the related data files and data structures thereof are furnished in the instructions part of the concerned formats.

c) FIU-IND have placed on their website editable electronic utilities to enable banks to file electronic CTR/STR who are yet to install/adopt suitable technological tools for extracting CTR/STR from their live transaction data base. It is, therefore, advised that in cases of banks, where all the branches are not fully computerized, the Principal Officer of the bank should cull out the transaction details from branches which are not yet computerized and suitably arrange to feed the data into an electronic file with the help of the editable electronic utilities of CTR/STR as have been made available by FIU-IND in their website <http://fiuindia.gov.in>.

d) In terms of instructions contained in paragraph 2.3(b) of this Master Circular, banks are required to prepare a profile for each customer based on risk categorisation. Further, vide paragraph 2.7, the need for periodical review of risk categorisation has been emphasized. It is, therefore, reiterated that banks, as a part of transaction monitoring mechanism, are required to put in place an appropriate software application to throw alerts when the transactions are inconsistent with risk categorization and updated profile of customers. It is needless to add that a robust software throwing alerts is essential for effective identification and reporting of suspicious transactions.

2.16 Cash Transaction Reports (CTR)

a) While detailed instructions for filing all types of reports are given in the instructions part of the related formats, banks should scrupulously adhere to the following:

- i) The Cash Transaction Report (CTR) for each month should be submitted to FIU-IND by 15th of the succeeding month. Cash transaction reporting by branches to their controlling offices should, therefore, invariably be submitted on monthly basis **(not on fortnightly basis)** and banks should ensure to submit CTR for every month to FIU-IND within the prescribed time schedule.
- ii) All cash transactions, where forged or counterfeit Indian currency notes have been used as genuine should be reported by the Principal Officer to FIU-IND immediately in the specified format (Counterfeit Currency Report – CCR). These cash transactions should also include transactions where forgery of valuable security or documents has taken place and may be reported to FIU-IND in plain text form.
- iii) While filing CTR, details of individual transactions below Rupees Fifty Thousand need not be furnished.
- iv) CTR should contain only the transactions carried out by the bank on behalf of their clients/customers excluding transactions between the internal accounts of the bank.
- v) A summary of cash transaction report for the bank as a whole should be compiled by the Principal Officer of the bank in physical form as per the format specified. The summary should be signed by the Principal Officer and submitted.

b) Suspicious Transaction Reports (STR)

- i) While determining suspicious transactions, banks should be guided by definition of suspicious transaction contained in PMLA Rules as amended from time to time.
- ii) It is likely that in some cases transactions are abandoned/aborted by customers on being asked to give some details or to provide documents. It is clarified that banks should report all such attempted transactions in STRs, even if not completed by customers, irrespective of the amount of the transaction.
- iii) Banks should make STRs if they have reasonable ground to believe that the transaction involve proceeds of crime generally irrespective of the amount of transaction and/or the threshold limit envisaged for predicate offences in part B of Schedule of PMLA, 2002 .
- iv) The Suspicious Transaction Report (STR) should be furnished within 7 days of arriving at a conclusion that any transaction, whether cash or non-cash, or a series of transactions integrally connected are of suspicious nature. The Principal Officer should record his reasons for treating any transaction or a series of transactions as suspicious. It should be ensured that there is no undue delay in arriving at such a conclusion once a suspicious transaction report is received from a branch or any other office. Such report should be made available to the competent authorities on request.
- v) In the context of creating KYC/AML awareness among the staff and for generating alerts for suspicious transactions, banks may consider the indicative list of suspicious activities contained in Annex-E of the 'IBA's Guidance Note for Banks, 2005'.
- vi) Banks should not put any restrictions on operations in the accounts where an STR has been made. Moreover, it should be ensured that there is no **tipping off** to the customer at any level.

2.17 Customer Education/Employee's Training/Employee's Hiring

a) Customer Education

Implementation of KYC procedures requires banks to demand certain information from customers which may be of personal nature or which has hitherto never been called for. This can sometimes lead to a lot of questioning by the customer as to the motive and purpose of collecting such information. There is, therefore, a need for banks to prepare specific literature/pamphlets etc. so as to educate the customer of the objectives of the KYC programme. The front desk staff needs to be specially trained to handle such situations while dealing with customers.

b) Employees' Training

Banks must have an ongoing employee training programme so that the members of the staff are adequately trained in KYC procedures. Training requirements should have different focuses for frontline staff, compliance staff and staff dealing with new customers. It is crucial that all those concerned fully understand the rationale behind the KYC policies and implement them consistently.

c) Hiring of Employees

It may be appreciated that KYC norms/AML standards/CFT measures have been prescribed to ensure that criminals are not allowed to misuse the banking channels. It would, therefore, be necessary that adequate screening mechanism is put in place by banks as an integral part of their recruitment/hiring process of personnel.

Annex- I

Customer Identification Procedure

Features to be verified and documents that may be obtained from customers

Features	Documents
Accounts of individuals - Legal name and any other names used - Correct permanent address	(i) Passport (ii) PAN card (iii) Voter's Identity Card (iv) Driving licence (v) Identity card (subject to the bank's satisfaction) (vi) Letter from a recognized public authority or public servant verifying the identity and residence of the customer to the satisfaction of bank (i) Telephone bill (ii) Bank account statement (iii) Letter from any recognized public authority (iv) Electricity bill (v) Ration card (vi) Letter from employer (subject to satisfaction of the bank) (any one document which provides customer information to the satisfaction of the bank will suffice)
Accounts of companies - Name of the company - Principal place of business - Mailing address of the company - Telephone/Fax Number	(i) Certificate of incorporation and Memorandum & Articles of Association (ii) Resolution of the Board of Directors to open an account and identification of those who have authority to operate the account (iii) Power of Attorney granted to its managers, officers or employees to transact business on its behalf (iv) Copy of PAN allotment letter (v) Copy of the telephone bill
Accounts of partnership firms - Legal name - Address - Names of all partners and their addresses - Telephone numbers of the firm and partners	(i) Registration certificate, if registered (ii) Partnership deed (iii) Power of Attorney granted to a partner or an employee of the firm to transact business on its behalf (iv) Any officially valid document identifying the partners and the persons holding the Power of Attorney and their addresses (v) Telephone bill in the

	name of firm/partners
Accounts of trusts & foundations - Names of trustees, settlers, beneficiaries and signatories - Names and addresses of the founder, the managers/directors and the beneficiaries - Telephone/fax numbers	(i) Certificate of registration, if registered (ii) Power of Attorney granted to transact business on its behalf (iii) Any officially valid document to identify the trustees, settlors, beneficiaries and those holding Power of Attorney, founders/managers/ directors and their addresses (iv) Resolution of the managing body of the foundation/association (v) Telephone bill

Annex – II

(List of various reports and their formats)

1. Cash Transaction Report (CTR)
2. Summary of CTR
3. Electronic File Structure - CTR
4. Suspicious Transaction Report (STR)
5. Electronic File Structure - STR
6. Counterfeit Currency Report (CCR)
7. Summary of CCR
8. Electronic File Structure - CCR

ANNEX - III**(List of Circulars on 'Know your customer' and monitoring of cash transactions)**

Sr.No.	Circular No. and date	Subject	Gist of instructions
1	DBOD.BP.BC.92/C. 469-76 dated 12 th August, 1976	Issue of DDs/TTs in excess of Rs.5000/-	Applicants (whether customer or not) for DD/MT/TT/Travellers cheques for amount exceeding Rs.10,000/- should affix Permanent Income Tax Number on the application.
2	DBOD.GC.BC.62/c. 408(A)/87 dated 11 th November, 1987	Frauds in banks- opening of new accounts.	Payment for imports should be made by debit to the accounts maintained with the same bank or any other bank and under no circumstances cash should be accepted for retirement of import bills. There should be reasonable gap of say, 6 months between the time an introducer opens his account and introduces another prospective account holder to the bank. Introduction of an account should enable proper identification of the person opening an account so that the person can be traced if the account is misused.
3	DBOD.BP.BC.114/C .469 (81)-91 dated 19 th April, 1991	Misuse of banking channels for violation of fiscal laws and evasion of taxes – Issue and payment of demand drafts for Rs.50,000 and above.	Banks to issue travellers cheques, demand drafts, mail transfers, telegraphic transfers for Rs. 50,000/- and above by debit to customers accounts or against cheques only and not against cash.
4	DBOD.BC.20/17.04. 001/92 dated 25 th August, 1992	Committee to enquire into various aspects relating to frauds and malpractices in banks.	Banks advised to adhere to the prescribed norms and safeguards while opening accounts etc.
5	DBOD.BP.BC.60/21	Diversion of working	Banks to ensure that withdrawals from

Sr.N o.	Circular No. and date	Subject	Gist of instructions
	.01.023/92 dated 21st December,1992	capital funds.	cash credit/overdraft accounts are strictly for the purpose for which the credit limits were sanctioned by them. There should be no diversion of working capital finance for acquisition of fixed assets, investments in associate companies/ subsidiaries and acquisition of shares, debentures, units of UTI and other mutual funds and other investments in the capital market.
6	DBOD.FMC.No.153/ 27.01.003/93-94 dated 1st September, 1993	Monitoring of flow of funds.	Banks to be vigilant and ensure proper end use of bank funds/monitoring flow of funds. Banks to keep vigil over heavy cash withdrawals by account holders which may be disproportionate to their normal trade/business requirements and cases of unusual trends. Doubtful cases to be reported to DBOD, Regional office.
7	DBOD.GC.BC.193/1 7.04.001/93 dated 18 th November, 1993	Frauds in banks – Encashment of Interest/Dividend Warrants, Refund Orders etc.	Banks to be vigilant in opening new accounts without proper introduction, new accounts with fictitious names and addresses. Banks instructed to strictly adhere to the instructions issued on opening and operating of bank accounts.
8	DBOD.GC.BC.202/1 7.04.001/93 dated 6 th December, 1993	The Committee to enquire into various aspects relating to frauds and malpractices in banks.	Customer identification while opening accounts including obtaining of photographs of customers while opening accounts.
9	DBOD.No.GC.BC.4 6/17.04.001 dated 22 nd April, 1994	The Committee to enquire into various aspects relating to frauds and malpractices in banks.	Clarifications given to banks regarding obtaining photographs of the depositors/account holder authorised to operate new accounts with effect from 1.1.1994. Obtaining of photographs would apply to residents and non-residents and all categories of deposits including fixed/recurring/cumulative

Sr.No.	Circular No. and date	Subject	Gist of instructions
			deposit accounts and also to those persons authorised to operate the accounts.
10	DBOD.BP.BC.106/21.01.001/94 dated 23 rd September, 1994	Fraudulent operations in deposit accounts-opening and collection of cheques/pay orders etc.	Banks to examine every request for opening joint accounts very carefully, look into the purpose, other relevant aspects relating to business, the financial position of the account holders and whether number of account holders are large. 'Generally crossed' cheques and payable to 'order' should be collected only on proper endorsement by the payee. Banks to exercise care in collection of cheques of large amounts and ensure that joint accounts are not used for benami transactions.
11	DBOD.BP.BC.57/21.01.001/95 dated 4 th May, 1995	Frauds in banks – Monitoring of deposit accounts.	Banks to introduce system of close watch of new deposit accounts and monitoring of cash withdrawals and deposits for Rs.10 lakh and above in deposit, cash credit and overdraft accounts. Banks to keep record of details of these large cash transactions in a separate register.
12	DBOD.BP.BC.102/21.01.001/95 dated 20 th September, 1995	Monitoring of Deposit Accounts.	Reporting of all cash deposits and withdrawals of Rs.10 lakhs and above with full details in fortnightly statements by bank branches to their controlling offices. Transactions of suspicious nature to be apprised to Head Office. RBI to look into these statements at the time of inspections
13	DBOD.BP.BC.42/21.01.001/96 dated 6 th April, 1996	Monitoring cash deposits and withdrawals of Rs.10 lakh and above in deposit/other accounts.	Banks asked to submit feedback on implementation of the system of close monitoring of large cash deposits and withdrawals of Rs.10 lakh and above.
14	DBOD.No.BP.BC.12	Furnishing of data-	Banks should satisfy themselves that

Sr.N o.	Circular No. and date	Subject	Gist of instructions
	/21.01.023/98 dated 11 th February 1998	violation of secrecy obligations.	information sought will not violate the laws relating to secrecy in banking transactions except under compulsion of law, duty to the public to disclose, where interest of bank requires disclosure and where disclosure is made with the express or implied consent of the customer.
15	DBS.FGV.BC.56.23. 04.001/98-99 dated 21 st June, 1999	Report of the Study Group on Large Value Bank Frauds.	Banks advised to implement the main recommendations of the Study Group on Large Value Bank Frauds.
16	DBOD.COMP.BC.N o.130/07.03.23/200 0-01 dated 14 th June, 2001	Internet Banking in India-Guidelines.	Banking facilities on Internet will be subject to the existing regulatory framework. Banks having physical presence in India only will be allowed to offer banking services over Internet to residents in India and any cross border transactions will be subject to existing exchange control regulations. Banks to establish identity and also make enquiries about integrity and reputation of the prospective customer. Internet accounts should be opened only after proper introduction and physical verification of the identity of the customer.
17	DBOD.BP.52/21.01. 001/2001-02 dated 5 th December, 2001	Prevention of Terrorism Ordinance,2001- Implementation thereof.	Banks should keep a watchful eye on the transactions of the 23 terrorist organisations listed in the Schedule to the Ordinance. Violations of the extant Acts or normal banking operations must be reported to the appropriate authorities under the Ordinance under advice to RBI. Banks to undertake 'due diligence' in respect of the 'KYC' principle.
18	DBOD.AML.BC.89/1 4.01.001/2001-02	Freezing of funds pursuant to United	Accounts of individuals and entities listed should be immediately frozen as

Sr.N o.	Circular No. and date	Subject	Gist of instructions
	dated 15 th April, 2002	Nations Security Council Resolution, 1390.	informed by the Security Council Sanctions Committee of the UN. If any transaction is detected involving any of these entities, banks to report to RBI promptly for necessary action.
19	DBOD.AML.BC.No. 102/14.01.001/2001-02 dated 10 th May, 2002	Monitoring of accounts - compliance with instructions.	Banks should ensure that no new accounts are opened by banned organisations. Banks to strictly adhere to the extant guidelines regarding opening and monitoring of accounts. Banks to confirm having issued instructions for immediate compliance by the branches and controlling offices.
20	DBOD.AML.BC.18/1 4.01.001/2002-03 dated August 16, 2002	Guidelines on "Know Your Customer" norms and "Cash transactions"	First circular on KYC. The customer identification should entail verification through an introductory reference from an existing account holder/a person known to the bank or on the basis of documents provided by the customer. The Board of Directors of the banks should have in place adequate policies that establish procedures to verify the bonafide identification of individual/ corporates opening an account. Branches of banks are required to report all cash deposits and withdrawals of Rs.10 lakhs and above as well as transactions of suspicious nature with full details in fortnightly statements to their controlling offices.
21	DBOD.NO.AML.BC. 58/14.01.001/2004-05 dated November 29, 2004	'Know Your Customer' (KYC) Guidelines – Anti Money Laundering Standards	Our guidelines were revisited to make those compliant with FATF recommendations and Basel Committee Report on CDD. Four pronged approach was prescribed to banks based on Customer Acceptance Policy, Customer Identification Procedure, Monitoring of Transaction and Risk Management.

Sr.N o.	Circular No. and date	Subject	Gist of instructions
22	DBOD.NO.AML.BC. 28 /14.01.001/2005- 06 dated August 23, 2005	Know Your Customer Guidelines- Anti- Money Laundering Standards	KYC guidelines on document requirement were relaxed for people belonging to financially disadvantageous sections in the society, who could open account with introductory reference.
23	DBOD.NO.AML.BC. 63/14.01.001/2005- 06 dated February 15, 2006	Prevention of Money Laundering Act, 2002 – Obligation of banks in terms of Rules notified thereunder	Reporting mechanism and formats were prescribed to banks to report cash and suspicious transactions to Financial Intelligence Unit- India (FIU-IND).
24	DBOD.AML.BC. No.77/ 14.01.001 / 2006-07 April 13, 2007	Wire transfers	Banks were advised to ensure that all wire transfers involving domestic and cross boarder fund transfers are accompanied by full originator information.
25	DBOD.AML.BC.No. 63/ 14.01.001/2007- 08 dated February 18, 2008	Know Your Customer (KYC) Norms/Anti Money Laundering (AML) Standards/Combating of Financing of Terrorism (CFT)	Revised guidelines on KYC/AML issued on review of risk categorization of customers; periodical updation of customer identification data and screening mechanism for recruitment /hiring process of personnel.
26	DBOD.AML.BC.No. 85/ 14.01.001/ 2007 -08 dated May 22, 2008	Prevention of Money Laundering Act, 2002 – Obligation of banks in terms of Rules notified thereunder.	Revised guidelines issued on CTR and STR by banks to FIU-IND.

RBI/2006-07/ 145

DBOD.No. Ret.BC. 34 /12.01.001/2006-07

**October 11, 2006
Ashwina 19, 1928**

Chief Executives of all
Scheduled Commercial Banks
(excluding Regional Rural Banks)

Dear Sir,

**Master Circular - Cash Reserve Ratio (CRR)
and Statutory Liquidity Ratio (SLR)**

Please refer to the Master Circular RBI/2005-06/70 DBOD.No.Ret.BC.18/12.01.001/2005-06 dated July 19, 2005 on the captioned subject. We enclose an updated version of the above Master Circular for your information.

2. This Master Circular is a compilation of the instructions contained in the circulars issued by Reserve Bank of India on the above subject, which are operational as on the date of this circular.

Yours faithfully,

(P.Vijaya Bhaskar)
Chief General Manager

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	APPENDIX

Master Circular - Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)

1. General

With a view to monitoring compliance with statutory reserve requirements viz. Cash Reserve Ratio and Statutory Liquidity Ratio by the Scheduled Commercial Banks (SCBs), Reserve Bank of India has prescribed statutory returns i.e. Form A return (for CRR) under Section 42 (2) of the RBI, Act, 1934 and Form VIII return (for SLR) under Section 24 of the Banking Regulation Act, 1949. The broad details of the reserve requirements are summarised below:

2. Cash Reserve Ratio (CRR)

2.1 Maintenance of CRR

Consequent upon the amendment to sub-section (1) of Section 42 of the RBI Act 1934, effective from June 22, 2006 the Reserve Bank having regard to the needs of securing monetary stability in the country, can prescribe the Cash Reserve Ratio (CRR) for Scheduled Commercial Banks without any floor rate or ceiling rate. The statutory minimum CRR requirement of 3 per cent of total demand and time liabilities no longer exists with effect from June 22, 2006, RBI has decided to continue with the status quo on the rate of CRR required to be maintained by Scheduled Commercial Banks at the rate of 5 per cent of the demand and time liabilities subject to the exemptions as indicated in para 2.3.7 of this circular.

2.2 Maintenance of incremental CRR

In terms of Section 42(1A) of RBI Act, 1934, the Scheduled Commercial Banks are required to maintain, in addition to the balances prescribed under Section 42(1) of the Act, an additional average daily balance, the amount of which shall not be less than the rate specified by the RBI in the notification published in the Gazette of India, such additional balance being calculated with reference to the excess of the total of the DTL of the bank as shown in the return referred to in section 42(2) of the Reserve Bank of India Act, 1934 over the total of its DTL at the close of the business on the date specified in the notification.

At present no incremental CRR is required to be maintained by the Scheduled Commercial Banks.

2.3 Computation of Demand and Time Liabilities

Liabilities of a bank may be in the form of demand or time deposits or borrowings or other miscellaneous items of liabilities. Liabilities of the banks may be towards banking system (as defined under Section 42 of RBI Act, 1934) or towards others in the form of Demand and Time deposits or borrowings or other miscellaneous items of liabilities. Reserve Bank of India has been authorized in terms of Section 42 (1C) of the RBI. Act, 1934 to classify any

particular liability and hence for any doubt regarding classification of a particular liability, the banks are advised to approach RBI for necessary clarification.

2.3.1 Demand Liabilities

'Demand Liabilities' include all liabilities which are payable on demand and they include current deposits, demand liabilities portion of savings bank deposits, margins held against letters of credit/guarantees, balances in overdue fixed deposits, cash certificates and cumulative/recurring deposits, outstanding Telegraphic Transfers (TTs), Mail Transfer (MTs), Demand Drafts (DDs), unclaimed deposits, credit balances in the Cash Credit account and deposits held as security for advances which are payable on demand. Money at Call and Short Notice from outside the Banking System should be shown against liability to others.

2.3.2 Time Liabilities

Time Liabilities are those which are payable otherwise than on demand and they include fixed deposits, cash certificates, cumulative and recurring deposits, time liabilities portion of savings bank deposits, staff security deposits, margin held against letters of credit if not payable on demand, deposits held as securities for advances which are not payable on demand and Gold Deposits.

2.3.3 Borrowings from banks abroad

Loans/borrowings from abroad by banks in India will be considered as 'liabilities to others' and will be subject to reserve requirements.

2.3.4 Arrangements with correspondent banks for remittance facilities

When a bank accepts funds from a client under its remittance facilities scheme, it becomes a liability (liability to others) in its books. The liability of the bank accepting funds will extinguish only when the correspondent bank honours the drafts issued by the accepting bank to its customers. As such, the balance amount in respect of the drafts issued by the accepting bank on its

correspondent bank under the remittance facilities scheme and remaining unpaid should be reflected in the accepting bank's books as an outside liability under head 'Liability to others in India' and the same should also be taken into account for computation of NDTL for CRR/SLR purpose.

The amount received by correspondent banks has to be shown as 'Liability to the Banking System' by them and not as 'Liability to others' and this liability could be netted off by the correspondent banks against the inter-bank assets. Likewise sums placed by banks issuing drafts/interest/dividend warrants are to be treated as 'Assets with Banking System' in their books and can be netted off from their inter-bank liabilities.

2.3.5 Other Demand and Time Liabilities (ODTL)

Other Demand and Time Liabilities (ODTL) include interest accrued on deposits, bills payable, unpaid dividends, suspense account balances representing amounts due to other banks or public, net credit balances in branch adjustment account, any amounts due to the "Banking System" which are not in the nature of deposits or borrowing. Such liabilities may arise due to items, like (i) collection of bills on behalf of other banks, (ii) interest due to other banks and so on. If a bank cannot segregate from the total of "Other Demand and Time Liabilities" (ODTL) the liabilities to the banking system, the entire 'Other Demand and Time Liabilities' may be shown against item II (c) 'Other Demand and Time Liabilities' of the return in Form 'A' and average CRR is required to be maintained on it by all Scheduled Commercial Banks; Participation Certificate issued to other banks, the balances outstanding in the blocked account pertaining to segregated outstanding credit entries for more than 5 years in inter branch adjustment account, the margin money on bills purchased / discounted and gold borrowed by banks from abroad, also should be included in ODTL.

2.3.6 Liabilities not to be included for DTL/NDTL computation

The under-noted liabilities will not form part of liabilities for the purpose of CRR;

- a) Paid up capital, reserves, any credit balance in the Profit & Loss Account of the bank, amount availed of as refinance from the RBI, and apex financial institutions like Exim Bank, NABARD, NHB, SIDBI etc.

- b) Amount of provision for income tax in excess of the actual/estimated liabilities.
- c) Amount received from DICGC towards claims and held by banks pending adjustments thereof.
- d) Amount received from ECGC by invoking the guarantee.
- e) Amount received from insurance company on ad-hoc settlement of claims pending Judgment of the Court.
- f) Amount received from the Court Receiver.
- g) The liabilities arising on account of utilization of limits under Bankers Acceptance Facility (BAF)

Scheduled Commercial Banks are not required to include inter-bank term deposits / term borrowing liabilities of original maturities of 15 days and above and upto one year in 'Liabilities to the Banking System' (item I of Form 'A'). Similarly banks should exclude their inter-bank assets of term deposits and term lending of original maturity of 15 days and above and up to one year in 'Assets with the Banking System' (item III of form A) for the purpose of maintenance of CRR. This concession is not available for maintenance of SLR.

Scheduled Commercial Banks are not required to include income flows received in advance such as annual fees and other charges which are not refundable for computation of Demand and Time Liability/Net Demand and Time Liability of the bank for maintenance of CRR/SLR.

2.3.7 Exempted Categories

Scheduled Commercial Banks are exempted from maintaining CRR on the following liabilities

- i) Liabilities to the banking system in India as computed under Clause (d) of the Explanation to section 42(1) of the RBI Act, 1934.
- ii) Credit balances in ACU (US\$) Accounts.
- iii) Transactions in Collateralized Borrowing and Lending Obligation (CBLO) with Clearing Corporation of India Ltd. (CCIL).
- iv) Demand and Time Liabilities in respect of their Offshore Banking Units (OBU's).

2.3.8 Loans out of FCNR (B) Deposits and IBFC Deposits

Loans out of Foreign Currency Non –Resident Accounts (Banks), (FCNR [B] Deposits Scheme) and Inter-Bank Foreign Currency (IBFC) Deposits should be included as part of bank credit while reporting in Form 'A'. For the purpose of reporting banks should convert their FCNR (B) Deposits, Overseas foreign currency assets and bank credit in India in foreign currency in 4 major currencies into rupees at FEDAI noon mean rate on the reporting Friday.

2.3.9 Assets with the Banking System

Assets with banking system include balances with banks in current accounts, balances with banks and notified financial institutions in other accounts, funds made available to banking system by way of loans or deposits repayable at call or short notice of a fortnight or less and loans other than money at call and short notice made available to the Banking System. Any other amounts due from banking system which cannot be classified under any of the above items are also to be taken as assets with the banking system.

2.3.10 Procedure for calculation of CRR

In order to improve the cash management by banks, as a measure of simplification, a lag of one fortnight in the maintenance of stipulated CRR by banks has been introduced with effect from the fortnight beginning 6th November 1999. Thus, all Scheduled Commercial Banks are required to maintain the prescribed Cash Reserve Ratio (which is currently @ 5% per cent with effect from the fortnight beginning October 02, 2004) based on their NDTL as on the last Friday of the second preceding fortnight.

2.3.11 Maintenance of CRR on daily basis

With a view to providing flexibility to banks in choosing an optimum strategy of holding reserves depending upon their intra period cash flows, all Scheduled Commercial Banks, are required to maintain minimum CRR balances upto 70 per cent of the total CRR requirement on all days of the fortnight with effect from the fortnight beginning December 28, 2002.

2.3.12 Payment of interest on eligible cash balances maintained by SCBs with RBI under CRR

Reserve Bank of India will not pay any interest on the CRR balances maintained by Scheduled Commercial Bank's with effect from the fortnight beginning June 24, 2006 in view of the amendment carried out to RBI Act 1934, omitting sub-section (1B) of section 42.

2.3.13 Penalties

From the fortnight beginning June 24, 2006 penal interest will be charged as under in cases of default in maintenance of CRR by Scheduled Commercial Banks:

- (i) In cases of default in maintenance of CRR requirement on a daily basis which is presently 70% of the total Cash Reserve Ratio requirement, penal interest will be recovered for that day at the rate of three per cent per annum above the bank rate on the amount by which the amount actually maintained falls short of the prescribed minimum on that day and if the shortfall continues on the next succeeding day/s, penal interest will be recovered at a rate of five per cent per annum above the bank rate.
- (ii) In cases of default in maintenance of CRR on average basis during a fortnight, penal interest will be recovered as envisaged in sub-section (3) of Section 42 of Reserve Bank of India Act, 1934.

The Scheduled Commercial Banks (SCBs) are required to furnish the particulars, such as date, amount, percentage, reason for default in maintenance of requisite CRR and also action taken to avoid recurrence of such default.

2.3.14 Fortnightly return in Form A

Under section 42 (2) of RBI Act, 1934, all SCBs are required to submit to RBI a provisional return in Form 'A' within 7 days from the expiry of the relevant fortnight. It is used for preparing press communiqué. The final Form 'A' is required to be sent to RBI within 20 days from expiry of the relevant fortnight. Based on the recommendation of the Working Group on Money Supply: Analytics and Methodology of Compilation, all Scheduled Commercial Banks in India are required to submit from the fortnight beginning October 9, 1998, Memorandum to form 'A' return giving details about paid-up capital, reserves, time deposits comprising of short term and long term, certificates of deposits,

NDTL, total CRR requirement etc., Annexure A to form 'A' return showing all foreign currency liabilities and assets and Annexure B to form 'A' return giving details about investment in approved securities, investment in non-approved securities, memo items such as subscription to shares /debentures / bonds in primary market and subscriptions through private placement.

For reporting in form 'A' return, banks should convert their overseas foreign currency assets and bank credit in India in foreign currency in four major currencies viz., US dollar, GBP, Japanese Yen and Euro into rupees at the FEDAI noon mean rate on reporting Friday.

3. Statutory Liquidity Ratio (SLR)

In terms of Section 24 (2-A) of the B.R. Act, 1949 all Scheduled Commercial Banks, in addition to the average daily balance which they are required to maintain under Section 42 of the RBI, Act, 1934, are required to maintain in India,

- a) in cash, or
- b) in gold valued at a price not exceeding the current market price,
- or
- c) in unencumbered approved securities valued at a price as specified by the RBI from time to time.

an amount which shall not, at the close of the business on any day, be less than 25 per cent or such other percentage not exceeding 40 per cent as the RBI may from time to time, by notification in gazette of India, specify, of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight,

At present, all SCBs are required to maintain a uniform SLR of 25 per cent of the total of their demand and time liabilities in India as on the last Friday of the second preceding fortnight which is stipulated under section 24 of the B.R. Act, 1949.

3.1 Procedure for computation of demand and time liabilities for SLR

The procedure to compute total net demand and time liabilities for the purpose of SLR under Section 24 (2) (B) of B.R. Act 1949 is similar to the procedure

followed for CRR purpose. However, it is clarified that Scheduled Commercial Banks are required to include inter-bank term deposits / term borrowing liabilities of original maturities of 15 days and above and up to one year in 'Liabilities to the Banking System'. Similarly banks should include their inter-bank assets of term deposits and term lending of original maturity of 15 days and above and up to one year in 'Assets with the Banking System' for the purpose of maintenance of SLR. However, both the above liabilities and assets are not to be included in the liabilities to /assets with the banking system for computation of DTL/NDTL for the purpose of CRR as mentioned in para 2.3.7 above.

3.2 Classification and Valuation of approved securities for SLR

As regards classification and valuation of approved securities for the purpose of Statutory Liquidity Ratio, banks may be guided by the instructions contained in our Master Circular-RBI/2006-07/30 DBOD.No.BP.BC.14/21.04.141/2006-07 dated July 1, 2006 (as updated from time to time) on Prudential norms for classification, valuation and operation of investment portfolio by banks

3.3 Penalties

If a banking company fails to maintain the required amount of SLR, it shall be liable to pay to RBI in respect of that default, the penal interest for that day at the rate of 3 per cent per annum above the bank rate on the shortfall and if the default continues on the next succeeding working day, the penal interest may be increased to a rate of 5 percent per annum above the Bank Rate for the concerned days of default on the shortfall.

3.4 Return in Form VIII (SLR) to be submitted to RBI

- i) Banks should submit to the RBI before 20th day of every month, a return in form VIII showing the amounts of SLR held on alternate Fridays during immediate preceding month with particulars of their DTL in India held on such Fridays or if any such Friday is a Public Holiday under the Negotiable Instruments Act, 1881 at the close of business on preceding working day.
- ii) Banks should also submit a statement as annexure to form VIII giving daily position of (a) value of securities held for the purpose of compliance with SLR

and (b) the excess cash balances maintained by them with RBI in the prescribed format

3.5 Correctness of computation of demand and time liabilities to be certified by Statutory Auditors.

The Statutory Auditors should verify and certify that all items of outside liabilities, as per the bank's books had been duly compiled by the bank and correctly reflected under DTL/NDTL in the fortnightly/monthly statutory returns submitted to RBI for the financial year.

Appendix

Master Circular

Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)

List of circulars consolidated by the Master Circular

Sr No	Circular No	Date	Subject	Corresponding paragraph number in this master circular
1	DBOD.No.Leg. BC.34/C.233A-	23/03/1985	Demand Liabilities, Time Liabilities, ODTL	2.3.1,2.3.2, 2.3.5

	85			
2	DBOD.No.BC. 111/12.02.001/97	13/10/1997	Borrowings from banks abroad-Maintenance of reserve requirement	2.3.3
3	DBOD.No.Ret.BC. 14/12.01.001/2003- 04	21/08/2003	Arrangements with correspondent banks for remittance facilities	2.3.4
4	DBOD.No.Ret.BC 149/C 236(G)71	27/12/1971	Other Demand and Time Liabilities	2.3.5
5	DBOD.No.BC.58/ 12.02.001/94-95	13/05/1995	Margin money on bills purchased	2.3.5
6	DBOD.No.Ret.BC. 40/c.236(G)Spl-86	27/03/1986	Amount received from DICGC	2.3.6(c)
7	DBOD.No.Ret.BC. 98/C.96(Ret)-86	12/09/1986	Exclusion from NDTL- Receipt from Court Receiver, Insurance Company and ECGC	2.3.6 (d,e,f)
8	DBOD.No.BC.191 /12.01.001/93	2/11/1993	Liabilities under Bankers Acceptance Facility (BAF)	2.3.6 (g)
9	DBOD.No.BC.5 /12.01.001/2001-02	7/08/2001	Reporting of Inter-bank liabilities in Form A	2.3.7
10	DBOD.No.BC.82 /12.01.001/2001- 2002	26/03/2002	Maintenance of CRR-ACU Dollar Funds-Exemption of	2.3.7(ii)
11	DBOD.No.Ret.BC. 63/12.01.001/2003 -04	14/01/2004	Maintenance of CRR /SLR on transaction in Collateralised Borrowing and Lending Obligation (CBLO)	2.3.7(iii)
12	DBOD.IBS.BC.88/ 23.13.004/2002-03	27/03/2003	Offshore Banking Units (OBUs) in Special Economic Zones (SEZs)	2.3.7(iv)
13	DBOD.No.BC.50/ 12.01.001/2000-01	7/11/2000	Collection of Data from Scheduled Commercial Banks in Annexure A and B	2.3.8
14	RBI/2005-2006/423 DBOD.No.BC.93/1 2.01.001/2005- 2006	22/06/2006	Maintenance of CRR on Exempted Categories	2.1, 2.3,2.10,2.3.7
15	DBOD.No.BC.54/ 12.01.001/2002-03	27/12/2002	Relaxation in Daily Minimum Cash Reserve Maintenance Requirement	2.3.11
16	RBI/2005-2006/422 DBOD.No.Ret.BC. 91/12.01.001/2005- 2006	22/06/2006	Section 42(1) of Reserve Bank of India Act, 1934- Maintenance of CRR	2.3.12, 2.3.7
17	RBI/2006-2007/106 DBOD.No.Ret.BC. 26/12.01.001/2006-	10/08/2006	Section 42 (1) of Reserve Bank of India Act, 1934- Penalties on default in	2.3.13

	07		maintenance of Cash Reserve Ratio (CRR)	
18	DBOD.BC.89/12.01.001/98-99	24/08/1998	Return in Form 'A'	2.3.14
19	DBOD.No.BC.117/12.02.001/97-98	21/10/1997	Rationalisation of Statutory Liquidity Ratio (SLR)	3
20	RBI/2006-07/30 DBOD.No.BP.BC.14/21.04.141/ 2006-2007	1/07/2006	Guidelines for classification and valuation of Investments by banks	3.2
21	DBOD.No.BC.87/12.02.001/2001-2002	10/04/2002	Valuation of Securities for the purpose of SLR	3.2
22	CPC.BC.69/279 (A)-84	20/10/1984	Data on maintenance of Statutory Liquidity Requirement-Supplemental information to the Special Return	3.4(ii)

GENERAL CIRCULARS

RBI/2008-09/340
DBOD.BP.No.104/21.04.132/2008-09

January 2, 2009

The Chairman and Managing Directors /
Chief Executives of all Commercial Banks

Dear Sir,

Prudential Guidelines on Restructuring of Advances by Banks

Please refer to our circular RBI/2008-09/143/DBOD.BP.BC.37/21.04.132/ 2008-09 dated August 27, 2008 on the captioned subject. This circular is a comprehensive set of guidelines rationalizing and putting together the existing guidelines. Special regulatory treatment for asset classification has been made available to all categories of advances except consumer and personal loans, capital market exposures and commercial real estate exposures. This treatment permits treating standard accounts as standard after restructuring, provided certain conditions are met. One of these conditions relates to the restructuring not being a repeated restructuring. Another condition stipulates that the dues to the bank are fully secured. The August 27, 2008 circular also allows restoration of standard asset classification to the accounts which may turn into non-performing during the period of restructuring approval process provided the restructuring package is implemented expeditiously i.e. within 90 days from the date of receipt of application by the bank/ taking up the restructuring process.

2. Since the spillover effects of the global downturn have also started affecting the Indian economy particularly from September 2008 onwards creating stress for the otherwise viable units/ activities, certain modifications were made in the above mentioned circular as a one time measure and for a limited period of time i.e. up to June 30, 2009 vide our circular RBI/2008-09/311.DBOD.BP.BC.93/21.04.132/2008-09 dated December 8, 2008. Special regulatory treatment was extended to Commercial Real Estate Exposures restructured for the first time as well as to exposures (other than commercial real estate, capital markets and personal/ consumer loans) which were viable but were facing temporary cash flow problems and needed a second restructuring.

3. It has been represented to RBI that

(a) While the modifications made by the circular dated December 8, 2008 would not be applicable to the accounts covered under the circular which turned NPAs prior to December 8, 2008, these need to be given the special regulatory treatment as these too have been affected by the swift effect of the global downturn on the Indian economy since September 2008. Moreover, banks need some lead time for operationalising the circular dated December 8, 2008.

(b) The period of 90 days allowed for restructuring is not adequate in view of the large number of accounts potentially requiring restructuring.

(c) Drawing power has been affected due to decline in inventory prices/ values necessitating conversion of irregular portions into Working Capital Term Loan (WCTL) on restructuring. However as the borrowers may be unable to provide further tangible security in the current context, accounts even after restructuring will be classified as NPAs. The condition of WCTL being fully secured by tangible security may, therefore, be relaxed.

4. The above issues have been examined by RBI. We recognize that the accounts to which special regulatory treatment has been extended in terms of the circular dated December 8, 2008 could have faced stress from September 2008 onwards and may not have had sufficient time to take remedial actions/ restructuring before turning NPAs. Similarly, it is possible that some of the accounts covered under the circular dated December 8, 2008 may have become NPAs during the lead time required by banks to operationalise the circular. Banks may also face operational difficulties in handling a comparatively large volume of restructuring proposals in the stipulated time period of 90 days. To preserve the economic and productive value of the affected assets, it is important that swift action is taken for detection of the weaknesses and restructuring package is put in place for viable accounts. In view of this, it has been decided that:

(a) All accounts covered under the circular dated December 8, 2008 which were standard accounts on September 1, 2008 would be treated as standard accounts on restructuring provided the restructuring is taken up on or before January 31, 2009 and the restructuring package is put in place within a period of 120 days from the date of taking up the restructuring package.

(b) The period for implementing the restructuring package would stand extended from 90 days to 120 days in respect of accounts covered under the circular dated August 27, 2008 also.

(c) The value of security is relevant to determine the likely losses which a bank might suffer on the exposure should the default take place. This aspect assumes greater importance in the case of restructured loans. However, owing to the current downturn, the full security cover for the WCTL created by conversion of the irregular portion of principal dues over the drawing power, may not be available due to fall in the prices of security such as inventories. In view of the extraordinary situation, this special regulatory treatment will also be available to '**standard**' and '**sub-standard accounts**', covered under circulars dated August 27, 2008 and December 8, 2008 even where full security cover for WCTL is not available, subject to the condition that provisions are made against the **unsecured portion of the WCTL**, as under:

- *Standard Assets: 20%.*
- *Sub-standard Assets: 20% during the first year and to be increased by 20% every year thereafter until the specified period (one year after the first payment is due under the terms of restructuring).*
- *If the account is not eligible for upgradation after the specified period, the unsecured portion will attract provision of 100%.*

These provisions would be in addition to the usual provisions as per the current regulation.

5. All the modifications indicated in para 4 are one time measure and would be available for restructuring packages implemented till June 30, 2009.

6. We re-iterate that the basic objective of restructuring is to preserve economic value of units, not evergreening of problem accounts. This can be achieved by banks and the borrowers only by careful assessment of the viability, quick detection of weaknesses in accounts and a time-bound implementation of restructuring packages.

Yours faithfully,
(Prashant Saran)
Chief General Manager-in-Charge

RBI/2008-09/ 335
Ref.DBS.ARS.No.BC. 02/ 08.91.001/ 2008-09

December 31, 2008

All Scheduled Commercial Banks

Dear Sir/ Madam,

Internal assignments in banks by statutory auditors

We invite a reference to RBI circular DBOD.No.App.BC.118/C.452(K)-89 dated April 22, 1989, wherein it was clarified to banks that any audit firm which has been assigned internal audit assignments during a financial year should not be considered for statutory audit assignments during that year and the following year.

2. The issue relating to the internal assignments allotted to the audit firms at the time of their appointment as statutory auditors has been examined afresh and it has been decided as under:

“Audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year. In case the firms are associated with internal assignment it should be ensured that they relinquish the internal assignment before accepting the statutory audit assignment during the year.”

3. The above instructions may be implemented with immediate effect.

4. Please acknowledge receipt.

Yours faithfully,

(P.S. Sharma)
General Manager

RBI/2008-09/322
DBOD.No.BP. 97 /21.04.158/2008-09

December 11, 2008

All Scheduled Commercial Banks
(excluding RRBs)

Dear Sir,

**Guidelines on Managing Risks and Code of Conduct in
Outsourcing of Financial Services by Banks**

Please refer to Para 7 of our circular DBOD.No.BP.40/21.04.158/2006-07 dated November 3, 2006 on the captioned subject.

2. It has been decided to add a new sub para 7.4 as below:

“As regards the off-shore outsourcing of financial services relating to Indian Operations, banks should additionally ensure that

- a) Where the off-shore service provider is a regulated entity, the relevant off-shore regulator will neither obstruct the arrangement nor object to RBI inspection visits / visits of banks internal and external auditors.
- b) The availability of records to management and the RBI will withstand the liquidation of either the offshore custodian or the bank in India.
- c) The regulatory authority of the offshore location does not have access to the data relating to Indian operations of the bank simply on the ground that the processing is being undertaken there (not applicable if off shore processing is done in the home country of the bank).
- d) The jurisdiction of the courts in the off shore location where data is maintained does not extend to the operations of the bank in India on the strength of the fact that the data is being processed there even though the actual transactions are undertaken in India and
- e) All original records continue to be maintained in India.”

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

RBI/2008-2009/313

DBOD.No.BP.BC.94 /08.12.001/2008-09

December 08, 2008

The Chairman & Managing Directors /
Chief Executive Officers of
All Scheduled Commercial Banks
(Excluding RRBs and LABs)

Dear Sir,

Lending under Consortium Arrangement / Multiple Banking Arrangements

Please refer to our circular RBI/2008-2009/183/DBOD.No.BP.BC.46/08.12.001/2008- 09 dated September 19, 2008 on the captioned subject.

2. The formats for declaration of information by the borrower at the time of applying for a credit facility to a bank (**Annex I**) and the format for exchange of information among the banks in respect of borrowers enjoying credit facilities from more than one bank (**Annex II**), enclosed to the aforesaid circular have been revised to reflect information relating to the derivatives transactions entered into by banks with the borrowers and the unhedged foreign currency exposures of the borrowers.

3. Banks are advised to use the revised formats with immediate effect.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

**Minimum Information to be Declared by Borrowing Entities to
Banks while Approaching for Finance under Multiple Banking Arrangement**

**A. Details of borrowing arrangements from other banks
(institution-wise and facility-wise)**

I.	Name and address of bank / institution	
II.	Facilities availed	
A.	<i>Fund-based credit facilities</i> (Indicate the nature of facilities e.g. working capital / demand loan / term loan / short term loan) / foreign currency loan, corporate loan / line of credit / Channel financing, bill discounting etc. amount and the purpose)	
B.	<i>Non-fund-based facilities other than derivatives</i> (Indicate the nature of facilities e.g. L/C, BG, DPG (I & F) etc. amount and the purpose)	
C.	<i>Derivatives contracts entered into with the bank</i> (Indicate the nature of the contract, maturity, amount and the purpose)	
III.	Date of sanction	
IV.	Present outstanding (In the case of derivatives contracts, negative MTM i.e which is not due for settlement may be indicated)	
V.	Overdues position, if any (In the case of derivatives contracts, the negative MTM i.e. amount payable to the bank under the contract but not yet paid may be indicated)	

VI.	Repayment terms (for demand loans, term loans, corporate loans, project - wise finance)	
VII.	Security offered (complete details of security both primary and collateral including specific cash flows assigned to project wise finance / loan raised & personal / corporate guarantee, to be furnished)	
VIII.	Requests for facilities which are under process	
[The information to be given for domestic and overseas borrowings from commercial banks, Financial Institutions and NBFCs]		

B. Miscellaneous Details

(Rs. in crore)

I.	CPs raised during the year and current outstanding	
II.	Details of financing outside banking system e.g. L/C Bills discounting	
III	Amount of un-hedged foreign currency exposures(please give currency-wise position in the format given below)	
(i)	<i>Short term exposures (less than one year)</i>	
(a)	Long positions	
(b)	Short positions	
(c)	Net Short term Exposure (a-b)	
(ii)	<i>Long term exposures (one year and beyond)</i>	
(a)	Long positions	
(b)	Short positions	
(c)	Net Long term exposure a-b)	
(iii)	Overall Net Position (i-ii) for each currency	
(iv)	Overall Net Position across all currencies	
III.	Main and allied activities with locations	

IV.	Territory of sales and market share	
V.	Details of financial aspects incl. DSCR Projections wherever applicable as per requirement of bank - Imp. Financial covenants, if any, agreed to / accepted with other lenders.	
VI.	CID A/Cs, within / outside financing Banks, being operated, if any	
VII.	Demands by statutory authorities / current status thereof	
VIII.	Pending litigations	
IX.	A declaration authorizing the bank to share information with other financing banks	

Annex - II

Revised Format under Multiple Banking Arrangement Credit Information Exchange

Part – I

Bio Data of the Company

I.	Borrowing party's name and address	
II.	Constitution	
III.	Names of Directors / Partners	
IV.	Business activity	
	* Main	
	* Allied	
V.	Names of other financing Banks	
VI.	Net worth of Directors / Partners	
VII.	Group affiliation, if any	
VIII.	Date on associate concerns, if banking with the same bank	
IX.	Changes in shareholding and management from the previous report, if any	

Part - II

Major credit quality indicators

I.	IRAC Classification	
II.	Internal Credit rating with narration	
III.	External Credit rating, if any	
IV.	Latest available Annual Report of the borrower	As on -----

Part – III

Exposure Details other than Derivatives

(Rs. in crore)

I.	Type of credit facilities, e.g. working capital loan / demand loan / term loan / short term loan / foreign currency loan, corporate loan / line of credit / Channel financing, contingent facilities like LC, BG & DPG (I & F) etc. Also, state L/C bills discounting / project wise finance availed).	
II.	Purpose of loan	
III.	Date of loan facilities (including temporary facilities)	
IV.	Amount sanctioned (facility wise)	
V.	Balance outstanding (facility wise)	
VI.	Repayment terms	
VII.	Security offered	
	* Primary	
	* Collateral	
	* Personal / Corporate Guarantees	
	* Extent of control over cash flow	
VIII.	Defaults in term commitments / lease rentals / others	
IX.	Any other special information like court cases, statutory dues, major defaults, adverse internal / external audit observations	

Part - IV

Exposure Details – Derivatives Transactions

(Rs. in crore)

Sr. No.	Nature of the derivatives Transactions	Notional Amount of contracts	Weighted - average maturity of contracts	Amount of positive MTM for the bank (Not due for settlement)	Amount of contracts classified as NPA	Notional Amount of outstanding contracts which have been restructured	Major reasons for restructuring (in brief)
A.	Plain Vanilla Contracts						
1.	Forex Forward contracts						
2.	Interest rate Swaps						
3.	Foreign Currency Options						
4.	Any other contracts (Please specify)						
B.	Complex derivatives including various types of option combinations designed as cost reduction/zero cost structures						
1.	Contracts involving <u>only</u> interest rate derivatives.						
2.	Other contracts including those involving foreign currency derivatives						

3.	Any other contracts (Please specify)						

Part – V

Un-hedged foreign currency exposures of the borrowee with currency-wise details

(Rs. in crore)

I	Short term exposures (less than one year)	
(a)	Long positions	
(b)	Short positions	
(c)	Net short- term exposure (a-b)	
II	Long term exposures (one year and beyond)	
(a)	Long positions	
(b)	Short positions	
(c)	Net long-term exposure (a-b)	
III	Overall Net Position (I –II) for each currency (Please give Overall Net Position in this format for each currency)	
IV	Overall Net Position across all currencies	

Part – VI

Experience with the borrower

I.	Conduct of funded facilities (based on cash management / tendency to overdraw)	
II.	Conduct of contingent facilities (based on payment history)	
III.	Compliance with financial covenants	
IV.	Company's internal systems & procedures	
V.	Quality of management	
VI.	Overall Assessment	
(The above to be rated as good, satisfactory or below par only)		
(*) Broad guidelines for incorporating comments under this head is furnished in the next page		

**Broad Guidelines for Incorporating Comments under Part - VI
(Experience) of the Credit Information Report**

		Good	Satisfactory	Below Par
I.	Conduct of funded facilities			
	* Over-drawings (No. of times)	Upto 4 times	5 to 6 times	Above 6 times
	* Average period of adjustment	Within 1 month	Within 2 months	Beyond 2 months
	* Extent of overdrawings (% of limit)	Upto 10%	10 to 20%	Above 20%
II.	Conduct of contingent facilities (Other than Derivatives)			
	* No. of Defaults	Upto 2 times	3 to 4 times	Above 4 times
	* Average period of adjustment	Within 1 week	Within 2 weeks	Beyond 2 weeks
III	Conduct of Derivatives Transactions			
	* No. of contracts where the positive MTM value due to the bank remained overdue for more than 30 days	<25% of total number of contracts	25-50% of total number of contracts	> 50% of total number of contracts
	* No. of contracts where the positive MTM value due to the bank remained overdue for more than 90 days and the account had to be classified as NPA (but later on regularized and is not NPA as on the date of exchange of information) Note: All cases where any of the contracts has been classified as NPA and continues to be NPA as on the date of the exchange of information should be shown as Below Par)	<1% of total number of contracts	1-5% of total number of contracts	> 5% of total number of contracts
	* No. of contracts restructured during the relevant period	<25% of total number of contracts	25-50% of total number of contracts	> 50% of total number of contracts
IV.	Compliance with financial covenants			
	* Stock statement / Financial data	Timely	Delay upto 15 days	Delay over 15 days
	* Creation of charge	Prompt	Delay upto 2 months	Delay over 2 months

V. Company's internal systems and procedures				
*	Inventory Management	Adequate systems are in place	Adequate systems are in place but not adhered	Adequate systems are not in place
*	Receivables Management	- do -	- do -	- do -
*	Resource Allocation	- do -	- do -	- do -
*	Control over Information	- do -	- do -	- do -
VI. Quality of management				
*	Integrity	Reliable	Nothing adverse	Cannot be categorized in previous columns
*	Expertise Competence / Commitments	Professional & visionary	Have necessary experience	-do-
*	Tract Record	Timely	Executions /	-do-

Annex - III

Part - I

Diligence Report

To,

The

Manager,

_____ (Name of the Bank)

I / We have examined the registers, records, books and papers of _____ Limited (the Company) as required to be maintained under the Companies Act, 1956 (the Act) and the rules made thereunder, the provisions of various statutes, wherever applicable, the provisions contained in the Memorandum and Articles of Association of the Company as well as the provisions contained in the Listing Agreement/s, if any, entered into by the Company with the recognized stock exchange/s, as may be applicable for the half year ended on _____. In my / our opinion and to the best of my / our information and according to the examination carried out by me / us and explanations furnished to me / us by the Company, its officers and agents. I / We report that in respect of the aforesaid period :

1. (a) The management of the Company is carried out by the Board of Directors comprising the following persons :

(b) During the period under review the following changes took place :
2. (a) The shareholding pattern of the company is as under :

(b) During the period under review the following changes took place:
3. The company has altered the following provisions of
 - (i) the Memorandum of Association during the period under review and has complied with the provisions of the Act.
 - (ii) the following Articles of Association during the period under review and has complied with the provisions of the Act.
4. The company has during the period under review, entered into the following transactions with business entities in which directors are interested.
5. The company has during the period under review, advanced loans, given guarantees and provided securities amounting to Rs. _____ to its directors and / or persons or firms or companies in which directors are interested.
6. The Company has during the period under review, made loans and investments; or given guarantees or provided securities to other business entities as under :
7. The amount borrowed by the Company from directors, members, public, financial institutions, banks and others during the period under review is / are within the borrowing limits of the Company. The break-up of the company's borrowings is as under:
8. The Company has during the period under review, not defaulted in the repayment of any public deposits or unsecured loans and the Company or its Directors are not under the Defaulter's list of Reserve Bank of India or in the Specific Approval List of ECGC.
9. The Company has during the period under review, created, modified or satisfied charges on the assets of the company as under :
10. The Forex Exposure and Overseas Borrowings of the company are as under"

11. The Company has issued, offered and allotted all the securities to the persons entitled thereto and has also issued letters, coupons, warrants and certificates thereof to the concerned persons and also redeemed its preference shares / debentures and bought back its shares (wherever applicable) in compliance with the specified procedures and within the stipulated time.
12. The Company has insured all its assets including the secured assets.
13. The Company has complied with the terms and conditions, set forth by the lending institution at the time of availing the facility and also during the currency of the loan and has utilized the funds for the purposes for which these were borrowed.
14. The Company has declared and paid dividends to its shareholders as per the provisions of the Companies Act, 1956.
15. The Company has paid all its statutory dues and that there are no arrears.
16. The Company has complied with the provisions stipulated in Section 372 A of the Companies Act in respect of its Inter Corporate loans and Investments.
17. The Company has complied with the applicable and mandatory Accounting Standards issued by the Institute of Chartered Accountants of India.
18. The Company has credited and paid to the Investor Education and Protection Fund all the unpaid dividends and other amounts required to be so credited.
19. A list of prosecutions initiated against or show cause notices received by the Company for alleged offences under the Act and also the fines and penalties or any other punishment imposed on the Company in such cases is attached.
20. The Company has complied with the various clauses of the Listing Agreement, if applicable.
21. The Company has deposited both Employees' and Employer's contribution to Provident Fund with the prescribed authorities.

Note : The qualification, reservation or adverse remarks, if any, may be stated at the relevant place(s).

Place :

Signature :

Date :

Name of Company Secretary :

C.P. No.:

Part - II

Certification of Borrowal Companies by Chartered Accountants / Company Secretaries

- i. Terms of reference for stock audit are to be spelt out clearly by the Banks, so that the Chartered Accountants can give focused attention to such areas.
- ii. End-use verification of funds lent, if certified by Statutory Auditors, will be a good comfort to the Banks.
- iii. As Banks quite often deal with unlisted companies, disclosure requirements for such companies above a specific turnover may be made akin to those for listed companies, viz. consolidated balance sheet, segmental reporting etc. Information on large shareholding also will be useful.
- iv. Further, the following additional certification either from Chartered Accountant or Company Secretary may also be thought of :-
 - (a) Company Directors not figuring in defaulters list (RBI / ECGC) / willful defaulters list etc.)
 - (b) Details of litigation above a specified cut off limit.
 - (c) A specific certificate, probably from the Company Secretary, regarding compliance with Sec. 372 (a) of the Companies Act.
 - (d) Details of creation / modification / satisfaction of charges on the assets of the company, position regarding insurance, show cause notices received, finds and penalties awarded.
- v. As regards rotation of Auditors, for the sake of operational convenience, it is suggested they may be changed once every 5 years instead of every 3 years.
- vi. In order to avoid concentration, group companies may have different Statutory / Internal Auditors in case group turnover exceeds Rs.100 crores.

December 8, 2008

The Chairman and
Managing Directors /
Chief Executive Officers of
All Scheduled Commercial Banks
(Excluding RRBs & LABs)

Dear Sir,

Prudential Guidelines on Restructuring of Advances by Banks

Please refer to our Press Release dated December 6, 2008 regarding RBI's Growth Stimulus. As indicated therein, it has been decided to effect the following modifications to prudential guidelines on restructuring of advances contained in our circular RBI/2008-09/143/ DBOD.No. BP.BC. No.37/ 21.04.132/2008-09 dated August 27, 2008 on the captioned subject.

- (i) In terms of para 6.1 of the aforesaid circular, exposures to commercial real estate, capital market exposures and personal/consumer loans are not eligible for the exceptional regulatory treatment of retaining the asset classification of the restructured standard accounts in standard category as given in para 6.2 of the circular. As the real estate sector is facing difficulties, it has been decided to extend exceptions/special treatment to the commercial real estate exposures which are restructured up to June 30, 2009.
- (ii) In terms of para 6.2.2(vi) of the circular, the special regulatory treatment is restricted only to the cases where the restructuring under consideration is not a 'repeated restructuring' as defined in para (v) of Annex 2 to the circular. In the face of the current economic downturn, there are likely to be instances of even viable units facing temporary cash flow problems. To address this problem, it has been decided, as a one-time measure, that the second restructuring done by banks of exposures (other than exposures to commercial real estate, capital market exposures and personal/consumer loans) upto June 30, 2009, will also be eligible for exceptional/special regulatory treatment.

Yours faithfully,

[P. Vijaya Bhaskar]
Chief General Manager

RBI/2008-09/ 307
DBOD.No.BP.BC.92 /21.06.001/2008-09

December 4, 2008

All Scheduled Commercial Banks
(excluding Local Area Banks and Regional Rural Banks)

Dear Sirs,

**Implementation of the New Capital Adequacy Framework (NCAF) –
Parallel run reporting format – Monitoring of Prudential Floor**

Please refer to paragraph 2.4 of our 'Master Circular – Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of NCAF', issued vide letter DBOD.No.BP.BC.11/21.06.001/2008-09 dated July 1, 2008, containing existing instructions regarding parallel run of the revised framework, introduced with effect from June, 2006.

2. The banks had been separately advised in May 2006 to cover certain broad elements while submitting their parallel run reports to their respective Boards, every quarter, for reviewing the results of the parallel run as also to furnish a copy of the report to the RBI. In the light of the experience gained in the parallel run of the NCAF over the last two years, and also with a view to ensuring a degree of standardisation in their reporting to the Boards and to the RBI, a reporting format (as per the Annex) has since been prepared for adoption by all the banks. The reporting in the format is expected to continue till March 2011/ March 2012, as per the date of migration to the NCAF by a bank, for monitoring compliance with Prudential Floors, envisaged in paragraph 4.1.2 of the aforesaid circular on NCAF.

3. The banks are advised to adopt the format for reporting to their Boards with effect from the quarter ending December 31, 2008. The format represents the minimum reporting requirements to the Board and banks could provide such additional information to their Boards as may be considered necessary. A copy of the quarterly report, duly approved by the Boards in the format prescribed, may also be sent to the Chief General Manager-in-Charge, Department of Banking Supervision, Central Office, Reserve Bank of India, World Trade Centre, Cuffe Parade, Coloba, Mumbai – 400 005, so as to reach RBI not later than a month from the end of the quarter to which it relates. In cases, where there the Board's approval of the report is likely to take longer time, the banks may furnish an advance copy of the report to the RBI, to be followed by the comments/remarks/guidance of the Board, if any, on the report.

Yours faithfully,

(P. Vijay Bhaskar)
Chief General Manager

**Format for the Parallel Run Report furnishing the Progress in Implementation
of New Capital Adequacy Framework for the Quarter ended**

Name of the Bank:.....

<u>Pillar I Aspects</u>

(Rs. in crore)

1.1 Capital Adequacy

1.1.1	Risk Weighted Assets		Basel-I		Basel-II	
			Book Value	Risk Weighted Value	Book Value	Risk Weighted Value
	RWA for Credit Risk					
	a)	<u>On Balance Sheet Items</u>				
	i.	Loan and Investment portfolio				
		• Standard				
		• NPA / NPI				
	ii.	Other Assets				
	b)	<u>Off Balance Sheet Items:</u>				
	i.	Market Related				
	ii.	Non-Market Related				
1.1.2	RWA for Market Risk					
1.1.3	RWA for Operational Risk					
1.1.4	Total Capital					
1.1.5		Tier I capital				
		Tier II capital				
	CRAR					

1.2 Rating profile of exposures

Sl. No.	Type of Exposure	Amount	Percentage of loan amount to total credit
1.2.1	Corporate Loans(Other than SME)		
	a) Rated		
	b) Unrated		
1.2.2	Corporate Loans(SME)		
	a) Rated		
	b) Unrated		
1.2.3	Securitised Exposures		N.A.
	a) Rated		
	b) Unrated		

Note: 'Rated' includes, ratings derived from Issuer rating / rating of other rated instruments of the same issuer.

1.3 Use of CRM Techniques - Extent of CRMs used

Sl. No.	Eligible Financial Collateral (FC)	Total amount of (FC) used	% to total amount	Net amount of FC after haircut	Percentage of FC to total RWA.	Capital relief availed on account of FC (9% of Net amount of FC after haircut)
1.3.1	Cash					
1.3.2	Gold					
1.3.3	Govt. Securities					
1.3.4	KVP/NSC					
1.3.5	LIC Policy					
1.3.6	Debt Securities					
	(i) Rated					
	(ii) Unrated					
1.3.7	Units of Mutual Fund					

1.4 Collateral Risk Management

	Govt. securities	Debt Securities	Gold	LIC/ NSC/ KVP	Units of MF
Frequency of Valuation of FC					

1.4.1 Any credit concentration recognized on account of the nature of collaterals?

1.4.2 Has the bank made an assessment of the market liquidity risk involved in the financial collateral? How is that taken into account in capital adequacy assessment under Pillar II?

1.4.3 What is the bank's assessment of operational risk especially the legal risk arising out of collaterals (such as on account of inadequate /incomplete documentation).

1.4.4 Does the bank hold as FC securities issued by any of its borrowing companies or their associates? If yes, the value of such FC may be indicated in the following table.

Latest Market value	Value after applicable haircut

1.4.5 Are any collateral securities for the bank's exposures held by the custodian? Does the bank ensure that the custodian segregates these securities from its own securities?

1.4.6 The amount of exposures subject to on-balance sheet netting.

1.4.7 Details of eligible non-financial collateral

	Basel-I	Basel-II
	The amount of NPA secured by physical collateral (in cases where the amount of provisions held is at least 15% of the outstanding).	The amount of <u>secured</u> portion of NPAs after taking into account only the physical collateral which is eligible as per para 5.12.4 of our circular dated April 27, 2007

Pillar II Aspects

2.1 Existence of ICAAP

2.1.1 Whether the bank has formulated the ICAAP with the approval of board?

2.1.2 If so, what are its main components and risks covered?

2.1.3 Whether the outcomes of the ICAAP are periodically submitted to the Board and RBI? At what periodicity the outcomes of the ICAAP are reviewed by the board and Senior Management?

2.1.4 Whether ICAAP is an integral part of the management and decision making in the bank?

2.2 Board and Senior management oversight

2.2.1 Whether the bank has a Risk Management Committee (RMC)? Is it a Board Level Committee?

2.2.2 If so, please indicate its composition and qualifications and experience of the members of the RMC.

2.2.3 Periodicity of submission of reports to the Board reviewing capital position and future capital needs of the banks.

2.2.4 Does the bank project its capital requirements in the medium term? If so, what parameters are taken into account in arriving at such projections?

2.2.5 Is the capital plan reviewed periodically? If yes, at what frequency? Please indicate the date of the last review.

2.2.6 Has the bank set up a separate Risk Management Department? If so, please indicate its broad set up.

2.2.7 Has the bank laid down a written detailed policy and procedure to ensure that the bank identifies, measures and reports all material risks to the board?

2.2.8 Does the bank have a process to relate its capital needs to risk?

- 2.2.9** Has the internal capital adequacy assessment process (ICAAP) is subject to an independent validation process? Is so, which agency conducts such validation – within or outside the bank? Whether validation has been brought within the scope of the Internal Audit?

2.3 Assessment of specific risks under ICAAP

2.3.1 Credit Risk

- A.** Has the bank identified any additional credit risks in the bank's credit portfolio such as credit concentration risk?
- B.** Does the bank think that its credit portfolio is well-diversified?
- C.** Does the bank assess the level of concentration risk in its non-retail portfolio by analyzing the distribution of such exposures across different bands within the regulatory ceiling for single borrower and group of borrower exposures, e.g. upto 5% of capital funds, 5-10% of capital funds and 10-15% of capital funds and so on?
- D.** The outstanding credit accounted for by the top 20 single borrower and top 20 borrower groups(separately):

Amount	% of total credit

- E.** Percentage of credit portfolio covered under the bank's internal rating system?

2.3.2 Operational Risk

- A.** Has the bank developed a framework for managing its operational risk exposure?
- B.** Does the bank consider that the capital maintained as per BIA is adequate for the level of operational risk it has.
- C.** Has the bank devised any strategy to transfer the operational risk outside the bank, such as by means of insurance?
- D.** Name the five sources of operational risks considered most significant for the bank at present, given its business mix and operational strategy?

2.3.3 Market Risk

- A.** Does the bank use VaR for managing any of its market risk exposures? If so, please indicate the names of such exposures?
- B.** Does the bank supplement the VaR measure with stress tests wherever it is used?
- C.** If so, please indicate the areas subjected to stress testing during the last quarter?
- D.** Is there a system of independent validation or the stress testing exercise? If so, by whom?

2.3.4 Interest rate risk in the banking book

- A. Does the bank assess its exposure to interest risk in the banking book?
- B. If so, does the bank calculate likely drop in Market Value of Equity with 200 bps change in interest rates? If so, please indicate the estimated impact of such shock as at the end of the last quarter.

2.3.5 Liquidity Risk

- A. How does the bank assess its liquidity risk exposure? Does it specifically estimate the market funding risk and market liquidity risk?
- B. Who is the authority/entity designated to monitor and manage the liquidity risk in the bank? Please give details.
- C. Whether the bank has a system of internal allocation of capital for liquidity risk? If so, please describe briefly.
- D. What are the five most important measures taken by the bank to control its liquidity risk?
- E. Total amount of bulk deposits taken from the 20 largest depositors and percentage of these deposits to total deposits

2.3.6 Non-quantifiable Risks

What is the methodology for assessing and controlling non-quantifiable risks such as reputation risk and strategic risk?

2.4 MIS and Audit

- 2.4.1 Please indicate the names and brief contents of the reports which are generated by the bank with a view to monitoring exposure to various risks and the final authority to whom the reports are put up? Please attach a separate sheet for this.
- 2.4.2 Does the external audit check/review the bank's ICAAP and other risk management reports? Are such Reports put up to the Audit Committee/RMC/Board for information?
- 2.4.3 Does the internal audit check the accuracy of MIS reports on risk management and capital adequacy submitted? Are the results of stress tests put up to the Board?
- 2.4.4 Does the bank have adequate MIS and level of computerisation and networking to support the implementation of Standardised approaches and ICAAP? If not, what are the plans and targets/deadlines set for achieving it?
- 2.4.5 Please indicate the major deficiencies identified in respect of the above.
- 2.4.6 Please indicate the steps taken to address the above deficiencies during the quarter.

2.5 Details of any additional capital requirement assessed by the bank

Sl. No.	Type of Risk	Capital add-on assessed	
		Amount	% age CRAR
2.5.1	Credit Concentration Risk		
2.5.2	Liquidity Risk		
2.5.3	Settlement Risk		
2.5.4	Reputational Risk		
2.5.5	Strategic Risk		
2.5.6	Risk for underestimation of Credit Risk		
2.5.7	Model Risk		
2.5.8	Risk on weakness in credit mitigants		
2.5.9	IRRBB		
2.5.10	Any other risks: (i) Quantifiable (ii) Non-quantifiable		
2.5.11	<i>In respect of risks already captured under Pillar-I</i>		
	(a) Credit Risk		
	(b) Market Risk		
	(c) Operational Risk		

2.6 Stress Testing

- A. Whether the bank has Board approved stress testing framework? What is the periodicity of review of stress testing framework?
- B. What are the risks covered under stress testing framework?
- C. At what periodicity, the stress tests are conducted and the results thereof are reviewed by the Board and senior management of the bank?
- D. Have there been any breaches in the stress tolerance levels in the past one year? If so, what are the remedial measures initiated by the bank?
- E. Is there any mechanism to validate the stress tests and their findings?

2.7 Skill development initiatives taken

How does the bank assess the adequacy of its human resources in terms of skills and specialisation required for smooth implementation of Basel II framework? Please indicate the HRD strategy adopted by the bank as also the major skill development initiatives taken during the quarter.

2.8 Miscellaneous

- A. What are the Board approved policy on disclosure?
- B. What are the mechanisms in place for validating the CRAR position computed as per the New Capital Adequacy framework?
- C. What are the assessments/findings /recommendations of these validation exercise?

RBI/2008-09/302
DBOD.No.BP.BC.89 /21.04.141/2008-09

December 1, 2008

All Scheduled Commercial Banks
(excluding Local Area Banks and Regional Rural Banks)

Dear Sir,

**Operations of foreign branches and subsidiaries of the Indian banks –
Compliance with statutory/regulatory/administrative prohibitions/ restrictions**

As you are aware, the banking operations carried out by the Indian banks are fully subject to various statutory and regulatory prohibitions and restrictions in force in India from time to time. The issue of applicability of these prohibitions / restrictions to the operations of foreign branches and subsidiaries of the Indian banks had arisen, and the matter has been examined by us. The position is clarified as under.

2. Section 5(b) of the Banking Regulation Act (B R Act), 1949 defines the business of banking and Section 6 (1) lays down the various forms of business which the banking companies can engage in. These Sections are also applicable to the public sector banks by virtue of a specific mention thereof in their respective statutes. Further, in terms of Section 19(1) of the B R Act, a bank can form a subsidiary company only for (i) undertaking an activity which is permitted to the parent bank itself under Section 6(1), *ibid*; (ii) carrying out the business of banking exclusively outside India; and (iii) undertaking such other business, considered conducive to the spread of banking in India, that the RBI may permit in public interest. This Section too is applicable to the public sector banks by virtue of the provisions of Section 51 of the B R Act.

3. In the course of operations of the Indian banks' branches and subsidiaries abroad, it is possible that while complying with the host-country regulatory requirements in certain jurisdictions, they might be required to undertake an activity which is not permitted under the B R Act / the respective statute of the public sector bank. In such circumstances, the banks are advised to ensure that they obtain from the RBI / Government of India necessary permission under Section 6 (1) (m) or 19 (1) (c), as the case may be, for undertaking such activities.

4. As regards transacting, by the foreign branches / foreign subsidiaries, in financial products which are not available in the Indian market and on which no specific prohibition has been currently placed by the RBI, no prior approval of the RBI would be required for the purpose provided these are merely plain-vanilla financial products. Banks should, however, ensure that their foreign branches / subsidiaries, dealing with such products in foreign jurisdictions, have adequate knowledge, understanding, and risk management capability for handling such products. Such products should also be appropriately captured and reported in the extant off-site returns furnished to the RBI. These products would also attract the prudential norms such as capital adequacy, credit exposure, periodical valuation, and all other applicable norms. In case the current RBI norms do not specify prudential treatment of such financial products, it would be incumbent upon the banks to seek specific RBI guidance in the matter.

5. If, however, the foreign branches / foreign subsidiaries of the Indian banks propose to handle structured financial products, banks should obtain prior approval of the RBI for the purpose by furnishing full particulars of these products including their regulatory treatment prescribed by the host-country regulators (for capital adequacy, valuation, pricing, exposure norms, etc), as also the risk management systems in place in the branch / subsidiary to deal with such products.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

RBI.No.2008-09/282
DBOD.BP.BC. 83 / 21.01.002/2008-09

November 15, 2008

All Commercial Banks
(excluding RRBs and LABs)

Dear Sirs,

Review of Prudential Norms – Provisioning for Standard Assets and Risk Weights for Exposures to Corporates, Commercial Real Estate and NBFC- ND-SI

Please refer to paragraph 5.5 of our Master Circular DBOD.No.BP.BC.20/21.04.048/2008-09 dated July 1, 2008 on IRAC Norms indicating the extant general provisioning requirements in respect of various types of standard assets and also paragraph 5.8.1, 5.11.2 and 5.13.5 of our Master Circular DBOD.No.BP.BC.11 / 21.06.001 / 2008-09 dated July 1, 2008 on New Capital Adequacy Framework indicating the risk weights in respect of the claims on corporates, claims secured by the commercial real estate and claims on Non-deposit taking systemically important non-banking financial companies (NBFC-ND-SI), other than asset finance companies (AFCs), respectively.

2. The aforesaid prudential requirements were prescribed in view of the continued high credit growth observed in specific sectors. On a review, it has now been decided, as a countercyclical measure, to effect the following changes in the aforesaid prudential norms, with immediate effect:

a) Provisioning Norms: The provisioning requirements for all types of standard assets stand reduced to a uniform level of 0.40 per cent except in the case of direct advances to agricultural and SME sectors, which shall continue to attract a provisioning of 0.25 per cent, as hitherto.

The revised norms would be effective prospectively but the provisions held at present should not be reversed. However, in future, if by applying the revised provisioning norms, any provisions are required over and above the level of provisions currently held for the standard category assets, these should be duly provided for.

b) Risk weights: The risk weights for the banks' claims on corporates, those secured by commercial real estate and the claims on the NBFC-ND-SI stand revised as follows:

- (i) Claims on corporates: All unrated claims, long term as well as short term, regardless of the amount of claim, on the corporates shall attract a uniform risk weight of 100 per cent.

- (ii) Claims secured by commercial real estate: Such claims would attract a risk weight of 100 per cent as against the extant risk weight of 150 per cent.
- (iii) Claims on NBFC-ND-SI: The claims on the rated as well as unrated NBFC-NDSI (other than AFCs), regardless of the amount of claim, shall be uniformly risk weighted at 100 per cent.

As regards the claims on AFCs, there is no change in the risk weights, which would continue to be governed by the credit rating of the AFC, except the claims that attract a risk weight of 150 per cent under the New Capital adequacy Framework, which shall be reduced to a level of 100 per cent.

3. The aforesaid modifications would also apply to banks under the Basel I framework.

Yours faithfully,

(Vinay Baijal)
Chief General Manager

RBI/2008-09/267
DBOD.No.BP.BC.76 /21.04.0132/2008-09

November 3, 2008

The Chairman and Managing Directors/
Chief Executive Officers of
All Scheduled Commercial Banks
(excluding Local Area Banks and Regional Rural Banks)

Dear Sir,

Prudential Guidelines on Restructuring of Advances by Banks

Please refer to paragraph 6.1 of our circular DBOD.No.BP.BC.37/21.04.132/2008-09 dated August 27, 2008 on the captioned subject, in terms of which only three categories of advances have been excluded from the special regulatory treatment for asset classification, upon their restructuring, as indicated vide paragraph 6 *ibid*. Thus, the housing loans granted by the banks would be eligible for special regulatory treatment, if restructured. In terms of paragraph 6.2.2 (iii), a ceiling of 10 years on the repayment period of the restructured advances (other than infrastructure advances) has also been stipulated for the restructured advances to be eligible for the special regulatory treatment.

2. It has been observed that the aforesaid ceiling of 10 years would make many of the housing loans ineligible for special regulatory treatment, since housing loans are normally granted with much longer repayment period.

3. The matter has been reviewed and it has been decided that the aforesaid ceiling of 10 years, over the repayment period of the restructured advances, would not be applicable for restructured housing loans, subject to compliance with all other terms and conditions prescribed in the aforesaid guidelines. The Board of Directors of the banks should prescribe the maximum period for restructured advances keeping in view the safety and soundness of advances.

4. It has also been decided that the restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points to the risk weights prescribed vide paragraph 5.10.1 of our Master Circular – Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of New Capital Adequacy Framework', issued vide circular DBOD.No.BP.Bc.11/21.06.0001/2008-09 dated July 1, 2008.

Yours faithfully,

(P Vijaya Bhaskar)
Chief General Manager

RBI/2008-09/252
DBOD.BP.BC.No.69/21.03.009/2008-09

October 29, 2008

All Scheduled Commercial Banks (excluding RRBs and LABs)
and All-India Term Lending and Refinancing Institutions

Dear Sirs,

Prudential Norms for Off-balance Sheet Exposures of Banks

Please refer to our circular DBOD.No.BP.BC.57 / 21.04.157 / 2008 – 09 October 13, 2008 on the captioned subject.

2. In terms of para 2.1 (i) of the aforesaid Circular, any receivable representing positive mark-to-market value of a derivative contract, if overdue for a period of 90 days or more, is required to be treated as non-performing asset and also makes all other funded facilities granted to the client as non-performing asset, following the principle of borrower-wise classification.

3. On a review of the matter, it has now been decided to confine the applicability of the principle of borrower-wise asset classification to only the overdues arising from forward contracts and plain vanilla swaps and options. Accordingly, any amount, representing positive mark-to-market value of the foreign exchange derivative contracts (other than forward contract and plain vanilla swaps and options) that were entered into during the period April 2007 to June 2008, which has already crystallised or might crystallise in future and is / becomes receivable from the client, should be parked in a separate account maintained in the name of the client / counterparty. This amount, even if overdue for a period of 90 days or more, will not make other funded facilities provided to the client, NPA on account of the principle of borrower-wise asset classification, though such receivable overdue for 90 days or more shall itself be classified as NPA, as per the extant IRAC norms. The classification of all other assets of such clients will, however, continue to be governed by the extant IRAC norms.

4. These relaxations will also be applicable to the foreign branches of Indian banks. All other instructions contained in the aforesaid Circular of October 13, 2008 remain unchanged.

Yours faithfully,

(Prashant Saran)
Chief General Manager-In-Charge

RBI/2008-09/217

DBOD.BP.BC. No.56 /21.04.157/2008-09

October 13 , 2008

The Chairman/ Chief Executive Officers
All commercial Banks
(excluding RRBs and LABs)

Dear Sir,

Guidelines on Exchange Traded Interest Rate Derivatives

Please refer to the guidelines on Exchange-Traded Interest Rate Derivatives issued vide our circular IDMC.MSRD.4801/06.01.03 dated June 3, 2003. In terms of this circular, banks were permitted to transact in Interest Rate Futures (IRFs) for the purpose of hedging the risk in their underlying investment portfolio.

2. It has now been decided to allow banks to take trading positions also in IRFs. Other provisions of above mentioned circular will continue to remain effective.

3. These guidelines will also be applicable to overseas branches of Indian banks.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

RBI /2008-09 / 218
DBOD.No.BP.BC.57 / 21.04.157 / 2008 – 09

October 13, 2008

All the Commercial Banks
(Excluding Local Area Banks and Regional Rural Banks)

Dear Sirs,

Prudential Norms for Off-balance Sheet Exposures of Banks

Please refer to our circular RBI/2008-09/125. DBOD.No.BP.BC.31/21.04.157/ 2008-09 dated August 8, 2008 on the captioned subject.

2. The issues regarding asset classification status of overdue payments in respect of derivative transactions and re-structuring of derivative contracts have been examined, and it is advised as under:

2.1 2.1 Asset Classification

- i) The overdue receivables representing positive mark-to-market value of a derivative contract will be treated as a non-performing asset, if these remain unpaid for 90 days or more. In that case all other funded facilities granted to the client shall also be classified as non-performing asset following the principle of borrower-wise classification as per the existing asset classification norms.
- ii) If the client concerned is also a borrower of the bank enjoying a Cash Credit or Overdraft facility from the bank, the receivables mentioned at item (i) above may be debited to that account on due date and the impact of its non-payment would be reflected in the cash credit/overdraft facility account. The principle of borrower-wise asset classification would be applicable here also, as per extant norms.
- iii) In cases where the contract provides for settlement of the current mark-to-market value of a derivative contract before its maturity, only the current credit exposure (not the potential future exposure) will be classified as a non-performing asset after an overdue period of 90 days.
- iv) As the overdue receivables mentioned above would represent unrealised income already booked by the bank on accrual basis, after 90 days of overdue period, the amount already taken to 'Profit and Loss a/c' should be reversed and held in a 'Suspense a/c' in the same manner as is done in the case of overdue advances.

2.2 2.2 Re-structuring of derivative contracts

In cases where a derivative contract is restructured, the mark-to-market value of the contract on the date of restructuring should be cash settled. For this purpose, any change in any of the parameters of the original contract would be treated as a restructuring.

3. These instructions will also be applicable to the foreign branches of Indian banks.

Yours faithfully,

(Prashant Saran)
Chief General Manager-In-Charge

RBI/2008-09/208
DPSS.CO.No.619/02.23.02/ 2008-09

October, 08, 2008

The Chairman and Managing Director / Chief Executive Officers
All Scheduled Commercial Banks including RRBs /
Urban Co-operative Banks / State Co-operative Banks /
District Central Co-operative Banks

Madam / Dear Sir

Mobile Banking transactions in India - Operative Guidelines for Banks

Mobile phones as a medium for providing banking services have been attaining greater importance. In order to ensure a level playing field and considering that the technology is relatively new, Reserve Bank has brought out a set of operating guidelines for adoption by banks. The guidelines that have been finalised following a wide consultative process shall be operational with immediate effect.

2. These guidelines are issued under Section 18 of the Payment and Settlement Systems Act, 2007 (Act 51 of 2007), without prejudice to permissions / approvals, if any, required under any other law.

Yours faithfully,

(G. Padmanabhan)
Chief General Manager

Mobile Banking transactions in India - Operative Guidelines for Banks

1. Introduction

- 1.1 Mobile phones as a medium for extending banking services have off-late been attaining greater significance. The rapid growth in users and wider coverage of mobile phone networks have made this medium an important platform for extending banking services to customers. With the rapid growth in the number of mobile phone subscribers in India (about 261 million as at the end of March 2008 and growing at about 8 million a month), banks have been exploring the feasibility of using mobile phones as an alternative channel of delivery of banking services. Some banks have started offering information based services like balance enquiry, stop payment instruction of cheques, transactions enquiry, location of the nearest ATM/branch etc. Acceptance of transfer of funds instruction for credit to beneficiaries of same/or another bank in favor of pre-registered beneficiaries have also commenced in a few banks. In order to ensure a level playing field and considering that the technology is relatively new, Reserve Bank has brought out a set of operating guidelines for adoption by banks.
- 1.2 For the purpose of these Guidelines, “mobile banking transactions” is undertaking banking transactions using mobile phones by bank customers that involve credit/debit to their accounts.

2. Regulatory & Supervisory Issues

- 2.1 Only banks which are licensed and supervised in India and have a physical presence in India will be permitted to offer mobile banking services.
- 2.2 The services shall be restricted only to customers of banks and/or holders of debit/credit cards issued as per the extant Reserve Bank of India guidelines.
- 2.3 Only Indian Rupee based domestic services shall be provided. Use of mobile banking services for cross border inward and outward transfers is strictly prohibited.
- 2.4 Banks may also use the services of Business Correspondent appointed in compliance with RBI guidelines, for extending this facility to their customers.
- 2.5 The guidelines issued by the Reserve Bank on ‘Risks and Controls in Computers and Telecommunications’ vide circular DBS.CO.ITC.BC. 10/ 31.09.001/ 97-98 dated 4th February 1998 will apply mutatis mutandis to mobile banking.
- 2.6 The guidelines issued by Reserve Bank on “Know Your Customer (KYC)”, “Anti Money Laundering (AML)” and Combating the Financing of Terrorism (CFT) from time to time would be applicable to mobile based banking services also.
- 2.7 Only banks who have implemented core banking solutions would be permitted to provide mobile banking services.
- 2.8 Banks shall file Suspicious Transaction Report (STR) to Financial Intelligence Unit – India (FIU-IND) for mobile banking transactions as in the case of normal banking transactions.

3. Registration of customers for mobile service

- 3.1 Banks shall put in place a system of document based registration with mandatory physical presence of their customers, before commencing mobile banking service. Reserve Bank would consider relaxation in specific cases while approving the proposals of banks.
- 3.2 On registration of the customer, the full details of the Terms and Conditions of the service offered shall be communicated to the customer.

4 Technology and Security Standards

- 4.1 Information Security is most critical to the business of mobile banking services and its underlying operations. Therefore, technology used for mobile banking must be secure and should ensure confidentiality, integrity, authenticity and non-repudiability. An illustrative, but not exhaustive framework is given at **Annex-I**.

5. Inter-operability

- 5.1 Banks offering mobile banking service must ensure that customers having mobile phones of any network operator is in a position to avail of the service. Restriction, if any, to the customers of particular mobile operator(s) is permissible only during the initial stages of offering the service, up to a maximum period of six months subject to review.
- 5.2 The long term goal of mobile banking framework in India would be to enable funds transfer from account in one bank to any other account in the same or any other bank on a real time basis irrespective of the mobile network a customer has subscribed to. This would require inter-operability between mobile banking service providers and banks and development of a host of message formats. To ensure inter-operability between banks, and between their mobile banking service providers, banks shall adopt the message formats like ISO 8583, with suitable modification to address specific needs.

6. Clearing and Settlement for inter-bank funds transfer transactions

- 6.1 To meet the objective of a nation-wide mobile banking framework, facilitating inter-bank settlement, a robust clearing and settlement infrastructure operating on a 24x7 basis would be necessary. Pending creation of such a national infrastructure, banks may enter into bilateral or multilateral arrangement for inter-bank settlements, with express permission from Reserve Bank of India, unless such arrangements have been authorized by the Reserve Bank under the Payment and Settlement System Act, 2007.

7. Customer Complaints and Grievance Redressal Mechanism

- 7.1 The customer /consumer protection issues assume a special significance in view of the fact that the delivery of banking services through mobile phones is relatively new. Some of the key issues in this regard are given at **Annex-II**.

8. Transaction limit

- 8.1 For the present, banks are permitted to offer this facility to their customers subject to a daily cap of Rs. 5000/- per customer for funds transfer and Rs.10,000/- per customer for transactions involving purchase of goods/services.
- 8.2 Banks may also put in place monthly transaction limit depending on the bank's own risk perception of the customer.

9. Board approval

- 9.1 Approval of the Board of Directors (Local Board in case of foreign banks) for the product, as also the perceived risks and mitigation measures proposed to be adopted must be obtained before launching the scheme.

10. Approval of Reserve Bank of India

- 10.1 Banks wishing to provide mobile banking services shall seek prior one time approval of the Reserve Bank of India, by furnishing full details of the proposal.

Technology and Security Standards

1. The security controls/guidelines mentioned in this document are only indicative. However, it must be recognised, the technology deployed is fundamental to safety and soundness of any payment system. Therefore, banks are required to follow the Security Standards appropriate to the complexity of services offered, subject to following the minimum standards set out in this document. The guidelines should be applied in a way that is appropriate to the risk associated with services provided by the bank and the system which supports these services.

2. Banks are required to put in place appropriate risk mitigation measures like transaction limit (per transaction, daily, weekly, monthly), transaction velocity limit, fraud checks, AML checks etc. depending on the bank's own risk perception, unless otherwise mandated by the Reserve Bank.

3. Authentication

Banks providing mobile banking services shall comply with the following security principles and practices for the authentication of mobile banking transactions:

- a) All mobile banking shall be permitted only by validation through a two factor authentication.
- b) One of the factors of authentication shall be mPIN or any higher standard.
- c) Where mPIN is used, end to end encryption of the mPIN is desirable, i.e mPIN shall not be in clear text anywhere in the network.
- d) The mPIN shall be stored in a secure environment.

4. Proper level of encryption and security shall be implemented at all stages of the transaction processing. The endeavor shall be to ensure end-to-end encryption of the mobile banking transaction. Adequate safe guards would also be put in place to guard against the use of mobile banking in money laundering, frauds etc. The following guidelines with respect to network and system security shall be adhered to:

- a) Implement application level encryption over network and transport layer encryption wherever possible.
- b) Establish proper firewalls, intruder detection systems (IDS), data file and system integrity checking, surveillance and incident response procedures and containment procedures.
- c) Conduct periodic risk management analysis, security vulnerability assessment of the application and network etc at least once in a year.
- d) Maintain proper and full documentation of security practices, guidelines, methods and procedures used in mobile banking and payment systems and keep them up to date based on the periodic risk management, analysis and vulnerability assessment carried out.

- e) Implement appropriate physical security measures to protect the system gateways, network equipments, servers, host computers, and other hardware/software used from unauthorized access and tampering. The Data Centre of the Bank and Service Providers should have proper wired and wireless data network protection mechanisms.

5. The dependence of banks on mobile banking service providers may place knowledge of bank systems and customers in a public domain. Mobile banking system may also make the banks dependent on small firms (i.e mobile banking service providers) with high employee turnover. It is therefore imperative that sensitive customer data, and security and integrity of transactions are protected. It is necessary that the mobile banking servers at the bank's end or at the mobile banking service provider's end, if any, should be certified by an accredited external agency. In addition, banks should conduct regular information security audits on the mobile banking systems to ensure complete security.

6. For mobile banking facilities which do not contain the phone number as identity, a separate login ID and password is desirable to ensure proper authentication.

Customer Protection Issues

1. Any security procedure adopted by banks for authenticating users needs to be recognized by law as a substitute for signature. In India, the Information Technology Act, 2000, provides for a particular technology as a means of authenticating electronic record. Any other method used by banks for authentication is a source of legal risk. Customers must be made aware of the said legal risk prior to sign up.
2. Banks are required to maintain secrecy and confidentiality of customers' accounts. In the mobile banking scenario, the risk of banks not meeting the above obligation is high. Banks may be exposed to enhanced risk of liability to customers on account of breach of secrecy, denial of service etc., on account of hacking/ other technological failures. The banks should, therefore, institute adequate risk control measures to manage such risks.
3. As in an Internet banking scenario, in the mobile banking scenario too, there is very limited or no stop-payment privileges for mobile banking transactions since it becomes impossible for the banks to stop payment in spite of receipt of stop payment instruction as the transactions are completely instantaneous and are incapable of being reversed. Hence, banks offering mobile banking should notify the customers the timeframe and the circumstances in which any stop-payment instructions could be accepted.
4. The Consumer Protection Act, 1986 defines the rights of consumers in India and is applicable to banking services as well. Currently, the rights and liabilities of customers availing of mobile banking services are being determined by bilateral agreements between the banks and customers. Taking into account the risks arising out of unauthorized transfer through hacking, denial of service on account of technological failure etc. banks providing mobile banking would need to assess the liabilities arising out of such events and take appropriate counter measures like insuring themselves against such risks, as in the case with internet banking.
5. Bilateral contracts drawn up between the payee and payee's bank, the participating banks and service provider should clearly define the rights and obligations of each party.
6. Banks are required to make mandatory disclosures of risks, responsibilities and liabilities of the customers on their websites and/or through printed material.
7. The existing mechanism for handling customer complaints / grievances may be used for mobile banking transactions as well. However, in view of the fact that the technology is relatively new, banks should set up a help desk and disclose the details of the help desk and escalation procedure for lodging the complaints, on their websites. Such details should also be made available to the customer at the time of sign up.
8. In cases where the customer files a complaint with the bank disputing a transaction, it would be the responsibility of the service providing bank, to expeditiously redress the complaint. Banks may put in place procedures for addressing such customer grievances. The grievance handling procedure including the compensation policy should be disclosed.
9. Customers complaints / grievances arising out of mobile banking facility would be covered under the Banking Ombudsman Scheme.
10. The jurisdiction of legal settlement would be within India.

RBI/2008-2009/183
DBOD No. BP. BC.46/ 08.12.001/2008-09

September 19, 2008

The Chairman & Managing Directors /Chief Executive Officers
of All Scheduled Commercial Banks (excluding RRBs and LABs)

Dear Sir,

Lending under Consortium Arrangement/Multiple Banking Arrangements

As you are aware, various regulatory prescriptions regarding conduct of consortium / multiple banking / syndicate arrangements were withdrawn by Reserve Bank of India in October 1996 with a view to introducing flexibility in the credit delivery system and to facilitate smooth flow of credit. However, Central Vigilance Commission, Government of India, in the light of frauds involving consortium/multiple banking arrangements which have taken place recently, has expressed concerns on the working of Consortium Lending and Multiple Banking Arrangements in the banking system. The Commission has attributed the incidence of frauds mainly to the lack of effective sharing of information about the credit history and the conduct of the account of the borrowers among various banks.

2 . The matter has been examined by us in consultation with the Indian Banks Association who are of the opinion that there is need for improving the sharing/dissemination of information among the banks about the status of the borrowers enjoying credit facilities from more than one bank. Accordingly, the banks are encouraged to strengthen their information back-up about the borrowers enjoying credit facilities from multiple banks as under:

- (i) At the time of granting fresh facilities, banks may obtain declaration from the borrowers about the credit facilities already enjoyed by them from other banks in **Annex 1**. In the case of existing lenders, all the banks may seek a declaration from their existing borrowers availing sanctioned limits of Rs.5.00 crore and above or wherever, it is in their knowledge that their borrowers are availing credit facilities from other banks, and introduce a system of exchange of information with other banks as indicated above.

- (ii) Subsequently, banks should exchange information about the conduct of the borrowers' accounts with other banks in the format given in **Annex II** at least at quarterly intervals.
- (iii) Obtain regular certification by a professional, preferably a Company Secretary, regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in **Annex III**.
- (iv) Make greater use of credit reports available from CIBIL.
- (v) The banks should incorporate suitable clauses in the loan agreements in future (at the time of next renewal in the case of existing facilities) regarding exchange of credit information so as to address confidentiality issues.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

ANNEX I**MINIMUM INFORMATION TO BE DECLARED BY BORROWING ENTITIES TO BANKS WHILE APPROACHING FOR FINANCE UNDER MULTIPLE BANKING ARRANGEMENTS****A. Details of borrowing arrangements from other banks (institution wise)**

I. Name and address of bank/institution	
II. Purpose for which borrowed	
III. Limit sanctioned (full details to be given, e.g. working capital / demand loan/ term loan / short term loan)/ foreign currency loan, corporate loan / line of credit / Channel financing contingent facilities like LC, BG, DPG (I & F) etc. Also, state L/C bills discounting/project wise finance availed)	
IV. Date of sanction	
V. Present outstanding	
VI. Overdues position, if any	
VII. Repayment terms (for demand loans, term loans, corporate loans, project - wise finance)	
VIII. Security offered (complete details of security both primary and collateral including specific cash flows assigned to project wise finance/loan raised & personal/ corporate guarantee, to be furnished)	
IX. Requests for facilities which are under process	

[The information to be given for domestic and overseas borrowings from commercial banks, Financial Institutions and NBFCs]

B. Miscellaneous Details

i. CPs raised during the year and current outstanding	
ii. Details of financing outside banking system e.g. L/C Bills discounting	
iii. Main and allied activities with locations	
iv. Territory of sales and market share	
v. Details of financial aspects incl. DSCR Projections wherever applicable as per requirement of bank – Imp. Financial covenants, if any, agreed to/accepted with other lenders.	
vi. CID A/cs, within/outside financing Banks, being operated, if any	
vii. Demands by statutory authorities/ current status thereof	
viii. Pending litigations	
ix. A declaration authorizing the bank to share information with other financing banks	

ANNEX II
REVISED FORMAT UNDER MULTIPLE BANKING ARRANGEMENT
CREDIT INFORMATION EXCHANGE
PART I (BIO DATA)

I.	Borrowing party's name and address	
II.	Constitution	
III.	Names of Directors / Partners	
IV.	Business activity • Main • Allied	
V.	Names of other financing Banks	
VI.	Net worth of Directors/Partners	
VII.	Group affiliation, if any	
VIII.	Date on associate concerns, if banking with the same bank	
IX.	Changes in shareholding and management from the previous report, if any	

PART II (FINANCIAL)

I.	IRAC Classification	
II.	Internal Credit rating with narration	
III.	External Credit rating, if any	
IV.	Latest available Annual Report of the borrower	As on -----

PART III (EXPOSURE DETAILS)

I.	Type of credit facilities, e.g. working capital loan / demand loan / term loan / short term loan / foreign currency loan, corporate loan / line of credit / Channel financing, contingent facilities like LC, BG & DPG (I & F) etc. Also, state L/C bills discounting / project wise finance availed).	
II.	Purpose of loan	
III.	Date of loan facilities (including temporary facilities)	
IV.	Amount sanctioned (facility wise)	
V.	Balance outstanding (facility wise)	
VI.	Repayment terms	
VII.	Security offered • Primary • Collateral • Personal / Corporate Guarantees • Extent of control over cash flow	
VIII.	Defaults in term commitments/ lease rentals / others	
IX.	Any other special information like court cases, statutory dues, major defaults, adverse internal / external audit observations .	
PART IV (EXPERIENCE)(*)		
I.	Conduct of funded facilities (based on cash management/ tendency to overdraw)	
II.	Conduct of contingent facilities (based on payment history)	
III.	Compliance with financial covenants	
IV.	Company's internal systems & procedures	
V.	Quality of management	
VI.	Overall Assessment	

(The above to be rated as good, satisfactory or below par only)

(*) Broad guidelines for incorporating comments under this head is furnished in the next page.

BROAD GUIDELINES FOR INCORPORATING COMMENTS UNDER PART IV

(EXPERIENCE) OF THE CREDIT INFORMATION REPORT

	GOOD	SATISFACTORY	BELOW PAR
I. Conduct of funded facilities			
• Overdrawings (No. of times)	Upto 4 times	5 to 6 times	Above 6 times
• Average period of adjustment	Within 1 month	Within 2 months	Beyond 2 months
• Extent of overdrawings (% of limit)	Upto 10%	10 to 20%	Above 20%
II. Conduct of contingent facilities			
• No. of Defaults	Upto 2 times	3 to 4 times	Above 4 times
• Average period of adjustment	Within 1 week	Within 2 weeks	Beyond 2 weeks
III. Compliance with financial covenants			
• Stock statement / Financial data	Timely	Delay upto 15 days	Delay over 15 days
• Creation of charge	Prompt	Delay upto 2 months	Delay over 2 months
IV. Company's internal systems and procedures			
• Inventory Management	Adequate systems are in place	Adequate systems are in place but not adhered	Adequate systems are not in place
• Receivables Management	- do -	- do -	- do -
• Resource Allocation	- do -	- do -	- do -
• Control over Information	- do -	- do -	- do -
V. Quality of management			
• Integrity	Reliable	Nothing adverse	Cannot be categorized in previous columns
• Expertise Competence/ Commitments	Professional & visionary	Have necessary experience	-do-
• Tract Record	Timely	Executions /	-do-

Part : I**DILIGENCE REPORT**

To,
The Manager,
_____ (Name of the Bank)

I/We have examined the registers, records, books and papers of _____ Limited (the Company) as required to be maintained under the Companies Act, 1956 (the Act) and the rules made thereunder, the provisions of various statutes, wherever applicable, the provisions contained in the Memorandum and Articles of Association of the Company as well as the provisions contained in the Listing Agreement/s, if any, entered into by the Company with the recognized stock exchange/s, as may be applicable for the half year ended on _____. In my/our opinion and to the best of my/our information and according to the examination carried out by me/us and explanations furnished to me/us by the Company, its officers and agents. I/We report that in respect of the aforesaid period:

1. the management of the Company is carried out by the Board of Directors comprising the following persons :
During the period under review the following changes took place :
2. the shareholding pattern of the company is as under :
During the period under review the following changes took place :
3. the company has altered the following provisions of
 - (i) the Memorandum of Association during the period under review and has complied with the provisions of the Act.
 - (ii) the following Articles of Association during the period under review and has complied with the provisions of the Act.
4. the company has during the period under review, entered into the following transactions with business entities in which directors are interested.
5. the company has during the period under review, advanced loans, given guarantees and provided securities amounting to Rs. _____ to its directors and/or persons or firms or companies in which directors are interested.
6. the Company has during the period under review, made loans and investments; or given guarantees or provided securities to other business entities as under:

7. the amount borrowed by the Company from directors, members, public, financial institutions, banks and others during the period under review is/are within the borrowing limits of the Company. The break up of the company's borrowings are as under:
8. the Company has during the period under review, not defaulted in the repayment of any public deposits or unsecured loans and the Company or its Directors are not under the Defaulter's list of Reserve Bank of India or in the Specific Approval List of ECGC.
9. the Company has during the period under review, created, modified or satisfied charges on the assets of the company as under:
10. the Forex exposure and Overseas Borrowings of the company are as under"
11. the Company has issued, offered and allotted all the securities to the persons entitled thereto and has also issued letters, coupons, warrants and certificates thereof to the concerned persons and also redeemed its preference shares/debentures and bought back its shares (wherever applicable) in compliance with the specified procedures and within the stipulated time.
12. the Company has insured all its secured assets.
13. the Company has complied with the terms and conditions, set forth by the lending institution at the time of availing the facility and also during the currency of the loan and has utilized the funds for the purposes for which these were borrowed.
14. the Company has declared and paid dividends to its shareholders as per the provisions of the Companies Act, 1956.
15. the Company has insured fully all its assets.
16. the Company / Directors are not in the willful defaulters' list of RBI.
17. the Company / Directors are not in the Specific Approval List of ECGC.
18. the Company has paid all its Statutory dues and that there are no arrears.
19. the Company has complied with the terms and conditions, set forth by the lending institution at the time of availing any facility and also during the currency of the loan.
20. the Company has used the funds for the purpose for which it borrowed.
21. the Company has declared and paid dividends to its shareholders, as per the provisions of the Companies Act.
22. the Company has complied with the provisions stipulated in Section 372 A of the

Companies Act in respect of its Inter Corporate loans and Investments.

23. the Company has complied with the applicable and mandatory Accounting Standards issued by the Institute of Chartered Accountants of India.
24. the Company has credited and paid to the Investor Education and Protection Fund all the unpaid dividends and other amounts required to be so credited.
25. a list of prosecutions initiated against or show cause notices received by the Company for alleged offences under the Act and also the fines and penalties or any other punishment imposed on the Company in such cases is attached.
26. the Company has complied with the various clauses of the Listing Agreement, if applicable.
27. the Company has deposited both Employees' and Employer's contribution to Provident Fund with the prescribed authorities.

Note : The qualification, reservation or adverse remarks, if any, may be stated at the relevant place(s).

Place:

Signature:

Date:

Name of Company Secretary:

C.P. No.:

Part II

CERTIFICATIONS OF BORROWAL COMPANIES
BY CHARTERED ACCOUNTANTS / COMPANY SECRETARIES

- i. Terms of reference for stock audit are to be spelt out clearly by the Banks, so that the Chartered Accountants can give focused attention to such areas.
- ii. End-use verification of funds lent, if certified by Statutory Auditors, will be a good comfort to the Banks.
- iii. As Banks quite often deal with unlisted companies, disclosure requirements for such companies above a specific turnover may be made akin to those for listed companies, viz. consolidated balance sheet, segmental reporting etc. Information on large shareholding also will be useful.
- iv. Further, the following additional certification either from Chartered Accountant or Company Secretary may also be thought of :-
 - (a) Company Directors not figuring in defaulters list (RBI/ECGC)/willful defaulters list etc.)
 - (b) Details of litigation above a specified cut off limit.
 - (c) A specific certificate, probably from the Company Secretary, regarding compliance with Sec. 372 (a) of the Companies Act.
 - (d) Details of creation/ modification/ satisfaction of charges on the assets of the company, position regarding insurance, show cause notices received, finds and penalties awarded.
- v. As regards rotation of Auditors, for the sake of operational convenience, it is suggested they may be changed once every 5 years instead of every 3 years.
- vi. In order to avoid concentration, group companies may have different Statutory / Internal Auditors in case group turnover exceeds Rs.100 crores.

RBI/2008-09/143
DBOD.No.BP.BC.No.37 /21.04.132/2008-09

August 27, 2008

The Chairman and Managing Directors/
Chief Executive Officers of
All Scheduled Commercial Banks
(excluding RRBs & LABs)

Dear Sir,

Prudential Guidelines on Restructuring of Advances by Banks

Please refer to the draft prudential guidelines on restructuring of loans by banks other than under Corporate Debt Restructuring(CDR) and Small and Medium Enterprises (SMEs)Debt Restructuring Mechanisms, which were placed on our website vide our circular DBOD.No.BP. BC.1522/21.04.132/2006-07 dated June 21, 2007 for public comments. These draft guidelines had been issued as per the announcement in the Annual Policy Statement for the year 2006-07, regarding constitution of a Working Group to review and align the existing guidelines on restructuring of advances (other than under CDR mechanism) on the lines of provisions under the revised CDR Mechanism.

2. Based on the recommendations of the Working Group and the public comments received on the draft prudential guidelines, the principles governing restructuring of different types of advances have now been aligned and fresh guidelines on the subject superseding all the guidelines on the subject issued so far, are enclosed.

3. These guidelines will be applicable to all accounts restructured after the date of this circular.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

PRUDENTIAL GUIDELINES ON RESTRUCTURING OF ADVANCES BY BANKS

1. Background

1.1 At present, the guidelines issued by the Reserve Bank of India on restructuring of advances (other than those restructured under a separate set of guidelines issued by the Rural Planning and Credit Department(RPCD) of the RBI on restructuring of advances on account of natural calamities) are divided into the following four categories:

- (i) Guidelines on restructuring of advances extended to industrial units.
- (ii) Guidelines on restructuring of advances extended to industrial units under the Corporate Debt Restructuring (CDR) Mechanism
- (iii) Guidelines on restructuring of advances extended to Small and Medium Enterprises (SME)
- (iv) Guidelines on restructuring of all other advances.

In these four sets of guidelines on restructuring of advances, the differentiation has been broadly made based on whether a borrower is engaged in an industrial activity or a non-industrial activity. In addition an elaborate institutional mechanism has been laid down for accounts restructured under CDR Mechanism. The major difference in the prudential regulations lies in the stipulation that subject to certain conditions, the accounts of borrowers engaged in industrial activities (under CDR Mechanism, SME Debt Restructuring Mechanism and outside these mechanisms) continue to be classified in the existing asset classification category upon restructuring. This benefit of retention of asset classification on restructuring is not available to the accounts of borrowers engaged in non-industrial activities except to SME borrowers. Another difference is that the prudential regulations covering the CDR Mechanism and restructuring of advances extended to SMEs are more detailed and comprehensive than that covering the restructuring of the rest of the advances including the advances extended to the industrial units, outside CDR Mechanism. Further, the CDR Mechanism is available only to the borrowers engaged in industrial activities.

1.2 Since the principles underlying the restructuring of all advances are identical, the prudential regulations too need to be aligned in all cases. Accordingly, this circular harmonises the prudential norms across all categories of debt restructuring mechanisms, other than those restructured on account of natural calamities which will continue to be covered by the extant guidelines issued by the RPCD. These prudential norms applicable to all restructurings including those under CDR Mechanism are laid down in para 3. The details of the institutional/organizational framework for CDR Mechanism and SME Debt Restructuring Mechanism are given in **Annex 1**.

It may be noted that while the general principles laid down in para 3 inter-alia stipulate that 'standard' advances should be re-classified as 'sub-standard' immediately on restructuring, all borrowers, with the exception of the borrowal categories specified in para 6.1 below (i.e consumer and personal advances, advances classified as capital market and real estate exposures), will be entitled to retain the asset classification upon restructuring, subject to the conditions enumerated in para 6.2.

1.3 Henceforth, the CDR Mechanism (**Annex 1**) will also be available to the corporates engaged in non-industrial activities, if they are otherwise eligible for restructuring as per the criteria laid down for this purpose. Further, banks are also encouraged to strengthen the co-ordination among themselves in the matter of restructuring of consortium/multiple banking accounts, which are not covered under the CDR Mechanism.

2. KEY CONCEPTS

Key concepts used in these guidelines are defined in **Annex 2**.

3. GENERAL PRINCIPLES AND PRUDENTIAL NORMS FOR RESTRUCTURED ADVANCES

The principles and prudential norms laid down in this paragraph are applicable to all advances including the borrowers, who are eligible for special regulatory treatment for asset classification as specified in para 6. In these cases, the provisions of paras 3.1.2, 3.2.1 and 3.2.2 would stand modified by the provisions in para 6.

3.1 Eligibility criteria for restructuring of advances

3.1.1 Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories.

3.1.2 Banks can **not** reschedule / restructure / renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re-classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring / rescheduling / renegotiation. In case there is undue delay in sanctioning a restructuring package and in the meantime the asset classification status of the account undergoes deterioration, it would be a matter of supervisory concern.

3.1.3 Normally, restructuring can not take place unless alteration / changes in the original loan agreement are made with the formal consent / application of the debtor. However, the process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.

3.1.4 No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis, depending on merits of each case. *Illustratively*, the parameters may include the Return on Capital Employed, Debt Service Coverage Ratio, Gap between the Internal Rate of Return and Cost of Funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance. The accounts not considered viable should not be restructured and banks should accelerate the recovery measures in respect of such accounts. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects / activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns/action.

3.1.5 While the borrowers indulging in frauds and malfeasance will continue to remain ineligible for restructuring, banks may review the reasons for classification of the borrowers as wilful defaulters specially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent and satisfy itself that the borrower is in a position to rectify the wilful default. The restructuring of such cases may be done with Board's approval, while for such accounts the restructuring under the CDR Mechanism may be carried out with the approval of the Core Group only.

3.1.6. BIFR cases are not eligible for restructuring without their express approval. CDR Core Group in the case of advances restructured under CDR Mechanism / the lead bank in the case of SME Debt Restructuring Mechanism and the individual banks in other cases, may consider the proposals for restructuring in such cases, after ensuring that all the formalities in seeking the approval from BIFR are completed before implementing the package.

3.2 Asset classification norms

Restructuring of advances could take place in the following stages :

- (a) before commencement of commercial production/operation;
- (b) after commencement of commercial production/operation but before the asset has been classified as 'sub-standard';
- (c) after commencement of commercial production/operation and the asset has been classified as 'sub-standard' or 'doubtful'.

3.2.1 The accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring.

3.2.2 The non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per extant asset classification norms with reference to the pre-restructuring repayment schedule.

3.2.3 All restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for up-gradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period' (**Annex 2**).

3.2.4. In case, however, satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

3.2.5 Any additional finance may be treated as 'standard asset', up to a period of one year after the first interest / principal payment, whichever is earlier, falls due under the approved restructuring package. However, in the case of accounts where the pre-restructuring facilities were classified as 'sub-standard' and 'doubtful', interest income on the additional finance should be recognised only on cash basis. If the restructured asset

does not qualify for upgradation at the end of the above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

3.2.6 In case a restructured asset, which is a standard asset on restructuring, is subjected to restructuring on a subsequent occasion, it should be classified as sub-standard. If the restructured asset is a sub-standard or a doubtful asset and is subjected to restructuring, on a subsequent occasion, its asset classification will be reckoned from the date when it became NPA on the first occasion. However, such advances restructured on second or more occasion may be allowed to be upgraded to standard category after one year from the date of first payment of interest or repayment of principal whichever falls due earlier in terms of the current restructuring package subject to satisfactory performance.

3.3 Income recognition norms

Subject to provisions of paragraphs 3.2.5, 4.2 and 5.2, interest income in respect of restructured accounts classified as 'standard assets' will be recognized on accrual basis and that in respect of the accounts classified as 'non-performing assets' will be recognized on cash basis.

3.4 Provisioning norms

3.4.1 Normal provisions

Banks will hold provision against the restructured advances as per the existing provisioning norms.

3.4.2 Provision for diminution in the fair value of restructured advances

(i) Reduction in the rate of interest and /or reschedulement of the repayment of principal amount, as part of the restructuring, will result in diminution in the fair value of the advance. Such diminution in value is an economic loss for the bank and will have impact on the bank's market value of equity. It is, therefore, necessary for banks to measure such diminution in the fair value of the advance and make provisions for it by debit to Profit & Loss Account. Such provision should be held in addition to the provisions as per existing provisioning norms as indicated in para 3.4.1 above, and in an account distinct from that for normal provisions.

For this purpose, the erosion in the fair value of the advance should be computed as the difference between the "*the present value of future cash flows (principal and interest) reckoned based on the current BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring*", and '*the present value of future cash flows' (principal and interest) based on rate charged as per the restructuring package*'. For computing the present value, the discount rate to be applied should be equivalent to the (current BPLR as on

the date of restructuring + appropriate term premium + credit risk premium applicable to the borrower as on the date of restructuring).

(ii) In the case of working capital facilities, the diminution in the fair value of the cash credit /overdraft component may be computed as indicated in para (i) above, reckoning the higher of the outstanding amount or the limit sanctioned as the principal amount and taking the tenor of the advance as one year. The term premium in the discount factor would be as applicable for one year. The fair value of the term loan components(Working Capital Term Loan and Funded Interest Term Loan) would be computed as per actual cash flows and taking the term premium in the discount factor as applicable for the maturity of the respective term loan components.

(iii) In the event any security is taken in lieu of the diminution in the fair value of the advance, it should be valued at Re.1/- till maturity of the security. This will ensure that the effect of charging off the economic sacrifice to the Profit & Loss account is not negated.

(iv) The diminution in the fair value may be re-computed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account, so as to capture the changes in the fair value on account of changes in BPLR, term premium and the credit category of the borrower. Consequently, banks may provide for the shortfall in provision or reverse the amount of excess provision held in the distinct account.

(v) If due to lack of expertise/ appropriate infrastructure, a bank finds it difficult to ensure computation of diminution in the fair value of advances extended by small/rural branches, as an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, banks will have the option of notionally computing the amount of diminution in the fair value and providing therefor, **at five percent** of the total exposure, in respect of all restructured accounts where the total dues to bank(s) are less than **rupees one crore** till the financial year ending March 2011. The position would be reviewed thereafter.

3.4.3 The total provisions required against an account (normal provisions plus provisions in lieu of diminution in the fair value of the advance) are capped at 100% of the outstanding debt amount.

4. PRUDENTIAL NORMS FOR CONVERSION OF PRINCIPAL INTO DEBT/EQUITY

4.1. Asset classification norms

A part of the outstanding principal amount can be converted into debt or equity instruments as part of restructuring. The debt/equity instruments so created will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of these instruments would also be determined based on the subsequent asset classification of the restructured advance.

4.2 Income recognition norms

4.2.1 Standard Accounts

In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognised on accrual basis.

4.2.2 Non- Performing Accounts

In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognised only on cash basis.

4.3 Valuation and provisioning norms

These instruments should be held under AFS and valued as per usual valuation norms. Equity classified as standard asset should be valued either at market value, if quoted, or at break-up value, if not quoted (without considering the revaluation reserve, if any,) which is to be ascertained from the company's latest balance sheet. In case the latest balance sheet is not available the shares are to be valued at Rs 1. Equity instrument classified as NPA should be valued at market value, if quoted, and in case where equity is not quoted, it should be valued at Rs. 1.00. Depreciation on these instruments should not be offset against the appreciation in any other securities held under the AFS category.

5. PRUDENTIAL NORMS FOR CONVERSION OF UNPAID INTEREST INTO 'FUNDED INTEREST TERM LOAN' (FITL), DEBT OR EQUITY INSTRUMENTS

5.1 Asset classification norms

The FITL/debt or equity instrument created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified. Further movement in the asset classification of FITL/ debt or equity instruments would also be determined based on the subsequent asset classification of the restructured advance.

5.2 Income recognition norms

5.2.1 The income, if any, generated by these instruments may be recognised on accrual basis, if these instruments are classified as 'standard', and on cash basis in the cases where these have been classified as a non-performing asset.

5.2.2 The unrealised income represented by FITL/Debt or equity instrument should have a corresponding credit in an account styled as "Sundry Liabilities Account (Interest Capitalization)".

5.2.3 In the case of conversion of unrealised interest income into equity, which is quoted, interest income can be recognized after the account is upgraded to standard category at market value of equity, on the date of such up gradation, not exceeding the amount of interest converted into equity.

5.2.4 Only on repayment in case of FITL or sale/redemption proceeds of the debt/equity instruments, the amount received will be recognized in the P&L Account, while simultaneously reducing the balance in the "Sundry Liabilities Account (Interest Capitalisation)".

5.3 Valuation & Provisioning norms

Valuation and provisioning norms would be as per para 4.3 above. The depreciation, if any, on valuation may be charged to the Sundry Liabilities (Interest Capitalisation) Account.

6. SPECIAL REGULATORY TREATMENT FOR ASSET CLASSIFICATION

6.1 The special regulatory treatment for asset classification, in modification to the provisions in this regard stipulated in para 3, will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions as enumerated in para 6. 2 below. Such treatment is not extended to the following categories of advances:

- i. *Consumer and personal advances*
- ii. *Advances classified as Capital market exposures*
- iii. *Advances classified as commercial real estate exposures;*

The asset classification of these three categories accounts as well as that of other accounts which do not comply with the conditions enumerated in para 6.2, will be governed by the prudential norms in this regard described in para 3 above.

6. 2 Elements of special regulatory framework

The special regulatory treatment has the following two components:

- (i) Incentive for quick implementation of the restructuring package.
- (ii) Retention of the asset classification of the restructured account in the pre-restructuring asset classification category

6.2.1 Incentive for quick implementation of the restructuring package.

As stated in para 3.1.2, during the pendency of the application for restructuring of the advance with the bank, the usual asset classification norms would continue to apply. The process of reclassification of an asset should not stop merely because the application is under consideration. However, as an incentive for quick implementation of the package, if the approved package is implemented by the bank as per the following time schedule, the asset classification status may be restored to the position which existed when the reference was made to the CDR Cell in respect of cases covered under the CDR Mechanism or when the restructuring application was received by the bank in non-CDR cases:

- (i) Within 120 days from the date of approval under the CDR Mechanism.
- (ii) Within 90 days from the date of receipt of application by the bank in cases other than those restructured under the CDR Mechanism.

6.2.2 Asset classification benefits

Subject to the compliance with the undernoted conditions in addition to the adherence to the prudential framework laid down in para 3:

- (i) In modification to para 3.2.1, an existing 'standard asset' will not be downgraded to the sub-standard category upon restructuring.
- (ii) In modification to para 3.2.2, during the specified period, the asset classification of the sub-standard/doubtful accounts will not deteriorate upon restructuring, if satisfactory performance is demonstrated during the specified period.

However, these benefits will be available subject to compliance with the following conditions:

- i) The dues to the bank are 'fully secured' as defined in **Annex 2**. The condition of being fully secured by tangible security will not be applicable in the following cases:
 - (a) SSI borrowers, where the outstanding is up to Rs.25 lakh.
 - (b) Infrastructure projects, provided the cash flows generated from these projects are adequate for repayment of the advance, the financing bank(s) have in place an appropriate mechanism to escrow the cash flows, and also have a clear and legal first claim on these cash flows.

- ii) The unit becomes viable in 10 years, if it is engaged in infrastructure activities, and in 7 years in the case of other units.
- iii) The repayment period of the restructured advance including the moratorium, if any, does not exceed 15 years in the case of infrastructure advances and 10 years in the case of other advances.
- iv) Promoters' sacrifice and additional funds brought by them should be a minimum of 15% of banks' sacrifice.
- v) Personal guarantee is offered by the promoter except when the unit is affected by external factors pertaining to the economy and industry.
- vi) The restructuring under consideration is not a 'repeated restructuring' as defined in para (v) of **Annex 2**.

7. MISCELLANEOUS

7.1 The banks should decide on the issue regarding convertibility (into equity) option as a part of restructuring exercise whereby the banks / financial institutions shall have the right to convert a portion of the restructured amount into equity, keeping in view the statutory requirement under Section 19 of the Banking Regulation Act, 1949, (in the case of banks) and relevant SEBI regulations.

7.2 Acquisition of equity shares / convertible bonds / convertible debentures in companies by way of conversion of debt / overdue interest can be done without seeking prior approval from RBI, even if by such acquisition the prudential capital market exposure limit prescribed by the RBI is breached. However, this will be subject to reporting of such holdings to RBI, Department of Banking Supervision (DBS), every month along with the regular DSB Return on Asset Quality. Nonetheless, banks will have to comply with the provisions of Section 19(2) of the Banking Regulation Act, 1949.

7.3 Acquisition of non-SLR securities by way of conversion of debt is exempted from the mandatory rating requirement and the prudential limit on investment in unlisted non-SLR securities, prescribed by the RBI, subject to periodical reporting to the RBI in the aforesaid DSB return.

7.4 Banks may consider incorporating in the approved restructuring packages creditor's rights to accelerate repayment and the borrower's right to pre-pay. The right of recompense should be based on certain performance criteria to be decided by the banks.

8. DISCLOSURES

Banks should also disclose in their published annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances in **Annex-3**. The information would be required for advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories separately.

9. ILLUSTRATIONS

A few illustrations on the asset classification of restructured accounts are given in **Annex-4**.

ORGANISATIONAL FRAMEWORK FOR RESTRUCTURING OF ADVANCES UNDER CONSORTIUM/MULTIPLE BANKING /SYNDICATION ARRANGEMENTS

A. Corporate Debt Restructuring (CDR) Mechanism

1.1 Objective

The objective of the Corporate Debt Restructuring (CDR) framework is to ensure timely and transparent mechanism for restructuring the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned. In particular, the framework will aim at preserving viable corporates that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

1.2 Scope

The CDR Mechanism has been designed to facilitate restructuring of advances of borrowers enjoying credit facilities from more than one bank/Financial Institution (FI) in a coordinated manner. The CDR Mechanism is an organizational framework institutionalized for speedy disposal of restructuring proposals of large borrowers availing finance from more than one banks/FIs. This mechanism will be available to **all borrowers** engaged in any type of activity subject to the following conditions:

- a) The borrowers enjoy credit facilities from more than one bank/FI under multiple banking / syndication / consortium system of lending.
- b) The total outstanding (fund-based and non-fund based) exposure is Rs.10 crore or above.

CDR system in the country will have a three tier structure :

- * CDR Standing Forum and its Core Group
- * CDR Empowered Group
- * CDR Cell

2. CDR Standing Forum

2.1 The CDR Standing Forum would be the representative general body of all financial institutions and banks participating in CDR system. All financial institutions and banks should participate in the system in their own interest. CDR Standing Forum will be a self-empowered body, which will lay down policies and guidelines, and monitor the progress of corporate debt restructuring.

2.2 The Forum will also provide an official platform for both the creditors and borrowers (by consultation) to amicably and collectively evolve policies and guidelines for working out debt restructuring plans in the interests of all concerned.

2.3 The CDR Standing Forum shall comprise of Chairman & Managing Director, Industrial Development Bank of India Ltd; Chairman, State Bank of India; Managing Director & CEO, ICICI Bank Limited; Chairman, Indian Banks' Association as well as Chairmen and Managing Directors of all banks and financial institutions participating as permanent members in the system. Since institutions like Unit Trust of India, General Insurance Corporation, Life Insurance Corporation may have assumed exposures on certain borrowers, these institutions may participate in the CDR system. The Forum will elect its Chairman for a period of one year and the principle of rotation will be followed in the subsequent years. However, the Forum may decide to have a Working Chairman as a whole-time officer to guide and carry out the decisions of the CDR Standing Forum. The RBI would not be a member of the CDR Standing Forum and Core Group. Its role will be confined to providing broad guidelines.

2.4 The CDR Standing Forum shall meet at least once every six months and would review and monitor the progress of corporate debt restructuring system. The Forum would also lay down the policies and guidelines including those relating to the critical parameters for restructuring (for example, maximum period for a unit to become viable under a restructuring package, minimum level of promoters' sacrifice etc.) to be followed by the CDR Empowered Group and CDR Cell for debt restructuring and would ensure their smooth functioning and adherence to the prescribed time schedules for debt restructuring. It can also review any individual decisions of the CDR Empowered Group and CDR Cell. The CDR Standing Forum may also formulate guidelines for dispensing special treatment to those cases, which are complicated and are likely to be delayed beyond the time frame prescribed for processing.

2.5 A CDR Core Group will be carved out of the CDR Standing Forum to assist the Standing Forum in convening the meetings and taking decisions relating to policy, on behalf of the Standing Forum. The Core Group will consist of Chief Executives of Industrial Development Bank of India Ltd., State Bank of India, ICICI Bank Ltd, Bank of Baroda, Bank of India, Punjab National Bank, Indian Banks' Association and Deputy Chairman of Indian Banks' Association representing foreign banks in India.

2.6 The CDR Core Group would lay down the policies and guidelines to be followed by the CDR Empowered Group and CDR Cell for debt restructuring. These guidelines shall also suitably address the operational difficulties experienced in the functioning of the CDR Empowered Group. The CDR Core Group shall also prescribe the PERT chart for processing of cases referred to the CDR system and decide on the modalities for enforcement of the time frame. The CDR Core Group shall also lay down guidelines to ensure that over-optimistic projections are not assumed while preparing / approving restructuring proposals especially with regard to capacity utilization, price of products, profit margin, demand, availability of raw materials, input-output ratio and likely impact of imports / international cost competitiveness.

3. CDR Empowered Group

3.1 The individual cases of corporate debt restructuring shall be decided by the CDR Empowered Group, consisting of ED level representatives of Industrial Development Bank of India Ltd., ICICI Bank Ltd. and State Bank of India as standing members, in addition to ED level representatives of financial institutions and banks who have an exposure to the concerned company. While the standing members will facilitate the conduct of the Group's meetings, voting will be in proportion to the exposure of the creditors only. In order to make the CDR Empowered Group effective and broad based and operate efficiently and smoothly, it would have to be ensured that participating institutions / banks approve a panel of senior officers to represent them in the CDR Empowered Group and ensure that they depute officials only from among the panel to attend the meetings of CDR Empowered Group. Further, nominees who attend the

meeting pertaining to one account should invariably attend all the meetings pertaining to that account instead of deputing their representatives.

3.2 The level of representation of banks / financial institutions on the CDR Empowered Group should be at a sufficiently senior level to ensure that concerned bank / FI abides by the necessary commitments including sacrifices, made towards debt restructuring. There should be a general authorisation by the respective Boards of the participating institutions / banks in favour of their representatives on the CDR Empowered Group, authorising them to take decisions on behalf of their organization, regarding restructuring of debts of individual corporates.

3.3 The CDR Empowered Group will consider the preliminary report of all cases of requests of restructuring, submitted to it by the CDR Cell. After the Empowered Group decides that restructuring of the company is prima-facie feasible and the enterprise is potentially viable in terms of the policies and guidelines evolved by Standing Forum, the detailed restructuring package will be worked out by the CDR Cell in conjunction with the Lead Institution. However, if the lead institution faces difficulties in working out the detailed restructuring package, the participating banks / financial institutions should decide upon the alternate institution / bank which would work out the detailed restructuring package at the first meeting of the Empowered Group when the preliminary report of the CDR Cell comes up for consideration.

3.4 The CDR Empowered Group would be mandated to look into each case of debt restructuring, examine the viability and rehabilitation potential of the Company and approve the restructuring package within a specified time frame of 90 days, or at best within 180 days of reference to the Empowered Group. The CDR Empowered Group shall decide on the acceptable viability benchmark levels on the following illustrative parameters, which may be applied on a case-by-case basis, based on the merits of each case :

- * Return on Capital Employed (ROCE),
- * Debt Service Coverage Ratio (DSCR),
- * Gap between the Internal Rate of Return (IRR) and the Cost of Fund (CoF),
- * Extent of sacrifice.

3.5 The Board of each bank / FI should authorise its Chief Executive Officer (CEO) and / or Executive Director (ED) to decide on the restructuring package in respect of cases referred to the CDR system, with the requisite requirements to meet the control needs. CDR Empowered Group will meet on two or three occasions in respect of each borrowal account. This will provide an opportunity to the participating members to seek proper authorisations from their CEO / ED, in case of need, in respect of those cases where the critical parameters of restructuring are beyond the authority delegated to him / her.

3.6 The decisions of the CDR Empowered Group shall be final. If restructuring of debt is found to be viable and feasible and approved by the Empowered Group, the company would be put on the restructuring mode. If restructuring is not found viable, the creditors would then be free to take necessary steps for immediate recovery of dues and / or liquidation or winding up of the company, collectively or individually.

4. CDR Cell

4.1 The CDR Standing Forum and the CDR Empowered Group will be assisted by a CDR Cell in all their functions. The CDR Cell will make the initial scrutiny of the proposals received from borrowers / creditors, by calling for proposed rehabilitation plan and other information and put up the matter before the CDR Empowered Group, within one month to decide whether rehabilitation is prima facie feasible. If found feasible, the

CDR Cell will proceed to prepare detailed Rehabilitation Plan with the help of creditors and, if necessary, experts to be engaged from outside. If not found prima facie feasible, the creditors may start action for recovery of their dues.

4.2 All references for corporate debt restructuring by creditors or borrowers will be made to the CDR Cell. It shall be the responsibility of the lead institution / major stakeholder to the corporate, to work out a preliminary restructuring plan in consultation with other stakeholders and submit to the CDR Cell within one month. The CDR Cell will prepare the restructuring plan in terms of the general policies and guidelines approved by the CDR Standing Forum and place for consideration of the Empowered Group within 30 days for decision. The Empowered Group can approve or suggest modifications but ensure that a final decision is taken within a total period of 90 days. However, for sufficient reasons the period can be extended up to a maximum of 180 days from the date of reference to the CDR Cell.

4.3 The CDR Standing Forum, the CDR Empowered Group and CDR Cell is at present housed in Industrial Development Bank of India Ltd. However, it may be shifted to another place if considered necessary, as may be decided by the Standing Forum. The administrative and other costs shall be shared by all financial institutions and banks. The sharing pattern shall be as determined by the Standing Forum.

4.4 CDR Cell will have adequate members of staff deputed from banks and financial institutions. The CDR Cell may also take outside professional help. The cost in operating the CDR mechanism including CDR Cell will be met from contribution of the financial institutions and banks in the Core Group at the rate of Rs.50 lakh each and contribution from other institutions and banks at the rate of Rs.5 lakh each.

5. Other features

5.1. Eligibility criteria

5.1.1 The scheme will not apply to accounts involving only one financial institution or one bank. The CDR mechanism will cover only multiple banking accounts / syndication / consortium accounts of corporate borrowers engaged in any type of activity with outstanding fund-based and non-fund based exposure of Rs.10 crore and above by banks and institutions.

5.1.2. The Category 1 CDR system will be applicable only to accounts classified as 'standard' and 'sub-standard'. There may be a situation where a small portion of debt by a bank might be classified as doubtful. In that situation, if the account has been classified as 'standard' / 'substandard' in the books of at least 90% of creditors (by value), the same would be treated as standard / substandard, only for the purpose of judging the account as eligible for CDR, in the books of the remaining 10% of creditors. There would be no requirement of the account / company being sick, NPA or being in default for a specified period before reference to the CDR system. However, potentially viable cases of NPAs will get priority. This approach would provide the necessary flexibility and facilitate timely intervention for debt restructuring. Prescribing any milestone(s) may not be necessary, since the debt restructuring exercise is being triggered by banks and financial institutions or with their consent.

5.1.3. While corporates indulging in frauds and malfeasance even in a single bank will continue to remain ineligible for restructuring under CDR mechanism as hitherto, the Core group may review the reasons for classification of the borrower as wilful defaulter specially in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent and satisfy itself that the borrower is in a position to rectify the wilful default provided he is granted an opportunity under the CDR mechanism. Such exceptional cases may be admitted for restructuring with the approval of the Core Group only. The Core Group may ensure that cases involving frauds or diversion of funds with malafide intent are not covered.

5.1.4 The accounts where recovery suits have been filed by the creditors against the company, may be eligible for consideration under the CDR system provided, the initiative to resolve the case under the CDR system is taken by at least 75% of the creditors (by value) and 60% of creditors (by number).

5.1.5. BIFR cases are not eligible for restructuring under the CDR system. However, large value BIFR cases, may be eligible for restructuring under the CDR system if specifically recommended by the CDR Core Group. The Core Group shall recommend exceptional BIFR cases on a case-to-case basis for consideration under the CDR system. It should be ensured that the lending institutions complete all the formalities in seeking the approval from BIFR before implementing the package.

5.2 Reference to CDR system

5.2.1. Reference to Corporate Debt Restructuring System could be triggered by (i) any or more of the creditor who have minimum 20% share in either working capital or term finance, or (ii) by the concerned corporate, if supported by a bank or financial institution having stake as in (i) above.

5.2.2. Though flexibility is available whereby the creditors could either consider restructuring outside the purview of the CDR system or even initiate legal proceedings where warranted, banks / FIs should review all eligible cases where the exposure of the financial system is more than Rs.100 crore and decide about referring the case to CDR system or to proceed under the new Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 or to file a suit in DRT etc.

5.3 Legal Basis

5.3.1 CDR is a non-statutory mechanism which is a voluntary system based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA). The Debtor-Creditor Agreement (DCA) and the Inter-Creditor Agreement (ICA) shall provide the legal basis to the CDR mechanism. The debtors shall have to accede to the DCA, either at the time of original loan documentation (for future cases) or at the time of reference to Corporate Debt Restructuring Cell. Similarly, all participants in the CDR mechanism through their membership of the Standing Forum shall have to enter into a legally binding agreement, with necessary enforcement and penal clauses, to operate the System through laid-down policies and guidelines. The ICA signed by the creditors will be initially valid for a period of 3 years and subject to renewal for further periods of 3 years thereafter. The lenders in foreign currency outside the country are not a part of CDR system. Such creditors and also creditors like GIC, LIC, UTI, etc., who have not joined the CDR system, could join CDR mechanism of a particular corporate by signing transaction to transaction ICA, wherever they have exposure to such corporate.

5.3.2 The Inter-Creditor Agreement would be a legally binding agreement amongst the creditors, with necessary enforcement and penal clauses, wherein the creditors would commit themselves to abide by the various elements of CDR system. Further, the creditors shall agree that if 75 per cent of creditors by value and 60 per cent of the creditors by number, agree to a restructuring package of an existing debt (i.e., debt outstanding), the same would be binding on the remaining creditors. Since Category 1 CDR Scheme covers only standard and sub-standard accounts, which in the opinion of 75 per cent of the creditors by value and 60 per cent of creditors by number, are likely to become performing after introduction of the CDR package, it is expected that all other creditors (i.e., those outside the minimum 75 per cent by value and 60 per cent by number) would be willing to participate in the entire CDR package, including the agreed additional financing.

5.3.3. In order to improve effectiveness of the CDR mechanism a clause may be incorporated in the loan agreements involving consortium / syndicate accounts whereby all creditors, including those which are not members of the CDR mechanism, agree to be bound by the terms of the restructuring package that may be approved under the CDR mechanism, as and when restructuring may become necessary.

5.3.4 One of the most important elements of Debtor-Creditor Agreement would be 'stand still' agreement binding for 90 days, or 180 days by both sides. Under this clause, both the debtor and creditor(s) shall agree to a legally binding 'stand-still' whereby both the parties commit themselves not to take recourse to any other legal action during the 'stand-still' period, this would be necessary for enabling the CDR System to undertake the necessary debt restructuring exercise without any outside intervention, judicial or otherwise. However, the stand-still clause will be applicable only to any civil action either by the borrower or any lender against the other party and will not cover any criminal action. Further, during the stand-still period, outstanding foreign exchange forward contracts, derivative products, etc., can be crystallised, provided the borrower is agreeable to such crystallisation. The borrower will additionally undertake that during the stand-still period the documents will stand extended for the purpose of limitation and also that he will not approach any other authority for any relief and the directors of the borrowing company will not resign from the Board of Directors during the stand-still period.

5.5 Sharing of Additional finance

5.5.1 Additional finance, if any, is to be provided by all creditors of a 'standard' or 'substandard account' irrespective of whether they are working capital or term creditors, on a pro-rata basis. In case for any internal reason, any creditor (outside the minimum 75 per cent and 60 per cent) does not wish to commit additional financing, that creditor will have an option in accordance with the provisions of para 4.6.

5.5.2 The providers of additional finance, whether existing creditors or new creditors, shall have a preferential claim, to be worked out under the restructuring package, over the providers of existing finance with respect to the cash flows out of recoveries, in respect of the additional exposure

5.6. Exit Option

5.6.1. As stated in para 4.5.1 a creditor (outside the minimum 75 per cent and 60 per cent) who for any internal reason does not wish to commit additional finance will have an option. At the same time, in order to avoid the "free rider" problem, it is necessary to provide some disincentive to the creditor who wishes to exercise this option. Such creditors can either (a) arrange for its share of additional finance to be provided by a new or existing creditor, or (b) agree to the deferment of the first year's interest due to it after

the CDR package becomes effective. The first year's deferred interest as mentioned above, without compounding, will be payable along with the last instalment of the principal due to the creditor.

5.6.2 In addition, the exit option will also be available to all lenders within the minimum 75 percent and 60 percent provided the purchaser agrees to abide by restructuring package approved by the Empowered Group. The exiting lenders may be allowed to continue with their existing level of exposure to the borrower provided they tie up with either the existing lenders or fresh lenders taking up their share of additional finance.

5.6.3 The lenders who wish to exit from the package would have the option to sell their existing share to either the existing lenders or fresh lenders, at an appropriate price, which would be decided mutually between the exiting lender and the taking over lender. The new lenders shall rank on par with the existing lenders for repayment and servicing of the dues since they have taken over the existing dues to the exiting lender.

5.6.4. In order to bring more flexibility in the exit option, One Time Settlement can also be considered, wherever necessary, as a part of the restructuring package. If an account with any creditor is subjected to One Time Settlement (OTS) by a borrower before its reference to the CDR mechanism, any fulfilled commitments under such OTS may not be reversed under the restructured package. Further payment commitments of the borrower arising out of such OTS may be factored into the restructuring package.

5.7. Category 2 CDR System

5.7.1. There have been instances where the projects have been found to be viable by the creditors but the accounts could not be taken up for restructuring under the CDR system as they fell under 'doubtful' category. Hence, a second category of CDR is introduced for cases where the accounts have been classified as 'doubtful' in the books of creditors, and if a minimum of 75% of creditors (by value) and 60% creditors (by number) satisfy themselves of the viability of the account and consent for such restructuring, subject to the following conditions :

- (i) It will not be binding on the creditors to take up additional financing worked out under the debt restructuring package and the decision to lend or not to lend will depend on each creditor bank / FI separately. In other words, under the proposed second category of the CDR mechanism, the existing loans will only be restructured and it would be up to the promoter to firm up additional financing arrangement with new or existing creditors individually.
- (ii) All other norms under the CDR mechanism such as the standstill clause, asset classification status during the pendency of restructuring under CDR, etc., will continue to be applicable to this category also.

5.7.2 No individual case should be referred to RBI. CDR Core Group may take a final decision whether a particular case falls under the CDR guidelines or it does not.

5.7.3 All the other features of the CDR system as applicable to the First Category will also be applicable to cases restructured under the Second Category.

5.8 Incorporation of 'right to recompense' clause

All CDR approved packages must incorporate creditors' right to accelerate repayment and borrowers' right to pre-pay. The right of recompense should be based on certain performance criteria to be decided by the Standing Forum.

B. SME Debt Restructuring Mechanism

Apart from CDR Mechanism, there exists a much simpler mechanism for restructuring of loans availed by Small and Medium Enterprises (SMEs). Unlike in the case of CDR Mechanism, the operational rules of the mechanism have been left to be formulated by the banks concerned. This mechanism will be applicable to all the borrowers which have funded and non-funded outstanding up to Rs.10 crore under multiple/consortium banking arrangement. Major elements of this arrangements are as under:

- i) Under this mechanism, banks may formulate, with the approval of their Board of Directors, a debt restructuring scheme for SMEs within the prudential norms laid down by RBI. Banks may frame different sets of policies for borrowers belonging to different sectors within the SME if they so desire.
- ii) While framing the scheme, banks may ensure that the scheme is simple to comprehend and will, at the minimum, include parameters indicated in these guidelines.
- iii) The main plank of the scheme is that the bank with the maximum outstanding may work out the restructuring package, along with the bank having the second largest share.
- iv) Banks should work out the restructuring package and implement the same within a maximum period of 90 days from date of receipt of requests.
- v) The SME Debt Restructuring Mechanism will be available to all borrowers engaged in any type of activity.
- vi) Banks may review the progress in rehabilitation and restructuring of SMEs accounts on a quarterly basis and keep the Board informed.

Key Concepts

- (i) **Advances:** The term 'Advances' will mean all kinds of credit facilities including cash credit, overdrafts, term loans, bills discounted/purchased, factored receivables, etc. and investments other than that in the nature of equity.
- (ii) **Agricultural Activities:** As defined in RPCD circular RPCD. No. Plan. BC. 84 / 04.09.01/ 2006-07 dated April 30, 2007 as modified from time to time.
- (iii) **Fully secured:** When the amounts due to a bank (present value of principal and interest receivable as per restructured loan terms) are fully covered by the value of security, duly charged in its favour in respect of those dues, the bank's dues are considered to be fully secured. While assessing the realisable value of security, primary as well as collateral securities would be reckoned, provided such securities are tangible securities and are not in intangible form like guarantee etc., of the promoter / others. However, for this purpose the bank guarantees, State Government Guarantees and Central Government Guarantees will be treated on par with tangible security.
- (iv) **Restructured accounts:** A restructured account is one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring would normally involve modification of terms of the advances/ securities, which would generally include, among others, alteration of repayment period/ repayable amount/ the amount of instalments/ rate of interest(due to reasons other than competitive reasons).
- (v) **Repeatedly restructured accounts:** When a bank restructures an account a second (or more) time(s), the account will be considered as a 'repeatedly restructured account'. However, if the second restructuring takes place after the period upto which the concessions were extended under the terms of the first restructuring, that account shall not be reckoned as a 'repeatedly restructured account'.
- (vi) **SMEs:** Small and Medium Enterprise (SME) is an undertaking defined in RPCD circulars RPCD.PLNFS. BC. No.63.06.02./ 2006-07 dated April 4, 2007 amended from time to time.
- (vii) **Specified Period:** Specified Period means a period of one year from the date when the first payment of interest or installment of principal falls due under the terms of restructuring package.
- (viii) **Satisfactory performance:** Satisfactory performance during the specified period means adherence to the following conditions during that period.

Non-agricultural cash credit accounts : In the case of non-agricultural cash credit accounts, the account should not be out of order any time during the specified period, for a duration of more than 90 days. In addition, there should not be any overdues at the end of the specified period.

Non-agricultural term loan accounts : In the case of non-agricultural term loan accounts, no payment should remain overdue for a period of more than 90 days. In addition there should not be any overdues at the end of the specified period.

All agricultural accounts: In the case of agricultural accounts, at the end of the specified period the account should be regular.

ANNEX- 3

(Rs. in crore)

Particulars of Accounts Restructured

		CDR Mechanism	SME Debt Restructuring	Others
Standard advances restructured	No. of Borrowers			
	Amount outstanding			
	Sacrifice (diminution in the fair value)			
Sub standard advances restructured	No. of Borrowers			
	Amount outstanding			
	Sacrifice (diminution in the fair value)			
Doubtful advances restructured	No. of Borrowers			
	Amount outstanding			
	Sacrifice (diminution in the fair value)			
TOTAL	No. of Borrowers			
	Amount outstanding			
	Sacrifice (diminution in the fair value)			

ANNEX-4
Asset Classification of Restructured Accounts under the Guidelines

	Particulars	Case 1	Case 2	Case 3	Case 4
I	Assumed due date of payment	31.01.2007	31.01.2007		
	Assumed date of restructuring	31.03.2007	31.03.2007	31.03.2007	31.03.2007
	Period of delinquency as on the date of restructuring	2 months	2 months	18 months	18 months
	Asset Classification (AC) before restructuring	'Standard'	'Standard'	'Doubtful - less than one year'	'Doubtful - less than one year'
	Date of NPA	NA	NA	31.12.05 (Assumed)	31.12.05 (Assumed)
II	Asset classification (AC) on restructuring				
	Assumed status of the borrower	Eligible for special regulatory treatment	Not eligible for special regulatory treatment	Eligible for special regulatory treatment	Not eligible for special regulatory treatment
	AC after restructuring	'Standard'	Downgraded to 'Sub-standard' w.e.f 31.03.07 (i.e., on the date of restructuring)	'Doubtful - less than one year'	'Doubtful - less than one year'
	Assumed first payment due under the revised terms	31.12.07	31.12.07	31.12.07	31.12.07
III	Asset classification after restructuring				
A	The account performs satisfactorily as per restructured terms				
(a)	AC during the specified one year period (i.e., from 31.12.07 to 31.12.08)	No change (i.e., remains 'Standard')	'Doubtful - less than one year' w.e.f. 31.03.08 (i.e. one year after classification as 'Substandard')	No change (i.e., remains 'Doubtful - less than one year')	'Doubtful - one to three years' w.e.f. 31.12.07 (i.e., one year after classification as 'Doubtful less than one year')
(b)	AC after the specified one year period	Continues in 'Standard' category	Upgraded to 'Standard' category	Upgraded to 'Standard' category	Upgraded to 'Standard' category

B If performance not satisfactory vis-à-vis restructured terms					
(a)	AC during the specified one year period (in case the unsatisfactory performance is established before completion of one year period)	Treated as sub-standard w.e.f 30.4.2007 and downgraded to 'Doubtful less than one year' with effect from 30.04.08.	'Doubtful - less than one year' w.e.f. 31.03.08 (i.e. one year after classification	'Doubtful one to three years' w.e.f. 31.12.07	'Doubtful - one to three years' w.e.f. 31.12.07 (i.e., one year after classification as 'Doubtful less than one year' (on 31.12.06)
(b)	AC after the specified one year period, if the unsatisfactory performance continues	Will migrate to 'Doubtful - one to three years' w.e.f. 30.04.09 and 'Doubtful more than three years' w.e.f. 30.04.2011.	Will migrate to 'Doubtful - one to three years' w.e.f 31.03.09 and 'Doubtful more than three years' w.e.f. 31.03.2011.	Will migrate to 'Doubtful - more than three years' w.e.f 31.12.09	Will migrate further to 'Doubtful more than three years' w.e.f. 31.12.09

RBI / 2008-09 / 138
DBOD.No.Leg. BC. 34 /09.07.005/2008-09

August 22, 2008

All Scheduled Commercial Banks
(Excluding RRBs)

Dear Sir,

Unclaimed Deposits / Inoperative Accounts in banks

Please refer to our Circular DBOD.No.Com.BC.109/C.408/A-77 dated October 1, 1977 wherein banks were advised that deposit accounts which have not been operated upon over a period, say two years should be segregated and maintained in separate ledger/s. Further, banks were also advised vide our circular no. DBOD.No.Leg.BC.45/C.466 (IV) / 89 dated November 15, 1989 that they should ensure that their branches follow-up accounts which remained inoperative for a year or so by sending suitable advices to the customers and if the said letters are returned undelivered, they may immediately be put on enquiry to find out the whereabouts of customers or their legal heirs in case they are deceased.

2. In view of the increase in the amount of the unclaimed deposits with banks year after year and the inherent risk associated with such deposits, it is felt that banks should play a more pro-active role in finding the whereabouts of the account holders whose accounts have remained inoperative. Further several complaints have been received in respect of difficulties faced by the customers on account of their accounts having been classified as inoperative. Moreover, there is a feeling that banks are undeservedly enjoying the unclaimed deposits, while paying no interest on it. Keeping these factors in view, we have reviewed the above instructions issued by us and advise banks to follow the instructions detailed below while dealing with inoperative accounts:

(i) Banks should make an annual review of accounts in which there are no operations (i.e. no credit or debit other than crediting of periodic interest or debiting of service charges) for more than one year. The banks may approach the customers and inform them in writing that there has been no operation in their accounts and ascertain the reasons for the same. In case the non operation in the account is due to shifting of the customers from the locality, they may be asked to provide the details of the new bank accounts to which the balance in the existing account could be transferred.

(ii) If the letters are returned undelivered, they may immediately be put on enquiry to find out the whereabouts of customers or their legal heirs in case they are deceased.

(iii) In case the whereabouts of the customers are not traceable, banks should consider contacting the persons who had introduced the account holder. They could also consider contacting the employer / or any other person whose details are available with them. They could also consider contacting the account holder telephonically in case his telephone number / Cell number has been furnished to the bank. In case of Non Resident accounts, the bank may also contact the account holders through e-mail and obtain their confirmation of the details of the account.

(iv) A savings as well as current account should be treated as inoperative / dormant if there are no transactions in the account for over a period of two years.

(v) In case any reply is given by the account holder giving the reasons for not operating the account, banks should continue classifying the same as an operative account for one more year within which period the account holder may be requested to operate the account. However, in case the account holder still does not operate the same during the extended period, banks should classify the same as inoperative account after the expiry of the extended period.

(vi) For the purpose of classifying an account as 'inoperative' both the type of transactions i.e. debit as well as credit transactions induced at the instance of customers as well as third party should be considered. However, the service charges levied by the bank or interest credited by the bank should not be considered.

(vii) Further, the segregation of the inoperative accounts is from the point of view of reducing risk of frauds etc. However, the customer should not be inconvenienced in any way, just because his account has been rendered inoperative. The classification is there only to bring to the attention of dealing staff, the increased risk in the account. The transaction may be monitored at a higher level both from the point of view of preventing fraud and making a Suspicious Transactions Report. However, the entire process should remain un-noticeable by the customer.

(viii) Operation in such accounts may be allowed after due diligence as per risk category of the customer. Due diligence would mean ensuring genuineness of the transaction, verification of the signature and identity etc. However, it has to be ensured that the customer is not inconvenienced as a result of extra care taken by the bank.

(ix) There should not be any charge for activation of inoperative account.

(x) Banks are also advised to ensure that the amounts lying in inoperative accounts ledger are properly audited by the internal auditors / statutory auditors of the bank.

(xi) Interest on savings bank accounts should be credited on regular basis whether the account is operative or not. If a Fixed Deposit Receipt matures and proceeds are unpaid, the amount left unclaimed with the bank will attract savings bank rate of interest.

3. Banks may also consider launching a special drive for finding the whereabouts of the customers / legal heirs in respect of existing accounts which have already been transferred to the separate ledger of 'inoperative accounts'.

Yours faithfully

(Prashant Saran)
Chief General Manager-in-Charge

RBI / 2008-09/125
DBOD.No.BP.BC. 31 /21.04.157/2008 – 09

August 8, 2008

All Scheduled Commercial Banks
(Excluding Local Area Banks and Regional Rural Banks)

Dear Sir,

Prudential Norms for Off-Balance Sheet Exposures of Banks

Please refer to RBI press release No.2007-2008 / 1528 dated May 30, 2008, in terms of which the draft guidelines on the captioned subject were released for comments / feedback. On the basis of the feedback received, the guidelines have been finalised and furnished in the Appendix for implementation.

2. It is clarified that initially only the amounts due to the bank under derivative contracts which remain unpaid in cash for a period of 90 days or more from the specified date of payment will be classified as non-performing assets (para 2.4 of the Appendix). The larger issue of considering the entire amount of receivables (i.e amount due and future receivables) as NPA is under consideration and a separate communication will follow, if required.

3. In respect of treatment of restructured derivatives contracts (contained in para 2.5 of the draft guidelines) also a separate communication would follow.

Yours faithfully,

(P Vijaya Bhaskar)
Chief General Manager

Appendix**Guidelines on Prudential Norms for Off-balance Sheet Exposures of Banks –
Capital Adequacy, Exposure, Asset Classification and Provisioning Norms**

At present, paragraphs 2.4.3 and 2.4.4 of the 'Master Circular on Prudential Norms on Capital Adequacy', DBOD.No.BP.BC.2/21.01.002/2008-09 dated July 1, 2008, stipulate the applicable credit conversion factors (CCF) for the foreign exchange and interest-rate related contracts under Basel-I framework. Likewise, paragraph 5.15.4 of our circular on 'Guidelines for Implementation of the New Capital Adequacy Framework' DBOD.No.BP.BC. 11/21.06.001/2008-09 dated July 1, 2008, prescribes the CCFs for these contracts under the Basel-II framework. Further, in terms of paragraph 2.3.2 of the 'Master Circular on Exposure Norms', DBOD.No.Dir.BC.19/ 13.03.000/2008-09 dated July 1, 2008, the banks have the option of measuring the credit exposure of derivative products either through the 'Original Exposure Method' or 'Current Exposure Method'.

2. In accordance with the proposal contained in the paragraph 165 (reproduced in **Annex 1**) of the Annual Policy Statement for the year 2008-09, released on April 29, 2008, **the following modifications** are prescribed to the existing instructions on the above aspects:

2.1 Credit Exposure – Method of computing the credit exposure

For the purpose of exposure norms, banks shall compute their credit exposures, arising on account of the interest rate & foreign exchange derivative transactions and gold, using the 'Current Exposure Method', as detailed in **Annex 2**. While computing the credit exposure banks may exclude 'sold options', provided the entire premium / fee or any other form of income is received / realised.

2.2 Capital Adequacy – Computation of the credit equivalent amount

For the purpose of capital adequacy also, all banks, both under Basel-I as well as under Basel-II framework, shall use the 'Current Exposure Method', as detailed in **Annex 2**, to compute the credit equivalent amount of the interest rate & foreign exchange derivative transactions and gold.

2.3 Provisioning requirements for derivative exposures

Credit exposures computed as per the current marked to market value of the contract, arising on account of the interest rate & foreign exchange derivative transactions, and gold, shall also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative and gold exposures.

2.4 Asset Classification of the receivables under the derivatives transactions

In respect of derivative transactions, any amount due to the bank, which remains unpaid in cash for a period of 90 days from the specified due date for payment, will be classified as non-performing assets as per the 'Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to the Advances Portfolio', contained in our Master Circular DBOD. No. BP.BC.20/ 21.04.048/2007-08 dated July 1, 2008.

3. The foregoing modifications will come into effect from the financial year 2008-09. Banks will, however, have the option of complying with the additional capital and provisioning requirements, arising from these modifications, in a phased manner, over a period of four quarters, ending March 31, 2009.

Annex 1**Extracts of paragraph 165 from the
Annual Policy Statement for the year 2008 – 09*****b) Off-Balance Sheet Exposures of Banks***

165. The Reserve Bank has, in the light of domestic developments, taken steps to strengthen the prudential framework in respect of on-balance sheet exposures of banks. Such measures included additional risk weights and provisioning requirements for exposures to specific sectors. In view of the recent developments in the global financial markets and drawing from suggestions for ensuring financial stability, it is proposed

- To review current stipulations regarding conversion factors, risk weights and provisioning requirements for specific off-balance sheet exposures of banks and prescribe prudential requirements as appropriate. The guidelines in this regard would be placed on the Reserve Bank website by May 15, 2008.

Annex 2

Para 5.15.4 of the RBI circular DBOD.No.BP.BC.11/21.06.001/2008-09 dated July 1, 2008 of the Master Circular on Prudential Guidelines on Capital Adequacy and Market Discipline – Implementation of the New Capital Adequacy may be substituted by the following text:

"5.15.4 Current Exposure Method

i) The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of current credit exposure and potential future credit exposure of these contracts. While computing the credit exposure banks may exclude 'sold options', provided the entire premium / fee or any other form of income is received / realized.

ii) Current credit exposure is defined as the sum of the positive mark-to-market value of these contracts. The Current Exposure Method requires periodical calculation of the current credit exposure by marking these contracts to market, thus capturing the current credit exposure.

iii) Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.

Table 9: CCF for market related off-balance sheet items

Residual Maturity	Credit conversion factors	
	Interest Rate Contracts	Exchange Rate Contracts & Gold
One year or less	0.50%	2.00%
Over one year to five years	1.00%	10.00%
Over five years	3.00%	15.00%

iv) For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.

v) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the foregoing criteria, the CCF or "add-on factor" applicable shall be subject to a floor of 1.00 per cent.

vi) No potential future credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

vii) Potential future exposures should be based on effective rather than apparent notional amounts. In the event that the stated notional amount is leveraged or enhanced by the structure of the transaction, banks must use the effective notional amount when determining potential future exposure. For example, a stated notional amount of USD 1 million with payments based on an internal rate of two times the BPLR would have an effective notional amount of USD 2 million. "

RBI/2008-09/111

UBD. PCB.Cir.No. 5/13.05.000/08-09

July 30, 2008

The Chief Executive Officer of all
Primary (Urban) Co-operative Banks

Dear Sir/Madam,

Agricultural Debt Waiver and Debt Relief Scheme, 2008 – Prudential Norms on Income Recognition, Asset Classification and Provisioning, and Capital Adequacy-UCBs

As you are aware, the Hon'ble Finance Minister, in his Budget Speech (paragraph 73) for 2008-09 has announced a debt waiver and debt relief scheme for farmers, for implementation by, *inter alia*, UCBs. The detailed scheme announced by the Government of India was communicated to the UCBs vide our circular UBD.PCB.Cir.No. 43/13.05.000/07-08 dated May 23, 2008.

2. The guidelines pertaining to Income Recognition, Asset Classification and Provisioning, and Capital Adequacy as applicable to the loans covered by the captioned scheme, are furnished in the Annex.

Yours faithfully,

(A.K Khound)
Chief General Manager-in-Charge

**PRUDENTIAL NORMS FOR THE BORROWAL ACCOUNTS COVERED UNDER THE
AGRICULTURAL DEBT WAIVER AND DEBT RELIEF SCHEME, 2008**

1. As advised vide the circular UBD.PCB.Cir.No. 43/13.05.000/07-08 dated May 23, 2008, while the entire 'eligible amount' shall be waived in the case of a small or marginal farmer, in the case of 'other farmers', there will be a one time settlement scheme (OTS) under which the farmer will be given a rebate of 25 per cent of the 'eligible amount' subject to the condition that the farmer repays the balance of 75 per cent of the 'eligible amount'.

2. Norms for the accounts subjected to Debt Waiver

2.1 As regards the small and marginal farmers eligible for debt waiver, the amount eligible for waiver, as defined in the Para 4 of the enclosure to the aforesaid circular, pending receipt from the Government of India, may be transferred by the banks to a separate account named "Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008". The balance in this account should be reflected under advances in the Balance sheet.

2.2 The balance in this account may be treated by the banks as a "performing" asset, provided adequate provision is made for the loss in Present Value (PV) terms, computed under the assumption that such payments would be received from Government of India in the following installments:

- a) 32% of the total amount due by September 30, 2008,
- b) 19% by July 31, 2009,
- c) 39% by July 2010, and
- d) the remaining 10% by July 2011.

However, the provision required under the current norms for standard assets, need not be provided for in respect of the balance in this account.

2.3 The discount rate for arriving at the loss in PV terms as at para 2.2 above should be taken as 9.56 per cent, being the yield to maturity on 364-day Government of India Treasury Bill, prevailing as on the date of this circular.

2.4 The prudential provisions held in respect of the NPA accounts for which the debt waiver has been granted may be reckoned for meeting the provisions required on PV basis.

2.5 In case, however, the amount of prudential provision held is more than the amount of provision required on PV basis, such excess provision may be reversed in a phased manner. This phased reversal

may be effected in the proportion of 32%, 19%, 39%, and 10% during the years ended March 2009, 2010, 2011 and 2012, respectively, only after the installments due from the Government, for the relative years, have been received.

2.6 On receipt of the final installment from the Government, the provision made for loss in PV terms may be transferred to the General Reserves, below the line.

2.7 In case the claim of a farmer is specifically rejected at any stage, the asset classification of the account should be determined with reference to the original date of NPA (as if the account had not been treated as performing in the interregnum based on the transfer of the loan balance to the aforesaid account) and suitable provision should be made. The provision made on PV basis may also be reckoned against the NPA-provisions required, consequent upon the account being treated as NPA due to the rejection of the claim.

3. Norms for the accounts subjected to the Debt Relief

3.1 Under the scheme, in the case of 'other' farmers, the farmer will be given a rebate of 25% of the "eligible amount", by the Government by credit to his account, provided the farmer pays the balance of 75% of the 'eligible amount'. The Scheme provides for payment of share of 75% by such farmers in three instalments and the first two instalments shall be for an amount not less than one-third of the farmer's share. The last dates of payment of the three instalments will be September 30, 2008; March 31, 2009 and June 30, 2009, respectively.

Asset Classification

3.2 Where the farmers covered under the Debt Relief Scheme have given the undertaking, agreeing to pay their share under the OTS, their relevant accounts may be treated by banks as "standard" / "performing" provided –

- (a) adequate provision is made by the banks for the loss in PV terms for all the receivables due from the borrowers as well as the Government; and
- (b) such farmers pay their share of the settlement within one month of the due dates.

Provisioning

3.3 Provisioning for standard assets: The accounts subject to debt relief would stand classified as standard assets after receipt of the aforesaid undertaking from the borrowers. Accordingly, such accounts would also attract the prudential provisioning as applicable to standard assets.

3.4 Provisioning on PV basis : For computing the amount of loss in PV terms under the Scheme, the cash

flows receivable from the farmers, as per the repayment schedule vide para 3.1 above, as well as from the government should be discounted to the present value. It may be assumed in this context that the Government's contribution would be received by June 30, 2010. The discount rate to be applied for the purpose should be the interest rate at which the loan was granted including the element of interest subsidy, if any, available from the Government.

3.5 The prudential provisions held in respect of the NPA accounts, for which the debt waiver has been granted, may be reckoned for meeting the provisions required on PV basis as well as for the standard assets (pursuant to classification of these loans as standard) and shortfall, if any, may be provided for. Thus, the total provisions held would comprise the provisions required on PV basis, provision for standard assets and excess prudential provisions, if any, towards NPA.

3.6 Provisioning in case of down-gradation of accounts: As mentioned at para 3.2 (b) above, the accounts subject to Debt Relief Scheme would be classified as standard / performing assets only if the farmers pay their share of the settlement within one month of the pre-specified due dates. In case, however, the payments are delayed by the farmers beyond one month of the respective due dates, the outstanding amount in the relevant accounts of such farmers shall be treated as NPA. The asset classification of such accounts shall be determined with reference to the original date of NPA, (as if the account had not been treated as performing in the interregnum based on the aforesaid undertaking). On such down-gradation of the accounts, additional provisions as per the extant prudential norms should also be made.

For meeting this additional provisioning requirement, the excess prudential provisions, if any, held; the amount of provisions held for standard assets (as per para 3.3 above) together with the provision made on PV basis, all in respect of such downgraded account, could be reckoned. Such additional prudential provisions too should be continued to be held and reversed only as per the stipulation at para 3.7 below.

3.7 Reversal of excess prudential provisions : In case the amount of the prudential NPA-provisions held are larger than the aggregate of the provision required on PV basis and for the standard assets (pursuant to classification of these loans as standard), such excess prudential provision should not be reversed but be continued to be held till the earlier of the two events, viz., : (a) till the entire outstanding of the borrower stands repaid – at which point, the entire amount could be reversed to the P/L account; or (b) when the amount of such excess provision exceeds the amount outstanding on account of the repayments by the borrower – at which point, the amount of provision in excess of the outstanding amount could be reversed to the P/L account.

3.8 Reversal of the provisions made on PV Basis: The provision made on PV basis represents a permanent loss to the bank on account of delayed receipt of cash flows and hence, should not be reversed to the P/L Account. The amount of such provision should, therefore, be carried till the account is finally settled and after receipt of the Government's contribution under the Scheme, the amount should be reversed to the General Reserves, below the line.

4. Grant of fresh loans to the borrowers covered under the Debt Waiver and Debt Relief Scheme

4.1 A small or marginal farmer will become eligible for fresh agricultural loans upon the eligible amount being waived, in terms of para 7.2 of the enclosure to the circular UBD.PCB.Cir.No. 43/13.05.000/07-08 dated May 23, 2008. The fresh loan may be treated as “performing asset”, regardless of the asset classification of the loan subjected to the Debt Waiver, and its subsequent asset classification should be governed by the extant IRAC norms.

4.2 In case of “other farmers” eligible for fresh short-term production loans and investment loans, as provided for in Para 7.6 and 7.7, respectively, of the enclosure to the circular UBD.PCB.Cir.No. 43/13.05.000/07-08 dated May 23, 2008, these fresh loans may be treated as “performing assets”, regardless of the asset classification of the loan subjected to the Debt Relief, and its subsequent asset classification should be governed by the extant IRAC norms.

5. Capital Adequacy

The amount outstanding in the account styled as “Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008” shall be treated as a claim on the Government of India and would attract zero risk weight for the purpose of capital adequacy norms. However, the amount outstanding in the accounts covered by the Debt Relief Scheme shall be treated as a claim on the borrowers and risk weighted as per the extant norms.

RBI/2008-09/98
DPSS.CO.No.144/02.23.01/2008-2009

July 22, 2008

To,

Chairman & Managing Director / Chief Executive Officers
of Scheduled Commercial Banks (other than Regional
Rural Banks) and Scheduled Urban Cooperative Banks

Sir / Madam,

Mobile Payments in India - Operating Guidelines for Banks

Reserve Bank of India (RBI) is in the process of finalizing the Operative Guidelines for banks on mobile payments. The Draft Guidelines were placed on RBI website and a number of comments have since been received. The comments are being compiled and after evaluation of the comments, the final Guidelines would be issued.

2. Meanwhile, it is observed that a few banks have already started offering mobile payment services to their customers without waiting for the release of RBI's Guidelines. While RBI has no objection for use of mobile channel to provide basic services such as mobile alerts for credit or debit entry, balance enquiry etc. which are in the nature of providing information, due care needs to be taken for permitting the channel for customers to initiate payment instructions. There are a number of attendant issues and therefore, banks are advised to keep on hold their mobile payment services till issuance of the final Guidelines. Banks may also dissociate themselves from any mobile based money transfer service which has not received explicit approval of RBI or not covered by any of the Guidelines issued by RBI.

Yours faithfully,

(A P Hota)
Chief General Manager

RBI/2007-2008/341

DBOD No.BP.BC 88/ 21.06.001./ 2007-08

May 30, 2008

The Chairman / CMD/ MD/ CEO
All Commercial Banks (excluding RRBs)

Dear Sir,

Capital Adequacy Norms – Treatment of banks' investments in subsidiaries/ associates and of the subsidiaries' /associates' investments in parent banks

Please refer to the paragraph 2.1.3 of the Master Circular DBOD No. BP.BC. 4/21.01.002 / 2007-08 dated July 2, 2007 on 'Prudential Norms on Capital Adequacy' and paragraph 4.4.6 of our circular DBOD. No. BP.BC. 90 / 20.06.001/ 2006-07 dated April 27, 2007 on 'Implementation of New Capital Adequacy Framework' regarding the treatment of banks' investments in subsidiaries / associates for the purpose of capital adequacy norms.

2. The norms governing the treatment of banks' investment in their subsidiaries and associates, and the investments by the banks' subsidiaries and associates in their parent banks, have been reviewed and it has been decided to revise the norms, both under the Basel - I and Basel - II Frameworks, as detailed below.

2.1. Bank's investment in a subsidiary / an associate

The investments of a bank in the equity as well as non-equity capital instruments issued by a subsidiary, which are reckoned towards its regulatory capital as per norms prescribed by the respective regulator, should be deducted at 50 per cent each, from Tier I and Tier II capital of the parent bank, while assessing the capital adequacy of the bank on 'solo' basis, under the Basel I Framework. (Under the extant instructions under Basel I environment, only the equity investments of a bank only in its subsidiaries are required to be deducted, only from Tier I capital of the bank; no such deduction is required for a bank's investment in associates.)

There is no change in the instructions in regard to the treatment of a bank's investment in its subsidiary / associate under the Basel II Framework.

2.2 Investments by a banking subsidiary / banking associate in its parent bank

The investments made by a banking subsidiary in the equity or non equity regulatory-capital instruments issued by its parent bank, should be deducted from such subsidiary's regulatory capital at 50 per cent each from Tier I and Tier II capital, in its capital adequacy assessment on a solo basis, under Basel I and Basel II Frameworks. In addition, under the Basel II Framework, the same treatment would be applied to the investment by a banking associate also, in its parent bank.

The treatment of investment by the non-banking financial subsidiaries / associates in the parent bank's regulatory capital would, however, be governed by the applicable regulatory capital norms of the respective regulators of such subsidiaries / associates.

3. It may please be noted that for the purpose of the foregoing norms, an "associate" would be defined as an entity in which the parent bank has an equity stake exceeding 30 per cent but less than 50 per cent of the paid up capital of the investee entity.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

RBI/2007-08/325
DBOD.No.BP.BC.84/21.04.018/2007-08

May 21, 2008

To

The Chairman and Chief Executive Officer
All Scheduled Commercial Banks
(excluding RRBs and LABs)

Dear Sir

Consolidated Financial Statement

The Accounting Standards (AS) issued by the Institute of Chartered Accountants of India (ICAI) prescribes the accounting of investments in subsidiaries, associates and joint ventures under AS 21 – Consolidated Financial Statement, AS 23 – Accounting for Investments in Associates in Consolidated Financial Statement and AS 27 – Financial Reporting of Interests in Joint Ventures. The Standards also specifically state the circumstances under which subsidiaries, associates or joint ventures can be excluded from consolidation. For example, exclusion from consolidation is permitted when the investment is held exclusively with a view to its subsequent disposal in the near future (within the next twelve months). The intention with regard to the disposal of the relevant investment should be considered at the time of acquisition of the investment.

2. It has been decided that the Board of Directors of banks should invariably record the intent of holding of the investment for a temporary period or otherwise at the time of investment in the subsidiary, associate and joint venture. In the absence of record of such intent by the Board at the time of such investment, the same would be taken into account for the purpose of consolidation.

Yours faithfully

(Prashant Saran)
Chief General Manager-in-Charge

RBI/2007-08/278
DBOD. No. BP. BC. 68 / 21.04.098/ 2007-08

April 9, 2008

Chairmen / Chief Executive Officers
All Commercial Banks
(excluding RRBs)

Guidelines on Asset-Liability Management (ALM) System

Please refer to DBOD Circular No.DBOD. BP. BC. 38 / 21.04.098/ 2007-08 dated October 24, 2007 advising banks to adopt a more granular approach to measurement of liquidity risk. Banks were also advised to undertake dynamic liquidity management and prepare the Statement of Structural Liquidity on daily basis. The Statement of Structural Liquidity was, however, to be reported to RBI, once a month, as on the third Wednesday of every month.

2. It was also indicated that to enable the banks to fine tune their existing MIS as per the modified guidelines, the revised norms as well as the supervisory reporting as per the revised format would commence with effect from the period beginning January 1, 2008 and the reporting frequency would continue to be monthly for the present. However, the frequency of supervisory reporting of the Structural Liquidity position shall be fortnightly, with effect from April 1, 2008.

3. Accordingly, banks are advised to submit the Statement of Structural Liquidity as on the first and third Wednesday of every month to Reserve Bank of India, Department of Banking Supervision, OSMOS Division. The due-date of the submission of the Statement would be the seventh day from the reporting date.

Yours faithfully,

(P. Vijaya Bhaskar)
Chief General Manager

RBI/2007-2008/254
DBOD.NO.BP. 64 / 21.04.158/ 2007-08

March 03, 2008

All Scheduled Commercial Banks (excluding RRBs)

Dear Sir,

Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks

Please refer to para 5.10(c) of our circular RBI/2006/167 DBOD.No.BP.40/ 21.04. 158 /2006-07 dated November 3, 2006 on the captioned subject.

2. The time limit given to the customer for preferring their complaints/grievances as specified in the above para has now been revised as under:

If a complainant does not get satisfactory response **from the bank within 30** days from the date of his lodging the complaint, he will have the option to approach the Office of the concerned Banking Ombudsman for redressal of his grievance/s.

3. Please acknowledge receipt.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

RBI/2007-2008/236

Ref.DBOD No. Ret.BC. 62/12.02.001/2007-08

February 13, 2008
Magha 24, 1929 (Saka)

All Scheduled Commercial Banks
(excluding Regional Rural Banks)

Madam/Dear Sir,

Section 24 of the Banking Regulation Act, 1949
Maintenance of Statutory Liquidity Ratio (SLR)

Please refer to our circular DBOD. No. BC. 137/12.02.001/97-98 dated October 21, 1997 on the captioned subject.

The Banking Regulation (Amendment) Act, 2007 replacing the Banking Regulation (Amendment) Ordinance, 2007 came into effect from January 23, 2007. Consequent upon amendment to Section 24 of the Banking Regulation Act, 1949 all scheduled commercial banks shall continue to maintain a uniform statutory liquidity ratio (SLR) of 25 per cent on their total net demand and time liabilities in the assets as specified in the enclosed notification No. DBOD.Ret.BC.61/ 12.02.001/2007-08 dated February 13, 2008.

Yours faithfully,

(Vinay Baijal)
Chief General Manager

February 13, 2008
Magha 24, 1929 (saka)

NOTIFICATION

In exercise of the powers conferred by sub-section (2A) of Section 24 of Banking Regulation Act, 1949 (10 of 1949) and, in partial modification of Notification DBOD No. BC.117/11.02.001/97-98 dated October 21, 1997, the Reserve Bank of India hereby specifies that every scheduled commercial bank shall continue to maintain in India assets as detailed below, the value of which shall not, at the close of business on any day, be less than 25 per cent of the total net demand and time liabilities in India as on the last Friday of the second preceding fortnight, valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:

- (a) Cash, or
- (b) Gold valued at a price not exceeding the current market price, or
- (c) Unencumbered investment in the following instruments which will be referred to as "statutory liquidity ratio (SLR) securities":
 - i. Dated securities as per the list given in the Annex;
 - ii. All Treasury Bills already issued, and to be issued in future, by the Government of India;
 - iii. Dated Securities to be issued in future by the Government of India under the market borrowing programme and under the market stabilization scheme with SLR status incorporated in the relevant notification;
 - iv. State Development Loans to be issued in future by State Governments under their market borrowing programme, with SLR status incorporated in the relevant notification; and
 - v. Any other instrument as notified in future by RBI for SLR status.

Explanation: "unencumbered investment" of a banking company shall include its investment in the aforesaid securities lodged with another institution for an advance or any other credit arrangement to the extent to which such securities have not been drawn against or availed of.

In computing the amount for the above purpose, the following shall be deemed to be cash maintained in India:

- (i) The deposit required under sub-section (2) of Section 11 of the Banking Regulation Act, 1949 to be made with the Reserve Bank by a banking company incorporated outside India;
- (ii) Any balances maintained by a scheduled bank with the Reserve Bank in excess of the balance required to be maintained by it under Section 42 of the Reserve Bank of India Act, 1934 (2 of 1934); and
- (iii) Net balances in current accounts with other scheduled commercial banks in India.

(Anand Sinha)
Executive Director

RBI/2007-2008/169
DBOD.No. BP. BC. 42 /21.01.002/2007-2008

October 29, 2007

The Chairman and Managing Director/
Chief Executive Officers of Commercial Banks
(Excluding Foreign Banks, RRBs and LABs)

Dear Sir,

Guidelines for issuing preference shares as part of regulatory capital

Please refer to our circular DBOD.No.BP.BC.57/21.01.002/2005-06 dated January 25, 2006 on the enhancement of banks' capital raising options for capital adequacy purposes. With a view to providing a wider choice of instruments to Indian banks for raising Tier I and Upper Tier II capital, it has been decided to allow the banks to issue the following types of preference shares in Indian Rupees, subject to extant legal provisions as per guidelines contained in Annex I and II:

i) Tier I capital

Perpetual Non-Cumulative Preference Shares (PNCPS)

ii) Upper Tier II capital

- a) Perpetual Cumulative Preference Shares (PCPS)
- b) Redeemable Non-Cumulative Preference Shares (RNCPS)
- c) Redeemable Cumulative Preference Shares (RCPS)

2. The Perpetual Non-Cumulative Preference Shares will be treated on par with equity, and hence, the coupon payable on these instruments will be treated as dividend (an appropriation of Profit & Loss Account). All other types of preference shares mentioned above will be treated as liabilities and the coupon payable thereon will be treated as interest (charged to Profit and Loss Account).

3. The addition of above instruments is expected to significantly enhance the range of eligible instruments available to the banks for capital adequacy purposes. Hence, it is not considered necessary to allow the banks to issue preference shares in foreign currency in overseas markets at this stage.

Yours faithfully

(Prashant Saran)
Chief General Manager-In-Charge

ANNEX 1

Guidelines on Perpetual Non-Cumulative Preference shares (PNCPS) as part of Tier I capital

1. Terms of Issue

1.1. Limits

The outstanding amount of Tier 1 preference shares along with Innovative Tier 1 instruments shall not exceed 40% of total Tier 1 capital at any point of time. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill and other intangible assets but before the deduction of investments. Tier 1 preference shares issued in excess of the overall ceiling of 40%, shall be eligible for inclusion under Upper Tier 2 capital, subject to limits prescribed for Tier 2 capital. However, investors' rights and obligations would remain unchanged.

1.2 Amount

The amount of PNCPS to be raised may be decided by the Board of Directors of banks.

1.3 Maturity

The PNCPS shall be perpetual.

1.4 Options

- i) PNCPS shall not be issued with a 'put option' or 'step up option'.
- ii) However, banks may issue the instruments with a call option at a particular date subject to following conditions:
 - a) The call option on the instrument is permissible after the instrument has run for at least ten years; and
 - b) Call option shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.

1.5 Classification in the Balance sheet

These instruments will be classified as capital and shown under "Schedule I-Capital" of the Balance sheet.

1.6 Dividend

The rate of dividend payable to the investors may be either a fixed rate or a floating rate referenced to a market determined rupee interest benchmark rate

1.7 Payment of Dividend

- (a) The issuing bank shall pay dividend subject to availability of distributable surplus out of current year's earnings, and if

- i) the bank's CRAR is above the minimum regulatory requirement prescribed by RBI;
 - ii) the impact of such payment does not result in bank's capital to risk weighted assets ratio (CRAR) falling below or remaining below the minimum regulatory requirement prescribed by Reserve Bank of India;
 - iii) In the case of half yearly payment of dividends, the balance sheet as at the end of the previous year does not show any accumulated losses; and
 - iv)** In the case of annual payment of dividends, the current year's balance sheet does not show any accumulated losses
- (b) The dividend shall not be cumulative. i.e., dividend missed in a year will not be paid in future years, even if adequate profit is available and the level of CRAR conforms to the regulatory minimum.
- (c) All instances of non-payment of dividend in consequence of conditions as at (a) above should be reported by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision, Central Office of the Reserve Bank of India, Mumbai.

1.8 Seniority of claim

The claims of the investors in PNCPS shall be senior to the claims of investors in equity shares and subordinated to the claims of all other creditors and the depositors.

Other conditions

- a. PNCPS should be fully paid-up, unsecured, and free of any restrictive clauses.
- b. Investment by FIIs and NRIs shall be within an overall limit of 49% and 24% of the issue respectively, subject to the investment by each FII not exceeding 10% of the issue and investment by each NRI not exceeding 5% of the issue. Investment by FIIs in these instruments shall be outside the ECB limit for rupee denominated corporate debt as fixed by Government of India from time to time. The overall non-resident holding of preference shares and equity shares in public sector banks will be subject to the statutory/regulatory limit.
- c. Banks should comply with the terms and conditions, if any, stipulated by SEBI/other regulatory authorities in regard to issue of the instruments.

2. Compliance with Reserve Requirements

- a) The funds collected by various branches of the bank or other banks for the issue and held pending finalisation of allotment of the Tier 1 preference shares will have to be taken into account for the purpose of calculating reserve requirements.
- b) However, the total amount raised by the bank by issue of PNCPS shall not be reckoned as liability for calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will not attract CRR/SLR requirements.

3. Reporting Requirements

3.1 Banks issuing PNCPS shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the capital raised, including the terms of issue specified at item 1 above together with a copy of the offer document soon after the issue is completed.

3.2 The issue-wise details of amount raised as PNCPS qualifying for Tier I capital by the bank from FIIs/NRIs are required to be reported within 30 days of the issue to the Chief General Manager, Reserve Bank of India, Foreign Exchange Department, Foreign Investment Division, Central Office, Mumbai 400 001 in the proforma given in the Appendix. The details of the secondary market sales / purchases by FIIs and the NRIs in these instruments on the floor of the stock exchange shall be reported by the custodians and designated banks, respectively to the Reserve Bank of India through the soft copy of the LEC Returns, on a daily basis, as prescribed in Schedule 2 and 3 of the FEMA Notification No.20 dated 3rd May 2000, as amended from time to time.

4. Investment in perpetual non-cumulative preference shares issued by other banks/ FIIs

- a) A bank's investment in PNCPS issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent of investing banks' capital funds as prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004-05 dated 6th July 2004.
- b) Bank's investments in PNCPS issued by other banks/ financial institutions will attract a 100% risk weight for capital adequacy purposes.
- c) A bank's investments in the PNCPS of other banks will be treated as exposure to capital market and be reckoned for the purpose of compliance with the prudential ceiling for capital market exposure as fixed by RBI.

5. Grant of advances against Tier 1 preference shares

Banks should not grant advances against the security of the PNCPS issued by them.

ANNEX 2

Terms and conditions applicable to Perpetual Cumulative Preference shares (PCPS) / Redeemable Non-Cumulative Preference Shares(RNCPS)/ Redeemable Cumulative Preference Shares(RCPS) as part of Upper Tier 2 Capital

1. Terms of Issue

1.1 Characteristics of the instruments

- a) These instruments could be either perpetual (**PCPS**) or dated (**RNCPS and RCPS**) instruments with a fixed maturity of minimum 15 years.
- b) The perpetual instruments shall be cumulative. The dated instruments could be cumulative or non-cumulative

1.2 Limits

The outstanding amount of these instruments along with other components of Tier 2 capital shall not exceed 100% of Tier 1 capital at any point of time. The above limit will be based on the amount of Tier 1 capital after deduction of goodwill and other intangible assets but before the deduction of investments.

1.3 Amount

The amount to be raised may be decided by the Board of Directors of banks.

1.4 Options

- i) These instruments shall not be issued with a 'put option'.
- ii) However, banks may issue the instruments with a call option at a particular date subject to strict compliance with each of the following conditions:
 - a) The call option on the instrument is permissible after the instrument has run for at least ten years; and
 - b) Call option shall be exercised only with the prior approval of RBI (Department of Banking Operations & Development). While considering the proposals received from banks for exercising the call option the RBI would, among other things, take into consideration the bank's CRAR position both at the time of exercise of the call option and after exercise of the call option.

1.5. Step-up option

The issuing bank may have a step-up option which may be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. The step-up shall not be more than 100 bps. The limits on step-up apply to the all-in cost of the debt to the issuing banks.

1.6. Classification in the balance sheet

These instruments will be classified as borrowings under Schedule 4 of the Balance sheet as item No.1.

1.7 Coupon

The coupon payable to the investors may be either at a fixed rate or at a floating rate referenced to a market determined rupee interest benchmark rate.

1.8. Payment of coupon

1.8.1 The coupon payable on these instruments will be treated as interest and accordingly debited to P& L Account. However, it will be payable only if

- a) The bank's CRAR is above the minimum regulatory requirement prescribed by RBI
- b) The impact of such payment does not result in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by RBI
- c) The bank does not have a net loss. For this purpose the Net Loss is defined as either (i) the accumulated loss at the end of the previous financial year/half year as the case may be; or (ii) the loss incurred during the current financial year.
- d) In the case of PCPS and RCPS the unpaid coupon will be treated as a liability. The interest amount due and remaining unpaid may be allowed to be paid in later years subject to the bank complying with the above requirements.
- e) In the case of RNCPS, deferred coupon will not be paid in future years, even if adequate profit is available and the level of CRAR conforms to the regulatory minimum.

1.8.2. All instances of non-payment of interest should be notified by the issuing banks to the Chief General Managers-in-Charge of Department of Banking Operations & Development and Department of Banking Supervision, Central Office of the Reserve Bank of India, Mumbai.

1.9. Redemption/repayment of redeemable preference shares included in Upper Tier II

1.9.1. All these instruments shall not be redeemable at the initiative of the holder.

1.9.2. Redemption of these instruments at maturity shall be made only with the prior approval of the Reserve Bank of India (Department of Banking Operations and Development, subject *inter alia* to the following conditions:

- a) the bank's CRAR is above the minimum regulatory requirement prescribed by RBI
- b) the impact of such payment does not result in bank's CRAR falling below or remaining below the minimum regulatory requirement prescribed by RBI

1.10. Seniority of claim

The claims of the investors in these instruments shall be senior to the claims of investors in instruments eligible for inclusion in Tier 1 capital and subordinate to the claims of all other creditors including those in Lower Tier 2 and the depositors. Amongst the investors of various instruments included in Upper Tier 2, the claims shall rank pari-passu with each other.

1.11 Amortisation for the purpose of computing CRAR

The Redeemable Preference Shares(both cumulative and non-cumulative) shall be subjected to a progressive discount for capital adequacy purposes over the last five years of their tenor, as they approach maturity as indicated in the table below for being eligible for inclusion in Tier 2 capital.

Remaining Maturity of Instruments	Rate of Discount (%)
Less than one year	100
One year and more but less than two years	80
Two years and more but less than three years	60
Three years and more but less than four years	40
Four years and more but less than five years	20

1.12 Other conditions

- a) These instruments should be fully paid-up, unsecured, and free of any restrictive clauses.
- b) Investment by FIIs and NRIs shall be within an overall limit of 49% and 24% of the issue respectively, subject to the investment by each FII not exceeding 10% of the issue and investment by each NRI not exceeding 5% of the issue. Investment by FIIs in these instruments shall be outside the ECB limit for rupee denominated corporate debt as fixed by Government of India from time to time. However, investment by FIIs in these instruments will be subject to separate ceiling of USD 500 million. The overall non-resident holding of preference shares and equity shares in public sector banks will be subject to the statutory/regulatory limit.
- c) Banks should comply with the terms and conditions, if any, stipulated by SEBI/other regulatory authorities in regard to issue of the instruments.

2. Compliance with Reserve Requirements

- a) The funds collected by various branches of the bank or other banks for the issue and held pending finalization of allotment of these instruments will have to be taken into account for the purpose of calculating reserve requirements.
- b) The total amount raised by a bank through the issue of these instruments shall be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

3. Reporting Requirements

Banks issuing these instruments shall submit a report to the Chief General Manager-in-charge, Department of Banking Operations & Development, Reserve Bank of India, Mumbai giving details of the debt raised, including the terms of issue specified at item 1 above together with a copy of the offer document soon after the issue is completed.

4. Investment in these instruments issued by other banks/ FIs

- a) A bank's investment in these instruments issued by other banks and financial institutions will be reckoned along with the investment in other instruments eligible for capital status while computing compliance with the overall ceiling of 10 percent of investing banks' capital find prescribed vide circular DBOD.BP.BC.No.3/ 21.01.002/ 2004-05 dated 6th July 2004 and also subject to cross holding limits.
- b) Bank's investments in these instruments issued by other banks/ financial institutions will attract a 100% risk weight for capital adequacy purposes.

5. Grant of advances against these instruments

Banks should not grant advances against the security of these instruments issued by them.

Appendix

Details of Investments by FIIs and NRIs in Perpetual Non-Cumulative Preference Shares qualifying as Tier-I capital

a) Name of the bank :

b) Total issue size/ amount raised (in Rupees):

c) Date of issue:

FIIs			NRIs		
No of FIIs	Amount raised		No. of NRIs	Amount raised	
	in Rupees	as a percentage of the total issue size		in Rupees	as a percentage of the total issue size

It is certified that

i. the aggregate investment by all FIIs does not exceed 49 percent of the issue size and investment by no individual FII exceeds 10 percent of the issue size.

ii. It is certified that the aggregate investment by all NRIs does not exceed 24 percent of the issue size and investment by no individual NRI exceeds 5 percent of the issue size.

Authorised Signatory

Date

Seal of the bank

June 26, 2007

**The Chairman/ Chief Executive Officer
All Commercial Banks
(excluding RRBs & LABs)**

Dear Sir,

Guidelines on Stress Testing

Improvement in risk management practices has been in focus since the introduction of the financial sector liberalization process in the mid nineties. The process gained momentum with the issue of regulatory guidelines and guidance notes on asset liability management and management of credit risk, market risk and operational risk by the Reserve Bank since 1999. Further, the announcement of implementation of the revised capital adequacy framework in India has brought the risk management capabilities of banks into greater focus.

2. Globally, banks are increasingly relying on statistical models to measure and manage the financial risks to which they are exposed. These models are gaining credibility because they provide a framework for identifying, analysing, measuring, communicating and managing these risks. Since models cannot incorporate all possible risk outcomes and are generally not capable of capturing sudden and dramatic changes, banks supplement models with 'stress tests'. Internationally, stress testing has become an integral part of banks' risk management systems and is used to evaluate the potential vulnerability to some unlikely but plausible events or movements in financial variables. There are broadly two categories of stress tests used in banks viz. sensitivity tests and scenario tests. These may be used either separately or in conjunction with each other.

Sensitivity tests are normally used to assess the impact of change in *one variable* (for example, a high magnitude parallel shift in the yield curve, a significant movement in the foreign exchange rates, a large movement in the equity index etc.) on the bank's financial position.

Scenario tests include simultaneous moves in a *number of variables* (for example, equity prices, oil prices, foreign exchange rates, interest rates, liquidity etc.) based on a single event experienced in the past (i.e., *historical scenario* – for example, natural disasters, stock market crash, depletion of a country's foreign exchange reserves) or a plausible market event that has not yet happened (i.e., *hypothetical scenario* - for example, collapse of communication systems across the entire region/ country, sudden or prolonged severe economic downturn) and the assessment of their impact on the bank's financial position.

3. Banks in India are beginning to use statistical models to measure and manage risks. Stress tests are, therefore, relevant for these banks. Notwithstanding the use of statistical models, stress tests are a relevant and integral part of banks' risk management frameworks. Further, the supervisory review process under Pillar 2 of Basel II framework is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. In the above background, the need for banks in India to adopt 'stress tests' as a risk management tool has been

emphasised in the Annual Policy Statement for 2006-07. Accordingly, the draft guidelines on stress testing were prepared and issued for feedback from banks. On the basis of the feedback received, the draft guidelines have been suitably revised and are furnished in the Annex . Guidelines on stress testing, as relevant for the Basel II framework, will be issued separately.

4. A copy of this circular may be placed before the Board of Directors at the next meeting for their information and appropriate guidance / advice. Banks shall put in place appropriate stress test policies and the relevant stress test framework for the various risk factors by September 30, 2007. As it is appreciated that banks may need to undertake the stress tests on a trial basis and use the results of these trial tests as a feedback to further refine the framework, it has been decided that banks be allowed some time to refine the stress testing frameworks. Banks are required to ensure that their formal stress testing frameworks, which are in accordance with the guidelines in Annex, are operational from March 31, 2008.

5. Please acknowledge receipt.

Yours faithfully,

(Prashant Saran)
Chief General Manager – in – Charge

Guidelines to banks on Stress Testing**Background**

1. Internationally, stress testing has become an integral part of a bank's risk management system and is used to evaluate its potential vulnerability to certain unlikely but plausible events or movements in financial variables. The vulnerability is usually measured with reference to the bank's profitability or / and capital adequacy. This brings to fore the inadequacies of managing risks on the basis of 'normal' business conditions and emphasises the importance of robust risk management systems which factor-in a forward looking element and recognise the need to manage risks 'over the economic cycle'.

2. There are broadly two categories of stress tests used in banks viz. sensitivity tests and scenario tests. These may be used either separately or in conjunction with each other. The stress events and scenarios identified / developed by a bank should be plausible and relevant to its portfolio.

Sensitivity tests are normally used to assess the impact of change in *one variable* (for example, a high magnitude parallel shift in the yield curve, a significant movement in the foreign exchange rates, a large movement in the equity index etc.) on the bank's financial position.

Scenario tests include simultaneous moves in a *number of variables* (for example, equity prices, oil prices, foreign exchange rates, interest rates, liquidity etc.) based on a single event experienced in the past (i.e., *historical scenario* – for example, natural disasters, stock market crash, depletion of a country's foreign exchange reserves) or a plausible market event that has not yet happened (i.e., *hypothetical scenario* - for example, collapse of communication systems across the entire region/ country, sudden or prolonged severe economic downturn) and the assessment of their impact on the bank's financial position.

Utility

3. A well designed and implemented stress testing framework would supplement banks' risk management systems and help in making these systems more robust. The stress testing framework also helps banks to be better equipped to meet the stress situations as and when they arise and also overcome them such that they do not become a serious threat to themselves or to the banking systems in which they operate.

4. Stress tests should, as far as possible, be conducted on a bank-wide basis. While applying the stress tests on a bank-wide basis, due consideration should be given to country or market or portfolio specific factors. Stress tests should be adequately tailored to capture these factors. Stress tests undertaken on a bank-wide basis enable the Board and senior management to assess the potential impact of the stress situations on the bank's earnings and capital position, and enable them to develop or choose appropriate strategies for mitigating and managing the impact of those situations. The framework also helps bank managements in understanding the bank's risk profile and adjusting it in accordance with their risk appetites. The stress test results should be considered while establishing and reviewing various policies and limits.

5. The stress testing frameworks perform the dual role of being a diagnostic tool for improving a bank's understanding of its risk profile, for assessing the adequacy of internal capital, for

supplementing the internal capital models where paucity of historical data limits the predictive power of the models, and for introducing a forward looking element in the capital assessment process. Banks need to understand the likely impact of the stress situations and relate it to the capacity of the bank's profitability to absorb the shocks and the consequent impact on the bank's capital. Considering the range of possible options to tackle the stress situations, banks may decide to hold a capital buffer that would be aligned to the exceptional but plausible stress situations. The stress testing framework will serve as an important component of banks' Internal Capital Adequacy Process (ICAAP) under the Basel II framework. Guidelines on stress testing, as relevant for the Basel II framework, will be issued separately.

Framework requirements

6. Banks shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems. The framework should satisfy the following essential requirements:

i) The Board approved 'stress testing policy' should detail (a) the frequency and procedure for identifying the principal risk factors which affect the bank's portfolio and should be stressed; (b) the methodology for constructing appropriate and plausible single factor and multi factor stress tests; (c) the procedure for setting the stress tolerance limits; (d) the process for monitoring the stress loss limits; (e) the remedial actions required to be taken at the relevant stages; (f) the authorities designated to activate the remedial actions; (g) the need for identification of the responsibilities assigned to various levels/ functional units; and (h) the need for specification of reporting lines.

ii) The senior management should be actively involved in identifying the principal risk factors; designing appropriate single factor/ multi factor stress tests; setting the stress tolerance limits; reviewing the stress test results and monitoring the stress loss limits; activating the appropriate remedial actions; periodically communicating the stress test results and the actions taken, if any, to the Board; reviewing the need to modify the stress testing framework with reference to certain elements like the risk factors, stress scenarios, levels of stress to be applied, the underlying assumptions, stress tolerance levels, remedial actions etc.; designing an appropriate MIS to support the stress tests to be conducted; and ensuring an appropriate and effective internal control mechanism to validate the stress tests and their findings;

iii) Board and senior management should regularly review the results of scenario analyses and stress tests, including the major assumptions that underpin them. Stress test results may be used for setting risk limits; allocating capital for various risks; managing risk exposures; and putting in place appropriate contingency plans for meeting the situations that may arise under adverse circumstances.

iv) Stress testing framework should be calibrated according to the complexity of each bank's business activities. The number of risk factors to be stressed would depend on the complexity of the portfolio and the risks the bank is exposed to. Banks should be able to justify their choice of stress

tests and the choice of risk factors that are stressed. Banks which have foreign operations, or/ and are active in derivatives markets, or/ and are operating an active trading portfolio should use a combination of scenario analysis and sensitivity tests. Other banks may confine themselves to sensitivity tests run relatively more frequently to assess the impact of the relevant principal risk factors on their financial condition.

v) Banks are free to choose the various assumptions underlying the stress tests and the basis for their assumptions. However, these should be well documented and available for verification by the supervisor / auditors. The assumptions underlying the stress tests should be reviewed periodically for assessing their validity. Banks should undertake fresh stress tests when there are significant modifications in the underlying assumptions. Such periodic reviews are necessary to ensure the integrity, accuracy, and reasonableness of the stress testing framework.

vi) Banks should use appropriate, accurate and complete data when performing stress tests. The IT resources should be commensurate with the complexity of the techniques and the coverage of the stress tests. Banks should have adequate MIS in place to support the stress testing framework. The systems should be able to support the conduct of stress tests on different risks at relevant levels (portfolios, regions, business units) and also aggregate the results for the bank as a whole.

vii) As the environment in which banks are operating is quite dynamic, there are changes in macroeconomic environment, banks' instruments, trading strategies and regulatory policies. The risk measurement methodologies and stress testing techniques in banks should, therefore, evolve to accommodate these changes. The stress testing framework should, therefore, be reviewed periodically to determine its efficacy and to consider the need for modifying any of the elements. The framework should be subjected to at least annual reviews which should cover, among others, the following aspects:

- (a) Adequacy of the documentation for various elements of the stress testing framework;
- (b) Integration of the stress testing framework in the day-to-day risk management processes;
- (c) Scope of coverage of the framework and the levels of stress applied;
- (d) Integrity of MIS and data feeding into the stress tests; and
- (e) Adequacy of the remedial actions and the efficiency of the systems for their activation;

Identification of risks

7. While traditionally stress tests are used in the context of managing *market risks*, these may also be employed in the management of *credit risks*, *operational risks* and *liquidity funding risk*. Banks should identify their major risks that should be subjected to stress tests. While identifying the major risks, banks should understand their exposures and the risks to which these are exposed as well as the correlation between these risks. An indicative list of the risks that banks, in general, are exposed to are credit risk, credit concentration risk, interest rate risk, price risk, foreign currency risk, impact of market movements on contingent credit risk, liquidity risk, operational risks, prepayment risk,

model risk, macro economic risk and political risk. The above is only an indicative list and banks should identify the risks to which they are exposed to with regard to their bank specific circumstances and portfolio.

Stress scenarios / levels

8. Banks should stress the relevant parameters at least at three levels of increasing adversity – minor, medium, and major – with reference to the normal situation and estimate the financial resources needed by it under each of the circumstances to

- a) meet the risk as it arises and for mitigating the impact of manifestation of that risk;
- b) meet the liabilities as they fall due; and
- c) meet the minimum CRAR requirements.

9. A scenario analysis measures the combined effect of adverse movements in more than one risk factor. Banks should determine the various risks that should be included in a scenario, take into account the linkages among the various risks without looking at each of them in isolation and assess the extent to which the stress would impact their financial position. Stress scenarios may be designed on the basis of either historical events or hypothetical events. An important element of scenario development will be the assessment and incorporation of the linkages between the various risk factors.

10. A few examples of stress factors / scenarios are as follows: domestic economic downturn, economic downturn of major economies to which the bank is directly exposed or to which the domestic economy is related; decline in the prospects of sectors to which the banks are having significant exposures; increase in level of NPAs and provisioning levels; increase in level of rating downgrades; failure of major counterparties; timing difference in interest rate changes (repricing risk); unfavourable differential changes in key interest rates (basis risk); parallel / non parallel yield curve shifts (yield curve risk); changes in the values of standalone and embedded options (option risk); adverse changes in exchange rates of major currencies; decline in market liquidity for financial instruments; stock market declines; tightening of market liquidity; significant operational risk events.

Frequency of stress testing

11. Banks may apply stress tests at varying frequencies dictated by their respective business requirements, relevance and cost. While some stress tests may be conducted daily or weekly – for example: trading book items for the various market risks; some others may be conducted at monthly or quarterly intervals – for example: those items which are less volatile in nature like credit risk in loans or HTM securities; interest rate risk in the banking book; and liquidity risk. Further, ad-hoc stress tests may be warranted when there are any special circumstances – for example: a rapidly deteriorating political / economic conditions in a country may warrant a quick assessment of the likely impact on the bank on account of its exposures to that country.

Interpretation of stress test results

12. The results of the various stress tests should be reviewed by the senior management and reported to the Board. These results should be an essential ingredient of bank's risk management systems.

13. Banks should be conscious of the fact that the stress tests only indicate the likely impact and do not indicate the likelihood of the occurrence of the stress events. Since stress testing is influenced by the judgment and experience of the people who design the stress tests, the effectiveness of the stress tests will depend upon whether banks have identified their major risks, whether they have chosen the right level of stress / stress scenarios, whether they have understood and interpreted the stress test results properly and whether they have initiated the necessary steps to address the situation presented by the stress test results. Hence, each of the above aspects need to be assigned their due importance.

14. Banks should document the stress tests undertaken by them, the underlying assumptions, the results and the outcomes. The documentation should be preserved *at least* for five years.

Remedial Actions

15. The remedial actions that banks may consider necessary to activate when the various stress tolerance levels are breached may include:

- a) Reduction of risk limits;
- b) Reduction of risks by enhancing collateral requirements, seeking higher level of risk mitigants, undertaking securitisation, and hedging;
- c) Amend pricing policies to reflect enhanced risks or previously unidentified risks;
- d) Augmenting the capital levels to enhance the buffer to absorb shocks;
- e) Enhancing sources of funds through credit lines, managing the liability structure, altering the liquid asset profile, etc.;

16. Banks should clearly identify the principles that they would be guided by while they decide on activation of the various remedial actions as appropriate to the stress event / level that may be reflected in the stress test results. The triggers for remedial actions may be identified clearly for example: with reference to the size of the potential loss or the impact on earnings and / or capital. In addition, the level of authority for determining the remedial action to be initiated should be clearly identified. The triggers, the remedial actions, the guiding principles for activation and the designated authorities should be properly documented and adopted/ applied as and when relevant.

17. As stress testing is an evolving area, a few **illustrative** examples of typical stress tests are presented in the Attachment purely with a view to aid in better perception of stress tests. Therefore, it would **not** be appropriate (i) to conclude that the levels of stress or the impacts mentioned in the illustrations are as perceived by the Reserve Bank or are recommended by the Reserve Bank and (ii) for banks to apply the illustrative stress tests as they are. Each bank should

ensure that the assumptions and the levels of stress are as determined by them and that the stress tests are suitably modified while designing their respective stress testing frameworks. The stress testing framework and methodology in each bank should be tailored to suit the size, complexity, risk philosophy, risk perceptions and skills in each bank.

Effective Date

18. Banks shall put in place appropriate stress test policies and the relevant stress test framework for the various risk factors by September 30, 2007. As it is appreciated that banks may need to undertake the stress tests on a trial basis and use the results of these trial tests as a feedback to further refine the framework, it has been decided that banks be allowed some time to refine the stress testing frameworks. Accordingly, banks may use the next 6 months to test and refine the stress testing framework and the under lying assumptions. At the same time, with a view to ensuring that stress testing frameworks for all relevant risk factors are formally operational in the Indian banking system without much delay, banks are required to ensure that their formal stress testing frameworks, which are in accordance with these guidelines, are operational from March 31, 2008.

Illustrative Examples of Stress Tests

As stress testing is an evolving area, a few illustrative examples of typical stress tests are presented below purely with a view to aid in better perception of stress tests among banks. Therefore, it would **not** be appropriate (i) to conclude that the levels of stress or the impacts mentioned in these illustrations are as perceived by the Reserve Bank or are recommended by the Reserve Bank and (ii) for banks to apply the illustrative stress tests as they are. Each bank should ensure that the assumptions and the levels of stress are as determined by them and that the stress tests are suitably modified while designing their respective stress testing frameworks in such a manner that it would be relevant to each bank's requirement. The stress testing framework and methodology in each bank should, however, be tailored to suit the size, complexity, risk philosophy, risk perceptions and skills in each bank. Banks should construct their own stress scenarios; ensure that appropriate risk factors are included; apply the appropriate levels of stress as they perceive to be plausible and ensure that the stress tests are economically meaningful.

Stress test illustration – 1 : Liquidity risk

1. The general sources of stress on liquidity in banks are seen to emerge from
 - a) Over-dependence on more volatile funding sources, such as wholesale funds and inter-bank funds;
 - b) Depositors' ability to switch funds among accounts by electronic means;
 - c) Bank's ratings downgrades or other negative news could cause, among others, reduced market access to unsecured borrowings from call money market; a reduction or cancellation of inter-bank credit lines; a reduction of deposits; and adversely affect a bank's capability of securitising its assets.
 - d) Off-balance sheet products that can give rise to sudden material demands for liquidity at banks include committed lending facilities to customers, committed backstop facilities, and committed back-up lines to special purpose vehicles.
 - e) Sharp and unanticipated market movements or defaults could cause demand for additional collateral calls from exchanges/ settlement platforms in connection with foreign exchange and securities transactions;

2. A primary liquidity risk is deposit run-offs in a bank-specific event. The assumptions that banks may utilise in the stress tests may be based on a combination of bank-specific historical data, industry data from prior stress events, and/or best guess estimates. When using bank-specific historical data, some banks may add an extra cushion to the assumed outflows to factor-in their perception that data largely based on stable historical periods may not adequately reflect depositor behaviour during a future stress event. The severity of deposit outflows in a bank's stress scenario depends upon factors including the strength of the bank's relationships with its customers, the proportion of deposits that is protected by deposit insurance, the composition of its balance sheet, and the duration of the crisis. Banks may reckon securitisation of the eligible assets as a potential source for liquidity after taking all relevant factors into account. While

considering stress scenarios, as a conservative measure, banks should not reckon the Reserve Bank as a contingent source for liquidity.

3. The broad assumptions that may be made on behaviour of liabilities during stress periods may be:
 - a) The percentage of retail deposits that may be withdrawn in a stress scenario is typically in the single digits, while a few banks may assume outflows in the low double digits. This reflects an assumption that retail depositors would be comforted by deposit insurance and so would not withdraw their deposits. Hence, retail for the purpose of stress tests would be those enjoying the protection of deposit insurance.
 - b) Corporate, bank and government deposits or other un-insured deposits may be assumed to reduce between 20 percent and 50 percent, typically over a one-month time span. Outflows may, sometimes, be assumed to be 100 percent for certain deposit types. Some banks may make finer distinction among different types of clients or on the basis of the bank's relationships with them.
 - c) Banks may recognise that disposal of assets to raise liquidity may entail application of haircuts (depending on the scenario) while arriving at their realisable value.
 - d) Banks may recognise that intra-group cash flows might be disrupted.
 - e) Banks may undertake the stress test where the stress scenario is expected to last over different time horizons say one month or less; two or three months; and six months or more.

4. A numerical illustration of a liquidity stress test when on account of an adverse rumour the bank's reputation for meeting its liabilities as and when they mature has been eroded is presented below. The broad assumptions are mentioned below:

(Rs. crore)

	1-7 days	8-14 days	15-28 days	29 days to 3 mths	> 3 to 6 mths	> 6 mths to 1 year	> 1 to 3 yrs	> 3 to 5 yrs	> 5 yrs	TOTAL
Normal										
Assets	50	50	150	200	200	300	350	250	250	1800
Wholesale deposits	12	18	40	50	40	50	10	10	0	230
Retail Deposits	40	50	140	200	310	300	190	140	200	1570
Total Liability	52	68	180	250	350	350	200	150	200	1800
Gap	-2	-18	-30	-50	-150	-50	150	100	50	0
Stress										
Assets	50	50	150	200	200	300	350	250	250	1800
Wholesale deposits	75	55	20	25	20	25	5	5	0	230
Retail Deposits	212	174	112	160	248	240	152	112	160	1570
Total Liability	287	229	132	185	268	265	157	117	160	1800
Gap	-237	-179	18	15	-68	35	193	133	90	0
Assumptions										
The stress scenario is expected to last three months										
1. Wholesale deposits - Fifty percent of these deposits are to be repaid in the first two buckets and the remaining fifty percent is re-deposited with a hike in interest rate by 1%.										
2. The retail deposits are fully covered by deposit insurance. However, 20% of the deposits in the third bucket onwards (i.e., 1570 – 90) are withdrawn in the first two buckets.										
3. Assets maturing beyond the first two buckets are sold at a discount of 10%, to the extent required, to meet the gap in the first two buckets. (i.e. Rs. 416 crore)										
				Impact of stress on liquidity						
				Loss on sale of assets			46.22			
				Higher Interest on -						
				Wholesale deposits			1.00			
				Total cost			47.22			

Stress test illustration – 2 : Interest rate risk – earnings perspective

Interest rate risk is the risk where changes in market interest rates might adversely affect a bank's financial condition. The immediate impact of changes in interest rates is on bank's earnings through changes in its Net Interest Income (NII). A long-term impact of changes in interest rates is on bank's Market Value of Equity (MVE) or Net worth through changes in the economic value of its assets, liabilities and off-balance sheet positions. The interest rate risk, when viewed from these two perspectives, is known as 'earnings perspective' and 'economic value' perspective, respectively. The present guidelines on asset liability management (BP.BC.8/21.04.098/99 dated February 10, 1999) to banks approach interest rate risk measurement from the 'earnings perspective' using the traditional Gap Analysis (TGA).

The following illustrations indicate a few methods of application of stress tests to assess the impact of interest rate risk from the earnings perspective.

(Rs. crore)

Time buckets ➡	1-14 days	15-28 days	29 days to 3 mths	> 3 to 6 mths	> 6 mths to 1 year	> 1 to 3 yrs	> 3 to 5 yrs	> 5 yrs	TOTAL
Particulars ↓									
RSA**	100	150	200	200	300	350	250	250	1800
RSL**	120	180	250	350	350	200	150	50	1650
Gap (RSA – RSL)	- 20	- 30	-50	-150	- 50	150	100	200	150

Annual Profit = Rs. 18 crore

** RSA – Rate sensitive assets; RSL – Rate sensitive liabilities

Example A : When interest rates increase by one percent across all time buckets both for assets and liabilities

	1-14 days	15-28 days	29 days to 3 mths	> 3 to 6 mths	> 6 mths to 1 year	> 1 to 3 yrs	> 3 to 5 yrs	> 5 yrs	TOTAL
RSA – Value	100	150	200	200	300	350	250	250	1800
RSL – Value	120	180	250	350	350	200	150	50	1650
Gap	-20	-30	-50	-150	-50	150	100	200	150
Intt. On RSA	1	1.5	2	2	3	3.5	2.5	2.5	18
Intt on RSL	-1.2	-1.8	-2.5	-3.5	-3.5	-2	-1.5	-0.5	-16.5
Impact on NII	-0.2	-0.3	-0.5	-1.5	-0.5	1.5	1	2	1.5
Impact on profit									8.33%

Assumptions: Where all assets and liabilities are linked to floating interest rates, any change in the interest rates would normally impact the interest rates pertaining to those assets and liabilities which are due for maturity/ re-pricing within the time horizon over which the stress is envisaged. In the Indian context, when there is a change in the prime lending rates (PLR) of banks, the change will impact the interest rates of all assets which are linked to the PLR, including those that are due for re-pricing/ maturity beyond the time horizon over which the stress is envisaged. Fixed interest rate exposures would be sensitive to interest rate changes with reference to the date of maturity and hence would not be affected by change in interest rates when these exposures are maturing beyond the time horizon over which the stress is envisaged. For the purpose of this illustration, the change in interest rates is assumed to immediately impact the interest rates pertaining to all assets and all liabilities, and, thus the NII.

- Increase in interest income on RSA = $1800 \times 0.01 = \text{Rs. } 18 \text{ crore}$
- Increase in interest expenditure on RSL = $1650 \times 0.01 = \text{Rs. } 16.50 \text{ crore}$
- Hence, NII has **increased** by Rs. 1.50 crore and the profits **increase** by 8.33%.
- The impact is equal to one percent of the Net gap between RSA and RSL (150×0.01)

Example B : When interest rates decrease by one percent across all time buckets both for assets and liabilities

	1-14 days	15-28 days	29 days to 3 mths	> 3 to 6 mths	> 6 mths to 1 year	> 1 to 3 yrs	> 3 to 5 yrs	> 5 yrs	TOTAL
RSA – Value	100	150	200	200	300	350	250	250	1800
RSL – Value	120	180	250	350	350	200	150	50	1650
Gap	-20	-30	-50	-150	-50	150	100	200	150
Intt. On RSA	-1	-1.5	-2	-2	-3	-3.5	-2.5	-2.5	-18
Intt on RSL	1.2	1.8	2.5	3.5	3.5	2	1.5	0.5	16.5
Impact on NII	0.2	0.3	0.5	1.5	0.5	-1.5	-1	-2	-1.5
Impact on profit									-8.33%

Assumptions: All assets and liabilities are linked to floating rate interest rates linked to benchmark rates. The change in interest rates immediately impacts the benchmark rates and thus the NII.

- Decrease in interest income on RSA = $1800 \times 0.01 = \text{Rs. } 18 \text{ crore}$
- Decrease in interest expenditure on RSL = $1650 \times 0.01 = \text{Rs. } 16.50 \text{ crore}$
- Hence, NII has **decreased** by Rs. 1.50 crore and the profits **decrease** by 8.33%.
- The impact is equal to one percent of the Net gap between RSA and RSL (150×0.01)

Example C : When interest rates increase by one percent for time buckets up to one year and decrease by one percent for time buckets beyond one year both for assets and liabilities

	1-14 days	15-28 days	29 days to 3 mths	> 3 to 6 mths	> 6 mths to 1 year	> 1 to 3 yrs	> 3 to 5 yrs	> 5 yrs	TOTAL
RSA – Value	100	150	200	200	300	350	250	250	1800
RSL – Value	120	180	250	350	350	200	150	50	1650
Gap	-20	-30	-50	-150	-50	150	100	200	150
Intt. On RSA	1	1.5	2	2	3	-3.5	-2.5	-2.5	1
Intt on RSL	-1.2	-1.8	-2.5	-3.5	-3.5	2	1.5	0.5	-8.5
Impact on NII	-0.2	-0.3	-0.5	-1.5	-0.5	-1.5	-1	-2	-7.5
Impact on profit									-41.67%

- RSA – RSL for time buckets up to one year = (-) 300. Hence, impact on NII for time buckets up to one year = $(-) 300 \times 0.01 = (-) \text{Rs. } 3 \text{ crore}$; i.e., a decrease in NII.

- RSA – RSL for time buckets beyond one year = (+) 450. Hence, impact on NII for time buckets beyond one year = $450 \times (-) 0.01 = (-)$ Rs. 4.50 crore; i.e., a decrease in NII.
- The aggregate **decrease** in NII is Rs. 7.50 crore and therefore the profits **decrease** by 41.67%.

Stress test illustration – 3 : Credit risk – Impact on capital adequacy

The stress tests for credit risk may assess the impact of an economic downturn on the bank's capital adequacy position especially under a Basel II scenario. An economic downturn could lead to a downgrade in the credit ratings awarded to a bank's counterparties by rating agencies. This might lead to a consequent increase in the risk weights for these exposures which will have an impact on the bank's capital adequacy position. This is a likely situation under a Basel II scenario where the risk weights will be related to the credit rating enjoyed by the counterparty exposures. A similar stress test may also be undertaken with reference to the internal rating grades awarded to the counterparties. The impact in this situation would be on the economic capital maintained by a bank.

The following two examples illustrate this impact on capital adequacy arising out of an economic downturn, under two assumptions (a) a uniform level of downgrade for all rating grades; and (b) a different level of downgrade for different rating grades.

Example A:

						Rs.crore
		Normal situation		Stress situation		
Rating scale	Risk weight	Exposure	RWA	Extent of down-grade (%)	Exposure	RWA
AAA	20	300	60.00	15	255	51.00
AA	50	200	100.00	15	215	107.50
A	50	100	50.00	15	115	57.50
BBB	100	300	300.00	15	270	270.00
BB & below	150	100	150.00		145	217.50
		1000	660.00		1000	703.50
Minimum Capital			59.40			63.32
Capital funds*	65					
CRAR			9.85			9.24

* Assumed capital funds.

- **Example B :**

						Rs.crore
		Normal situation		Stress situation		
Rating scale	Risk weight	Exposure	RWA	Extent of down-grade (%)	Exposure	RWA
AAA	20	300	60.00	15	255	51.00
AA	50	200	100.00	20	205	102.50
A	50	100	50.00	25	115	57.50
BBB	100	300	300.00	30	235	235.00
BB & below	150	100	150.00		190	285.00
		1000	660.00		1000	731.00
Minimum Capital			59.40			65.79
Capital funds*	65					
CRAR			9.85			8.89

* Assumed capital funds

Stress test illustration – 4 : Credit risk

The stress tests for credit risk may also assess the impact of an increase in the level of non performing loans (NPLs). This could have a two way impact – one on the bank's NPA levels as well as on the additional provisioning requirements which would have a consequent impact on the bank's profits and the CRAR. Banks may also conduct stress tests with reference to the extent of provisioning that may be required by the regulator for various asset categories.

Example A: The regulatory provisioning requirement under a stress situation is assumed as 1% for all Standard (S); 25% for Substandard (SS), and 100% for all Doubtful categories.

Rs. Crore					
		Normal situation		Stress situation *	
Asset Classification	Rate of Provisioning (%)	Exposure	Provision	Revised rate of provisioning (%)	Provision
S	1	900	9.00	1.00	9.00
SS	10	40	4.00	25	10.00
D1	20	10	2.00	100	10.00
D2	30	15	4.50	100	15.00
D3	100	35	35.00	100	35.00
		1000	54.50		79.00
Profit		18		-6.50	
Addl. Provisions					24.50
Impact on profits (%)				-136.11	
ROA		1.80		-0.65	
Capital funds		95		70.50	
RWA		954.50		930.00	
CRAR		9.95		7.58	

* Assumed capital funds – Rs. 95 crore

Note:

1. **Profit** under stress situation = $18 - 24.50 = (-) 6.50$
2. **Capital funds** under stress situation = $95 - 24.50 = 70.50$
3. RWA under normal situation = $1000 - (4.00 + 2.00 + 4.50 + 35.00) = 954.50$
4. **RWA** under stress situation = $1000 - (10.00 + 10.00 + 15.00 + 35.00) = 930$

Example B: The downgrade from Standard to NPA (sub standard) is assumed to be 10% (i.e., the extent of present level of gross NPAs) and the provisioning requirements under stress situation are assumed as in example A above:

Rs. Crore							
		Normal situation				Stress situation *	
Asset Classification	Rate of Provisioning (%)	Exposure	Provision	Extent of down-grade (%)	Exposure	Revised rate of provisioning (%)	Provision
S	1.00	900	9.00	10	810	1	8.10
SS	10	40	4.00		130	25	32.50
D1	20	10	2.00		10	100	10.00
D2	30	15	4.50		15	100	15.00
D3	100	35	35.00		35	100	35.00
		1000	54.50		1000		100.60
Profit		18				-28.10	
Addl. Provisions							46.10
Impact on profits						-256.11	
ROA		1.80				-2.81	
Capital funds		95				48.00	
RWA		954.50				907.50	
CRAR		9.95				5.29	

Note:

1. **Profit** under stress situation = $18 - 46.10 = (-) 28.10$
2. **Capital funds** under stress situation = $[95 - (9.00 - 8.10)] - 46.10 = 48.00$
3. **RWA** under stress situation = $1000 - (32.50 + 10.00 + 15.00 + 35.00) = 907.50$

Stress test illustration – 5 : Foreign exchange risk

The stress test for exchange rate may assess the impact of change in exchange rate on the bank's open positions and consequently its capital requirements. To model direct foreign exchange risk only the overall net open position of the bank may be given an adverse shocks (say 5%, 10% and 15%). The overall net open position is measured by aggregating the sum of short positions or the sum of long positions; whichever is greater regardless of sign. Banks may adopt a more conservative method for computing open positions. The impact of the stress event could be measured with reference to

- a) the additional capital that may be required to be maintained; and
- b) the loss on account of change in value

Example A:

Foreign exchange open positions				
Currency		Limits (in millions)	Rupee equivalent (Rs. Crore)	
USD		5	22.50	
EURO		4	23.20	
GBP		3	24.00	
Sw. Franc		7	26.60	
Jap Yen		500	22.50	
Total			118.80	
Stress (%)			Rupee equivalent (Rs. Crore)	Additional capital required (Rs. Crore)
5			1247.4	0.53
10			1306.8	1.07
15			1366.2	1.60
	Normal	5% stress	10% stress	15% stress
Capital funds	65*	65	65	65
Risk weighted assets	660*	665.84	671.78	677.72
CRAR	9.85	9.76	9.68	9.59

* Assumed

Example B :

(Rs. Crore)						
Currency	Rate (in Rs.)	OB/ OS	Position	Rupee equivalent		
USD	45	OS	3	13.50		
EURO	58	OS	4	23.20		
GBP	80	OB	2	16.00		
Sw. Franc	38	OS	5	19.00		
Jap Yen	0.45	OB	450	20.25		
Annual profits				18.00		
Currency	Rupee equivalent 5 % stress	Net impact on P/L account	Rupee equivalent 10% stress	Net impact on P/L account	Rupee equivalent 15% stress	Net impact on P/L account
USD	14.18	-0.68	14.85	-1.35	15.53	-2.03
EURO	24.36	-1.16	25.52	-2.32	26.68	-3.48
GBP	16.80	0.80	17.60	1.60	18.40	2.40
Sw. Franc	19.95	-0.95	20.90	-1.90	21.85	-2.85
Jap Yen	21.26	1.01	22.28	2.03	23.29	3.04
		-0.97		-1.95		-2.92
% of profits		5.4		10.8		16.2

Note:

- a) The Rupee has depreciated against all currencies by 5%, 10% and 15%.
- b) Since Rupee has depreciated, the bank incurs a loss on oversold positions and makes a gain on the overbought positions.

RBI/2006-2007/335
Ref. DBS. CO.PP.BC 6/11.01.005/2006-07

April 20, 2007

The Chairman / CEO
All Scheduled Commercial Banks (excluding RRBs)

Madam / Dear Sir,

Compliance function in banks

As you are aware, draft guidelines on compliance function in banks were placed on the website vide Ref No. DBS.CO.PP.BC 1/11.01.005/2006-07 dated November 16, 2006. Based on the responses / comments on the draft guidelines received from banks, Self Regulatory Organizations and others, the draft guidelines have been suitably modified.

The guidelines may be implemented in full within a time frame of six months from the date of this circular. The implementation would be subjected to comprehensive review by the Reserve Bank of India during the ensuing Annual Financial Inspection.

Yours faithfully,

(G.Gopalakrishna)
Chief General Manager-in-Charge

Preamble

The banks in India already have certain compliance processes in place in accordance with the recommendations of the Ghosh Committee report of 1992. These processes and the organizational structures through which they operate have been primarily shaped by the existing RBI guidelines to banks as also by the banks' own standards of internal governance. However, as the present arrangements in the banks show, its evolution as an institutional arrangement has not kept pace with the increasing complexities and sophistication in the banking business. In a number of banks, compliance function is yet to be fully cognizant of the "compliance risk" and the reputational risk arising out of compliance failures causing huge economic costs. Consequently, there is a critical need for the management of that risk as one of the key facets of integrated risk management or enterprise wide risk management framework.

Compliance function in banks is one of the key elements in the banks' corporate governance structure. The compliance function in banks has to be adequately enabled and made sufficiently independent. The Basel Committee on Banking Supervision (BCBS) document (April 2005) essentially articulates this perception. This circular seeks to introduce certain principles, standards and procedures relating to compliance function consistent with the BCBS document and keeping in view the operating environment in India. This circular also intends to articulate that the compliance function is an integral part of governance along with the internal control and risk management process. For the compliance function to be effective, it must be supported by a healthy compliance culture within the organization. The guidelines are also intended to guide the bank led Financial Conglomerates in managing their "Group wide compliance risk".

In this circular, a set of minimum guidelines have been laid down. There are significant differences among the banks with regard to their scale of operations, their risk profiles and organizational structures. Therefore, the banks should organize their compliance functions and set priorities for the management of the compliance risks in their organization to suit their requirements.

Compliance and Compliance function in Banks

Introduction

The Compliance Function has to ensure strict observance of all statutory provisions contained in various legislations such as Banking Regulation Act, Reserve Bank of India Act, Foreign Exchange Management Act, Prevention of Money Laundering Act etc. as well as to ensure observance of other regulatory guidelines issued from time to time; standards and codes prescribed by BCSBI, IBA, FEDAI, FIMMDA etc; and also each bank's internal policies and fair practices code. Compliance laws, rules and standards generally cover matters such as observing proper standards of market conduct, managing conflicts of interest, treating customers fairly, and ensuring the suitability of customer advice. They typically include specific areas such as the prevention of money laundering and terrorist financing, and may extend to tax laws that are relevant to the structuring of banking products or customer advice.

Compliance laws, rules and standards have various sources, including primary legislation, rules and standards issued by legislators and supervisors, market conventions, codes of practice promoted by industry associations, and internal codes of conduct applicable to the staff members of the bank. For the reasons mentioned above, these are likely to go beyond what is legally binding and embrace broader standards of integrity and ethical conduct.

Each bank, will formulate a Compliance Function for their bank. It shall be the responsibility of bank's Compliance Officer in the bank to assist the top management in managing effectively the compliance risks faced by the bank.

2. Compliance Risk and significance of Compliance Function

- 2.1 The BCBS paper on Compliance and the Compliance Function in Banks (April 2005) defines Compliance risk as “the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities” (together, “*compliance laws, rules and standards*”).
- 2.2 The compliance area is critically important in identifying, evaluating, and addressing legal and reputational risks. Given the significance of these risks, a

strong Group¹/enterprise-wide compliance programme is a necessity for banks. A group/enterprise-wide compliance programme helps the bank to look at and across business lines and activities of the organization as a whole and to consider how activities in one area of the firm may affect the legal and reputational risks of other business lines and the entire group/ enterprise.

- 2.3 A group/enterprise-wide compliance programme could help management and the Board in understanding where the legal and reputational risks in the organization are concentrated, provide comparisons of the level and changing nature of risks, and identify those control processes that most need enhancement. The compliance function must therefore ensure that controls and procedures capture the appropriate information to allow senior management and the board to better perform their risk management functions on a group-wide basis.

3. Responsibility of the Board and Senior Management

Compliance starts at the top. It will be most effective in a corporate culture that emphasizes standards of honesty and integrity and one in which the board of directors and senior management lead by example.

3.1 Responsibility of the Board of Directors

- The Board would be responsible for ensuring that an appropriate compliance policy is in place in the bank to manage compliance risk and also overseeing its implementation. It has to ensure that compliance issues are resolved effectively and expeditiously by senior management with the assistance of compliance staff. If necessary, the Board may delegate these tasks to the Audit Committee of the Board (ACB) or a specific Board level Committee constituted for the purpose. The Board or ACB or the Board Committee, as the case may be, should review compliance function on a quarterly basis. A detailed annual review should also be placed before the Board/ ACB or the Board level Committee. In order to ensure there is no potential for any conflict of interest and that the activities of the compliance function are subject to independent review, the compliance function and the audit function of the bank should necessarily be kept separate.

3.2 Responsibility of Senior Management

- 3.2.1 The bank's senior management would be responsible for establishing a written compliance policy that would contain the basic principles to be followed by the

¹ A Group is defined as parent and its subsidiaries (as defined in AS-21). However, banks are also encouraged to promote a similar compliance culture across their associates and joint ventures (as defined in AS-23 and AS 27 respectively).

management and staff, and would explain the main process by which compliance risk would be identified and managed through all levels of the organization.

3.2.2 The senior management would ensure that appropriate remedial or disciplinary action is taken if breaches are identified.

3.2.3 Senior management should, with the assistance of the compliance function:

- at least once a year, identify and assess the main compliance risk facing the bank and formulate the plans to manage them.
- Submit to the Board/ ACB/ Board Committee, as the case may be, quarterly and annual reviews as prescribed in para 3.1 above, in such a manner as to assist board members to make an informed judgment on whether the bank is managing its compliance risk effectively; and
- report promptly to the board of directors or the ACB on any material compliance failure (e.g. failure that may attract a significant risk of legal or regulatory sanctions, material financial loss, or loss to reputation).

4. The Compliance Policy

4.1 A robust compliance system in a bank should include a well documented Compliance Policy, outlining the compliance philosophy of the bank, role and set up of the Compliance Department, composition of its staff and their specific responsibilities. The policy should be reviewed annually by the Board.

4.2 Broadly, the policy should provide for the following aspects:

- Setting up of an independent Compliance Department at the Head Office with a senior executive heading it with adequate support staff and its role and responsibilities specified.
- Compliance structure in controlling offices and branches specifying the role and responsibility of each functionary in the compliance units.
- Measures to ensure independence of the compliance function. It would be necessary that the remuneration of the compliance functionaries is not related to the business line for which they exercise compliance responsibilities though it could generally be related to the financial performance of the bank as a whole.
- Focus of the compliance function on regulatory compliance, statutory

compliance, compliance with fair practice codes and other codes prescribed / suggested by self-regulatory organizations, government policies, bank's internal policies and prevention of money laundering and funding of illegal activities.

- Monitoring of and monitoring mechanism for the compliance testing procedure.
- Reporting requirements including reporting of monitoring results, compliance risk assessment, change in the compliance risk profile etc by compliance function to the senior management and the Board of Directors or ACB or the committee of the Board as the case may be.
- Right of the compliance function to have access to information necessary to carry out its responsibilities and for pointing out / looking into possible breaches of compliance policy.
- Relationship between Chief Compliance Officer and heads of other functional departments.
- Independence of the compliance function from audit function and clarity on their respective roles.
- Mechanism for dissemination of information on regulatory prescriptions and guidelines among operational staff and periodic updating of operational manuals to incorporate changes in regulatory and legal etc., prescriptions.
- Approval process for all new processes and products by the Compliance Department prior to their introduction.
- Right of the compliance function to freely disclose its findings and views to senior management, Board / ACB or the Committee of the Board.

5. The Compliance structure

5.1. Depending on its branch network, size and complexity of the business operations, sophistication of products and services offered etc, every bank should decide on the organizational structure and composition of its compliance unit. The structure may, however, be laid down within the overall framework of these guidelines and should avoid all potential conflicts of interest.

5.2 A Compliance Department having formal status should be set up at the Head Office of the bank, (in the case of foreign bank branches it should be at the bank's Principal Office in India). The compliance department should have an executive or senior staff member of the cadre not less than in the rank of

DGM or equivalent designated as Group Compliance Officer or Head of Compliance with overall responsibility for coordinating the identification and management of the bank's compliance risk and supervising the activities of other compliance function staff. He should report to the senior management of the bank but have the right to report directly to the Board of Directors or ACB or the committee of the Board, as the case may be.

- 5.3 The Compliance Officer in a bank should be appointed for a fixed tenure, as laid down in the bank's compliance policy, and during that tenure, he may be removed / transferred only with the approval of the Board and through an internal administrative procedure in which his negligence in discharging compliance function or his serious acts of omission and commissions in other financial or administrative matters is established and recorded in a transparent manner.
- 5.4 The Board, Audit Committee of the Board or any other Board Committee as the case may be, should be kept informed of any change in the Chief Compliance Officer as also the reason for the change in the incumbent. The Reserve Bank of India shall be kept informed of the name of the Chief Compliance Officer as also any change thereof, as and when it takes place.
- 5.5 In the case of larger banks, compliance staff may be located within operating business lines. Internationally active banks (including foreign banks having a presence in India) may also have group and local compliance officers reporting to their own Regional / Global Head while closely working with the local CEO on regulatory / compliance issues.
- 5.6 Some banks may wish to organize their compliance function within their operational risk function, as there is a close relationship between compliance risk and certain aspects of operational risk. Others may prefer to have separate compliance and operational risk functions, but establish mechanisms requiring close cooperation between the two functions on compliance matters.
- 5.7 The Compliance Department should be provided with adequate staff. Further, each Department in the Head Office and controlling offices and the branches (and / or Strategic Business Units (SBUs) in the case of certain banks as considered appropriate depending on their business delivery model) should have distinct compliance function and the functions should be undertaken by specifically identified / designated compliance official who would report to the Chief Compliance Officer.
- 5.8 The staff in the Compliance Department at the Head Office as also Compliance Officers at controlling offices and branches / SBUs should primarily focus

on compliance functions. However, in small sized banks with limited branch network, the compliance staff could be assigned some other duties while ensuring that there is no conflict of interest. Under no circumstances, the compliance staff should be assigned audit/inspection duty as it gives rise to serious conflict of interest in view of the fact that all products and processes are expected to be cleared by the Compliance Department and its audit needs to be carried out independently by separate set of staff.

- 5.9 In some banks, the entire compliance responsibilities may not be carried out by the compliance department and may be vested in different departments depending on the business model, size; structure etc. Compliance function staff who reside in operating business units or in local subsidiaries may have a reporting line to operating business unit management or local management, but it may be ensured that they also have a reporting line through to the head of compliance as regards their compliance responsibilities. In cases where compliance function staff reside in independent support units (e.g. legal, financial control, risk management), a separate reporting line from staff in these units to the head of compliance may not be necessary. However, these units should co-operate closely with the head of compliance.
- 5.10 In all such cases, there should invariably be an appropriate mechanism for co-ordination among these departments to enable the Chief Compliance Officer to perform the assigned responsibilities effectively.
- 5.11 The compliance function should also attend to the compliance of directions from other regulators (IRDA, SEBI etc) in those cases where the activities of the bank are not limited to the banking sector. For example, a bank which is acting as a corporate agent for distribution of other companies' insurance products may receive direction from IRDA, which should be a part of the compliance function. Further, discomfort conveyed to the bank on any issue by other regulators, should be brought to the notice of the Reserve Bank of India.
- 5.12 The Chief Compliance Officer should be the nodal point of contact between the bank and the regulator. Regardless of how the compliance function is organized within a bank, it should be independent and sufficiently resourced, its responsibilities should be clearly specified and its activities should be subject to periodic and independent review.
- 5.13 Apart from the basic qualifications, the Compliance staff should preferably have fair knowledge of law, accountancy and information technology and also adequate practical experience in various business lines and audit/inspection

functions to enable them to carry out their duties effectively. In order to keep the compliance staff up-to-date with developments in the areas of banking laws, rules and standards, regular and systematic education and training in new products and services introduced in the banking industry as well as in the areas of corporate governance, risk management, supervisory practices etc. may be considered.

6. Compliance principles, process and procedures

- 6.1. The Compliance Department at the Head Office should play the central role in the area of identifying the level of compliance risk in each business line, products and processes and issue instructions to operational functionaries / formulate proposals for mitigation of such risk. It should periodically circulate the instances of compliance failures among staff along with preventive instructions.
- 6.2. Inspection/audit findings should serve as a feedback mechanism for the Compliance Department for assessing the areas of compliance breaches/failures. The Chief Compliance Officer should be an invitee to the meetings of the ACB. A check-list on the compliance aspect may be made part of the inspection report for the inspectors / concurrent auditors to verify the level of compliance. The audit function should keep the Head of compliance informed of audit findings related to compliance.
- 6.3. Compliance function should vet the guidelines / circulars issued, for compliance with regulatory guidelines before these are disseminated amongst the operational units. The compliance function should incorporate a robust mechanism to:
 - i) ensure that regulatory guidelines / instructions are promptly issued / disseminated within the organization.
 - ii) monitor compliance with the regulatory guidelines/ instructions
- 6.4. The Compliance Department should serve as a reference point for the bank's staff from operational departments for seeking clarifications/ interpretations of various regulatory and statutory guidelines
- 6.5. The Compliance function should on a pro active basis identify, document, assess the compliance risks associated with banks' business activities and products. The compliance risks in all new products and processes should be thoroughly analyzed and appropriate risk mitigants by way of necessary checks and balances should be put in place before launching. The Chief Compliance Officer should be a member of the 'new product' committee/s to ensure that the new products / processes have clearance from all perspectives including compliance. All new products should be subjected to intensive monitoring for the first six months of introduction to ensure that the indicative parameters of compliance risk are adequately monitored.

- 6.6 Banks should develop function-wise Compliance Manuals duly approved by the Chief Compliance Officer if their operating manuals do not already contain specific sections or chapters on compliance and provide these to the staff associated with the respective functions.
- 6.7 The Compliance Department should, at frequent intervals, interact with Legal Department, Operational Risk Management Department, Taxation Department and Audit/Inspection Department of the bank to take stock of the latest developments. Compliance officers should have access to all information they require and have the right to conduct investigation and report the findings to the Chief Compliance Officer. The Chief Compliance Officer shall necessarily be a participant in the quarterly informal discussions held with RBI. In case no quarterly meeting is held, he should meet the Chief General Manager, DBS in charge of the concerned bank at Central Office of RBI, once in every quarter of the year, to discuss compliance issues.
- 6.8 The compliance functionary should be looked at as a friend, philosopher and guide by the business units. There should be close co-ordination and partnership between Compliance and Business Operations functions. The interaction may be formalized by making the Chief Compliance Officer a member of the various inter-departmental committees in the bank.
- 6.9 The compliance function should monitor and test compliance by performing sufficient and representative compliance testing and the results of such compliance testing should be reported to the senior management.
- 6.10 It should also consider ways to measure compliance risk (e.g. by using performance indicators) and use such measurements to enhance compliance risk assessment.
- 6.11 Compliance staff should be empowered to conduct compliance reviews/investigations, whenever required. The authority to use external experts for the purpose of investigation, if required, should be left to the discretion of the Chief Compliance Officer.
- 6.12 The compliance function should be free to report to senior management on any irregularities without fear of disfavour from management or other staff members. Although its normal reporting line should be to senior management, the compliance function should also have the right of direct access to the board of directors or to the Audit Committee of the board or a

committee of the Board, as the case may be, bypassing normal reporting lines. It may be useful for the board or the Audit Committee or the special Committee of the Board to meet with the head of compliance at least annually, as this will help the board or board committee to assess the extent to which the bank is managing its compliance risk effectively.

- 6.13 An Annual Report on compliance failures/breaches should be compiled and placed before the Board/ACB/Board Committee and circulated to all the functional heads. Non-compliance with any regulatory guidelines and administrative actions initiated against the bank and or corrective steps taken to avoid recurrence of the lapses should be disclosed in the annual report of the banks.
- 6.14 The code of conduct for employees should envisage working towards earning the trust of the society by dealing with customers in a fair manner and conducting business operations consistent with rules and regulations. Due weightage could be given to record of compliance during performance appraisal of staff at various levels. Staff accountability should be examined for all compliance failures.

7. The Compliance Programme

- 7.1 The responsibilities of the compliance function should be carried out under a compliance programme that sets out its planned activities. The compliance programme should be risk-based and subject to oversight by the head of compliance to ensure appropriate coverage across businesses and co-ordination among risk management functions.
- 7.2. The compliance function may have specific statutory responsibilities (e.g. fulfilling the role of anti-money laundering officer). Banks should carry out an annual compliance risk assessment in order to identify and assess major compliance risks faced by them and prepare a plan to manage the risks. The Annual review should broadly cover the following aspects.
- Compliance failures, if any during the preceding year and consequential losses and regulatory action as also steps taken to avoid recurrence of the same.
 - List of all major regulatory guidelines issued during the preceding year and steps taken by the bank to ensure compliance.
 - Independence of compliance function

- Scope of compliance procedures and processes,
 - System of internal control to minimize compliance risk.
 - Compliance with fair practices codes and adherence to standards set by self regulatory bodies and accounting standards.
 - Progress in rectification of significant deficiencies pointed out in the internal audit, statutory audit and RBI inspection reports and position of implementation of recommendations made therein.
 - Strategy for the next year including restructuring of compliance department, if necessary, posting/transfer/training of staff.
- 7.3. Apart from the exhaustive annual review, a monthly report on the position of compliance risk may be put up to the senior management/CEO by the Chief Compliance Officer. A brief report on the compliance position may also be placed before the Board/ACB/Board Committee, as the case may be on a quarterly basis.
- 7.4. Instances of all material compliance failures which may attract significant risk of legal or regulatory sanctions, financial loss or loss of reputation should be reported to the Board/ACB/Board Committee promptly.
- 7.5. The activities of the compliance function should be subject to annual review by the internal audit. Compliance risk shall be included in the risk assessment methodology of the internal audit function and the audit programme shall cover the adequacy and effectiveness of the bank's compliance function including testing of controls commensurate with the perceived level of risk.

8. Guidance and education

The compliance function should advise and assist the senior management on compliance laws, rules and standards, including keeping them informed on developments by establishing written guidance to staff on the appropriate implementation of compliance laws, rules and standards through policies and procedures and other documents such as compliance manuals, internal codes of conduct and practice guidelines.

9. Cross Border issues

Banks may choose to carry on business in various jurisdictions for a variety of legitimate reasons. In such cases, it should be ensured that they comply with applicable laws and regulations in all such jurisdictions and that the organization and structure of the compliance function and its responsibilities are

consistent with local legal and regulatory requirements. It is for local businesses to ensure that compliance responsibilities specific to each jurisdiction are carried out by individuals with the appropriate local knowledge and expertise, with oversight from the head of compliance in co-operation with the bank's other risk management functions.

RBI/2006-2007/333
DBOD.No.BP.BC. 86/21.04.157/2006-07

April 20, 2007

Chairmen/ Chief Executive Officers
All Commercial Banks (excluding RRBs),
All India Term-Lending & Refinancing Institutions &
Primary Dealers

Dear Sir,

Comprehensive Guidelines on Derivatives

As indicated in paragraph 137 of the Mid-term Review of Annual Policy for year 2006-07, an Internal Group was constituted by the Reserve Bank to review the existing guidelines on derivatives and formulate comprehensive guidelines on derivatives by banks.

2. Draft comprehensive guidelines on derivatives based on the recommendations of the Group were placed on the RBI website on December 11, 2006 and were open for comments from all concerned.

3. Comments were received from a wide spectrum of banks and other market participants. The guidelines have been suitably revised in the light of the feedback received and are furnished in the **Annex**.

4. Guidelines in respect of foreign exchange derivatives will be issued separately.

Yours faithfully,

Prashant Saran
Chief General Manager-in-Charge

ANNEX

Comprehensive guidelines on derivatives

1. Definition of a Derivative

A derivative¹ is a financial instrument:

(a) whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the 'underlying');

(b) that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and

(c) that is settled at a future date.

1.1 In India, different derivatives instruments are permitted and regulated by various regulators, like Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and Forward Markets Commission (FMC). Broadly, RBI is empowered to regulate the interest rate derivatives, foreign currency derivatives and credit derivatives. For regulatory purposes, derivatives have been defined in the Reserve Bank of India Act, as follows:

“derivative”² means an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called “underlying”), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the Bank from time to time.

¹ As defined in International Accounting Standard (IAS) 39.

² As defined in section 45U of RBI (Amendment) Act 2006.

2. Derivatives Markets

There are two distinct groups of derivative contracts:

- Over-the-counter (OTC) derivatives: Contracts that are traded directly between two eligible parties, with or without the use of an intermediary and without going through an exchange.
- Exchange-traded derivatives: Derivative products that are traded on an exchange.

3. Participants

Derivatives serve a useful risk-management purpose for both financial and non-financial firms. It enables transfer of various financial risks to entities who are more willing or better suited to take or manage them. Participants of this market can broadly be classified into two functional categories³, namely, market-makers and users.

1. **User:** A **user** participates in the derivatives market to manage an underlying risk.
2. **Market-maker:** A **market-maker** provides bid and offer prices to users and other market-makers. A market-maker need not have an underlying risk.

At least one party to a derivative transaction is required to be a market-maker.

4. Purpose

Users can undertake derivative transactions to hedge - specifically reduce or extinguish an existing identified risk on an ongoing basis during the life of the derivative transaction - or for transformation of risk exposure, as specifically permitted by RBI. Users can also undertake hedging of a homogeneous group of assets & liabilities, provided the assets & liabilities are individually permitted to be hedged.

Market-makers can undertake derivative transactions to act as counterparties in derivative transactions with users and also amongst themselves.

³ This is a purely functional definition. For example, a market making entity, if he is undertaking a derivative transaction to manage an underlying risk, would be acting in the role of a user.

5. Eligibility criteria:

(i) Market-makers:

- All Commercial Banks (excluding LABs & RRBs) & Primary Dealers* (PDs).

Banks and PDs should develop sufficient understanding and expertise about derivative products both in terms of staff and systems in order to undertake derivative business as market makers.

(ii) Users:

- Business entities with identified underlying risk exposure.

6. Broad principles for undertaking derivative transactions

The major requirements for undertaking any derivative transaction from the regulatory perspective would include:

- Market-makers may undertake a transaction in any derivative structured product (a combination of permitted cash and generic derivative instruments) as long as it is a combination of two or more of the generic instruments permitted by RBI and does not contain any derivatives as underlying;
- Market-makers should be in a position to arrive at the fair value of all derivative instruments, including structured products on the basis of the following approach :
 - (a) Marking the product to market, if a liquid market in the product exists.
 - (b) In the case of structured products, marking the constituent generic instruments to market.
 - (c) If (a) and (b) are not feasible, marking the product to model, provided:
 - All the model inputs are observable market variables.
 - Full particulars of the model, including the quantitative algorithm should be documented.

It may be ensured that structured products do not contain any derivative, which is not allowed on a stand alone basis.

* All references to Primary Dealers in these guidelines apply to stand-alone PDs, not Bank-PDs.

- All permitted derivative transactions, including roll over, restructuring and novation shall be contracted only at prevailing market rates.
- All risks arising from derivatives exposures should be analysed and documented, both at transaction level and portfolio level.
- The management of derivatives activities should be an integral part of the overall risk management policy and mechanism. It is desirable that the board of directors and senior management understand the risks inherent in the derivatives activities being undertaken.
- Market-makers should have a 'Suitability and Appropriateness Policy' vis-à-vis users in respect of the products offered, on the lines indicated in these guidelines.
- Market-makers may, where they consider necessary, maintain cash margin/liquid collateral in respect of derivative transactions undertaken by users on mark-to-market basis.

7. Permissible derivative instruments

At present, the following types of derivative instruments are permitted, subject to certain conditions:

- **Rupee interest rate derivatives** – Interest Rate Swap (IRS), Forward Rate Agreement (FRA), and Interest Rate Futures (IRF).
- **Foreign Currency derivatives** – Foreign Currency Forward, Currency Swap and Currency Option – (Separate guidelines regarding Foreign Currency derivatives are being issued).

Definitions of these generic derivatives are provided in the **Appendix A**.

7.1. Rupee Interest Rate Derivatives

(a) Product Market:

- (i) **Over the Counter (OTC)** – Forward Rate Agreements & Interest Rate Swaps
- (ii) **Exchange Traded** – Interest Rate Futures

(b) Products:

- (i) **Forward Rate Agreement (FRA)**
- (ii) **Interest Rate Swap (IRS)**

Eligible entities can undertake different types of plain vanilla FRAs/ IRS. Swaps having explicit/ implicit option features such as caps/ floors/ collars are not permitted.

(iii) Interest Rate Futures (IRF)

(c) Benchmark Rate/s for FRA/ IRS

Any domestic money or debt market rupee interest rate; or, rupee interest rate implied in the forward foreign exchange rates, as permitted by RBI in respect of MIFOR swaps.(cf paragraph 3 of DBOD Circular No. DBOD.BP.BC. 53/ 21.04.157/ 2005-06 dated December 28, 2005)

(d) Participants

Users

All business entities, including banks and Primary Dealers.

Market-makers

- (i) **For Forward Rate Agreement / Interest Rate Swap** - All Commercial Banks (excluding LABs & Regional Rural Banks) and Primary Dealers.
- (ii) **For Interest Rate Futures** – Primary Dealers.

(e) Purpose:

Users

- (i) For hedging (as defined in paragraph 4 above) underlying exposures
 - (a) Banks, PDs and AFIs can undertake FRA/ IRS to hedge the interest rate risk on any item(s) of asset or liability on their balance sheet.
 - (b) Banks may undertake interest rate futures transactions to hedge the interest rate risk on their investments in Government securities in AFS and HFT portfolios.
- (ii) PDs may hold trading position in IRF, subject to internal guidelines in this regard.

8. Risk management and corporate governance aspects

This section sets out the basic principles of a prudent system to control the risks in derivatives activities. These include:

- a) appropriate oversight by the board of directors and senior management;
- b) adequate risk management process that integrates prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring and frequent management reporting; and
- c) comprehensive internal controls and audit procedures.

8.1 Corporate governance

- a) It is vital, while dealing with potentially complex products, such as derivatives that the board and senior management should understand the nature of the business which the bank is undertaking. This includes an understanding of the nature of the relationship between risk and reward, in particular an appreciation that it is inherently implausible that an apparently low risk business can generate high rewards.
- b) The board of directors and senior management also need to demonstrate through their actions that they have a strong commitment to an effective control environment throughout the organization.
- c) The board and senior management, in addition to advocating prudent risk management, should encourage more stable and durable return performance and discourage high, but volatile returns.
- d) The board of directors and senior management should ensure that the organization of the bank is conducive to managing risk. It is necessary to ensure that clear lines of responsibility and accountability are established for all business activities, including derivative activities.
- e) The central risk control function at the head office should also ensure that there is sufficient awareness of the risks and the size of exposure of the trading activities in derivatives operations.

The compliance risks in all new products and processes should be thoroughly analysed and appropriate risk mitigants by way of necessary checks and balances should be put in place before the launching of new products. The Chief Compliance Officer must be involved in the mechanism for approval of new products and all such products should be signed off by

him. The Compliance Officer should also review and sign off all the existing products in light of these guidelines.

8.2 Board and senior management oversight

Consistent with its general responsibility for corporate governance, the board should approve written policies which define the overall framework within which derivatives activities should be conducted and the risks controlled. The management of derivative activities should be integrated into the bank's overall risk management system using a conceptual framework common to the bank's other activities.

The policy framework for derivatives approved by the board may be general in nature. But the framework should cover the following aspects:

- a) establish the institution's overall appetite for taking risk and ensure that it is consistent with its strategic objectives, capital strength and management capability to hedge or transfer risk effectively, efficiently and expeditiously.
- b) define the approved derivatives products and the authorized derivatives activities.
- c) detail requirements for the evaluation and approval of new products or activities.
- d) provide for sufficient staff resources and other resources to enable the approved derivatives activities to be conducted in a prudent manner;
- e) ensure appropriate structure and staffing for the key risk control functions, including internal audit;
- f) establish management responsibilities;
- g) identify the various types of risk faced by the bank and establish a clear and comprehensive set of limits to control these;
- h) establish risk measurement methodologies which are consistent with the nature and scale of the derivatives activities;
- i) require stress testing of risk positions ; and

- j) detail the type and frequency of reports which are to be made to the board (or committees of the board).

The type of reports to be received by the board should include those which indicate the levels of risk being undertaken by the institution, the degree of compliance with policies, procedures and limits, and the financial performance of the various derivatives and trading activities. Internal and external audit reports should be reviewed by a board-level audit committee and significant issues of concern should be drawn to the attention of the board.

8.3 Suitability and Appropriateness Policy

The rapid growth of the derivatives market, especially structured derivatives has increased the focus on 'suitability' and 'appropriateness' of derivative products being offered by market-makers to customers (users) as also customer appropriateness. Market-makers should undertake derivative transactions, particularly with users with a sense of responsibility and circumspection that would avoid, among other things, misselling. It is an imperative that market-makers offer derivative products in general, and structured products, in particular, only to those users who understand the nature of the risks inherent in these transactions and further that products being offered are consistent with users' business, financial operations, skill & sophistication, internal policies as well as risk appetite. Inadequate understanding of the risks and future obligations under the contracts by the users, in the initial stage, may lead to potential disputes and thus cause damage to the reputation of market-makers. The market-makers may also be exposed to credit risk if the counterparty fails to meet his financial obligations under the contract.

The market-makers should carry out proper due diligence regarding 'user appropriateness' and 'suitability' of products before offering derivative products to users. Each market-maker should adopt a board-approved 'Customer Appropriateness & Suitability Policy' for derivatives business.

The objective of the policy is prudential in nature: to protect the market-maker against the credit, reputation and litigation risks that may arise from a user's

inadequate understanding of the nature and risks of the derivatives transaction. In general, market-makers should not undertake derivative transactions with or sell structured products to users that do not have properly documented risk management policies that include, among other things, risk limits for various risk exposures. Furthermore, structured products should be sold only to those users which follow prudent accounting and disclosure norms and are capable of ascertaining the mark to market position of these products on an on-going basis. While selling structured products the selling banks should make available a calculator or at least access to a calculator (say on the market maker's website) which will enable the users to mark to market these structured products on an ongoing basis.

While undertaking derivative transactions with or selling structured derivative products to a user, a market-maker should:

- a) document how the pricing has been done and how periodic valuations will be done. In the case of structured products, this document should contain a dissection of the product into its generic components to demonstrate its permissibility, on the one hand, and to explain its price and periodic valuation principles, on the other. The following information may be shared with the user:
 - (i) Description of the transaction
 - (ii) Building blocs of the transaction
 - (iii) Rationale along with appropriate risk disclosures
 - (iv) Sensitivity analysis identifying the various market parameters that affect the product.
 - (v) Scenario Analysis encompassing both the possible upside as well as the downsides
- b) analyse the expected impact of the proposed derivatives transaction on the user;
- c) ascertain whether a users has the appropriate authority to enter into derivative transactions and whether there are any limitations on the use of specific types of derivatives in terms of the former's board memorandum/policy, level at which derivative transactions are approved, the involvement of senior management in decision-making and monitoring derivatives activity undertaken by it,

- d) identify whether the proposed transaction is consistent with the user's policies and procedures with respect to derivatives transactions, as they are known to the market-maker,
- e) ensure that the terms of the contract are clear and assess whether the user is capable of understanding the terms of the contract and of fulfilling its obligations under the contract,
- f) inform the customer of its opinion, where the market-maker considers that a proposed derivatives transaction is inappropriate for a customer. If the customer nonetheless wishes to proceed, the market-maker should document its analysis and its discussions with the customer in its files to lessen the chances of litigation in case the transaction proves unprofitable to the customer. The approval for such transactions should be escalated to next higher level of authority at the market-maker as also for the user,
- g) ensure the terms of the contract are properly documented, disclosing the inherent risks in the proposed transaction to the customer in the form of a Risk Disclosure Statement which should include a detailed scenario analysis (both positive and negative) and payouts **in quantitative terms** under different combination of underlying market variables such as interest rates and currency rates, etc., assumptions made for the scenario analysis and obtaining a written acknowledgement from the counterparty for having read and understood the Risk Disclosure Statement.
- h) guard against the possibility of misunderstandings all significant communications between the market-maker and user should be in writing or recorded in meeting notes.
- i) ensure to undertake transactions at prevailing market rates and to avoid transactions that could result in acceleration/deferment of gains or losses,
- j) should establish internal procedures for handling customer disputes and complaints. They should be investigated thoroughly and handled fairly and promptly. Senior management and the Compliance Department/Officer should be informed of all customer disputes and complaints at a regular interval.

It may also be noted that the responsibility of 'Customer Appropriateness and Suitability' review is on the market-maker.

8.4 Documentation

Market participants are advised to ensure that the documentation requirements in respect of derivative contracts are complete in all respects. Illustratively:

- (i) For the sake of uniformity and standardization in respect of all derivative contracts, participants may use ISDA documentation, with suitable modifications for continuing ongoing relationships. Counterparties are free to modify the ISDA Master Agreement by inserting suitable clauses in the schedule to the ISDA Master Agreement to reflect the terms that the counterparties may agree to, including the manner of settlement of transactions and choice of governing law of the Agreement. In case of 'one off' transactions, appropriate documentation may be used.
- (ii) It may be mentioned that besides the ISDA Master Agreement, participants should obtain specific confirmation for each transaction which should detail the terms of the contract such as gross amount, rate, value date, etc..
- (iii) It is also preferable to make a mention of the Master Agreement in the individual transaction confirmation.
- (iv) Participants should further evaluate whether the counterparty has the legal capacity, power and authority to enter into derivative transactions.
- (v) Participants shall obtain documentation regarding customer suitability, appropriateness etc. as specified .

8.5 The identification of risk

Market-makers should identify the various types of risk to which they are exposed in their derivatives activities. The main types of risk are:

- . credit risk
- . market risk
- . liquidity risk
- . operational risk
- . legal risk

The risks generally associated with derivatives are enunciated in **Appendix B**.

8.6 Risk measurement

Accurate measurement of derivative-related risks is necessary for proper monitoring and control. All significant risks should be measured and integrated into a entity-wide risk management system.

The risk of loss can be most directly quantified in relation to *market risk* and *credit risk* (though other risks may have an equally or even greater adverse impact on earnings or capital if not properly controlled). These two types of risks are clearly related since the extent to which a derivatives contract is "in the money" as a result of market price movements will determine the degree of credit risk. This illustrates the need for an integrated approach to the risk management of derivatives. The methods used to measure market and credit risk should be related to:

- a) the nature, scale and complexity of the derivatives operation;
- b) the capability of the data collection systems; and
- c) the ability of management to understand the nature, limitations and meaning of the results produced by the measurement system.

Mark-to-market

The measurement process starts with marking to market of risk positions. This is necessary to establish the *current* value of risk positions and to recognize profits and losses in the books of account. It is essential that the revaluation process is carried out by an independent risk control unit or by back office staff who are independent of the risk-takers in the front office, and that the pricing factors used for revaluation are obtained from a source which is independently verifiable.

Measuring market risk

The risk measurement system should assess the probability of *future* loss in derivative positions. In order to achieve this objective, it is necessary to estimate:

- a) the sensitivity of the instruments in the portfolio to changes in the market factors which affect their value (e.g. interest rates, exchange rates and volatilities); and
- b) the tendency of the relevant market factors to change based on past volatilities and correlations.

The assumptions and variables used in the risk management method should be fully documented and reviewed regularly by the senior management, the independent risk management unit and internal audit.

Stress tests

Regardless of the measurement system and assumptions used to calculate risk on a day-to-day basis, entities should conduct regular stress tests to evaluate the exposure under worst-case market scenarios (i.e. those which are *possible* but not *probable*). Stress tests need to cover a range of factors that could either generate extraordinary losses or make the control of risk very difficult. Stress scenarios may take into account such factors as the largest historical losses actually suffered by the entity and evaluation of the current portfolio on the basis of extreme assumptions about movements in interest rates or other market factors or in market liquidity. The results of the stress testing should be reviewed regularly by senior management and should be reflected in the policies and limits which are approved by the board of directors and senior management.

Options

The measurement of the market risk in options involves special considerations because of their non-linear price characteristics. This means that the price of an option does not necessarily move in a proportionate relationship with that of the underlying instrument, principally because of gamma and volatility risk. Measurement of risk exposure of an options portfolio may therefore require the use of simulation techniques to calculate, for example, changes in the value of the options portfolio for various combinations of changes in the prices of the underlying instruments and changes in volatility. The risk exposure would be calculated from that combination of price and volatility change that produced the largest loss in the portfolio. Other more elaborate simulation techniques may be used.

Measuring credit risk

The credit risks of derivatives products have two components: pre-settlement risk and settlement risk. They should be monitored and managed separately.

Pre-settlement risk is the risk of loss due to a counterparty defaulting on a contract during the life of a transaction.

Settlement risk arises where securities or cash are exchanged and the loss can amount to the full value of the amounts to be exchanged. In general, the time-frame for this risk is quite short and arises only where there is no delivery against payment.

8.7 Risk Limits

Risk limits serve as a means to control exposures to the various risks associated with derivative activities. Limits should be integrated across all activities and measured against aggregate (e.g., individual and geographical) risks. Limits should be compatible with the nature of the entity's strategies, risk measurement systems, and the board's risk tolerance. To ensure consistency between limits and business strategies, the board should annually approve

limits as part of the overall budget process. The system of limits should include procedures for the reporting and approval of exceptions to limits. It is essential that limits should be rigorously enforced and that significant and persistent breaches of limits should be reported to senior management and fully investigated.

Market risk limits

Market risk limits should be established at different levels of the entity, i.e. the entity as a whole, the various risk-taking units, trading desk heads and individual traders. It may also be appropriate to supplement these with limits for particular products. In determining how market risk limits are established and allocated, management should take into account factors such as the following:

- a) past performance of the trading unit;
- b) experience and expertise of the traders;
- c) level of sophistication of the pricing, valuation and measurement systems;
- d) the quality of internal controls;
- e) the projected level of trading activity having regard to the liquidity of particular products and markets; and
- f) the ability of the operations systems to settle the resultant trades.

Some commonly used market risk limits are: notional or volume limits, stop loss limits, gap or maturity limits, options limits and value-at-risk limits. These are described in **Appendix C**. The selection of limits should have regard to the nature, size and complexity of the derivatives operation, market volatility and to the type of risk measurement system. In general, the overall amount of market risk being run by the entity is best controlled by value-at risk limits. These provide senior management with an easily understood way of monitoring and controlling the amount of capital and earnings which the entity is putting at risk through its trading activities.

Stop loss limits may be useful for triggering specific management action (e.g. to close out the position) when a certain level of unrealized losses are reached. They do not however control the potential size of loss which is inherent in the position or portfolio (i.e. the Value at Risk) and which may be greater than the stop loss limit. They will thus not necessarily prevent losses if the position cannot be exited (e.g. because of market illiquidity).

It may be appropriate to set limits on particular products or maturities (as well as on portfolios) in order to reduce market and liquidity risk which would arise from concentrations in these. Similarly, risks associated with options can be controlled by concentration limits based on strike price and expiration date. This reduces the potential impact on earnings and cash flow of a large amount of options being exercised at the same time.

Credit limits

Banks should establish both pre-settlement credit limits and settlement credit limits. The former should be based on the credit-worthiness of the counterparty in much the same way as for traditional credit lines. The size of the limits should take into account the sophistication of the risk measurement system: if notional amounts are used (which is *not* recommended), the limits should be correspondingly more conservative.

It is important that entities should establish separate limits for settlement risk. The amount of exposure due to settlement risk often exceeds the credit exposure arising from pre-settlement risk because settlement of derivatives transactions may involve the exchange of the total value of the instrument or principal cash flow. Settlement limits should have regard to the efficiency and reliability of the relevant settlement systems, the period for which the exposure will be outstanding, the credit quality of the counterparty and the entity's own capital adequacy.

Entities should have efficient systems in place to aggregate its exposure to a counterparty across fund based and non fund based exposures, including

derivatives. These aggregate exposures should be within the single counterparty exposure limits set by the management or regulator, whichever is less.

Liquidity limits

The *cash flow/funding liquidity risk* in derivatives can be dealt with by incorporating derivatives into the entity's overall liquidity policy and, in particular, by including derivatives within the structure of the maturity mismatch limits. A particular issue is the extent to which entities take account of the right which may have been granted to counterparties to terminate a derivatives contract under certain specified circumstances, thus triggering an unexpected need for funds.

It is necessary for entities to take into account the funding requirements which may arise because of the need to make margin payments in respect of exchange-traded derivatives. The entity should have the ability to distinguish between margin calls which are being made on behalf of clients (and monitor the resultant credit risk on the user-clients) and those which arise from proprietary trades.

As noted earlier, the *market* or *product* liquidity risk that arises from the possibility that the entity will not be able to exit derivatives positions at a reasonable cost, can be mitigated by setting limits on concentrations in particular markets, exchanges, products and maturities.

8.8 Management Information Systems

The frequency and composition of board and management reporting should depend upon the nature and significance of derivative activities. Where applicable, board and management reports should consolidate information across functional and geographic divisions. Board and management reporting should be tailored to the intended audience, providing summary information to senior management and the board and more detailed information to line management.

8.9 Independent risk control

There should be a mechanism within each entity for independently monitoring and controlling the various risks in derivatives. The inter-relationship between the different types of risks needs to be taken into account.

Entities which are **market-makers** in derivatives should maintain a unit which is responsible for monitoring and controlling the risks in derivatives. This unit should report directly to the board (or ALCO) or to senior management who are not directly responsible for trading activities. Where the size of the entity or its involvement in derivatives activities does not justify a separate unit dedicated to derivative activities, the function may be carried out by support personnel in the back office (or in a "middle office") provided that such personnel have the necessary independence, expertise, resources and support from senior management to do the job effectively.

Whatever form the risk control function takes, it is essential that it is distanced from the control and influence of the trading function.

The minimum risk control functions which should be performed include the following:

- a) the monitoring of market risk exposures against limits and the reporting of exceptions to middle office;
- b) the marking-to-market of risk exposures and reconciliation of risk positions and profit/loss between the front and back offices;
- c) the preparation of management reports, including daily profit/loss results and gross and net risk positions; and
- d) the monitoring of credit exposures to individual counterparties against limits and the reporting of exceptions to middle office.

The risk management system and the effectiveness and independence of the risk control unit should themselves be subject to regular review by internal audit.

8.10 Operational controls

Operational risk arises as a result of inadequate internal controls, human error or management failure. This risk in derivatives activities is particularly important, because of the complexity and rapidly evolving nature of some of the products. The nature of the controls in place to manage operational risk must be commensurate with the scale and complexity of the derivatives activity being undertaken. As noted earlier, volume limits may be used to ensure that the number of transactions being undertaken does not outstrip the capacity of the support systems to handle them.

Segregation of duties

Segregation of duties is necessary to prevent unauthorized and fraudulent practices. This has a number of detailed aspects but the fundamental principle is that there should be clear separation, both functionally and physically, between the front office which is responsible for the conduct of trading operations and the back office which is responsible for processing the resultant trades.

A basic and essential safeguard against abuse of trust by an individual is to insist that all staff should take a minimum continuous period of annual leave (say 2 weeks) each year. This makes it more difficult to conceal frauds in the absence of the individual concerned.

Policies and procedures

Policies and procedures should be established and documented to cover the internal controls which apply at various stages in the work flow of processing and monitoring trades. Apart from segregation of duties, these include:

- trade entry and transaction documentation
- confirmation of trades
- settlement and disbursement
- reconciliations
- revaluation
- exception reports

- accounting treatment
- audit trail

A checklist of some of the key controls under these headings is given in **Appendix D**.

Contingency plan

Plans should be in place to provide contingency systems and operations support in the case of a natural disaster or systems failure. These should include emergency back-up for dealing functions as well as critical support functions. Contingency plans should be reviewed and tested on a regular basis.

9. Internal audit

Internal audit is an important part of the internal control process. Audit should be conducted by qualified professionals, who are independent of the business line being audited. Audit should be supplementary and not be a substitute for risk control function. The scope of audit coverage should be commensurate with the level of risk and volume of activity.

Internal audit function should:

- a) review the adequacy and effectiveness of the overall risk management system, including compliance with policies, procedures and limits;
- b) review the adequacy and test the effectiveness of the various operational controls (including segregation of duties) and staff's compliance with the established policies and procedures;
- c) investigate unusual occurrences such as significant breaches of limits, unauthorized trades and unreconciled valuation or accounting differences;
- d) evaluate the reliability and timeliness of information reported to senior management and the board of directors;
- e) trace and verify information provided on risk exposure reports to the underlying data sources;
- f) be an appraisal of the effectiveness and independence of the risk management process;

- g) ensure that risk measurement models, including algorithms, are properly validated; and
- h) include an evaluation of the adequacy of the derivative valuation process and ensure that it is performed by parties independent of risk-taking activities. Auditors should test derivative valuation reports for accuracy. For hedge transactions, auditors should review the appropriateness of accounting.
- i) evaluate the risk disclosure statements issued to customers in terms of adherence to Customer Suitability and Appropriateness Policy

In preparing internal audit reports, major control weaknesses should be highlighted and a management action plan to remedy the weaknesses should be agreed with a timetable. Management should respond promptly to audit findings by investigating identified system and internal control weaknesses and implementing corrective action. Thereafter, management should periodically monitor newly implemented systems and controls to ensure they are working appropriately. Failure of management to implement recommendations within an agreed timeframe should be reported to the Audit Committee.

10. Prudential norms relating to derivatives

The prudential norms relating to derivatives – minimum capital adequacy requirement, credit exposure norms, ALM etc. will be as prescribed by RBI from time to time.

11. Prudential limits on derivatives

The gross PV 01 of all non-option rupee derivative contracts (including rupee – foreign currency contracts) should be within 0.25 per cent of the net worth of the bank as on the last balance sheet date. The gross PV01 may be determined by aggregating net PV01 of different benchmarks, ignoring the signs. The limit would also exclude the PV 01 of derivatives which are hedges for balance sheet items, provided these hedges meet the criteria of hedge effectiveness as laid down in our circular IDMC.MSRD.4801 /06.01.03/2002-03 dated June 3, 2003.

12. Regulatory reporting, balance sheet disclosures, valuation and Accounting

The current regulatory reporting and balance sheet disclosures as prescribed from time to time by RBI may continue for present. The extant guidelines on valuation and accounting would also continue to be in place till revised guidelines in this regard are finalised. The reporting requirement in alignment with the revised accounting guidelines would be communicated later.

Appendix A

Product Definitions

Forward Rate Agreement (FRA)

A Forward Rate Agreement is a financial contract between two parties to exchange interest payments for a 'notional principal' amount on settlement date, for a specified period from start date to maturity date. Accordingly, on the settlement date, cash payments based on contract (fixed) and the settlement rate, are made by the parties to one another. The settlement rate is the agreed bench-mark/ reference rate prevailing on the settlement date.

Interest Rate Swap (IRS)

An Interest Rate Swap is a financial contract between two parties exchanging or swapping a stream of interest payments for a 'notional principal' amount on multiple occasions during a specified period. Such contracts generally involve exchange of a 'fixed to floating' or 'floating to floating' rates of interest. Accordingly, on each payment date - that occurs during the swap period - cash payments based on fixed/ floating and floating rates, are made by the parties to one another.

Interest Rate Futures (IRF)

Interest Rate Future is a standardized, exchange-traded contract with an actual or notional interest-bearing instrument(s) as the underlying asset.

Foreign Exchange Forward

A foreign exchange forward is an over-the-counter contract under which a purchaser agrees to buy from the seller, and the seller agrees to sell to the purchaser, a specified amount of a specified currency on a specified date in the future - beyond the spot settlement date - at a known price denominated in another currency (known as the forward price) that is specified at the time the contract is entered into.

Currency Swaps

A currency swap is an interest rate swap where the two legs to the swap are denominated in different currencies. Additionally the parties may agree to exchange the two currencies normally at the prevailing spot exchange rate with an agreement to reverse the exchange of currencies, at the same spot exchange rate, at a fixed date in the future, generally at the maturity of the swap.

Currency Options

A currency option is a contract where the purchaser of the option has the right but not the obligation to either purchase (call option) or sell (put option) and the seller (or writer) of the option agrees to sell (call option) or purchase (put option) an agreed amount of a specified currency at a price agreed in advance and denominated in another currency (known as the strike price) on a specified date (European option) or by an agreed date (American option) in the future.

Interest Rate Caps and Floors

An interest rate cap is an interest rate option in which payments are made when the reference rate exceeds the strike rate. Analogously, an interest rate floor is an interest rate option in which payments are made when the reference rate falls below the strike rate.

Appendix B

Types of derivatives risks

1. Credit risk

Credit risk is the risk of loss due to a counterparty's failure to perform on an obligation to the institution. Credit risk in derivative products comes in two forms:

Pre-settlement risk is the risk of loss due to a counterparty defaulting on a contract during the life of a transaction. The level of exposure varies throughout the life of the contract and the extent of losses will only be known at the time of default.

Settlement risk is the risk of loss due to the counterparty's failure to perform on its obligation after an institution has performed on its obligation under a contract on the settlement date. Settlement risk frequently arises in international transactions because of time zone differences. This risk is only present in transactions that do not involve delivery versus payment and generally exists for a very short time (less than 24 hours).

2. Market risk

Market risk is the risk of loss due to adverse changes in the market value (the price) of an instrument or portfolio of instruments. Such exposure occurs with respect to derivative instruments when changes occur in market factors such as underlying interest rates, exchange rates, equity prices, and commodity prices or in the volatility of these factors.

3. Liquidity risk

Liquidity risk is the risk of loss due to failure of an institution to meet its funding requirements or to execute a transaction at a reasonable price. Institutions involved in derivatives activity face two types of liquidity risk : market liquidity risk and funding liquidity risk.

Market liquidity risk is the risk that an institution may not be able to exit or offset positions quickly, and in sufficient quantities, at a reasonable price. This inability may be due to inadequate market depth in certain products (e.g. exotic derivatives, long-dated options), market disruption, or inability of the bank to access the market (e.g. credit down-grading of the institution or of a major counterparty).

Funding liquidity risk is the potential inability of the institution to meet funding requirements, because of cash flow mismatches, at a reasonable cost. Such funding requirements may arise from cash flow mismatches in swap books, exercise of options, and the implementation of dynamic hedging strategies.

4. Operational risk

Operational risk is the risk of loss occurring as a result of inadequate systems and control, deficiencies in information systems, human error, or management failure. Derivatives activities can pose challenging operational risk issues because of the complexity of certain products and their continual evolution.

5. Legal risk

Legal risk is the risk of loss arising from contracts which are not legally enforceable (e.g. the counterparty does not have the power or authority to enter into a particular type of derivatives transaction) or documented correctly.

6. Regulatory risk

Regulatory risk is the risk of loss arising from failure to comply with regulatory or legal requirements.

7. Reputation risk

Reputation risk is the risk of loss arising from adverse public opinion and damage to reputation.

Appendix C

Commonly used market risk limits

1. Notional or volume limits

Limits based on the notional amount of derivatives contracts are the most basic and simplest form of limits for controlling the risks of derivatives transactions. They are useful in limiting transaction volume, and liquidity and settlement risks. However, these limits cannot take account of price sensitivity and volatility and say nothing about the actual level of risk (in capital or earnings terms) faced by the institution. Derivatives participants should not therefore use these limits as a stand-alone tool to control market risk.

2. Stop loss limits

These limits are established to avoid unrealized loss in a position from exceeding a specified level. When these limits are reached, the position will either be liquidated or hedged. Typical stop loss limits include those relating to accumulated unrealized losses for a day, a week or a month.

Some institutions also establish management action trigger (MAT) limits in addition to stop loss limits. These are for early warning purposes. For example, management may establish a MAT limit at 75 percent of the stop loss limit. When the unrealized loss reaches 75 percent of the stop loss limit, management will be alerted of the position and may trigger certain management actions, such as close monitoring of the position, reducing or early closing out the position before it reaches the stop loss limits.

The above loss triggers complement other limits, but they are generally not sufficient by themselves. They are not anticipatory; they are based on unrealized losses to date and do not measure the potential earnings at risk based on market characteristics. They will not prevent losses larger than the stop loss limits if it becomes impossible to close out positions, e.g. because of market illiquidity.

3. Gap or maturity band limits

These limits are designed to control loss exposure by controlling the volume or amount of the derivatives that mature or are repriced in a given time period. For example, management can establish gap limits for each maturity band of 3 months, 6 months, 9 months, one year, etc. to avoid maturities concentrating in certain maturity bands. Such limits can be used to reduce the volatility of derivatives revenue by staggering the maturity and/or repricing and thereby smoothing the effect of changes in market factors affecting price. Maturity limits can also be useful for liquidity risk control and the repricing limits can be used for interest rate management.

Similar to notional and stop loss limits, gap limits can be useful to supplement other limits, but are not sufficient to be used in isolation as they do not provide a reasonable proxy for the market risk exposure which a particular derivatives position may present to the institution.

4. Value-at-risk limits

These limits are designed to restrict the amount of potential loss from certain types of derivatives products or the whole trading book to levels (or percentages of capital or earnings) approved by the board and senior management. To monitor compliance with the limits, management calculates the current market value of positions and then uses statistical modeling techniques to assess the probable loss (within a certain level of confidence) given historical changes in market factors. There are three main approaches to calculating value-at-risk : the correlation method, also known as the variance/covariance matrix method; historical simulation and Monte Carlo simulation.

The advantage of value-at-risk (VAR) limits is that they are related directly to the amount of capital or earnings which are at risk. Among other things, they are therefore more readily understood by the board and senior management. The level of VAR limits should reflect the maximum exposures authorized by the board and senior management, the quality and sophistication of the risk measurement systems and the performance of the models used in assessing potential loss by comparing projected and actual results. One drawback in the use of such models is that they are only as good as the assumptions on which they are based (and the quality of the data which has been used to calculate the various volatilities, correlations and sensitivities).

5. Options limits

These are specifically designed to control the risks of options. Options limits may include Delta, Gamma, Vega, Theta and Rho limits.

Delta is a measure of the amount an options price would be expected to change for a unit change in the price of the underlying instrument.

Gamma is a measure of the amount delta would be expected to change in response to a unit change in the price of the underlying instrument.

Vega is a measure of the amount an option's price would be expected to change in response to a unit change in the price volatility of the underlying instrument.

Theta is a measure of the amount an option's price would be expected to change in response to changes in the options time to expiration.

Rho is a measure of the amount an option's price would be expected to change in response to changes in interest rates.

Appendix D

Recommendations on operational controls

A. Segregation of Duties

There should be clear segregation, functionally and physically, between the front office and back office.

There should be a middle office independent of the trading room and it should be responsible, *inter alia*, for undertaking various risk related monitoring, product approval, validation of valuation models used, stress testing, back testing of the risk limits etc. and also for regulatory reporting and compliance.

B. Trade Entry and Transaction Documentation

Management should ensure that procedures are in place to provide a clear and fully documented audit trail of derivatives transactions.

All derivatives transactions should be sequentially controlled to ensure that all deals are accounted for and to provide an audit trail for deals effected.

Every transaction should be updated (i.e. mark to market) in the calculation of market and credit risk limits.

- Deals should be transacted at market rates.

C. Confirmation Procedures

The method of confirmation used should provide a documentation trail that supports the institution's position in the event of disputes.

D. Settlement and Disbursement Procedures

Specific procedures should be established for the initiation of, and authority for, fund transfer.

Daily independent reconciliation of transferred funds with nostro accounts and general ledger is an essential control for detection of errors or misapplications of funds.

E. Reconciliation Procedures

All pertinent data, reports, and systems should be reconciled on a timely basis to ensure that the institutions official books agree with dealers records. At the minimum, the following reports should be reconciled:

Unusual items and any items outstanding for an inordinately long period of time should be investigated.

There should be adequate audit trail to ensure that balances and accounts have been properly reconciled. Reconciliation records and documentation should be maintained and independently reviewed. Such record should be kept for an appropriate period of time prior to their destruction.

F. Revaluation Procedures

The revaluation procedures should cover the full range of derivatives instruments included in the institutions trading portfolio.

Revaluation rates should be obtained from or verified by a source (or different sources in the case of OTC derivatives) independent of the dealers, representative of the market levels and properly approved. Revaluation calculations should be independently checked.

Revaluation rates and calculations should be fully documented.

G. Exceptions Reports

To track errors, frauds and losses, the back office should generate management reports that reflect current status and trends for the following items:

- Outstanding general ledger reconciling items.
- Failed trades.
- Off-market trades.
- After-hours and off-premises trading.
- Aging of unconfirmed trades.
- Suspense items payable/receivable.
- Brokerage payments.
- Miscellaneous losses.
- Limit breaches
- Details of deals resulting in exceptional profits and losses

The management information system/reporting system of the institution should enable the detection of unusual patterns of activity (i.e. increase in volume, new trading counterparties, etc.) for review by management.

RBI/2006-2007/281

DBOD. No. BP.BC. 66/ 21.01.002/ 2006-2007

March 6, 2007

**All Commercial Banks
(Excluding RRBs)**

Dear Sir,

Prudential Limits for Inter- Bank Liabilities (IBL)

As you are aware, in India, while the counterparty risk concentration on the assets side has attracted adequate attention and received regulatory policy response, the concentration risk on the liability side of the banks has not received similar attention. Liability side management has its own merits from the point of view of financial stability. Controlling the concentration risk on the liability side of banks is therefore as important as controlling the concentration risk on asset side. More particularly, uncontrolled IBL may have systemic implications, even if, the individual counterparty banks are within the allocated exposure. Further, uncontrolled liability of a larger bank may also have a domino effect. In view of this, it has become important to put in place a comprehensive framework of liability management so that banks are aware of the risks inherent in following a business model based on large amount of IBL and the systemic risks such a model may entail.

2. In order to reduce the extent of concentration on the liability side of the banks, the following measures are prescribed:

- (a) The IBL of a bank should not exceed 200% of its networth as on 31st March of the previous year. However, individual banks may, with the approval of their Boards of Directors, fix a lower limit for their inter-bank liabilities, keeping in view their business model.
- (b) The banks whose CRAR is at least 25% more than the minimum CRAR (9%) i.e. 11.25% as on March 31, of the previous year, are allowed to have a higher limit up to 300% of the net worth for IBL.

- (c) The limit prescribed above will include only fund based IBL within India (including inter-bank liabilities in foreign currency to banks operating within India). In other words, the IBL outside India are excluded.
 - (d) The above limits will not include collateralized borrowings under CBLO and refinance from NABARD, SIDBI etc.
 - (e) The existing limit on the call money borrowings prescribed by RBI will operate as a sub-limit within the above limits.
 - (f) Banks having high concentration of wholesale deposits should be aware of potential risk associated with such deposits and may frame suitable policies to contain the liquidity risk arising out of excessive dependence on such deposits.
3. The above guidelines will be applicable from April 1, 2007. However, banks, which are not in a position to comply with these requirements from April 1, 2007, may furnish a plan to RBI for approval indicating the date by which they would be able to comply with the requirements.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

RBI/2006-07/132

DBOD.BP.BC No. 31 / 21.04.018/ 2006-07

September 20, 2006

The Chairmen/Chief Executives of
All Commercial Banks
(excluding RRBs)

Dear Sir,

**Section 17 (2) of Banking Regulation Act, 1949 –
Appropriation from Reserve Fund**

In terms of section 17 (1) and 11 (1)(b) (ii) of the Banking Regulation Act, 1949 banks are required to transfer, out of the balance of profit as disclosed in the profit and loss account, a sum equivalent to not less than 20 per cent of such profit to Reserve Fund. This provision is a minimum requirement. Considering the imperative need for augmenting the reserves, it was advised vide circular DBOD.No.BP.BC.24/21.04.018/ 2000-2001 dated September 23, 2000 that all scheduled commercial banks operating in India (including foreign banks) should transfer not less than 25 per cent of the 'net profit' (before appropriations) to the Reserve Fund with effect from the year ending 31 March 2001.

2. In terms of Sec 17(2), where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the Reserve Bank explaining the circumstances relating to such appropriation. In order to ensure that their recourse to drawing down the Statutory Reserve is done prudently and is not in violation of any of the regulatory prescriptions, banks are advised in their own interest to take prior approval from the Reserve Bank before any appropriation is made from the statutory reserve or any other reserves.

3. Banks are further advised that:

- (i) all expenses including provisions and write-offs recognized in a period, whether mandatory or prudential, should be reflected in the profit and loss

account for the period as an 'above the line' item (i.e. before arriving at the net profit);

- (ii) wherever draw down from reserves takes place with the prior approval of Reserve Bank, it should be effected only 'below the line' (i.e. after arriving at the profit/loss for the year); and
- (iii) it should also be ensured that suitable disclosures are made of such draw down of reserves in the 'Notes on Accounts' to the Balance Sheet.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

April 5, 2006

All Scheduled Commercial Banks
(except RRBs)

Dear Sir,

Guidelines on compliance with Accounting Standard (AS) 11 (revised 2003)
- 'The Effects of Changes in Foreign Exchange Rates'

Please refer to para 4.2 of the Annex to our circular DBOD.No.BP.BC.76/21.04.018/2004-2005 dated March 15, 2005.

2. It was advised therein that in respect of Indian branches and integral foreign operations, those foreign currency transactions, which were not recorded in Indian Rupees on the date of the transaction or were being recorded using a notional exchange rate may be recorded at the date of the transaction by using the weekly average closing rate of the preceding week, published by FEDAI, if the same approximates the actual rate at the date of the transaction. It was also advised that banks might use the quarterly average closing rate, published by FEDAI at the end of each quarter, for translating the income and expense items of non-integral foreign operations during the quarter.

3. Further, it was indicated that the weekly average closing rate of the preceding week would not be considered approximating the actual rate at the date of the transaction if the difference between (a) the weekly average closing rate of the preceding week and

(b) the exchange rate prevailing at the date of the transaction, is more than five percent of (b). In respect of non-integral foreign operations, where the banks use the quarterly average closing rate, if the difference between the exchange rate at the date of the transaction and the quarterly average closing rate is more than ten percent of the exchange rate prevailing at the date of the transaction, the limit would not be considered approximating the actual rate.

4. On a review, it has now been decided to revise the above threshold limits as follows :

- i) The weekly average closing rate of the preceding week would not be considered approximating the actual rate at the date of the transaction if the difference between (a) the weekly average closing rate of the preceding week and (b) the exchange rate prevailing at the date of the transaction, is more than **three-and-a-half percent** of (b).
 - ii) In respect of non-integral foreign operations, the quarterly average closing rate would not be considered approximating the actual rate at the date of the transaction if the difference between (a) the quarterly average closing rate and (b) the exchange rate prevailing at the date of the transaction, is more than **seven percent** of (b).
5. Banks are, however, encouraged to equip themselves to record the foreign currency transactions of Indian branches as well as integral foreign operations and translate the income as well as expense items of non-integral foreign operations at the exchange rate prevailing on the date of the transaction.
6. The above guidelines will come into effect immediately.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge



भारतीय रिज़र्व बैंक

RESERVE BANK OF INDIA

www.rbi.org.in

RBI /2004-05/395

DBOD No.BP.BC.76 /21.04.018/2004-05

March 15, 2005

All Scheduled Commercial Banks
(except RRBs)

Dear Sir,

Guidelines on compliance with Accounting Standard (AS) 11(revised 2003) 'The Effects of Changes in Foreign Exchange Rates'

As you are aware, Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates' (revised 2003) issued by the Institute of Chartered Accountants of India (ICAI), has come into effect in respect of accounting periods commencing on or after April 1, 2004 and is mandatory in nature from that date.

2. The applicability of the Standard to banks has been examined by the Reserve Bank in consultation with ICAI and Foreign Exchange Dealers' Association of India (FEDAI). Based on the consultations with ICAI and FEDAI and also taking into account the difficulties expressed by banks in complying with the Standard, the issues that arise and require clarification have been identified and the guidelines on compliance with AS 11(revised 2003) are furnished in the Annex.

3. Banks are advised to place these Guidelines before the Board of Directors and ensure strict compliance with the Standard.

4. These guidelines are in supersession of the instructions contained in our circular DBOD No.BP.BC.71/21.04.018/2003-2004 dated March 31, 2004.

Yours faithfully,

(C.R.Muralidharan)
Chief General Manager-in-Charge

भारतीय रिज़र्व बैंक, मुंबई, महाराष्ट्र, भारत
 डाक बॉक्स नं. 1, चण्डीनगर, मुंबई - 400005

Department of Banking Operations and Development, Central Office, Centre 1, Cuffe Parade, Colaba, Mumbai - 400005

फ़ोन नं. 91-22-22189131 टेलीफैक्स नं. 91-22-22183785 ईमेल ID: cgmicdbodco@rbi.org.in

मुद्रांक नं. 76/21.04.018/2004-05

**ANNEX****Guidelines for Compliance by Banks - Accounting Standard (AS) 11(revised 2003),
'The Effects of Changes in Foreign Exchange Rates'**

Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates' (revised 2003) issued by the Institute of Chartered Accountants of India (ICAI), has come into effect in respect of accounting periods commencing on or after April 1, 2004 and is mandatory in nature from that date. Based on the consultations with ICAI and Foreign Exchange Dealers' Association of India (FEDAI) and also taking into account the feedback received from banks, the issues that may arise while complying with the Standard and require clarification have been identified. Banks may be guided by the following while complying with the Standard.

2. Banks are advised to place these guidelines before the Board of Directors and ensure strict compliance with the Standard.

3. Classification of Integral and Non-integral Foreign Operations.

3.1 Paragraph 17 of the Standard states that the method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations". While complying with the Standard, a doubt may arise on the classification of representative offices set up in foreign countries, foreign branches and off-shore banking units set up in India as "integral foreign operation" or "non-integral foreign operation".

Action to be taken by banks

3.2. Paragraphs 18 and 19 of the Standard explain "integral foreign operation" and "non-integral foreign operation". Paragraph 20 of the Standard provides indications as to when a foreign operation is a non-integral foreign operation rather than an integral foreign operation. Taking into consideration the operation of the foreign branches of Indian banks and the indicators listed in paragraph 20, foreign branches of Indian banks would be classified as "non-integral foreign operations". Similarly, Offshore Banking Units (OBUs) set up in India by banks would also be classified as "non-integral foreign operations". Taking into consideration the operation of the representative offices of banks set up abroad and the explanation in paragraph 18 of the Standard, Representative Offices would be classified as "integral foreign operations". These classifications are for the limited purpose of compliance with the Standard.

4. Exchange rate for recording foreign currency transactions and translation of financial statements of non-integral foreign operation.

4.1. As per paragraphs 9 and 21 of the Standard, a foreign currency transaction should be recorded by Indian branches and integral foreign operations, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction. Further, paragraph 24 (b) of the Standard states that income and expense items of non-integral



foreign operations should be translated at exchange rates at the dates of the transactions. While adopting the Standard, Indian branches and integral foreign operations of banks may face difficulty in applying the exchange rate prevailing at the date of the transaction in respect of the items which are not being recorded in Indian Rupees or are currently being recorded using a notional exchange rate, due to their extensive branch network and volume of transactions. Similarly, banks may face difficulty in translating income and expense items of a non-integral foreign operation by applying the exchange rates at the dates of the transactions.

Action to be taken by banks

4.2. Banks, which are in a position to apply the exchange rate prevailing on the date of the transaction for recording the foreign currency transactions at their Indian branches and integral foreign operations and for translating the income and expense items of non-integral foreign operations as required under AS 11 are encouraged to comply with the requirements. Banks, which have an extensive branch network, which have a high volume of foreign currency transactions and are not fully equipped on the technology front may be guided by the following:

- i) Paragraph 10 of the Standard allows, for practical reasons, the use of a rate that approximates the actual rate at the date of the transaction. For example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. Similarly, in respect of the non-integral foreign operations, paragraph 25 of the Standard provides that for practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate income and expense items of a foreign operation. The Standard also states that if exchange rates fluctuate significantly, the use of average rate for a period is unreliable. Therefore, as per the Standard, except in cases where exchange rates fluctuate significantly, a rate that approximates the actual rate at the date of the transaction may be used. Since the enterprises are required to record the transactions at the date of the occurrence thereof, the weekly average closing rate of the preceding week can be used for recording the transactions occurring in the relevant week, if the same approximates the actual rate at the date of the transaction. In view of the practical difficulties which banks may have in applying the exchange rates at the dates of the transactions and since the Standard allows the use of a rate that approximates the actual rate at the date of the transaction, banks may use average rates as detailed below:
- ii) FEDAI has agreed to publish a weekly average closing rate at the end of each week and a quarterly average closing rate at the end of each quarter for various currencies.
- iii) In respect of Indian branches and integral foreign operations, those foreign currency transactions, which are currently not being recorded in Indian Rupees at the date of the transaction or are being recorded using a notional exchange rate may now be recorded at the date of the transaction by using the weekly average closing rate of the preceding week, published by FEDAI, if the same approximates the actual rate at the date of the transaction.



- iv) Generally, Indian banks prepare the consolidated accounts for their domestic and foreign branches at quarterly or longer intervals. Hence, banks may use the quarterly average closing rate, published by FEDAI at the end of each quarter, for translating the income and expense items of non-integral foreign operations during the quarter.
- v) If the weekly average closing rate of the preceding week does not approximate the actual rate at the date of the transaction, the closing rate at the date of the transaction should be used. For this purpose, the weekly average closing rate of the preceding week would not be considered approximating the actual rate at the date of the transaction if the difference between (a) the weekly average closing rate of the preceding week and (b) the exchange rate prevailing at the date of the transaction, is more than five percent of (b). In respect of non-integral foreign operations, if there are significant exchange fluctuations during the quarter, the income and expense items of non-integral foreign operations should be translated by using the exchange rate at the date of the transaction instead of the quarterly average closing rate. For this purpose, the exchange rate fluctuation would be considered as significant, if the difference between the two rates is more than ten percent of the exchange rate prevailing at the date of the transaction. The limit of five/ten percent variation has been considered as appropriate since such variation is not expected to have a material impact on the amount of the relevant items such as foreign currency loans and advances and deposits, and operating results.
- vi) Banks are, however, encouraged to equip themselves to record the foreign currency transactions of Indian branches as well as integral foreign operations and translate the income as well as expense items of non-integral foreign operations at the exchange rate prevailing on the date of the transaction.

5. Closing rate

5.1. Paragraph 7 of the Standard defines 'Closing rate' as the exchange rate at the balance sheet date.

Action to be taken by banks

5.2. In order to ensure uniformity among banks, closing rate to be applied for the purposes of AS 11(revised 2003) for the relevant accounting period would be the last closing spot rate of exchange announced by FEDAI for that accounting period.

6. RBI considers that with the issue of the guidelines as above and adoption of the prescribed procedures, there should normally be no need for any Statutory Auditor for qualifying financial statements of a bank for non-compliance with Accounting Standard 11 (revised 2003). Hence, it is essential that both the banks and the Statutory Central Auditors adopt the guidelines and the procedures prescribed. Whenever specific difference in opinion arises among the auditors, the Statutory Central Auditors would take a final view. Persisting difference, if any, could be sorted out in prior consultation with RBI, if necessary.

Circular on Framework of Analysis of Balance Sheets

BP.BC.3/21.04.109/99

February 8, 1999

All Scheduled Commercial Banks

Dear Sir,

Framework on Analysis of Balance Sheets

As you are aware, the analysis of the financial position of banks as disclosed in the balance sheets is not being done in a systematic manner with a view to evaluating the critical parameters of performance and initiating appropriate corrective measures. Peer group comparison of performance parameters is also not attempted to evaluate the operational efficiency, strengths and weaknesses in performance vis-à-vis competitors. Further, in the absence of uniformity among banks in using various financial and non-financial parameters, the results are not always objective. It has, therefore, been decided that a uniform framework should be devised to enable banks to undertake focussed scrutiny of the balance sheets to identify/analyse the key measures of returns and risks, assumed by banks and to demonstrate the relationship of returns and risks.

2. We enclose a format in which the balance sheet analysis has to be undertaken. The suggested framework is broadly divided into two parts – Part-I identifies the inputs and Part-II indicates the various ratios, amounts etc. which require detailed interpretation. The inputs and outputs are broadly classified on CAMEL basis. An attempt has also been made to measure the liquidity and interest rate risks assumed by banks.

3. Banks are, therefore, advised to analyse the balance sheets immediately on finalisation of their annual accounts as per the suggested framework and submit a memorandum to their Board of Directors. The copy of the note put up to the Board together with the analysis (in floppies), may be submitted to the OSMOS Division, Reserve Bank of India, Department of Banking Supervision, Central Office, Centre-1, World Trade Centre, Cuffe Parade, Mumbai-400 005, on a regular basis.

4. The mismatches in cash flows and interest rates may, however, be analysed from March 31, 2000, by which time the Asset-Liability Management System would have stabilised.

5. Please acknowledge receipt.

Yours faithfully,

Sd/-

(C.R. Muralidharan)
General Manager

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Encls: Printed Booklet and 3 ½ Floppy Disc.

Endt.DBOD.No.BP.2122/21.04.108/99 of date.

Copy forwarded for information to (as per sheet attached)

(Salim Gangadharan)

Deputy General Manager

Annexure

S.No.	The return/statement to submitted	Periodicity	Chapter in Vol.I in which a reference has been made to the return/statement	Office to which a return/statement is required to be submitted	Time limit for submission	Remarks	Page No.
1	2	3	4	5	6	7	8
31A	Analysis of Balance Sheet	Annual (31 st March)	7.12	Central Office of DBS, OSMOS Division.	Within on month from the date of finalisation of Balance Sheet	A copy of the Board Note together with analysis (in floppies) should be submitted)	After page No.73

[Vol.II – BP.BC.No.3 of 1999]

PART – 1

[Rs. Crore]

Analysis of Balance Sheet As on:

Name of the Bank

	As on 31-3-..... (Previous to previous year)	As on 31-3-..... (Previous year)	As on 31-3-..... (Current year)
Capital Funds			
Tier I			
Paid up Capital			
Deduct			
Investment in subsidiaries			
Intangible Assets & Losses			
Total deduction			
Add			
Statutory Reserves			
Share Premium			

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Capital Reserves (Surplus on Sale of assets)
 Other disclosed reserves (Revenue reserves)
 Total
 Tier I Capital
 Tier II
 Undisclosed reserves and cumulative perpetual
 preference shares
 Revaluation reserves (at discount)
 Capital reserves (excess provision on investments)
 General Provisions & loss reserves
 Hybrid debt capital instruments
 Subordinated debt (at discount)
 Tier II Capital
 Total Capital (Tier 1+II)
 Total Risk Weighted Assets
 No. of Equity shares
 [Market price per share (Rs.)]
 Asset Quality
 A Loan Assets
 Gross Advance
 Net Advances
 Total Off-Balance Sheet Exposures
 Classification of Advances by Risk
 Standard
 Sub-standard
 Gross
 Net
 Doubtful
 Gross
 Net
 Less
 Gross
 Net
 Total

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Gross NPAs

Net NPAs

Rating-wise Distribution of Standard

Advances – (amounts)

NPAs Carrying Govt. Guarantees (Classified As Performing)

Large Exposures

In excess of:

10% of net owned fund

25% of net owned fund

Changes in NPAS Profile

NPAs at the beginning of the year

New accretion of NPAs during the year

Recoveries effected during the year

Due to upgradation

Due to compromise/write-off

Actual recoveries

NPAs at the end of the year

B. Investments

Maturing within 1 year

Maturing between 1 year and 3 years

Maturing between 3 years and 5 years

Maturing between 5 years

Total investment

Investments in Approved Securities

Permanent

Current

Other Investments

Investments in Shares

Investments in Bonds/Debentures of which

Through Public Offer

Rated

Unrated

Through Private Placement

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Rated
Unrated
NPAs in Investments
Provisions held against NPAs in Investment
Earnings Appraisal
Interest/Discount earned
Interest/Discount on loans and advances/bills (net of interest tax)
Income on investments
Interest on additional balances with RBI & others
Interest on market lendings
Commission, exchange & brokerage
Other operating income
Total operating income
Interest expended
Interest on deposits
Interest on borrowings
Staff expenses
Other operating expenses
Total operating expenses
Write-offs
Bad-debts written off
Other assets written off
Capitalised assets written off
Provision & Contingencies
Provision for loan losses
Provision for depreciation in investments
Provision for tax
Other Provisions
Operating profit before provisions
Net operating profit
Realised gains/losses on sale of assets
Profit before tax
Profit after tax

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Adjustments:

Excess provision on investments written back

Income on Recapitalisation Bonds

Excess profit on account of significant changes or
deviations in accounting policies

Adjusted operating profit before provisions

Adjusted net operating profit

Adjusted profit before tax

Adjusted profit after tax

Certain Key Figures

Earning assets

Non-earning assets

Average total assets

Total Equity at the beginning of the year

Total Equity at the end of the year

Average yield on funds (%)

Average yield on investments (%)

Total return on investments (%)

Average cost of funds (%)

Average cost of deposits (%)

Non-interest income

Non-interest expenditure

Net total income

Retained earnings

Dividend paid/proposed

Business (Aggregate Deposits + Advances)

Net Owned Funds

Market Risks

Liquidity Risk

Purchased funds

Core deposits

Cash flows

Remaining upto 14 days

Inflows

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Outflows
Remaining more than 14 days to 28 days
Inflows
Outflows
Remaining more than 28 days to 90 days
Inflows
Outflows
Remaining more than 90 days to 1 year
Inflows
Outflows
Remaining more than 1 year to 3 years
Inflows
Outflows
Remaining more than 3 years and above
Inflows
Outflows
Interest Rate Risk
Rate Sensitive Assets Maturing/Repricing
Within 28 days
More than 28 days to 90 days
More than 90 days to 1 year
More than 1 year to 3 years
More than 3 years
Rate Sensitive liabilities Maturing Repricing
Within 28 days
More than 28 days to 90 days
More than 90 days to 1 year
More than 1 year to 3 years
More than 3 years
Number of Employees
Cost Per Employee
Staff productivity
Profit per employee

652 Guidance Note on Audit of Banks**PART 2****Performance Measures****Risk Based Capital Ratios****CRAR (Total capital/RWAs)****Core CRAR (Tier I capital/RWAs)****Adjusted CRAR****Asset Quality****Gross NPAs to Gross Advances****Net NPAs to Net Advances****Incremental NPAs to opening Gross Standard Advances****Provision for Loan Losses to Gross Advances****Loan Loss Provisions and Write Offs to Gross Advances****Provisions for Loan Losses to NPAs****Gross NPAs (including NPAs in investments) to Total Assets****Net NPAs (including NPAs in Investments) to Total Assets****Net NPAs to Total Equity****Large Exposures to NOF****Ratio of Off-Balance Sheet Items to Total Assets****NPAs in Investments To Other Investments****Earnings****Return on Assets-pre tax****Return on Assets – adjusted pre tax****Return on Assets – post tax****Return on Assets – adjusted post tax****Equity multiplier****Return on Risk Weighted Assets-post tax****Return on Risk Weighted Assets-adjusted post tax****Return on Equity-pre tax****Return on Equity-adjusted pre tax****Return on Equity-post tax****Return on Equity-adjusted post tax**

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Accretion on Equity
Earnings Per Share
P/E Ratio
Net Interest Income (NII)
Net Interest Margin (NIM)
Risk Adjusted NIM
Non-Interest Margin
Profit Margin
Profit Margin – adjusted net profit
Interest expense ratio
Non-interest expenses ratio
Provision for loan loss ratio
Provision for depreciation in investments ratio
Tax ratio
Efficiency (Cost-Income) Ratio
Overhead Efficiency (burden) Ratio
Asset utilisation
Staff productivity
Profit per employee
Break Even Volume of Business per Employee
Net Total Income per Employee Liquidity
Purchased Funds to Total Assets
Net Loans to Total Assets
Core Deposits to Total Net Advances
Investments in Short Term Assets (maturing within one year to Purchased Funds)
Investments in Short Term Assets (maturing within one year) to Total Assets
Mismatches (cash flows) % of outflows
Upto 14 days
More than 14 days to 28 days
More than 28 days to 90 days
More than 90 days to 1 years
More than 1 year to 3 years

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More than 3 years

Mismatches (RSA – RSL as % to total equity)

Within 28 days

More than 28 days to 90 days

More than 90 days to 1 year

More than 1 year to 3 years

Significance and Interpretation of important Financial Parameters suggested in the Framework

Performance of banks affects the earnings (Net Interest Income and Net Interest Margin) and the economic value (Market Value of Equity) and their ability to be funded in the deposit and inter-bank market. The primary purpose of the suggested parameters is to identify/analyse the key measures of returns and risks (especially credit risk and market risks), assumed by the banks and to demonstrate the relationship of these returns and risks.

The significance and interpretations of some of the important parameters, suggested in the framework are given below:

A. Capital Funds

1. Risk Weighted Assets (RWA)

Any disproportionate increase in RWAs vis-à-vis the growth of total assets signifies the bank's appetite for assuming more risks for maximising returns. Such disproportionate growth may also be a conscious policy of the bank management to change the flow of its resources from investments in Govt. stocks to loan book in a booming credit market for realising credit spread. A critical analysis of the composition of risk weighted assets is called for.

2. Adjusted Capital to Risk-Weighted Assets

(Net of Net NPAs) Ratio (ACRAR)

The ratio reckons the unimpaired capital (Net of Net NPAs) available within the bank to mitigate potential adverse impacts of credit, market and operational risks. If the ratio is lower than the prudential level of 8%, the cushion available for absorbing future loss is limited.

B. Asset Quality

3. NPAs guaranteed by Government

(Classified as standard assets)

The NPAs, guaranteed by State/Central Government are treated as standard assets and no prudential provision as of now is made even though most of such advances ceased to generate any income to the banks. The exposures of the banks to such assets need to be analysed to gauge the quality of the loan book.

4. Ratio of Incremental NPAs to Opening Gross/Standard Advances

The ratio on Incremental NPAs to Opening Gross/Standard Advances would

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basically reveal the asset quality of standard advances of banks. Higher ratio indicates the aggressive loan philosophy or poor asset quality of banks.

5. Gross/Net NPAs (including NPAs in Investments to total Assets)

The evaluation of asset quality in India is based on Gross/Net NPAs to Gross/Net advances, which reckons only a part of the balance sheet items. The ratio of Gross/Net NPAs (including NPAs in Investments) total Assets would reveal the degree of impairment of assets in the balance sheet.

6. Ratio of Net NPAs to Total Equity

Ratio of Net NPAs to Total Equity indicates the equity cover for NPAs. If the ratio is greater than unity, that particular bank is financing NPAs out of interest paying liabilities. This sort of funding pattern would adversely affect the profitability of banks.

7. Rating-wise details of Standard Advances

In the context of interest rate deregulation and freedom given to banks to price their assets and liabilities, most of the banks are prescribing spreads (risk premia) over their PLRs. The risk premia are being charged on the basis of inherent quality of borrowers as revealed in their credit ratings. With the objective of improving the return on advances, banks may dilute their appraisal standards and let even low quality customers into the balance sheets. This process leads to 'Adverse Selection' and dilution of portfolio quality. A larger proportion of borrowers in the higher end of spread over PLR would boost the current interest income but could be viewed potentially as risk prone. The rating-wise analysis of standard assets would facilitate to evaluate the portfolio quality. The migration analysis (movement of borrowers from higher to lower ratings – negative migration or lower to higher ratings – positive migration) of borrowers is now accepted as standard tool for evaluation of portfolio quality. The expected and unexpected loan losses are also estimated on the basis of migration analysis.

8. Investments in bonds/debentures

Bonds/debentures are emerging as direct credit substitutes and most of these instruments are being placed privately without ratings. It is, therefore, suggested that the exposure of banks in this segment may be analysed very closely, as investments in low quality bonds/debentures would alter the risk profile.

9. NPAs in Investments

With large exposures in bonds/debentures, and mostly through private placement route, there is an imperative need to assess the quality of investments portfolio quality. Thus, the data on NPAs in investments and provisions held against identified losses due to credit risk should be analysed.

10. Large Exposures to NOF

At present, banks are not permitted to lend more than 25% / 50% of their NOF to single and group (infrastructure projects upto 60%) borrowers, respectively. However, there is no limit on total exposures in excess of a threshold, say 10% of NOF. In most of the western countries, the sum total of exposures in excess of threshold limit of 10% of NOF has been prescribed to restrict the concentration problem. The total exposure is generally fixed at 600% to 800% of NOF. The ratio of Large Exposures to NOF provides a good measure of concentration risk. The

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ratio is a better pointer of future asset quality problems.

11. Ratio of off-balance sheet items to total Assets

With the introduction of prudential regulations, banks are increasingly going in for off-balance sheet products and the risk profile of these products, unless proper risk management systems are put in place would mount. When the ratio goes up, specific analysis of the off-balance sheet products such as the composition, compliance with prudential limits, portfolio quality, etc. should be undertaken.

C. Earnings

12. Operating Profits before and after income on Recapitalisation Bonds

In order to measure the true profitability of banks, analysis of operating profits – before and after interest income on Recapitalisation Bonds where applicable, is suggested. In case the adjustment brings out negative operating profits, it clearly indicates the structural weaknesses of banks in the profitability front. This adjustment is specifically relevant in view of the recommendations of Narasimham Committee on banking sector reforms.

13. Adjusted ROAs & ROE before and after tax

Accounting practices amongst banks were never uniform over the years. This apart the write-back of provisions held against depreciation in investments has boosted the net profit of some of the banks in 1997-98. Similarly, significant changes/deviations in / from the established accounting practices often boost profits. In order to gain uniformity of various return performance measures, it is suggested that net profits published may be suitably modified and the various performance measures are calculated on the basis of published and adjusted net profit.

14. Return on Risk-Weighted Assets

The ratio of Return on Assets basically focuses only balance sheet items. The disintermediation process has transformed the balance sheet profile and most of the banks are scouting for off-balance sheet items for fee-based income. This process has significantly altered the risk profile of banks. Thus, the measure of Return on Risk Weighted Assets, which captures the off-balance sheet activities of the bank as well reveal the relationship between the risks and returns. In case the ratio has consistently been decreasing, it indicates that the bank has not been adequately compensated for the additional risks assumed. This ratio also recognises the growing role of fee income or the differing expense levels in connection with various lines of business.

15. Equity Multiplier (EM)

A bank's EM compares assets with equity and large values indicate a large amount of debt financing relative to equity. EM thus measures financial leverage and represents both a profit and risk measurement. EM affects a bank's profit because it has a multiplier impact on Return on Assets (ROA) to determine a bank's Return on Equity (ROE). EM is also a risk measure because it reflects how many assets can go into default before a bank becomes insolvent. It is true that the Risk Weighted Capital Adequacy standards prescribes the minimum equity support, but it lacks much or its leverage due to preponderance of its focus on credit risk. The banking system is now exposed a larger extent to market risks and risk weight of 2.5% in respect of investments in Government Securities and other Approved securities as a

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cover against market risks has not been adequate. Thus, a critical scrutiny of EM helps us to evaluate whether capital support is proportionate to the risks assumed in the balance sheet.

16. Earning Per Share (EPS) / P/E Ratio

The EPS and P/E ratios indicate the ability of the bank to access the capital market and the appetite of the bank's scrip in the market. The capital market looks at these ratios very closely.

17. Net Interest Income (NII) & Net Interest Margin (NIM)

NII and NIM are a summary of measure of a bank's net interest return on income producing assets. These two measures are extremely important in evaluating a bank's ability to manage interest rate risk. The higher amount / ratio shows the financial strength of the bank. Any decline in the amount / ratio may be adduced to large non-performing assets or the bank is not strategically placed to take advantage of the movements in market interest rates.

18. Return on Assets (ROA)

ROA is the financial indicator of the efficiency of banks. A lower ROA signifies poor return on assets or high operating expenses or losses in loans or investment portfolios. The analysis of ROA may be extended to Profit Margin (PM) and Asset Utilisation (AU) Ratios to identify the real reason/s for high/poor ROA. High ROA may be due to excessive risk appetite or trading positions. Thus, detailed scrutiny of asset quality, ALM mismatches and even accounting practices may be undertaken.

19. Risk Adjusted Net Interest Margin (RANIM)

Normally, RANIM is a refinement of NIM which factors into provisions made against loan losses. RANIM represents NII, net of provisions for probable loan losses as a percentage to total earning assets. It may, however, be noted that depreciation in investment portfolio on account of market risks has been significant of late and as such the provisions made against investments which are impaired due to adverse movements in YTM may also be deducted from NII. With this extension, the analysis throws open not only the impact of credit risk but also market risks on the profitability of banks.

20. Total Return on Investments

Total return on investments, inter alia, takes into account the coupon yield, capital gain/(loss) and reinvestment income. This measure gives the actual return on investment unlike the conventional measure of average yield on investments. The total return concept recognises the impact of market interest rate movements on portfolio values.

21. Efficiency (Cost-Income) Ratio/Overhead Efficiency (burden) Ratio

Efficiency (Cost – income) ratio and Overhead Efficiency (burden) ratio, which represents operating cost (non-interest expenses) as a percentage of Net Total Income (total income minus interest expenses) and Non-Interest Income as a percentage of Non-Interest Expenses, reveal the cost efficiency and the cross subsidisation of various bank products. Higher the ratios, the lower are the profitability of banks. Ideally, the cost-income ratio should not exceed 60.

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22. Profit Margin (PM)

PM measures a bank's ability to control expenses and reduce taxes. The greater the PM, the most efficient is a bank in reducing expenses or taxes or both. Five additional ratios like Interest expense ratio (Interest Expenses to Total Income), Non-interest expenses ratio (Non-Interest Expenses to Total Income), Provision for loan loss ratio (Provision for loan losses to total income), Provision for depreciation in investments ratio (Provision for depreciation in investments to total income) and Tax ratio (Income tax to total income) isolates the impact of specific types of expenses and taxes.

23. Asset Utilisation (productivity)

The asset productivity depends on the proportion of earning assets to total assets or earning base of banks. The earnings could be augmented through efficient asset allocation. The portfolio changes i.e. investment or loan are not only induced by changes in environment but also the yield differential and changing risk profiles.

24. Break-even Volume of Business per Employee and Net Total Income per Employee

The ratios indicate the staff productivity in banks, which is very important in a competitive environment. A comparison of the ratios among the Peer Group would reveal the relative efficiency and staff productivity of banks.

D. Risk Measures

Liquidity/Interest Rate Risk

25. Purchased Funds to Total Assets

Purchased funds which include all inter-bank and short-term institutional liabilities and certificate of deposits are basically volatile and are used for funding assets would entail liquidity risk. The higher ratio indicates the magnitude of liquidity risk embedded in the balance sheet.

26. Net Loans to total Assets

Loans, essentially being illiquid, a higher ratio of loans to total assets indicate the illiquidity of the bank.

27. Core Deposits to Net Advances

The advance portfolio of banks in India is illiquid and therefore, it should be funded out of core deposits. Otherwise, the banks would be facing severe liquidity risk when the market is experiencing liquidity crunch. Lower ratio indicates the potential liquidity problems of banks.

28. Investments in Short-term Assets to Purchased Funds / total Assets

The investment portfolios of many of the banks are generally long-term while the liabilities are short-term. At the same time, the market for investments is shallow. Thus, the liquidity of the bank could be maintained only by proper control over the maturity profile of investments. The lower the ratio, the higher is the liquidity risk.

29. Mismatches in Cash Flows

The ideal measurement of liquidity in the Indian context is cash flows. RBI has recently issued guidelines for Asset-Liability Management (ALM) framework in

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banks. The cash flow details may be obtained to evaluate the liquidity profile of banks.

30. Gap Analysis

The deregulation of interest rates has exposed the banks to market risk, especially interest rate risk. The monitoring of mismatches in cash flows, repricing dates and currency is going to be the top management/supervisory focus and the measure of gaps in different time buckets is suggested. The gaps would reveal the potential loss/gain in NII/NIM on account of changes in market interest rates. The ratio of gaps to total Equity reveals the magnitude of risk being borne and the ability to absorb the hit on capital.

The important ratios/other parameters used in Balance Sheet Analysis

1. Adjusted CRAR =
$$\frac{\text{Total Capital Net NPAs}}{\text{Risk Weighted Assets Net NPAs}}$$
2. Incremental NPAs to opening Gross advances = New accretion to NPAs during the year gross advances at the beginning of the year
3. Incremental NPAs to opening Gross Standard Assets =
$$\frac{\text{New accretion to NPAs during the year}}{\text{Gross standard advances at the beginning of the year}}$$
4. Net NPAs to total equity =
$$\frac{\text{Net NPAs}}{\text{Total Equity}}$$
5. Credit concentration to NOF =
$$\frac{\text{Large Exposures in excess of 10\% of NOF}}{\text{NOF}}$$
6. Return on Equity =
$$\frac{\text{Net Profit}}{\text{Total Equity at the Beginning of the year + Total Equity at the end of the year}}$$
7. Return on RWAs =
$$\frac{\text{Net Profit}}{\text{RWAs}}$$
8. Return on Assets =
$$\frac{\text{Net Profit}}{\text{Average Total Assets}}$$
9. Equity Multiplier =
$$\frac{\text{Total Assets}}{\text{Total Equity}}$$
10. Accretion to Equity =
$$\frac{\text{Retained Earnings}}{\text{Total Equity at the end of the previous year}}$$

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11. Earnings Per Share (EPS) =
$$\frac{\text{Net Profit}}{\text{No. of Equity Shares}}$$
12. P/E Ratio =
$$\frac{\text{Stock Price}}{\text{EPS}}$$
13. Net Interest Income (Nil) = Interest Income – Interest Expended
14. Net Interest Margin (NIM) =
$$\frac{\text{Nil}}{\text{Total Earning Assets}}$$
15. Risk Adjusted NIM =
$$\frac{\text{Nil Provision for loan loss and depreciation in investments}}{\text{Total Earning Assets}}$$
16. Non Interest Margin =
$$\frac{\text{Non Interest Income – Non Interest Expenses}}{\text{Total Assets}}$$
17. Profit Margin =
$$\frac{\text{Net Profit}}{\text{Total Income}}$$
18. Interest Expense Ratio =
$$\frac{\text{Interest Expended}}{\text{Total Income}}$$
19. Non Interest Expense Ratio =
$$\frac{\text{Non Interest Expenses}}{\text{Total Income}}$$
20. Provision for Loan Loss Ratio =
$$\frac{\text{Provision for loan loss}}{\text{Total Income}}$$
21. Provision for Depreciation in Investments Ratio =
$$\frac{\text{Provision for Depreciation in Investments}}{\text{Total Income}}$$
22. Tax Ratio =
$$\frac{\text{Provision for Tax}}{\text{Total Income}}$$
23. Net Total Income = Total Income – Interest Expended
24. Efficiency (Cost – Income) Ratio =
$$\frac{\text{Non Interest Expenses}}{\text{Net Total Income}}$$
25. Overhead Efficiency Ratio =
$$\frac{\text{Non Interest Income}}{\text{Non Interest Expenses}}$$

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26. Break even volume of business per employee = $\frac{\text{Cost per employee}}{\text{Nil/Business}}$
27. Net total income per employee = $\frac{\text{Net total income}}{\text{Number of employees}}$
28. Asset Utilisation = $\frac{\text{Total Income}}{\text{Total Assets}}$
29. Purchased funds to Total Assets = $\frac{\text{Inter bank and short-term institutional borrowings + Certificate of Deposits}}{\text{Total Assets}}$
30. Mismatches in Cash Flows = $\frac{\text{Mismatch in a bucket}}{\text{Total outflows in a bucket}}$
31. Mismatches in Repricing = $\frac{\text{Rate Sensitive Assets (RSAs) – Rate Sensitive Liabilities (RSLs)}}{\text{Total Equity}}$
32. Total Return on Investments = Coupon income + Capital gain (+) or Capital loss (–) + reinvestment income.