

HANDBOOK
— FOR —
DIRECTORS
— OF —
REGIONAL
RURAL BANKS



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1. Introduction

1.1 Establishment of RRBs

Rural credit policy In India has had at its core the twin goals of bringing an increasing number of people within the formal financial system and using credit as an instrument of poverty alleviation. Several measures have been taken by the Government of India and the Reserve Bank from time to time to achieve these goals. Even after commercial banks were brought into the field of rural banking in the post-nationalisation scenario to supplement the efforts of cooperatives, a large segment of the rural population remained outside the fold of banking services at that time. A Working Group constituted by the Government of India in 1975 under the Chairmanship of Shri M. Narasimham to explore the possibilities of evolving an alternative rural credit agency recommended formation of a new set of regionally oriented rural banks which would combine the local feel and familiarity characteristic of cooperatives and the professionalism and resource base of commercial banks. Following the recommendation, Regional Rural Banks (RRBs) were set up first on 2nd October, 1975. Their number went up to 196 by the year 1987.

1.2 Place of RRBs in Indian Banking System

The RRBs have a special place in the multi-agency approach adopted to provide agricultural and rural credit in India. These banks are state-sponsored, regionally based and rural-oriented. As enshrined in the Preamble to the RRBs Act, 1976, the RRBs were established "with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs, and for matters connected therewith and incidental thereto".

The RRBs were treated as scheduled banks right from their inception and functioned alongside the larger commercial banks and the cooperative banks. Over a period of time, they have developed an impressive branch network in the rural sector. During the three decades of their existence, the RRBs have passed through several phases. However, with their focus of operations mainly in the rural areas, the RRBs have always been in an ideal position to provide financial services to the rural population.

It was in the year 2004 that the Government of India, based on the recommendations of the Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (headed by Prof. V S Vyas), decided to consolidate the RRBs into state-level entities within the

same sponsor bank. The amalgamation process which began in September 2005, gained momentum in the subsequent period, bringing down the total number of RRBs to 88 as at the end of May 2008, out of which 42 were stand alone RRBs, 45 were amalgamated RRBs and 1 RRB was newly set up in the Union Territory of Pondicherry.

As at the end of December 2007, RRBs had 14,467 branches in the country. Of these, 11,337 were rural branches and 2,509 were semi-urban branches. These constituted about 29 per cent of the total rural and semi-urban branches of all scheduled commercial banks in the country.

1.3 Salient features of RRBs

1.3.1 Capital structure and shareholding pattern

As per the Regional Rural Banks Act, 1976, the authorized capital of an RRB is Rs 5 crore, which can be increased or decreased by the Central Government in consultation with NABARD and the sponsor bank, but cannot be less than Rs 25 lakh.

However, the issued capital should not be less than Rs 25 lakh or more than Rs 1 crore. The issued capital is held by the Central Government, the State Government and the sponsor bank in the ratio 50:15:35.

1.3.2 Business of RRBs

As per the Act, the RRBs transact the business of 'banking' as defined under the Banking regulation Act, 1949 (i.e., accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise). RRBs can carry on any business which a commercial bank is allowed to carry on; however, the Act enjoins upon the RRBs the responsibility of lending to small and marginal farmers and agricultural labourers, and to cooperative societies, including agricultural marketing and processing societies, primary agricultural credit societies, farmers' service societies etc. as also to artisans, small entrepreneurs and persons of small means engaged in trade, commerce or industry, or other productive activities, within the notified area in relation to the bank. With the passage of time, the concept of lending to this 'target group' has been withdrawn and the RRBs have been allowed to lend to any person in their notified area of operation, with the condition that advances to 'priority sector' (details in Chapter VII) should not be less than 60 per cent of their total advances.

1.3.3 Regulation and supervision

The RRBs being part of the banking system and conducting the business of banking in India are subject to regulation by the Reserve Bank in matters relating to opening of branches, collection of deposits, lending to various sectors, rates of interest on deposits and loans, investment of funds, maintenance of cash reserve (CRR) and liquid assets (SLR), etc. These banks are, however, supervised by the National Bank for Agriculture and Rural Development (NABARD), which in terms of the provisions of Section 35 of the Banking Regulation Act, 1949, is empowered to inspect the RRBs. Presently, NABARD supervises RRBs through on-site inspections and off-site monitoring.

2. Governance Structure of RRBs

2.1 Governance hierarchy in RRBs

In a generic sense, governance refers to the task of running an organization and involves moral, ethical and legal values, framework under which business decisions are taken. Good governance is equitable and effective governance that promotes the rule of law and establishes a climate of trust and confidence.

As mentioned in the previous chapter, RRBs have three share-holders, viz. (a) The Government of India; (b) State Government and (c) the Sponsor Bank. Their roles are briefly mentioned below:

2.1.1 Government of India (GOI)

The Regional Rural Banks Act has vested wide powers with the Government of India (GOI) in relation to RRBs, which include the following :

- GOI holds 50 per cent of the paid up share capital of an RRB.
- GOI nominates two directors (non-official directors) on the Board of an RRB.
- The establishment of any RRB, location of its Head Office, etc. are decided by the GOI in consultation with the sponsor bank and the State Government concerned.
- GOI, after consultation with the RBI and the sponsor bank and by notification in the Official Gazette is empowered to make rules for carrying out the provisions of the RRBs Act, as also to give directions to RRBs in regard to matter of policy involving public interest, etc.

2.1.2 The Sponsor Bank

As banks which were primarily responsible for sponsoring the RRBs and guiding them during the initial days, the sponsor banks continue to play a very important role even today. The following responsibilities inter alia have been entrusted to the sponsor bank :-

- 35 per cent of the share capital of an RRB is subscribed by the sponsor bank.
- The sponsor bank can nominate two official directors on the Board of its sponsored RRB.
- The Chairman of an RRB is at present an officer from the sponsor bank and his salary is borne by the sponsor bank.

- Sponsor bank aids and assists its RRB in reorienting and training of personnel during the initial years of functioning of the RRB and providing such managerial and financial assistance as may be mutually agreed upon between it and the RRB.

2.1.3 The State Government

The State Government plays a vital role in respect of RRBs operating in the State concerned.

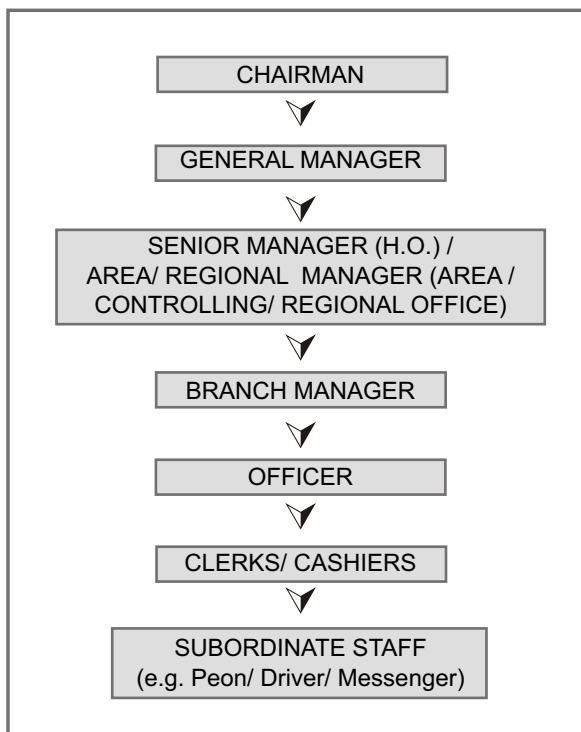
- State Government has a stake in the equity of RRBs to the extent of 15 per cent.
- State Government is entitled to nominate two of its officers as directors on the Board of an RRB.
- State Government plays an active role in the building up of infrastructural facilities such as all-weather roads, acquiring of suitable premises for location of branches, etc.
- Making effective security arrangements for the RRBs is one of the prime responsibilities of the State Government.

2.2 Organisational Pattern of RRBs

The success or failure of an organisation largely depends upon the weaving of a good organisational pattern. An organisational pattern provides a workable mechanism by which collective endeavour and action by a group of persons and institutions are synchronized to deliver optimal results. The hierarchical structure generally prevalent in RRBs is as follows:

At the Head Office level, the organizational pattern consists of both apex and professional managements assisted by Class III and Class IV staff members. As per the existing branch licensing policy for RRBs, there could be one Area Office for every 25 branches. The Area Manager is generally in the rank of a Scale III Officer and has adequate powers to function in a decentralized and effective manner. The Area Office is generally attached to one of the main branches of the RRB, to reduce over-head expenditure.

Chart 2.1 : The Hierarchical Structure in RRBs



2.3 The Chairman

The chairman is appointed by the sponsor bank in consultation with NABARD, if the person is an officer of the sponsor bank. The Act also provides that in case the chairman is not an officer of the sponsor bank, prior approval of the Government of India is necessary for appointment.

The Chairman is a whole time director of the bank and devotes his time to the affairs of the RRB. He looks after the management of the bank, subject to the superintendence, control and direction of the Board of Directors. He presides over the meetings of the Board and in the case of equality of votes over an issue, has a second or casting vote.

2.4 Board of Directors

The general superintendence, direction and management of the affairs and business of an RRB are vested in the Board of Directors. However, the Board is not expected to interfere with the day-to-day working of the bank. The Board is required to act on business principles and to have due regard to public interest while discharging its functions. The Board of Directors is mainly responsible for policy formulation and performance appraisal and also taking decisions on matters which are beyond the powers of the Chairman.

2.4.1 Composition & Types of Directors

The composition of the Board is important inasmuch as it determines the ability of the Board to collectively provide the leadership and ensures that no single individual or a group is able to dominate the decision-making process.

In terms of the RRBs Act, 1976, the Board of Directors of an RRB consists of nine directors out of which, seven (including the chairman) are official directors and two are non-official. The following Table exhibits the composition and types of directors on the Boards of RRBs:

Chart 2.2 : Composition & Types of Directors

Sr. No.	Type of Director	Designation	Nominated by	Numbers
1.	Official	Chairman	Usually by the sponsor Bank with approval of NABARD	1
2.	Official	Director	State Government	2
3.	Official	Director	Sponsor Bank	2
4.	Official	Director	Reserve Bank of India	1
5.	Official	Director	NABARD	1
6.	Non-Official	Director	Government of India (GOI)	2
			TOTAL	9

The Central Government may increase the number of directors of the Board up to fifteen in the aggregate and also prescribe the manner in which the additional numbers may be filled in. The objective of broad-basing the structure of the Boards of RRBs is primarily to draw synergy from varied experiences and expertise of persons coming from various organisations and backgrounds.

2.4.2 Tenure/Terms of Office

A director (other than the Chairman) holds office for a period not exceeding two years from the date of assumption of office or as the authority nominating him may specify at the time of his nomination. He may, on the expiry of the said period, continue to hold office until his successor is nominated and is also eligible for re-nomination.

As per the RRBs Act, the chairman of an RRB is appointed for a specific period not exceeding five years and is eligible for re-appointment. At present, the Chairman of an RRB is appointed initially for a period of three years.

2.4.3 Disqualifications

As stated in the Act, a person can be disqualified for being appointed or nominated as a Director if

- (a) he is, or at any time has been adjudged insolvent or has suspended payment of his debt or has compounded with his creditors; or
- (b) he is of unsound mind and has been so declared by a competent court;
- (c) he is, or has been, convicted of an offence which in the opinion of the Central Government involves moral turpitude.

2.4.4 Vacation of the seat of Directors

The seat of a director falls vacant, if he

- (a) becomes subject to any disqualification as specified in the above paragraph;
- (b) is absent without leave of the Board for more than three consecutive meetings thereof. Alternatively, if the director resigns his office by giving a written notice to his nominating authority and if the authority accepts his resignation, the director is deemed to have vacated his office.

2.4.5 Fees & Allowances of Directors

- (a) The Central Government determines the fees and allowances payable to a director.
- (b) No fee is paid to any director, if he is an officer of the Central Government, State Government, RBI, NABARD, Sponsor Bank or any other bank.
- (c) The allowances payable to a director, who is an officer of the Central Government, State Government, RBI, NABARD, Sponsor Bank or any other bank, are paid by the government or bank by which such officer is employed.

- (d) The fees and allowances payable to any director other than those referred to in item No.(c) are paid by the concerned RRB.

2.5 Committees of the Board

As it may not be possible for all the members of the Board to meet frequently to deal with all matters concerning the bank in detail and as it may need specialized advice in regard to certain issues, various committees and sub-committees are appointed. As provided for in the Act, the Board may constitute such committees, whether consisting wholly of directors or wholly of other persons or partly of directors and partly of other persons, as it may think fit, for such purposes as it may decide.

Members of the committees are paid fees and allowances as determined by the Central Government. Details of payment applicable to directors as state in Para 2.4.5 are also applicable to members of the committees.

Different Committees (illustrative)

Some of the important committees of the Boards of banks are (i) Executive Committee, (ii) Audit Committee, (iii) Risk Management Committee etc.

Executive (Management) Committee

The role and responsibilities of the Executive Committee include business planning and policy formulation, monitoring of the exposures (both credit and investment) by the bank, review of the adequacy of the risk management process and upgradation thereof, internal control systems and ensuring compliance with the statutory / regulatory framework etc. This committees meets more frequently than the Board does to discuss issues of importance to the bank's operations.

Audit Committee

The Audit Committee oversees the internal supervisory system, audit of policies framed by the Board and their implementation, ensuring integrity of information supplied to regulatory/ supervisory institutions and also deals with issues relating to inspection, audit and statutory inspection of the banks and compliance to the audit/ inspection reports.

Risk Management Committee

The Committee deals with the policies for management of the risk profile of the bank, including credit risk, market risk and operational risk. Chapter IV deals with the subject of 'risk management' in greater detail.

2.6 Officers and Staff of RRBs

The Central Government formulates the policy for manpower norms in RRBs. At present, the manpower norms as recommended by the Agarwal Committee and communicated by the Government of India, Ministry of Finance in January 2001 are still applicable. These norms are currently under re-examination and any revised norms will be notified by the Central Government in due course.

Some important parameters of the existing norms are indicated below:

2.6.1 Head Office level

To have uniformity among RRBs and to avoid compliment of staff at administrative units, the Head Office of an RRB may have 3 to 7 departments depending on its size. The emphasis should be on keeping the administrative units lean. The suggested staffing pattern for Head Office is as under:

Size Position	Up to 50 branches	51-100 branches	101-150 branches	More than 150 branches
Chairman	1	1	1	1
General Manager	1	1	2	2
Senior Manager (Scale III)	3	4	6	7
Manager (Scale II)	2	3	5	6
Manager/Officer (Scale I)	3	4-6	7-10	11-15
Clerks	3	4-5	6-7	8-9
TOTAL	13	17-20	21-31	35-40

2.6.2 Area Office Level

The post of Area Manager can be created only for those RRBs having 50 or more branches. There is one Area Manager for every 25 branches. The Area Office should be invariably attached to one of the main branches in a cluster of 25 branches. This is required to reduce overhead expenditure. The Area Manager should be in Scale III and should have adequate powers to function in a decentralized and effective manner.

2.6.3 Controlling Office Level

Consequent to amalgamation of RRBs, the concept of Controlling Office (CO) has been introduced from January 2006 in the amalgamated RRBs. Accordingly, amalgamated RRBs are permitted to open CO instead of Area Office. While for the first 75 branches one CO has been prescribed, thereafter for a cluster of 50 branches the amalgamated RRBs can have one additional CO.

2.6.4 Branch Categorisation

The categorisation of branches is as follows:

Business level	Category of the branch
Up to Rs 1 crore	Small branch
Above Rs 1 crore; up to Rs 12.5 crore	Medium branch
Above Rs 12.5 crore	Large branch

A small branch may be headed by an officer in Scale I, medium branch by Scale II and large branch by Scale III. The business of a branch may be decided on the basis of average outstanding deposits and advances calculated on notified Fridays of preceding two financial years.

2.6.5 Staffing norms

The maximum permissible staff strength of an RRB (including officers, clerks and messenger who are regular employees of the bank) is 4.00 per unit. A 'unit' includes Head Office, Area Office and branch, but does not include extension counters and satellite offices. In addition, RRBs with Credit-Deposit Ratio (C-D Ratio) above 60 per cent are allowed to recruit additional manpower at the rate of 0.1 staff in the officer cadre per 10 per cent increase in C-D Ratio.

At the time of application of the above norms, the RRBs having surplus staff were required to redeploy their excess staff through extension of branch network, expansion of area of operation and deputation to deficit RRBs. Banks having shortage of staff were, on the other hand, required to manage the shortage through branch rationalization, outsourcing wherever possible and automating Head Offices/ branches.

2.6.6 The General Manager

The General Manager of RRB is responsible for the day to day management and overall functioning of the bank as decided by the Board through the Chairman. He acts as a link between the Board and other personnel in the RRB and provides guidance and direction to other functionaries including the branch managers. Being next to the Chief Executive of the RRB, he has an important role in providing a conducive environment for efficient functioning of the bank.

3. Roles and Responsibilities of Directors

3.1 Role of Directors

The work of the Board includes strategy formulation and policy making, supervision of executive management and accountability to the stakeholders. Gone are the days when a directorship was sinecure, involving an occasional meeting and some supportive questions. Now-a-days, much more is expected of directors. The role of a director is now crucial, challenging and, of course, potentially highly rewarding.

The Board of Directors is the supreme authority and policy maker in the RRB. Each director on the Board plays a number of important and constructive roles for the smooth functioning and growth of his bank.

The main roles of the directors are to ensure that (i) the bank is efficiently and professionally managed (ii) sound policies are formulated and high ethical operating practices are followed (iii) customer service of the highest order is provided.

A Director's role can be explained under various sub-heads as under:

i) Role of a guide

- The Director should be familiar with the general economy and infrastructure of the area of operation of his RRB.
- He should be aware of the important provisions of various Acts applicable to RRBs, such as the RRBs Act, 1976, The Reserve Bank of India Act, 1934 and The Banking Regulation Act, 1949.
- He should be conversant with the administrative and staff regulations/ rules formulated by the Board of Directors of his RRB.
- He should go through the latest reports and recommendations of Expert Committees / Working Groups appointed by GOI/ RBI/ NABARD etc. which have an impact on RRBs in general and his RRB in particular.
- He should keep himself abreast of important changes in the economic and monetary policies particularly with reference to banking and rural development.
- He is expected not only to clarify the policies, but should also explain the background

and rationale of the policies. Such knowledge would help him guide the deliberations of Board meetings meaningfully and also help in evolving sound policies for the working of the RRB.

ii) Role of a coordinator

- He should be in touch and maintain cordial relations with all other directors and also with state/ district level functionaries to facilitate coordination in efforts of various agencies involved in the process of rural development.
- A Director on the Board is one among equals. He should, therefore, instill a sense of camaraderie among his colleagues on the Board so that discussions in the Board meeting are conducted in a friendly and constructive way.
- He should strive to work towards better harmony and coordination among all the directors on such occasions when the Board fails to function as a team of equals.

iii) Role as the representative of the sponsoring organisation

- He should keep himself continuously updated with the latest policy decisions and instructions of his nominating organization and gainfully utilize his knowledge to bring about necessary improvements in the functioning of the RRB.

(iv) Role of a watch-guard

- He should ensure that all the proposals before the Board are consistent with normal banking practices / guidelines / directions / instructions of GOI/RBI/NABARD and not violative or in contravention of any law of the land;
- He should endeavour to ensure that the resources of his RRB are judiciously and gainfully utilized as per prescribed norms of lending and investment and also that utmost economy is observed in establishment and other operational expenses;
- He should carefully examine the budget proposals of expenditure as and when placed before the Board for approval and satisfy himself about the justifiability of such expenditure;
- He should review analytically the working results of his RRB, identify and examine adverse factors responsible for any losses and suggest constructive measures wherever feasible;
- He should see whether his RRB promptly submits statutory and other periodical returns to the concerned authorities;
- He should record his dissent when any particular decision in the Board meeting is not in accordance with the policies and guidelines issued by the appropriate authorities (RBI/NABARD/ GOI etc.) or is otherwise not in the best interest of the institution;
- He should remain vigilant against any adverse publicity in respect of his bank through any media and against any serious complaint received from the customers targeting

any staff of the bank. He should satisfy himself that such complaints are properly investigated by the competent authority and suitable action is taken against the guilty.

- He should be well within his rights to seek information on any aspects of the working of the RRB if, in his opinion, such information is vital to the discharge of his duties as a director.

In addition to the roles usually played by all the directors, the RBI/ NABARD nominee directors on the Boards of RRBs can make further valuable contribution by helping the bank in operationalising the strategic plans and in evolving appropriate policies in areas like HRD, MIS etc.

3.2 Duties of a Director

The ultimate success or failure of an organization is very much dependent upon the knowledge, judgement, business acumen and decision-making capacity of the people at the helm. Any neglect or default in carrying out the assigned duties on the part of the Board members will not only ruin the future prospect of the organization, but also harm the interest of everyone connected with it. The Board should function as an effective body and place the growth and profitability of the organization on the top of everything else. To be able to function as competent Board members, every Board member must remember that he has a mission to accomplish and nothing should be allowed to stand in his way in attaining the same.

Forest E. Myers in the book "Basics for Bank Directors" opines that as a board member, a director has at least three duties to perform, viz.

- a) Duty of Care :** A director should devote time, exercise ordinary diligence, and use reasonable judgement to ensure his bank is run prudently and with due regard for the bank's shareholders.
- b) Duty of Obedience :** A director should obey applicable laws in his personal dealings with the bank and ensure that his bank complies with the relevant laws and regulations.
- c) Duty of Loyalty :** A director should not engage in activities or make use of information obtained as a director that benefits him at the expense of his bank.

3.3 Responsibilities of a Director

The director is a part of the top management of his bank and is, therefore, required to look into the entire gamut of functioning in the best interest of the bank. While discharging his duties and responsibilities, he must act honestly and with due diligence. He is expected to act with that amount of care and prudence, which any responsible person is expected to do in his own business.

The various responsibilities of a director on the Board of a RRB can be grouped under two broad categories :

- Statutory responsibilities

- Promotional and developmental responsibilities.

Statutory responsibilities

A director should

- (i) Sign oath of secrecy on being nominated as a director; otherwise he may be prohibited from attending Board meetings.
- (ii) Attend Board meetings regularly, sign Minutes book and participate in deliberation. If a Director is unable to attend the meeting due to circumstances beyond his control, he should take leave of absence and inform the Chairman and his parent organisation.
- (iii) Sign the balance sheet etc. after statutory audit is completed.
- (iv) Ensure that no decision is taken in the Board meeting which is contrary to the GOI/ RBI/ NABARD instructions/ guidelines.
- (v) Ensure that affairs of the bank are conducted on business principles keeping in view the public interest.

Promotional and developmental responsibilities

Following are some of the areas where the Directors can contribute and in the process guide the RRBs:

- (i) Preparation of realistic credit plans and monitoring of credit plan implementation,
- (ii) Preparation of schemes for various deposit/ credit related matters covering both traditional and innovative areas,
- (lii) Training of officers & staff;
- (iv) Action plan for improving the operational viability of RRBs,
- (v) Prompt reporting of frauds, embezzlement of funds, dacoities etc.
- (vi) Prompt compliance of NABRD inspection report and sponsor bank's management audit report.

The directors should, in particular, look carefully into issues like:

- (I) Excessive lending and Chairman's lending powers
- (li) High / low credit deposit ratios
- (lii) Liquidity mismatches
- (Iv) Frequent sanctions to individuals / groups of borrowers
- (V) Exposure in excess of prudential limits
- (Vi) Reduction / recovery of NPAs

- Vii) Status of housekeeping
- Viii) Opening/closing/merging/relocating branches
- Ix) Late/non reporting of frauds
- x) Staff accountability in the case of frauds, misappropriation etc.
- xi) Submission of statutory returns in time

3.4 Qualities of a successful director

There are three primary traits that characterize a successful director interest, integrity and independence.

Interest

A good director takes an active interest in the bank's affairs. Successful directors devote time to keeping up with the bank's activities - major business lines, risk exposures, risk management, competitors, customer service, performance, regulatory compliance and future plans. He attends all board and committee meetings (where he is a member) and offers advice and counsel when he believes it will help the bank. He prepares in advance for meetings so that he can make informed decisions concerning issues confronting the bank. Good directors ask meaningful questions so that they can fully understand matters under consideration. They also follow up with management, checking on the status of actions to be taken and for completing tasks and addressing problems in a timely fashion.

Integrity

A good director is honest and ethical in his or her dealings with the bank. He is loyal to the bank and puts the bank's interest ahead of his own. He honours confidentiality and does not attempt to personally profit from what he learns. He abstains from discussions and votes when conflicts of interest exist and discloses pertinent personal interests when necessary. Good directors also strictly adhere to laws restricting lending to bank directors. They meet their financial obligations to the bank and provide a positive example to all bank personnel helping to instill a culture of fairness and honesty within the organisation.

Independence

A good director is an independent thinker who is financially independent from the bank and is not easily influenced by the senior management. To be truly independent means that a director is not a relative, business partner, employee or person who does not rely on any member of the bank's senior management for his or her own livelihood. It also means that the director's loyalty is to the bank and its best interest and that the director does not subjugate the bank's interest to that of a senior management official who extended the invitation to join the board.

In addition, independent directors voice their opinions even if they are unpopular, vote for what is in the bank's best interest and not because it is what the majority desires. Independent directors are paid only for being on the board and do not take payments for products and services sold to the bank.

There are many attributes of a good director. However, directors with traits such as interest, integrity and independence know enough about their banks to objectively evaluate proposals and make objective decisions, without hope of gain or fear of reprisal.

3.5 DOs and DON'Ts for directors

A list of DO's and DON'Ts is furnished below for guidance of the directors of RRBs. The list is illustrative and not exhaustive, and is not regarded as a substitute to the special duties, responsibilities or rights of the Board of Directors as enunciated in the RRBs Act and/ or by-laws of the respective banks.

Do's

A) *Issues regarding discipline and involvement*

- 1) Attend Board meetings regularly in time and participate effectively.
- 2) Request the Chairman to furnish you with the Board papers and follow-up reports on a definite time schedule.
- 3) Study the papers relating to the Board meeting thoroughly and use the good offices of the Chairman for eliciting any information of the Board meetings.
- 4) Involve yourself fully in the formulation of general policy of the bank, and ensure proper monitoring of its implementation.
- 5) Be familiar with broad objectives of the bank and the policy laid down by GOI/ RBI/ NABARD.

B) *Constructive and development aspects*

- 1) Give your valuable suggestions, contribute and welcome constructive ideas for efficient functioning and better management of the bank.
- 2) Keep the main objectives of the bank in mind all the time.
- 3) Keep yourself updated with the policy guidelines issued by the bank.
- 4) Work as a team and neither sponsor nor be prejudiced against individual proposals. Management on its part is supposed to furnish full facts and complete papers in advance.
- 5) Benefit the management of the bank from the knowledge, intelligence, guidance and experience you possess.
- 6) Keep yourself abreast of all the developments and change taking place in the economy, in particular, the banking sector.
- 7) Play a constructive role in the discharge of responsibility of the management towards the public at large.

- 8) Provide guidance and help to the management of the bank to improve its image and customer service.

C) Business-specific contribution

Ensure that all the items, which are required to be placed before the Board in every meeting or at periodical intervals, are included in the Agenda, e.g.

- (i) Follow-up action on the decision taken in the previous meeting,
- (ii) Latest financial position including sources and deployment of funds,
- (iii) Default in maintenance of CRR/ SLR and in repayment to the higher financing/ refinancing agencies,
- (iv) Efficient management of funds and improving profitability,
- (v) Sectoral deployment of funds and priority sector/ weaker sections lending,
- (vi) Important circulars received from RBI/ NABARD,
- (vii) Progress in the implementation of Development Action Plan or other strategic plan, if any,
- (viii) Information relating to recovery and NPAs,
- (ix) Compliance of the provisions relating to income recognition, asset classification and provisioning norms,
- (x) Review of compliance on inspection/ audit reports,
- (xi) Cases relating to vigilance, fraud, embezzlement and misappropriation,
- (xii) Internal control systems, housekeeping and rationalization of policies and procedures,
- (xiii) Customer service,
- (Xiv) Development of a good Management Information System (MIS),
- (xv) Computerisation of operations, etc.

D) Reporting to the Nominating Authority:

Important decisions taken/ serious issues noticed relating to the working of the RRBs and their financial position should be communicated by the nominee directors to their parent offices (i.e., their nominating authorities).

DON'T's

A) Non-interference:

- 1) Don't interfere in the day-to-day functioning of the bank.
- 2) Don't involve yourself in matters of personnel administration of the bank such as transfers, postings, promotion etc. of any of its employees.

- 3) Don't give instructions/ directions to any individual officer/ staff of the bank on any matter at any time. Route such instructions / directions through the Chief Executive of the bank.
- 4) Don't do any such thing which will interfere with and/ or be subversive of maintenance of discipline, good conduct and integrity of the staff.

B) Non-sponsorship

- 1) Don't sponsor any loan proposal, buildings and sites for bank's premises, enlistment or empanelment of contractors, architects, doctors, lawyers etc.
- 2) Don't approach or influence for sanction of any kind of facility.
- 3) Don't encourage any individual officer/ staff of the bank for approaching you in any matter of personal interest.
- 4) Don't accept any facility / obligation from the bank or from any of its employees.
- 5) Don't insist on availment of such facility from any employee/ branch manager of the bank for which neither he/ she is authorized, nor competent to provide.
- 6) Don't participate in the discussions in the Board meeting on a proposal in which you are directly or indirectly involved. Disclose your interest well in advance to the Chairman of the Board.
- 7) Don't sponsor any candidate for recruitment or promotion or posting or transfer etc.

C) Confidentiality

- 1) Don't reveal the discussions at the Board meetings to any of the bank employees / other persons as you are under oath of secrecy and fidelity.
- 2) Don't show the bank's agenda papers/ notes to anybody. Return those papers to the bank after the meeting.
- 3) Don't call for papers, files, notes etc. related to agenda items of the Board meeting directly from the departments concerned. All information/ clarification which is necessary, should be made available by the Chairman/ Chief Executive of the bank.
- 4) Don't display the logos or distinctive design of the bank on your visiting card/ letterhead. Indicate only your directorship of the bank on your visiting card or letterhead.

4. Conduct of Meetings

4.1 Meetings of the Board

The conduct of meetings of the Boards of Directors of RRBs is governed by the RRB (Meeting of the Board) Rules.

The Board is required to hold at least six meetings in a year and at least one meeting in every quarter. The meetings are convened by the Chairman and are held at the office of the bank or at any other place in the notified area as the Board may decide.

Generally, the Chairman of the RRB presides over meeting of the Board of Directors. However, in his absence, any Director who has been authorized by the Chairman to preside or any director in relation to any particular meeting will preside over the Board.

In circumstance where in the absence of both the Chairman and the authorised Director, the Directors present at the meeting have to select one among themselves to preside over the meeting. It is generally expected that the nominee directors representing institutions like RBI, NABARD should not prefer to act as pro-tem Chairman in view of their regulatory and statutory responsibilities. Further, it should be ensured that during the absence of the regular Chairman, decisions which have implications on the long term policy perspective of the bank should be avoided.

4.2 Notice of meetings

A notice of at least fifteen days is required to be ordinarily given to every director for a meeting of the Board. The notice is sent to the director at the address specified by him in this behalf and a list of business proposed to be transacted at the meeting is circulated along with the notice.

The rules stipulate that no business, other than that for which the meeting was convened, can be transacted at a meeting of the Board except with the consent of the Chairman and majority of the Directors present, unless one week's notice of such business has been given in writing to the Chairman.

4.3 Special meetings

The Chairman can call a meeting of the Board after a written request has been received by him from not less than four directors. The requisition should state the purpose for which the meeting is required to be called. Such meetings are required to be held within 21 days from the date of

receipt of such requisition. The Chairman may also summon urgent meeting of the Board, for which a notice of at least seven days is required to be given to each director.

4.4 Quorum

A quorum of one third of the total number of directors or four whichever is higher, is required for holding a meeting of the Board.

Section 14 of the RRBs Act, 1976 stipulates that no director shall take part in the discussion of, or vote on, any contract, loan, arrangement or proposal entered into or to be entered into by or on behalf of the RRB, if he is, in any way, whether directly or indirectly, interested in the contract, loan, arrangement or proposal, and where he does so, his presence at the meeting shall not count for the purpose of forming any quorum at the time of any such discussion or vote. In such a case, the quorum shall be three.

If a meeting of the Board could not be held for want of quorum, then the meeting automatically stands adjourned till the same day next week, at the same place and time. If that day is a public holiday, the meeting is held on the next succeeding day, which is not a public holiday.

4.5 Agenda notes

Before the agenda of the present meeting is taken up, the Board of Directors need to confirm the minutes of the previous Board Meeting and follow-up of the decisions taken during the previous Board Meetings. Another important issue which call for attention of the Board of Directors is the Review of sanctions made by the Chairman since the last Board Meeting and confirm his actions wherever required. Though chairmen of most of the banks are prudent in exercising their powers, the Board of Directors needs to be cautious on the issue.

Some other issues which call for scrutiny include Important communications/ letters received from NABARD/ RBI/ GOI/ Sponsor Bank and action taken by the bank on these communications/ instructions, performance of the bank under Annual Action Plan (AAP), Performance review against Memorandum of Understanding (MOU), if any, classification of investments (i.e, held for trade, held till maturity, marked for sale), Profit & Loss Account for the quarter etc. A detailed list of the common agenda items and the issues for each quarter are given in the Annex to this chapter.

It is expected that generally all directors would come well prepared for the agenda to be taken up at the meeting. Nominee directors representing institutions viz. RBI, NABARD and sponsor banks have a special responsibility to ensure that the agenda to be taken up and the decisions to be taken at the meeting do not clash with the policy guidelines issued by their institutions.

If the directors are not able to attend the Board meeting, they should convey their views / comments on the important items of agenda to the Chairman by letter / fax/ e-mail.

4.6 Recording of Business

The proceedings and the decisions taken at the meeting of the Board are recorded in a book called 'Minute Book', which need to be signed by the Chairman or the person who presides over the meeting. Though generally the Copies of such minutes are forwarded to each Director by

post, it is better if the latest available communication means are used in transmitting the minutes. As indicated earlier, the minutes of each meeting are placed before the next meeting for confirmation. Sometimes, there is a lack of follow-up of the decisions taken at the meetings and the directors rely entirely on the feedback given by the bank. Such situation should be avoided in the best interest of the directors and the institutions they are representing.

4.7 Business by Circulation

At times, the issues are also referred to the directors for their decisions by mail or post which is called as 'Business by Circulation'. Generally issues on which the chairman needs the opinion of the directors on certain urgent policy issues come under this category. Though in very few occasions such events take place, the law does recognize such decisions. Any business circulated and approved through this method require necessary quorum as in the normal Board meeting. The result of mandate of by such meeting will be as effective and binding as if business were decided by the directors present at Board meeting.

When a business is transacted by circulation, a record of business so transacted needs to be minutised and also signed by the Chairman and entered in the Minutes Book. However, it is desirable that this method may be resorted to only when urgent policy intervention is necessary and should not be resorted to in a routine manner.

4.8 Recording of dissent

The decision on the issues discussed in the Board is by a majority of the votes by the Directors present and voting. However, in case equality of votes on any issue, the Chairman has a second or casting vote.

If there is a dissent by a Director/ Directors on any agenda item placed for transacting the business in a meeting, it has to be properly recorded, along with the reasons for the dissent.

Common agenda to be placed in every Board Meeting

01. Confirmation the minutes of the previous Board Meeting.
02. Follow up action of decisions taken during the previous Board Meetings.
03. Review of financial position of 1/6th of the total branches by rotation.
04. Review of sanctions made by the Chairman since the last Board Meeting.
05. Review of SLR/CRR position of the Bank and particulars of Investments made since the last Board Meeting.
06. Review of pending disciplinary cases/ fraud cases and follow-up thereof.
07. Position of suit-filed accounts and execution of petitions in various courts by the Bank.
08. Internal control and House Keeping of the Bank:
 - a) Balancing,
 - b) Interest checking,
 - c) DD reconciliation,
 - d) Items in Sundry Assets/ Sundry Liabilities for more than 3 months.
09. Statement of latest financial position and deployment of funds.
10. Important communications/ letters received from NABARD/ RBI/ GOI/ Sponsor Bank and action taken thereon.
11. Progress under KCC/ SHGs/ SGSY and review thereof.
12. Review of performance of the Bank under top 50 NPA accounts and total NPA position of the Bank.
13. Position under court cases in various suits filed by the employees and others against the Bank/ by the Bank (other than for recovery of loans).
14. TA paid to Chairman for review and approval.
15. Overdue position of the Bank.

In additions to the common agenda the following are placed in the 1st quarter:

01. Branch rationalisation programme for the year viz., Branch expansion, conversion of satellite branches, closure and merger of branches.
02. Adoption of audited financial statements.

03. Classification of investments (i.e, held for trade, held till maturity, marked for sale).
04. Note on loss making branches.
05. Performance of the bank under Annual Action Plan (AAP).
06. Performance review against Memorandum of Understanding (MOU).
07. Seeking permission of the Board to apply for re-finance limits from Sponsor Bank/ NABARD.
08. Review of the Investments as at March (i.e., closure of the year).

In additions to the common agenda the following are placed in the 2nd quarter:

01. Recovery performance based as per Demand Collection Balance (DCB) Register.
02. Performance of the Bank under Annual Action Plan.
03. Performance review against Memorandum of Understanding (MOU).
04. Review of loans and advances sanctioned by the Board.
05. Profit & Loss Account for the quarter.

In additions to the common agenda the following are placed in the 3rd quarter:

01. Review of investments.
02. Performance review against Memorandum of Understanding (MOU).
03. Performance of the bank under Annual Action Plan.
04. Profit & Loss Account for the quarter.

In additions to the common agenda the following are placed in the 4th quarter:

01. Review of investments.
02. Performance review against MOU.
03. Performance of the bank under Annual Action Plan.
04. Review of loans and advances sanctioned by the Board.
05. Profit & Loss Account for the quarter.

5. Understanding Financial Management

Banks are financial intermediaries and resources mobilized by them in the form of deposits or through borrowings are required to be gainfully deployed so as to meet the cost of funds and also to generate some surplus. After meeting the statutory requirements of Cash Reserve (CRR) and liquidity (SLR), the funds available are to be used for lending or investment. This chapter deals with some fundamental principles of lending and investment and highlights the role of the Board of Directors in evolving suitable policies and monitoring compliance by the bank.

5.1 General principles of sound lending

Though lending is a basic function of a bank, the bank is expected to take care of the inherent risks in the business of lending. It is required to follow a cautious policy while lending in order to minimize risks.

Safety

The banker owes a duty to his depositors to employ their money judiciously, so that losses might be avoided.

Liquidity

It is not enough that the money that the bank lends should come back, but it should come back fairly quickly and not get tied up for an unduly long period.

Profitability

No business institution can afford to run the business in loss and banks are no exception. Unless a bank earns profits, it cannot pay interest to its depositors and meet its establishment costs. The bank must, therefore be able to build up adequate reserves out of profits and strengthen its financial position.

Diversification

A banker must avoid concentration of advances to a few borrowers and should spread out the risk over a large number of borrowers, variety of activities and larger geographical areas.

National interest

RRBs are required to lend to the priority sector which comprises agriculture, small scale industries and other activities/ areas such as small business and retail trade, housing,

professional and self-employed persons, education, micro finance etc. Targets have been stipulated for lending to priority sector (60 per cent of total credit) and the weaker sections (15 per cent of total credit). While lending, RRBs have to keep in mind these targets.

5.2 Lending policy of the bank

The Board of Directors must oversee the bank's operations to ensure that the bank operates in a safe and sound manner and that risks to the institution are properly controlled. In doing so, it establishes policies in major areas and holds the management accountable for implementing these policies.

Each bank is required to have a lending policy, taking into account, inter alia, the areas/ activities to be treated as thrust areas for financing, the lending norms including interest rates, margin and security norms, the types of loans to be granted, and the follow-up and recovery measures. The policy should also stipulate the powers and the responsibilities of the officers at various levels within the bank in regard to sanction of loans and the mechanism for reporting to Controlling Office/ Head Office etc. at periodic intervals.

Because of today's more complex business environment, it is critically important that directors understand and assess the potential or prospective impact of risk positions on bank performance. Managing risk prospectively means measuring it accurately, understanding its implications and ensuring that appropriate risk management systems are in place before the risk leads to problems for the bank.

5.3 Prudential norms relating to lending

In order to reflect a bank's actual financial health in its balance sheet and as per the recommendations made by the Committee on Financial System (Chairman: Shri M. Narasimham), Reserve Bank of India has introduced, in a phased manner, prudential norms for (i) income recognition, (ii) asset classification and (iii) provisioning for the advances portfolio of the RRBs.

Broadly, 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. Availability of security or net worth of the borrower/ guarantor should not be taken into account for the purpose of treating an advance as non-performing asset or otherwise. Lastly, the provisioning should be made on the basis of the classification of assets into different categories.

Non-Performing Assets

An asset becomes non-performing when it ceases to generate income for the bank. Except for agricultural loans, a non-performing asset is at present defined as (i) a loan or an advance where interest and/or installment of principal remain overdue for more than 90 days, (ii) a cash credit / overdraft account which remained out of order for more than 90 days and (iii) a bill purchased/discounted which remained overdue for more than 90 days. Any amount due to the

bank under any credit facility, if not paid by the due date fixed by the bank becomes overdue. An amount will be out of order if the outstanding balance remains continuously in excess of either the sanctioned limit or drawing power or there is no credit continuously for 90 days as on balance sheet date or credits are not enough to cover the interest debited during the same period.

Income should be recognized only when actually received and not on accrual basis. Banks should not charge and take into income account interest on any NPA.

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

If any account becomes NPA as at the close of any year, interest accrued and credited to income account in the corresponding previous year, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

Asset classification

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

- a) Sub-Standard Assets
- b) Doubtful Assets
- c) Loss Assets

Sub-Standard Assets

With effect from 31 March 2005, a sub-standard asset is one, which has remained NPA for a period not exceeding 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.

Doubtful Assets

With effect from March 31, 2005, an asset is classified as doubtful if it has remained in the sub-standard category for 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, 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.

Loss Assets

A loss asset is one where loss has been identified by the bank or internal or external auditors or the NABARD 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.

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.

Asset classification should be based on credit weaknesses and extent of dependence on collateral security for realization of dues. Treatment of accounts as NPAs should be based on record of recovery or threat of loss or recoverability being in doubt. The availability of security / networth of borrower or guarantor should not be taken into account for the purpose of treating an account as NPA.

Banks are required to 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. Identification of assets as NPAs should be done on an ongoing basis.

Agricultural advances

The NPA norms applicable for agricultural advances were revised in July 2004. According to the revised guidelines, a loan granted for short duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for two crop seasons and a loan granted for long duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for one crop season. For the purpose of these guidelines, "long duration" crops are those with crop season longer than one year and crops, which are not "long duration" crops, are 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 (SLBC) in each State. Depending upon the duration of crops raised by a farmer, the above NPA norms would also be made applicable to agricultural term loans availed of by him. The above norms are applicable to direct agricultural advances only. They are not applicable in the case of activities allied to agriculture, such as dairy, poultry, fishery etc.

Provisioning norms

The primary responsibility for making adequate provisions for any diminution in the value of assets is that of bank management and statutory auditors.

In conformity with the prudential norms, provisions are required to be made on the non-performing assets on the basis of classification of assets into prescribed categories as shown below:

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.

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

Sub-standard 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.

Standard assets

Banks have been advised to make general provision for standard assets at the following rates:

- (a) direct advances to agricultural and SME sectors at 0.25 per cent;
- (b) all other advances at 0.40 per cent.

5.4 Investment by RRBs

At present, investments of banks comprise SLR securities and non-SLR securities. These investments are classified in the balance sheet, for the purpose of disclosure, under five groups viz., (i) Government securities, (ii) Other approved securities, (iii) Shares, (iv) Debentures & Bonds, and (v) Others (CP, Mutual Fund Units, etc.). While the first two classifications represent the banks' investments in SLR securities, the others represent the non-SLR securities. Investments should be shown in the balance sheet net of depreciation.

Banks are also required to classify their entire investment portfolio under two categories, viz. permanent and current. The entire SLR portfolio can be classified as permanent, while the entire Non-SLR portfolio would be classified as current.

SLR investments

In terms of Section 24 of the Banking Regulation Act, 1949, all commercial banks including Regional Rural Banks are required to maintain Statutory Liquidity Ratio (SLR) at 25 percent of their Net Demand and Time Liabilities (NDTL) in cash or gold or in unencumbered approved securities. In the case of RRBs, the balances maintained by them in call or fixed deposits with their sponsor banks were earlier treated as "cash" and hence, reckoned towards their maintenance of SLR. However, as a prudential measure, it was felt desirable that RRBs should maintain their entire SLR portfolio in government and other approved securities and accordingly, all RRBs were advised in April 2002 to maintain their entire SLR holdings in government and other approved securities, by converting existing deposits with sponsor banks into government securities by March 31, 2003. Subsequently, they were advised that deposits maturing beyond March 2003 may be allowed to continue till the date of maturity. All banks are encouraged to hold government securities in demat format in the CSGL accounts. Board should prepare a plan of investment in government securities at the beginning of every year. Sponsor banks are required to tender advice and guidance to the bank in this regard.

Presently, RRBs have been exempted from the 'mark to market' norms in respect of their SLR-securities. Accordingly, RRBs have been given freedom to classify their entire investment portfolio of SLR-securities under permanent category' with valuation on book value basis. Permanent" investments should be valued at cost and in case the cost price is higher than the face value, the premium should be amortized over the remaining period of maturity of the security. On the other hand, where the cost price is less than the face value, the difference should be ignored and should not be amortized or taken to income account since the amount represents unrealised gain.

Non-SLR investments

As part of the overall package of measures designed to improve their operational efficiency and profitability, in January 1995 RRBs were provided access to profitable avenues for investment of their non-SLR surplus funds after meeting their target group and service area obligations. Since then, the target group lending has been replaced with the priority sector lending concept. Detailed guidelines have also been issued from time to time to RRBs by Reserve Bank of India on investment in non-SLR securities, keeping in view the need to contain the risks arising out of the non-SLR investment portfolio covering debt instruments/ securities issued by corporates, banks, All India Financial Institutions, and State and Central Government sponsored institutions etc. RRBs have been given parity with other commercial banks over choice of investment avenues.

Some important points of regulatory requirements governing investment by RRBs are as under:

- Banks should not invest in Non-SLR debt securities of original maturity of less than one- year other than commercial paper and certificates of deposits.
- 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.

- Banks must not invest in unrated debt securities, unlisted securities and unlisted shares of All-India Financial Institutions.
- Banks should make their own internal credit analysis and rating even in respect of rated issues and not entirely rely on the ratings of external agencies, and 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.
- RRBs should make investment in non-SLR securities in dematerialized form only.
- The Board of Directors of banks should fix a prudential limit for their total investment in non-SLR securities subject to existing limits prescribed by RBI and sub-limits for the following listed debt securities:
 - a) bonds of public sector undertakings
 - b) bonds of All-India Financial Institutions
 - c) unsecured redeemable bonds floated by nationalised banks
 - d) infrastructure bonds floated by All India financial Institutions
 - e) units of UTI.

While there is no ceiling on investments covered under a) to d) above, the investments covered under e) should not exceed 5 per cent of incremental deposits at the end of the preceding financial year.

5.5 Investment policy Role of the Board of Directors

Investment policies are required to be formulated by each bank duly approved by the Board of Directors, after taking into account all the relevant issues specified in the guidelines on non-SLR investments issued by RBI. Banks should put in place proper risk management systems for capturing and analyzing the risk in respect of non-SLR investments 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.

The Board should devise a system to ensure that the prudential limits prescribed for investment are scrupulously complied and should appropriately address the issue of ensuring compliance with the prudential limits on an ongoing basis.

The Board of Directors should, in particular, review the following aspects of non-SLR investments twice a year:

- a) Total business (investment and divestment) during the reporting period;
- b) Compliance with the prudential limits prescribed by the Board for non-SLR investments;

- c) Rating migration of the issuers/ issues held in the bank's books and consequent diminution in the portfolio quality; and
- d) Extent of non-performing investments in the non-SLR category.

Non-performing investment

A non-performing investment (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, 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 issued by the same issuer would also be treated as NPI.

Valuation of Investments

All non-SLR Investments should be marked to market script wise at the year end or at more frequent intervals. Net depreciation under each classification would be recognized and fully provided for and net appreciation under each category would be ignored. Net depreciation should be held under IFR account. Book value of each individual scrip will not undergo any change. Provision for depreciation should be debited to P/L account. If provision created on account of depreciation in any year is found to be in excess, then the excess should be credited to P/L account and an equivalent amount (net of tax and transfer to statutory reserve) should be appropriated to IFR. If interest and principal is in arrears, interest should not be reckoned and appropriate provisions should be made. Depreciation should not be set off in respect of these NPIs against appreciation in respect of standard securities under the category concerned.

General guidelines

The investment policy should establish responsibility for administration of the investment portfolio, list of acceptable types of investments, specify approximate quality and quantity, giving consideration to legal requirements, liquidity needs, etc. A reasonable distribution of maturities should be established and tailored to the bank's liquidity requirements.

Diversification of portfolio should be considered to avoid concentrations by issuer, type of investment and locale. Sufficient analytical data must be provided for review, on a regular basis, to allow the Board and senior management to make an informed judgment of the effectiveness of the investment policy. The policy should also designate the officer/s to whom the Board delegates responsibility for day-to-day management of the portfolio, and those officers to whom authority has been granted for purchasing and selling of securities.

The extent and the parameters of the investment policy will, however, vary and depend on individual bank's needs, complexity of the portfolio and expertise of the management. The policy should be reviewed annually by the Board and re-affirmed.

5.6 Interpretation of financial statements

Financial statements are necessary sources of information about companies, including banks, for a wide variety of users. Users of financial statement information do not necessarily need to know everything about accounting to use the information in basic statements. However, to effectively use financial statement information, it is helpful to know a few simple concepts and to be familiar with some of the fundamental characteristics of basic financial statements. The most important financial statements are the Income Statement (Profit and Loss Account) and the Balance Sheet.

The Income Statement (Profit and Loss Account)

The Income Statement shows a bank's income and expenses during the accounting year. A bank's income comprises (i) interest income, (ii) treasury income and (iii) other/ fee-based income. Similarly, the costs incurred by a bank would include (i) Interest expenditure, (ii) Non-interest expenditure or Operating Costs, (iii) Staff costs, (iv) Overheads and (v) Provisions or Risk Costs.

The factors that would need to be analysed in the case of the Profit and Loss Account are, therefore, the following:

- 1) Total Interest Income
- 2) Total Non-Interest Income
- 3) Total Interest Expenditure
- 4) Total Non-Interest Expenditure
- 5) Provisions & Write Offs

From these data, other useful information can be derived as under:-

- Operating Income = Total Income (1+2)
- Operating Profit = (1 + 2) (3 + 4)
- Net Profit = Operating profit 5
- Net Interest Income = 13

If the bank has earned a profit, the source of the profit needs to be analysed. It has to be seen whether the profit or increase in profit is mainly due to treasury income and a lower level of loan loss provisions; if so, the profits may not be sustainable on a longer time horizon.

The Balance Sheet

The Balance Sheet is a statement detailing what a company owns (assets) and claims against the company (liabilities and owners' equity) as on a particular date. The balance sheet must balance - that's why it's called a balance sheet - and the concept of balancing relies on the accounting equation : "Assets = Liabilities + Owner's Equity". In other words, the assets must equal the claim on assets. Balance sheets may be quite detailed depending on the nature and complexity of a business, including the business of banking. Regardless of their complexity, however, the same basic notions of construction apply.

Source of funds

These appear on the liability side of the Balance Sheet. Apart from the paid-up capital and reserves, the source of funds for a bank would include deposits, borrowings including refinance and profits retained in business.

There is no restriction in respect of avenues for mobilization of deposits by RRBs. Deposits can be mobilized from the public at interest rates which are to be fixed by the banks themselves. Deposits include both demand deposits and time deposits; but the cost of getting long-term deposits is higher. Hence, it would be worthwhile to mobilize major chunks of deposits under demand deposits and short term fixed deposits so as to keep the cost of funds at a lower level.

As regards borrowings, RRBs obtain refinance from their sponsor banks as well as from NABARD for various purposes at relatively lower interest rates. RRBs financing the small and medium enterprise (SME) sector are also eligible for refinance from the Small Industries Development Bank of India (SIDBI).

Deployment of funds

Funds are deployed in various forms of assets. Apart from the fixed assets in the form of land and building etc., and a small part of the assets being held as 'cash in hand', the main items on the asset side are balances with other banks (including sponsor banks), loans and investments. The basic principles of lending and investment including the prudential norms as applicable in the case of RRBs, have already been dealt with in the earlier sections of this chapter.

5.7 Interpretation of Major Ratios

One of the ways in which financial statements can be put to work is through ratio analysis. In finance, ratios are usually two items in the financial statement that may be related to one another and may provide the prudent user a good deal of information. Of the myriad of ratios that could be generated, some will be more meaningful than others. Some of these ratios, together with their interpretation, are furnished below.

Nature of Ratios	Interpretation of Ratios	Remarks
BUSINESS RATIOS		
Non-earning assets to total assets	Higher the percentage, lower the efficiency of assets	Needs to be reduced
High cost borrowings to total borrowings	Higher the percentage, higher the cost to the bank	Needs to be reduced
Overdues/ NPAs to total outstanding advances	Higher the percentage, higher the risk	Needs to be reduced
Cash and balances with other banks in current account to total assets	Higher the ratio, lower the profitability	Needs to be reduced
High yielding investments to total investments	Higher the percentage, higher the yield	Needs to be increased
High yielding loans and advances to total loans and advances	Higher the percentage, higher the yield	Needs to be increased
Interest income to recovery	Higher the ratio, higher the cash earnings	Needs to be increased
Balance outstanding per deposit account	Higher the amount, lower the transaction cost	Needs to be increased
Balance outstanding per loan account	Higher the amount, lower the transaction cost	Needs to be increased
Business (deposits plus advances) per employee /per branch	Indicates the level of efficiency	Needs to be increased
PROFITABILITY RATIOS		
Total yield (income) to working fund (total assets or liabilities)	Higher the ratio, better the management of funds	Needs to be increased
Total cost (expenses) to working fund	Lower the ratio, better the resource management	Needs to be reduced
Miscellaneous income to working fund	Indicates earnings from non-fund based activities. Higher the ratio, better the profitability.	Needs to be increased
Transaction cost to working fund	Indicates cost of management of business. Lower the ratio, better the profitability	Needs to be reduced
Risk costs (loan loss provisions made) to working fund	Lower the ratio, better the profitability	Needs to be reduced

5.8 Risk management

The concept of risk in banking

The term 'risk' is generally associated with financial losses, but is more accurately described as an uncertainty that could result in losses or adverse fluctuations in profitability. By virtue of their nature of business, the banks face a significant number of risks which can be categorized as follows:

- Credit risk
- Market risk
- Operational risk
- Liquidity risk

Credit Risk

Credit risk refers to the risk of non-payment of loans or investments made by the bank. As lending and investment constitute the main activities of a bank, credit risk is the major risk faced by banks. While there are various models for managing credit risk, some prudential limits are necessary to start with, so that the magnitude of credit risk can be limited. The prudential limits include the following:

- a. stipulate benchmark current/ debt-equity and profitability ratios for the borrower, debt service coverage ratio or other ratios, with flexibility for deviations. The conditions subject to which deviations are permitted and the authority therefor should also be clearly spelt out in the Loan Policy;
- b. single/ group borrower limits (exposure limits), which may be lower than the limits prescribed by Reserve Bank of India, to provide a filtering mechanism;
- c. substantial exposure limit i.e. sum total of exposures assumed in respect of those single borrowers enjoying credit facilities in excess of a threshold limit, say 10 per cent or 15 percent of capital funds.
- d. Maximum exposure limits to industry, sector, etc.

Credit risk can also be lowered through proper appraisal of loans and investment proposals, and proper follow-up of loans.

Market risk

Banks deal with assets the prices of which often fluctuate. Market risk is the risk associated with adverse fluctuations in market prices. It could relate to changes in interest rates, equity prices or foreign exchange rates, which are market determined parameters. Banks may become exposed to market risk through their proprietary trading (i.e., trading on their own account) or as a consequence of their customer business. Historically, credit risk has caused the most problems for banks worldwide, but the speed with which market risk can translate into losses explains why banks are eager to control this risk.

The Board of Directors of a bank should clearly define market risk management policies, procedures, prudential risk limits, review mechanisms and reporting and auditing systems. The policies should address the bank's exposure on a consolidated basis and clearly articulate the risk measurement systems that capture all material sources of market risk and assess the effects on the bank. The operating prudential limits and the accountability of the line management should also be clearly defined.

The Asset-Liability Management Committee (ALCO) (described later in greater detail) should function as the top operational unit for managing the balance sheet within the performance/ risk parameters laid down by the Board. The banks should also set up an independent Middle Office to track the magnitude of market risk on a real time basis. The Middle Office should comprise of experts in market risk management, economists, statisticians and general bankers and may be functionally placed directly under the ALCO. The Middle Office should also be separated from Treasury Department and should not be involved in the day to day management of Treasury. The Middle Office should apprise the top management / ALCO / Treasury about adherence to prudential / risk parameters and also aggregate the total market risk exposures assumed by the bank at any point of time.

Operational risk

Operational risk can be defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events". Operational risk, therefore, includes losses that arise from events such as:

- internal fraud
- external fraud
- clients, products and business practices
- damage to physical assets
- business disruption and system failures
- execution, delivery and process management

Developments such as the use of automated technology, e-banking, outsourcing, innovative financial techniques, mergers and acquisitions, and so on, often expose banks to a higher degree of operational risk than before. In fact, over the last few years, operational risk has emerged as the second largest risk that banks face after credit risk

Liquidity risk

Liquidity planning is an important facet of risk management framework in banks. Liquidity is the ability to efficiently accommodate deposit and other liability decreases, as well as, fund loan portfolio growth and the possible funding of off-balance sheet claims. A bank has adequate liquidity when sufficient funds can be raised, either by increasing liabilities or converting assets promptly and at a reasonable cost. It encompasses the potential sale of liquid assets and borrowings from money, capital and forex markets.

The bank is also exposed to a maturity mismatch, creating a potential funding gap. Funding a 5-year asset with a 1-year loan exposes the bank to liquidity risk. This is because, after one year, funding will need to be renewed. In practice, banks often enter into sequential short-term loans, often referred to as rollover funding.

In order to address liquidity risk, the bank should also evolve a system for monitoring high value deposits (other than inter-bank deposits) to track the volatile liabilities. The liquidity profile of banks also depends on the market conditions, which influence the cash flow behaviour. Thus, banks should evaluate liquidity profile under different conditions, viz. normal situation, bank specific crisis and market crisis scenario. The banks should establish benchmark for normal situation, cash flow profile of on / off balance sheet items and manages net funding requirements. Further, the cash flows arising out of contingent liabilities in normal situation and the scope for an increase in cash flows during periods of stress should also be estimated. It is quite possible that market crisis can trigger substantial increase in the amount of draw downs from cash credit/ overdraft accounts, contingent liabilities like letters of credit, etc.

The risk management process

Generally, a committee approach to risk management is being adopted by banks. While the Asset - Liability Management Committee (ALCO) deals with different types of market risk, the Credit Policy Committee (CPC) oversees the credit / counterparty risk. Thus, market and credit risks are managed in a parallel two-track approach in banks. Banks could also set-up a single Committee for integrated management of credit and market risks. Generally, the policies and procedures for market risk are articulated in the ALM policies and credit risk is addressed in Loan Policies and Procedures.

The management of credit risk should encompass the following:

- a. Measurement of risk through credit rating/ scoring;
- b. Quantifying the risk through estimating expected loan losses i.e. the amount of loan losses that bank would experience over a chosen time horizon (through tracking portfolio behaviour over 5 or more years) and unexpected loan losses i.e. the amount by which actual losses exceed the expected loss (through standard deviation of losses or the difference between expected loan losses and some selected target credit loss quantile);
- c. Risk pricing on a scientific basis; and
- d. Controlling the risk through effective Loan Review Mechanism and portfolio management.

5.9 Asset-Liability Management (ALM)

Guidelines have not been issued specifically to the RRBs in regard to asset-liability management (ALM) so far. However, given the types of business the RRBs are now handling and the growth in their assets/ liabilities consequent upon amalgamation, as a result of which they are exposed to risks in a bigger way, there is need for these banks to be aware of ALM techniques as a tool for

managing risk. While it may be difficult to have assets and liabilities of the same maturities, same volumes etc., the crux of ALM is to ensure that assets and liabilities move together; if not, the gap between them is taken care of.

The ALM process rests on three pillars:

- ALM Information Systems
 - ◆ Management Information Systems (MIS)
 - ◆ Information availability, accuracy, adequacy and expediency
- ALM Organisation
 - ◆ Structure and responsibilities
 - ◆ Level of top management involvement
- ALM Process
 - ◆ Risk parameters
 - ◆ Risk identification
 - ◆ Risk measurement
 - ◆ Risk management
 - ◆ Risk policies and procedures, prudential limits and auditing, reporting and review.

ALM has to be supported by a management philosophy which clearly specifies the risk policies and procedures and prudential limits. This framework needs to be built on sound methodology with necessary information system as back up. Thus, information is the key to the ALM process.

ALM Organisation

Successful implementation of the ALM/ risk management process would require strong commitment on the part of their boards and senior management. The board should have overall responsibility for management of risks and should decide the risk management policy and procedures, set prudential limits, auditing, reporting and review mechanism in respect of liquidity, interest rate and forex risks.

The Asset - Liability Committee (ALCO) consisting of the bank's senior management including the Chief Executive Officer, should be responsible for ensuring adherence to the policies and limits set by the Board as well as for deciding the business strategy in line with the bank's business and risk management objectives.

The ALM Support Groups consisting of operating staff should be responsible for analysing, monitoring and reporting the risk profiles of the bank's business to the ALCO. The staff should also prepare forecasts based on simulations showing the effects of various possible changes in market conditions and recommend the action needed to adhere to bank's internal limits.

The ALCO is a decision making unit responsible for planning from risk-return perspective including the strategic management of liquidity, interest rate and forex risks. The business and risk management strategy of the bank should ensure that the bank operates within the limits / parameters set by the Board. The business issues that an ALCO considers, inter alia, includes pricing of both deposits and advances (i.e., fixing the interest rates), desired maturity profile and mix of the incremental assets and liabilities, etc. In addition to monitoring the risk levels of the bank, the ALCO reviews the results of and progress in implementation of the decisions made in the previous meetings. The ALCO's future business strategy decisions should be based on the banks views on current interest rates. In respect of the funding policy, for instance, its responsibility would be to decide on source and mix of liabilities or sale of assets. Towards this end, it will have to develop a view on future direction of interest rate movements and decide on funding mixes between fixed vs. floating rate funds, wholesale vs. retail deposits, short term vs. long term deposits etc. Individual banks will have to decide the frequency for holding their ALCO meetings depending on their own business levels, risk profile and other requirements.

Composition of ALCO

The size (number of members) of ALCO would depend on the size of each RRB, level of business and organisational structure. To ensure commitment of the Top Management and timely response to market dynamics, the CEO (Chairman) should head the Committee. The Chiefs of Investment/ Treasury including Credit, Planning, etc can be members of the Committee. In addition, the Head of the Information Technology Division, if a separate division exists, should also be an invitee for building up of Management Information System (MIS) and related IT network. Banks may at their discretion even have Sub-committees and Support Groups.

5.10 Recovery and NPA Management

As noted earlier, non-recovery of loans in time resulting in non-performing assets (NPAs) has been a major problem in all banks, more so in RRBs which generally operated on a low funds base. The gross NPA level of RRBs at the aggregate level which stood at 12.8 per cent as at the end of March 2005 has reduced to 6.39 per cent as at the end of March 2007, but is still higher than the gross NPAs of the commercial banks. A higher NPA increases the effective cost of lending and prevents proper recycling of funds. Several measures have, therefore, been put in place by these banks to improve recovery and reduce the level of NPAs.

As a part of NPA management, recovery of NPA dues from borrowers is accorded top priority by RRBs as it helps the banks to recycle the funds for providing further credit. In order to improve further the recovery performance of RRBs, following measures have been taken:

- Formulation of transparent recovery policy indicating role of branch managers/ field officers /Area Office/ Controlling Office/ Head Office,
- Recovery through courts and existing legal system in chronic/ wilful cases of default,
- Recovery with the help of the government machinery (the district administration), particularly under government-sponsored programmes,

- Introduction of One Time Settlement Scheme for chronic NPAs,
- Recovery through compromise settlement on case-to-case basis in respect of sticky advances,
- Approaching Lok Adalats for recovery of chronic overdues,
- Involvement of NGOs, Self Help Groups and Farmers' Clubs in the recovery of loans,
- Tie up with other agencies (Sugar factories, Milk Societies etc.) for recovery of loans,
- Introduction of package of incentives for regular and prompt payment of dues by the borrowers.
- Making the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act applicable to RRBs.

6. Control Mechanism and Mis

6.1 The control process

Managerial control process seeks to ensure that performance of an organization conforms to the plans and is in tune with the organizational objectives. The three basic steps in a control process are (i) establishing standards, (ii) measuring performance against the set standards and (iii) correcting deviations from the standards. The success of a banking organization depends a lot on effective controls to ensure that public money is used most effectively and efficiently and that the corporate objectives are achieved.

6.2 Delegation of powers

Flow of authority in the RRB originates from the Chairman, who is the Chief Executive of the bank. Authority flows from the Chairman to the General Manager and down to the departmental heads and branch managers. Some RRBs have also delegated powers to various operational committees in the departments and to specific cells designed to help the departmental heads. Delegation of adequate powers to the branch manager facilitates efficient customer service and minimizes complaints.

6.3 Submission of control returns

Prescribing certain basic statements to be submitted periodically by the branches to the Head Office of the bank as control returns is yet another instrument of control. The statements should clearly specify the type of information to be submitted and the manner and the periodicity with which these should be submitted by the branches. At the branch level, a record of such statements has to be maintained, while at the Head Office level, adequate arrangements should be put in place to properly scrutinize the statements and see if any improvement in functioning is necessary.

6.4 Internal Audit and Inspection

In keeping with the overall objective of inspection which is to aid the management in achieving efficiency and effectiveness in operations, internal audit/ inspection provides the management with observations relating to whether the policy and plans of activities prescribed by the management have been implemented and whether the checks are being followed adequately so that corrective measures can be taken when required.

While audit is a quantitative analysis of the operations and is primarily concerned with correct and honest record keeping in accordance with sound accounting principles and statutory requirements, inspection is somewhat broader in scope and includes not only elements of audit, but also a qualitative view of the management systems being followed in the organization.

Internal inspection which is conducted by officials posted to the internal audit and inspections cell of the Head Office of the same bank, covers the entire gamut of operations such as maintenance of cash balance, current and other accounts of the bank, internal accounts including suspense and sundry deposits accounts, record of dead stock and stationery, balancing of the books of accounts, use of delegated and discretionary powers, quality of loan assets, investments made by the bank etc.

6.5 Surprise visits

Surprise visits by Head Office functionaries including the Chairman and the General Manager as also the Area Manager are very important checks. Among others, these visits also help in addressing the problems faced by the branch and improving the business level.

6.6 External audit and inspection

In addition to internal audit/ inspection, RRBs also have to undergo external audit/ inspection by (i) statutory auditors, (ii) NABARD and (iii) the sponsor bank.

6.6.1 Statutory audit

In terms of Section 19 (1) of the RRBs Act, 1976, the RRBs have to appoint, with the approval of the Central Government, auditors for auditing their annual accounts. The audit for this purpose includes auditing the Head Office of the bank and one-third of its branches as at the end of the year. Such audit report, inter alia, states:

- Whether the balance sheet projects a full and fair position containing all necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank;
- Whether or not the transactions which have come to the auditor's notice, have been within the powers of the bank;
- Whether or not the returns and statements received from the offices and branches of the bank have been found adequate for the purpose of the audit; and
- Whether the profit and loss account shows a true balance of profit or loss for the period covered by such accounts.

6.6.2 NABARD inspection

Under Section 35 of the Banking Regulation Act, 1949, NABARD is empowered to inspect the books and accounts of the RRBs. The prime objective of the statutory inspections is to ensure general safety of public deposits. However, NABARD, through these statutory inspections, has also been endeavouring for further developing and strengthening the RRBs to enable them to play a far more effective and efficient role in meeting the rural credit requirements.

As mentioned earlier, the general banking environment emerging out of the financial sector reforms has also been extended to a substantial extent to the RRBs. While the Capital to Risk-weighted Assets Ratio (CRAR) has not yet been made applicable to these banks, the other prudential norms viz., income recognition, asset classification and provisioning have been extended to cover RRBs since 1995-96. These changes have necessitated a review of the strategy adopted by NABARD for the inspection and supervision of the RRBs.

Under the revised strategy, a sharper focus of the NABARD's inspection is given on the core areas of the functioning of banks pertaining to Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems Compliance (the CAMELSC model). Thus NABARD's focus in its statutory 'on-site' inspections is on making core assessments, leaving the collateral appraisals to supplementary inspections. The micro level aspects are to be taken care of by the banks themselves by way of internal inspections or by other agencies such as auditors.

Off-site Surveillance

As a part of the new strategy of supervision, a system of 'Off-site Surveillance' has been introduced as a supplementary tool to the on-site inspection. Its objectives are to obtain and analyse critical data on a continuous basis, to identify areas of supervisory concern and to identify early warning signals and risky areas requiring further probe. The system basically envisages desk scrutiny of operations of the RRBs through a set of statutory and non-statutory returns. While the periodical statutory on-site inspections attempt an overall evaluation of the performance of the banks with a stipulated period, off-site surveillance envisages continuous supervision supplementing the on-site inspections with additional instruments of supervision.

6.7 Compliance to the audit/ inspection reports

All reports submitted by auditors/ inspectors, whether internal or external, call for prompt compliance by the bank, within a set time frame. In this connection, the role of the Board of Directors, particularly of the Audit Committee of the Board is crucial. The Board, through the Audit Committee should continuously monitor effective compliance with the major findings of the audits/ inspections so that corrective action is taken wherever called for without loss of time. The Board should be extra careful while dealing with cases of fraud and malfeasance as these need strong measures to stop recurrence.

6.8 Guidelines on Know Your Customer (KYC) norms and Anti-Money Laundering (AML) standards

The objective of 'Know Your Customer' (KYC) guidelines is to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering activities. KYC procedures also enable banks to understand their customers and their financial dealings better, which in turn help them manage their risks prudently. Comprehensive guidelines on KYC/ AML norms were issued to RRBs by Reserve Bank of India in February 2005. In terms of the guidelines, banks should frame their KYC policies incorporating the following four key elements:

- i. Customer Acceptance Policy;
- ii. Customer Identification Procedures;
- iii. Monitoring of Transactions; and
- iv. Risk management

For the purpose of KYC policy, a 'Customer' may be 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.

Some important features of the KYC/AML norms

- i. Banks are required to develop a clear Customer Acceptance Policy approved by their Boards of Directors laying down explicit criteria for acceptance of customers. The Customer Acceptance Policy must ensure that explicit guidelines are in place on various aspects of customer relationship in the bank.
- ii. Necessary checks must be made 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 organizations etc. Care should be taken to see that no account is opened in anonymous or fictitious/benami name(s).
- iii. Documentation requirements and other information to be collected in respect of different categories of customers will depend on perceived risk and keeping in mind the requirements of the Prevention of Money Laundering Act, 2002 and guidelines issued by Reserve Bank of India from time to time.
- iv. Banks may 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.
- v. 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.

- vi. Banks should ensure that its branches continue to maintain proper record of all cash transactions (deposits and withdrawals) of Rs.10 lakh and above. RRBs are required to appoint a Principal officer and put in place a system of internal reporting of suspicious transactions and cash transactions of Rs.10 lakh and above.
- vii. 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. 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 may be put up before the Audit Committee of the Board on quarterly intervals.

Prevention of Money Laundering Act (PMLA), 2002

The Government of India, Ministry of Finance, Department of Revenue, have issued a notification dated July 1, 2005 in the Gazette of India, notifying the Rules under the Prevention of Money Laundering Act (PMLA), 2002. In terms of the 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.

Regional Rural Banks have been advised to go through the provisions of PMLA, 2002 and the Rules notified thereunder and take all steps considered necessary to ensure compliance with the requirements of Act.

Maintenance of records of transactions

RRBs are required to introduce a system of maintaining proper record of transactions as mentioned below:

- I) All cash transactions of the value of more than rupees ten lakh or its equivalent in foreign currency;
- ii) 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;
- iii) 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 has taken place;
- Iv) All suspicious transactions whether or not made in cash and by way of as mentioned in the Rules.

Information to be preserved

The following information in respect of transactions need to be preserved:

- I) nature of the transactions;
- li) amount of the transaction and the currency in which it was denominated;
- lii) date on which the transaction was conducted; and
- lv) parties to the transaction.

Maintenance and Preservation of records

RRBs 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.

The banks are required to 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, 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.

Reporting to Financial Intelligence Unit-India

In terms of the PMLA rules, RRBs are required to report information relating to cash and suspicious transactions to the Director, Financial Intelligence Unit-India (FIU-IND).

- I) The cash transaction report (CTR) for each month should be submitted to FIU-IND by 15th of the succeeding month. While filing CTR, individual transactions below rupees fifty thousand may not be included.
- li) 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.

The Principal Officer will be responsible for timely submission of CTR and STR to the Financial Intelligence Unit India. No restrictions should be put on operations in the accounts where an STR has been made; however, it should be ensured that there is no tipping off to the customer at any level.

6.9 Vigilance machinery in RRBs

The Karmakar Committee on Empowering RRB Boards for Operational Efficiency set up by the Reserve Bank has observed in its report that arrangements to give undivided attention to vigilance related cases are not obtaining in most of the RRBs. Only 59 RRBs had established an exclusive Vigilance Cell, while the remaining RRBs had a set up where the work related to the Vigilance Cell was clubbed with other functions. As recommended by the Committee, all RRBs should set up separate Vigilance Cell to carry out all interventions in conformity with the directions and guidelines of the Central Vigilance Commission (CVC).

6.10 Management Information System

As the name suggests, Management Information System (MIS) is a formal method of making available to management the accurate and timely information necessary to facilitate the decision-making process and enable the organization's planning, control and operational functions to be carried out effectively. The system provides information on the past, present and projected future and on relevant events inside and outside the organization.

Good decisions are backed by good information. The Board needs concise, accurate and timely reports to help it perform its duties and responsibilities. This can be done through a properly constructed MIS.

Categories of Management Information

Management information can be conveniently categorized into the following three main areas:

Strategic planning information

It relates to the top management tasks of deciding on the objectives of the organization, on the levels and the kind of resources required to attain the objectives, and on the policies that govern the acquisition, use and disposition of resources. Strategic planning depends heavily upon information external to a specific organization.

Management control information

It helps managers take those actions which are in the best interests of the organization. Management control information is often interdepartmental in that the inputs come from various organizational groups cutting across established functional boundaries.

Operational information

It pertains to the day-to-day activities of the organization and helps assure that specific tasks are performed effectively and efficiently. Operational information generally originates in one department.

Essentials of a good information system

The value of information supplied by MIS depends on the information quality, quantity, timeliness and relevance to management action. However, some essential attributes of a good information system include i) accuracy and timeliness, (ii) quantitative adequacy/ conciseness, (iii) reliability, (iv) consistency and flexibility and (v) user-orientation.

Components of a MIS

MIS generally comprises the following steps: (a) Input, (b) Analysis and processing, (c) Storage and retrieval, (d) Output and (e) Information flow.

Both the input (i.e., data) and the output (i.e., the analysed information) are directly related to information requirements of the organization. To produce the output, it would be necessary to collect input data and information from different sources, have it processed and analysed, make use of past data, have a proper storage and retrieval sub-system and finally, a proper communication and feedback system which may ensure that data and information flow properly from one point to another without excessive time lags and distortion.

Designing an MIS

The following steps are necessary for designing and installing a MIS:

1) Analysis and determination of system's requirements

Such analysis attempts to answer the points such as the objectives of the organization, types of activities to be carried out, type of evaluation required to assess impact of such activities, data to be collected by whom and how, data to be processed by whom and how and where, accuracy and reliability of such data, and information generated to be used by whom and how etc.

2) Design of information system

The next step is the actual design of the information system in such a manner that it fulfils, with minimum cost and delay and in the required form, the information requirements of the management.

3) Procurement of necessary material

The third step is the procurement of the necessary material and the provision of required facilities, so that the system could be put into operation.

4) Installation

The information system should be set up keeping in mind to retain as far as possible the existing procedures and systems, and to replace the other components which require change slowly.

5) Operation and follow-up

The output of the system is examined against the objectives for which the system was designed. We should try to continuously improve upon the system taking into account the changed situation.

6.11 Role of Information Technology (IT)

Information Technology (IT) has revolutionalised the functioning of banks and financial institutions the world over. It has transformed the repetitive and overlapping systems and procedures into simple single key pressing technology resulting in speed, accuracy and efficiency in conducting business. IT has enabled banks to introduce innovative value-added products and services to their customers, viz. Electronic Payment Systems through Credit/

Debit, Smart E-Cards, E-Commerce and buy-now-pay-later product ranges, internet-based shopping - delivering goods and services at comforts of one's home and billing and debiting customers' accounts directly and swiftly.

Developments in IT-related banking activities

- Branch automation and networking to facilitate 'anytime and anywhere' banking;
- Increasing use of ATMs;
- Introduction of Electronic Funds Transfer to bring about greater efficiency as also reduction in risks in funds transfer;
- Sharing of payment system delivery points so as to effectively reduce cost and simultaneously to ensure healthy competition and product differentiation;
- Information Security (IS) on the network in the banking and financial sector;
- Establishment of Clearing Corporation of India Ltd. (CCIL);
- Introduction of Negotiated Dealing System (NDS);
- Installation of Centralised Funds Management System (CFMS);
- Implementation of Structured Financial Messaging System (SFMS);
- Operationalisation of the Real Time Gross Settlement System (RTGS);
- Introduction of digital signatures and certification of electronic messages, IDRBT (Institute for Development and Research in Banking Technology) being the Certification Authority for the banking sector.

Risk Factors in IT-related Banking Services

The IT-related risk factors in banking services could relate to (i) the IT environment, (ii) the IT operations, or (iii) the IT products/ services.

IT environment

Risk in this category arise due to the commercial and business environment within which the computer and telecommunication systems operate. Some such risks are:

- (i) There is a lack of regulatory / legal framework covering electronic transactions leading to disputes;
- (ii) The bank's IT resources are not deployed appropriately to meet its overall business strategy;
- (iii) The structure fails to provide and define reporting lines and responsibilities for the IT functions;
- (iv) Location of technology resources is susceptible to the risks of unforeseen events (e.g., Riots and sabotage) and sometimes natural calamities (e.g., floods / earthquake etc.);

- (v) The responsibilities and liabilities of suppliers and customers to whom jobs are outsourced are not properly assessed and documented.

IT operations

This category contains risks that arise from day-to-day transaction processing on computer systems. Such risks can be as under:

- (i) Errors which arise from a number of sources including errors made during development and amendment of computer programmes, or made by data entry operators or by misusing systems house-keeping tools and sensitive facilities;
- (ii) Frauds which arise when banks fail to diagnose vulnerable points within their systems and to guard against unauthorized access or activity;
- (iii) Accidental or intentional disclosure of sensitive financial information about the bank and its customers;
- (iv) Components of the bank's technical infrastructure bringing the system down in the event of occurrence of an unexpected or planned event;

IT products/services

The risks that arise from technology-based products and services primarily meant for providing better, faster services to the customers are included here.

However, while it will be necessary to identify and assess the risks associated with IT-related activities, like any other banking activities, it does not mean that IT should not be adopted, because it forms the backbone of any modern MIS and also helps the bank in reducing costs, providing effective and efficient customer service and bringing out new products and services to satisfy the ever-rising needs of the customers.

Cost & benefit of MIS

Though a strong MIS helps in reduction of various costs in banks, we must also appreciate that collection and analysis of information also costs heavily to the banks. The cost of operating the information system would include those on account of the following:

- Hardware
- Systems analysis, design and implementation
- Conversion of data
- Physical space and environmental control factors
- Personnel, maintenance, support facilities, etc.

The bank must undertake a detailed cost-benefit analysis before deciding how much it can spend for building up an MIS. However, the benefits that are likely to accrue to the bank as a result of information flow through the MIS need to be properly assessed. In fact, it is one of the key factors for growth as also for risk management, liquidity management, asset-liability management, regulatory compliance and overall effective management of the bank.

7. Business Development in RRB

7.1 Profitability of RRBs

In the early nineties, it was clear that the RRBs had suffered huge losses in the process of working in rural areas catering to the credit needs of the 'target group' and there was an urgent necessity to improve their profitability. While several committees went into the financial health of RRBs and gave far-reaching recommendations on alternative structural measures, it was decided by the Government of India to strengthen the RRBs on a 'stand-alone' basis. To tackle the problem of poor performance, several RRBs were recapitalised between 1994-95 to 1999-2000. Simultaneously, prudential guidelines were made applicable to them with a view to improving the quality of their assets and ensuring better management of loans. The 'target group' approach to lending was gradually withdrawn and RRBs were brought on par with commercial banks in matters relating to collection of deposits and lending/ investment. They were, however, subjected to the priority sector lending requirements on the lines of other scheduled commercial banks.

While there are several reasons for losses incurred by the RRBs, some basic reasons are low level of productivity (measured as 'per branch' and 'per employee' business, which is total of outstanding advances and deposits) and the low financial margin, which could be due to lower proportion of high-yielding loans and investments, high cost of deposits and / or borrowings and poor recovery of loans reflected in high level of NPAs. The problems of individual banks could be identified by using certain performance indicators, which would enable the banks to take remedial measures.

Development Action Plans (DAP)

The RRBs were advised to prepare bank-specific Development Action Plans (DAP) as part of the turn-around strategy to bring current viability in the short run and sustainable viability within a reasonable period of time. Such DAPs were to be prepared by taking into account their present status of viability on the basis of existing costs of funds, yield on funds, spread or margin available etc. and identification of the problems/ constraints which had led to the present position.

This was followed by planning for the future, based on the potential and prospects identified (branch-wise) and an in-depth analysis of various parameters viz., financial, organizational, Human Resources related etc. for improving efficiency and productivity. Subsequently, the DAPs were broken up into branch-wise and department-wise action plans for actual implementation.

The planning process, inter alia, also included the following:

- Integrating different functional areas of the bank to ensure that different parts did not go in different directions;
- Diversifying activities and raising the productivity level;
- Recovery of loans to augment the resource base of the bank;
- Human resources planning keeping in view the future business requirements;
- Developing human resources through training.

7.2 Deposit Mobilisation

Within the given policy framework of the RRBs and the inherent weakness in the system, it is necessary for the RRBs to give due attention to proper funds management which is one of the more critical factors affecting profitability. Funds management essentially involves raising of resources and deploying them in profitable ventures in such a way that cost of the funds raised is not only offset from the returns in deployment of funds, but also leaves some surplus. For raising funds, RRBs face stiff competition from other banks, both commercial and cooperative banks.

As deposits constitute the major source of funds for RRBs and in view of the cost implications, it would be worthwhile to go for a major portion of deposits in the form of demand deposits and short term fixed deposits where the costs are lower. Various strategies are adopted by banks in mobilisation of deposits from the public and banks have been increasingly adopting a 'marketing' approach for deposit mobilisation, with focus on identification of customer needs and offering of products accordingly. The marketing approach would focus on the four P's, i.e. product, price, place and promotion.

At the branch level, the staff should be well aware of the bank's products and also the products being offered by other banks in the area, including the 'price' structure of the products and the place of delivery. Promotional efforts are also required to be made both to educate the prospective customer about the bank's products and to create awareness about the products in their mind. Of course, while mobilising the deposits, the requirement of KYC norms are to be kept in view.

7.3 Lending to Priority Sector

Regional Rural Banks were originally allowed to lend only to the "Target Group" comprising small and marginal farmers, landless labour, rural artisans and other weaker sections of society. Subsequently, on considerations of operational profitability, they were allowed to lend up to 60 per cent of their incremental lending during a year to 'Non-Target Group' borrowers.

From 1997-98 onwards, lending to 'target Group' approach was discontinued and the concept of 'priority sector lending' was made applicable to RRBs. RRBs were advised that their advances to the priority sector should constitute 40 per cent of their total outstanding advances, as in the case of commercial banks. Within the overall target of 40 per cent, the advances granted to weaker

sections of society should constitute 25 per cent of the priority sector advances (10% of total outstanding advances).

The priority sector lending target has subsequently been revised to 60 per cent of total advances, with sub-target of 15 per cent for weaker sections. The guidelines on priority sector lending by RRBs have been revised in August 2007. A list of items included in different segments of the priority sector and the category of borrowers under Weaker Sections in the priority sector are summarised below.

7.3.1 Classification of priority sector advances

(I) Agriculture (Direct and Indirect finance)

Direct finance to agriculture includes short, medium and long term loans given for agriculture and allied activities (dairy, fishery, piggery, poultry, beekeeping, etc.) directly to the following:

- individual farmers (without limit)
- Self-Help Groups (SHGs) or Joint Liability Groups (JLGs) of individual farmers (without limit)
- Others (such as corporates, partnership firms and institutions) up to Rs 1 crore and one-third of finance above Rs 1 crore

Indirect finance to agriculture includes loans given for agriculture and allied activities other than the above and includes loans given to intermediaries for the purpose.

(ii) Small Enterprises (Direct and Indirect Finance)

Small enterprises (erstwhile SSI) comprise a very important segment of the rural economy, next only to agriculture. Direct finance to small enterprises includes all loans given to the following:

- Micro and small (manufacturing) enterprises engaged in manufacture/production, processing or preservation of goods, with original investment in plant and machinery not exceeding Rs 5 crore, and
- Micro and small (service) enterprises engaged in providing or rendering of services with original investment in equipment not exceeding Rs 1 crore.
- The micro and small (service) enterprises also include small road & water transport operators, small business and professional & selfemployed persons.

Indirect finance to small enterprises includes 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

This includes 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

Micro credit is defined as 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 Micro Finance Institutions (MFIs) for on-lending up to Rs. 50,000 per borrower.

(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 loans granted to educational institutions;

(vi) Housing loans:

Loans up to Rs. 20 lakh to individuals for purchase/ construction of dwelling unit per family 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. Loans by banks to their own employees are not included under the priority sector.

7.3.2 The weaker sections under priority sector include the following:

- Small and marginal farmers with land holding of 5 acres and less, and landless labourers, tenant farmers and share croppers.
- Artisans, village and cottage industries where individual credit limits do not exceed Rs. 50,000/-.
- Beneficiaries of Swarnjayanti Gram Swarojgar Yojana (SGSY).
- Scheduled Castes and Scheduled Tribes.
- Beneficiaries of Differential Rate of Interest (DRI) scheme.
- Beneficiaries under Swarna Jayanti Shahari Rojgar Yojana (SJSRY).
- Beneficiaries under the Scheme for Liberation and Rehabilitation of Scavengers (SLRS).
- Advances to Self Help Groups
- Loans to distressed poor to prepay their debt to informal sector, against appropriate collateral or group security.
- Persons from minorities communities as may be notified by the Government of India from time to time.

7.3.3 Common guidelines for priority sector advances

Some important general guidelines issued to banks from time to time by the Reserve Bank in connection with priority sector lending include the following:

- The bank staff should help the borrowers in completion of the application forms.

However, in areas covered by special schemes such as SGSY, the concerned project authorities like DRDAs, DICs, etc. should arrange for completion of application forms received from borrowers.

- Banks should give acknowledgement for loan applications received from the weaker sections.
- 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.
- Branch Managers may reject loan applications (except in respect of SC/ST) provided the cases of rejection are verified subsequently by the higher authorities. In the case of proposals from SC/ST, however, rejection should be at a level higher than that of Branch Manager.
- Repayment programme for loans 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 the case of borrowers affected by natural calamities, banks may convert drawings in excess of the value of security into a term loan repayable over a reasonable period of time and provide further working capital and extend/ re-phase the instalments due under term loans.
- Branch Managers should be vested with discretionary powers to sanction proposals from weaker sections without frequent references to any higher authority.

7.4 RRBs and micro finance

Micro finance refers to the provision of thrift, credit and other financial services and products of very small amount to the poor for enabling them to raise their income levels and improve their living standards. It may be recalled that the RRBs were established mainly for this purpose, i.e. providing financial services in the rural sector to the weaker sections. Hence, it will not be wrong to label RRBs as the original "micro finance banks".

Due to several advantages, micro credit is generally purveyed by banks through 'groups', rather than in the individual mode.

7.4.1 The Self Help Group (SHG)- Bank Linkage Programme

A Self-Help Group (SHG) is generally an unregistered group of poor people having homogenous social and economic background, voluntarily coming together to save small amounts regularly, to mutually agree to contribute to a common fund and to meet their emergency needs on mutual help basis. The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment thereof. In fact, peer pressure has been recognized as an effective substitute for collaterals in the case of lending to the SHGs.

Financing through SHGs reduces transaction costs for both lenders and borrowers. While the bank has to handle only a single SHG account instead of a number of small-sized individual accounts, borrowers as part of a SHG cut down expenses on travel (to & from the branch and other places) for completing paper work and on the loss of workdays in canvassing for loans.

Selection of SHGs for lending

The following criteria are broadly adopted for selecting SHGs for the purpose of linkage (lending by banks):

- a) The Group should be in existence for at least six months.
- b) The Group should have actively promoted the savings habit.
- c) Although the Groups could be either formal (registered) or informal (unregistered), normally they are informal in nature.
- d) Membership of the group could be between 10 to 20 persons.

SHG Lending as Normal Lending Activity

The SHG-Bank linkage programme is to be treated by the financing bank as a normal business activity. Banks have been advised that they may consider lending to SHGs as part of their mainstream credit operations both at policy and implementation level. They should 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.

It has also been advised by the Reserve Bank that 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.

Opening of Savings Bank A/c.

The SHGs registered or unregistered which are engaged in promoting savings habits among their members are 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.

Documentation

Keeping in view the nature of lending and status of borrowers, banks may prescribe simple documentation for lending to SHGs. A simple system requiring minimum procedures and documentation is a pre-condition for augmenting flow of micro credit. Hence, RRBs 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.

Lending norms

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.

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.

Models of linkage

Banks have been allowed to 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 RRBs to individual borrowers directly or through any intermediary (including MFIs) is reckoned as part of their priority sector lending.

It is, however, 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.

7.5 Financial inclusion and the role of RRBs

In order to bring about financial inclusion in the country, i.e. to bring into the fold of banking the segment of population which lies excluded from such services, the Reserve Bank of India has advised RRBs, along with other banks, to open basic "no-frills" accounts, with either nil or very low balance requirement. RRBs have been specifically advised also to allow small overdraft facilities in such accounts to make these accounts more attractive to the prospective customers.

Further, RRBs are also issuing General Credit Cards (GCC) under the scheme announced by Reserve Bank of India. The credit facility extended under the Scheme is in the nature of a revolving credit and the GCC holder is entitled to draw cash from the specified branch of a bank up to the limit sanctioned. Banks have flexibility in fixing the limit based on the assessment of income and cash flow of the entire household. However, the total credit facility under GCC for an individual should not exceed Rs.25,000. The borrowers would be eligible for availment of the credit facilities provided under GCC as per their requirement without any insistence on security

and the purpose or end-use of the credit. Fifty per cent of credit outstanding under GCC up to Rs.25,000 will be eligible for being treated as indirect agricultural finance by the RRB under priority sector lending.

7.6 Other activities

The RRBs which were set up to act as catalysts in the process of rural transformation, have indeed a very important role to play in the present context of expanding banking services to the hitherto excluded sections of the society. Three decades of dealing with the weaker sections of the rural society and customers with low-asset base has provided the RRBs with a lot of expertise which can be suitably leveraged in serving this segment of the population. To do this would, however, need strengthening of these institutions in the first place and improving their financial position. With this end, the Reserve Bank formulated a package of measures in December 2005 which would augment the resource base of the RRBs and provide them access to new business methods. The package broadly includes the following:

Line of credit from sponsor banks

Sponsor banks should effectively use the RRBs sponsored by them to increase flow of credit to the rural areas. To supplement the resources of the RRBs, sponsor banks may provide to RRBs lines of credit at a reasonable rate of interest.

Since loans granted by commercial banks (including the sponsor banks) to RRBs for on-lending to agriculture and allied activities are allowed to be classified as indirect finance to agriculture in the books of the concerned commercial banks/ sponsor banks, the amount lent by RRBs out of funds borrowed from commercial banks/ sponsor banks, should not be classified by them as part of their priority sector advances. The RRBs should not also include such lending as part of their bank credit for the purpose of computing achievement under priority sector lending.

Access to inter-RRB term money/ borrowings

As there are no restrictions on RRBs' access to term money markets, it has been clarified that within this framework RRBs can borrow from/ place funds with other RRBs including those sponsored by other banks, subject to counter-party credit risk policy and limits.

Access to repo/ CBLO markets

RRBs can enter into ready forward transactions (repos) in government securities with SGL/CSGL account holders, subject to the conditions specified by Reserve Bank of India in this regard. Further, they can participate in CBLO (collateralized borrowing and lending obligation) market with the settlement undertaken through their Gilt Account. Collateralised Borrowing and Lending Obligation (CBLO) is a money market instrument developed by the Clearing Corporation of India Ltd. (CCIL) for the benefit of the entities which are not able to fully take advantage of the inter-bank call money market. RRBs desirous of participating in repos/ CBLO market can approach their sponsor banks for guidance. Sponsor banks have been advised to actively facilitate such access and provide necessary training to RRB staff. With a view to equipping RRBs' staff with necessary skill, the Reserve Bank and NABARD can help in organising training

programmes for them in the regulatory and operational aspects of the repo/ CBLO market.

Issue of credit/debit cards and setting-up of ATMs

To be able to provide better facilities to the customers, RRBs can now issue credit cards/ debit cards in collaboration with their sponsor banks or other banks.

In case any RRB wishes to set up an off-site ATM in its area of operation, it can do so after assessing the cost and benefit. Prior approval of RBI need not be obtained, but on opening of such ATMs, RRBs should immediately inform the respective Regional Office of Reserve Bank of India (Rural Planning and Credit Department) for the purpose of getting a formal authorisation for the place of business.

Opening of Currency Chests

Requests from RRBs for opening of currency chests is considered by the Reserve Bank on case-by-case basis, taking into account their financial position, compliance with SLR/ CRR/ inspection findings, general position of management, grading, etc. Such requests should be submitted to the respective Regional Offices of the Reserve Bank (RPCD).

Forex business

RRBs have been allowed to undertake non-trade related current account transactions pertaining to release of foreign exchange for certain specified purposes such as private visits, business travel, medical treatment, overseas education, visa fees, etc. They can also open Foreign Currency (Non-Resident) Deposit Accounts (FCNR accounts) of non-resident Indians/ persons of Indian origin.

Pension/ Government business

Banks authorised to handle government business are permitted to appoint sub-agents in terms of the agency agreements. RRBs are also eligible to be appointed as sub-agents for handling pension and other government business and as such they have been advised to contact the banks concerned.

Other forms of business

RRBs may have access to credit portfolio of sponsor banks through participation certificates on a risk sharing basis. RRBs are also allowed to participate in consortium lending within their area of operations.

7.7 Branch Licensing Policy for RRBs

Rationalisation of branch network can bring about substantial improvement in the operational results of a bank. The opening of branches by banks is governed by the provisions of Section 23 of the Banking Regulation Act, 1949. In terms of these provisions, banks cannot open a new place of business in India or abroad or change otherwise than within the same city, town or village, the location of the existing place of business without the prior approval of the Reserve Bank. It is, therefore, mandatory for RRBs to seek prior approval/ licence from Rural Planning and Credit Department (RPCD) of RBI before opening of new branches/ offices.

General policy on branch licensing of RRBs

The Boards of Directors of RRBs are required to decide on the policy and strategy for setting up new branches, taking into account the yearly business plan, potential for business at the new centres, (for opening of branches), profitability of the proposed branches, efficacy of the internal control system, redeployment of staff where surplus manpower has been identified, extension of prompt and cost-effective customer service to the clientele etc.

The proposal for opening, shifting, merger or conversion of branches is to be submitted to the respective Regional Office of NABARD in the prescribed application Form VI, with an advance copy to the concerned Regional Office of the Reserve Bank. The Empowered Committees for RRBs, constituted by the Reserve Bank at its Regional Offices, deliberates on the matter and makes recommendation on such applications. Details of 'Empowered Committees' are furnished in the next chapter.

No separate approval of sponsor bank is required. Further; approval of the sub-group of the District Consultative Committee (DCC) will also not be required for opening of branches. However, in case of shifting/ merger/ conversion of branches, approval of the sub-group of DCC is required.

Conditions for opening of new branches

An RRB should fulfill the following conditions to become eligible for opening of new branches:

- i) It should not have defaulted in maintenance of SLR and CRR during the last two years. but subject to the seriousness of the default, the Empowered Committee may take decision to reject or accept the proposal for opening of branch/es.
- ii) It should have rectified most of the major irregularities pointed out by NABARD in its last inspection report.
- iii) Its gross NPA level should not be more than the National Average for RRBs.
- iv) It should have earned profit in each of the last two years. In case of loss-making RRBs, the concerned RRB should indicate as to how the proposed branch will help in reducing the loss
- v) It should not normally resort to fresh recruitment of staff for manning the proposed branch/es.

With a view to encouraging RRBs to open branches in hitherto uncovered districts, the compliance with conditions prescribed at Serial Nos. (iii) to (v) above have been left to the discretion of the Empowered Committee.

Opening of branches at Rural/Semi-Urban/Urban and Metropolitan Centres

The RRBs can identify rural centres (population up to ten thousand), semi-urban centres (population more than ten thousand but up to one lakh), urban centres (population more than one lakh but up to ten lakh) and metropolitan centres (population more than ten lakh) for opening of branches depending upon the business potential and profitability of the proposed branches.

The proposals of RRBs for opening of new branches are considered by RBI on a very selective basis and on merits of each case, taking into consideration the overall financial position of the RRB, quality of its management, efficacy of the internal control system, profitability and other relevant factors.

Opening of Controlling Offices/Area Offices

After the process of amalgamation of RRBs started in September 2005, a large number of RRBs has been amalgamated till date. Consequently, there are now new RRBs as a result of amalgamation and old RRBs which have not undergone amalgamation. Amalgamated RRBs having 75 branches are now allowed to open Controlling Offices in the ratio of one Controlling Office for every 50 branches. RRBs (which have not undergone amalgamation), having 50 or more branches, are allowed to open Area Offices in the ratio of one Area Office for every 25 branches. The Area Offices/ Controlling Offices are not permitted to transact any banking business. However, RRBs are required to obtain licences from the concerned Regional Office of RBI (RPCD) prior to functioning/ opening of these offices.

Opening of Service Branch

RRBs are allowed to set up Service Branches / Central Processing Centres/ Back Offices exclusively to attend to back office functions such as data processing, verification and processing of documents, issuance of cheque books, demand drafts etc. and other functions incidental to their banking business. These offices have no interface with customers and are not allowed to be converted into General Banking branches. These offices are treated on par with a branch and the RRBs are required to obtain necessary licence from the concerned Regional Office of RBI (RPCD).

Shifting of Branches

Rural areas

The shifting of branches in rural centres can be effected by RRBs themselves without obtaining the prior approval of RBI, subject to their complying with the following conditions:

- Both the existing and proposed centres are within the same block ;
- The relocated branch would be able to cater adequately to the banking needs of the villages served by the existing branch.

Semi-urban areas

RRBs can shift their branches at semi-urban centres within the same locality/ municipal ward without the prior approval of RBI. It should, however, be ensured that the locality/ ward is not rendered unbanked due to the shifting of branch/es.

Urban/Metropolitan areas

The RRBs may shift their branches in urban/metropolitan centres within the same locality/municipal ward without the prior approval of RBI.

Merger of loss making branches

If two loss making branches of an RRB are in close proximity (i.e., within a distance of about 5 kms), the RRB can consider merging the two with a view to rationalizing the spatial spread of branches and reducing establishment / operating costs.

Conversion of full-fledged branches into satellite/mobile offices

The RRBs may themselves decide the need for conversion of the existing loss making branches into satellite/mobile offices keeping in view the cost-benefit aspect, the likely inconvenience that may be caused to the existing clientele, the effect of the conversion on the performance in the preparation of district credit plan and priority sector lending.

Satellite Offices

The following guidelines may be followed by the RRBs in respect of satellite offices:

- a) The satellite offices should be established at fixed premises in the surrounding villages and should be controlled and operated from a base branch located at central village/block headquarters.
- b) Each satellite office should function on a few specified days (at least twice) in a week at specified hours.
- c) All types of banking transactions may be conducted at these offices.
- d) The customers of satellite offices may be permitted to transact business at the base branch on non-operating days of such offices.
- e) While separate ledgers/registers/scrolls may be maintained for each satellite office, all the transactions carried out at these offices should be incorporated in the books of account of the base branch.
- f) The staff attached to the base branch, preferably consisting of a member of supervisory staff, a cashier-cum-clerk and an armed guard, may be deputed to the satellite offices.
- g) Adequate arrangements for insurance of furniture, cash-in-transit, etc. may be made.

Conversion of branches into satellite offices at centres other than rural is not permissible.

RRBs are, however, allowed to convert satellite offices into full-fledged branches after obtaining concurrence from the Empowered Committee on RRBs.

Mobile Offices

The scheme of mobile offices envisages the extension of banking facilities through a well protected van with arrangements for two or three officials of the bank sitting in it with books, safe containing cash, etc. The mobile unit would visit the places proposed to be served by it on certain specified days/hours. The mobile offices would be attached to a branch of the RRB. The mobile offices should not visit the rural places which are served by co-operative banks and places served by regular offices of commercial banks.

Automated Teller Machines (ATMs)

RRBs need not obtain permission of RBI for installation of ATMs at branches and Extension Counters for which they hold licences issued by RBI. RRBs should, however, report to the concerned Regional Office of the Reserve Bank (RPCD) and DESACS as and when ATM is installed at a branch or an Extension Counter. In case any RRB wishes to set up an off-site ATM in its area of operation, it may do so after assessing the cost and benefit. Prior approval of RBI need not be obtained, but on opening of such ATMs, RRBs should immediately inform the respective Regional Office of the Reserve Bank (RPCD) for the purpose of getting a formal authorisation for the place of business.

Extension Counters

The RRBs, with the approval of their Boards of Directors, can open Extension Counters at the premises of the institutions of which they are principal bankers after obtaining licence from the concerned Regional Office of RBI (RPCD) for the purpose. Extension Counter can be opened within the premises of big offices/factories, hospitals, military units, educational institutions, etc. Extension counters can also be opened at places of worship and market places and the condition of being principal bankers would not apply in such cases.

For upgrading the extension counters into full-fledged branches, RRBs should approach the concerned Regional Office of RBI (RPCD) for prior approval. Approval is subject to certain conditions being fulfilled such as (i) the Extension Counter functioning for a minimum period of five years, (ii) the number of deposit accounts exceeding 2000 during the last one-year and (iii) average deposits (on a monthly basis) for the last three years not being less than Rs.2 crore. While these are broad guidelines, decisions are taken on a case by case basis.

8. The Road Ahead

8.1 Consolidation of RRBs

The RRBs, set up with the intention of extending credit to the weaker sections of the population living in the rural areas, have succeeded to a great extent in the objective of taking banking services to the villages, but have not made any significant impact on credit to the rural poor during the past 30 years of their existence. This has to be viewed in the context of the policy framework for rural development adopted in India with focus on income and employment generation and poverty alleviation.

The renewed emphasis on agricultural and rural development by the Government of India would lead to a growing demand for different types of financial services in the rural areas, as the financial needs of the rural economy become diversified. The present structure of rural credit may not be able to fully cater to the same. The cooperative credit structure suffers from many infirmities and, hence, the RRB network will have to be leveraged for benefiting the rural areas. As against their present share of about 10 per cent of the total bank credit in the agricultural sector, RRBs have to provide a larger share of credit disbursed calling for much larger resource mobilization, as also greater efforts for their institutional strengthening. Thus, on one hand, the concept of RRBs has to be pursued in the interest of the rural economy and on the other, the RRBs have an opportunity to cash in on the gap between demand and supply of banking and financial services in the rural sector.

Since, however, the RRBs were constrained in their operations by lack of proper geographical coverage, because of the 'notified area of operation' usually comprising one district or a few districts and the existence of a large number of very small banks was clearly not viable, steps have been taken to consolidate the RRBs on a State-wise and sponsor-bank wise basis, as indicated in Chapter I. This is aimed at addressing the issues of geographical coverage and economy of scale and enabling the RRBs to effectively compete with other banks in a progressively more deregulated environment. The process which started in September 2005, is still continuing, as the Government of India, Ministry of Finance issues the required notification on a case by case basis. As a result of this process of amalgamation, the number of RRBs has been reduced from 196 to 88 (as at end of May 2008) and the figure is likely to get further reduced. With increase in size, however, there is a need for better governance of the RRBs. The role of the Board of Directors is extremely important in this regard.

8.2 Empowered Committees on RRBs

The Reserve Bank has constituted Empowered Committees (EC) in its Regional Offices under the chairmanship of its Regional Directors and with members drawn from NABARD, sponsor banks, conveners of SLBCs and the State Governments to ensure that the RRBs adhere to good governance and comply with prudential regulations. The functions of the Committee are broadly as under:

- (i) Monitoring agricultural lending by RRBs;
- (ii) Resolving the operational and procedural problems faced by RRBs in extending rural credit;
- (iii) Providing regulatory clarifications, guidance on Non-SLR investments, prudential norms, branch expansion/ rationalisation, performance under priority sector and government sponsored programmes, etc.;
- (iv) Examining the proposals for grant of permission to RRBs To undertake insurance agency business without risk participation basis;
- (V) Periodic review of performance of RRBs.

The forum of EC is also being utilised to discuss and monitor the proposals for amalgamation of RRBs. With a view to ensuring smooth transition of the business/ undertakings of the erstwhile RRBs to the new RRB from the effective date of amalgamation, the operational issues relating to maintenance of CRR, SLR, etc., by the erstwhile RRBs and subsequently by the new RRB/s, are also envisaged to be sorted out at the level of the Empowered Committee.

Applications received from RRBs for opening of currency chests would be examined and recommended by EC based on the prescribed norms to Reserve Bank for consideration. On the issue of branch licensing of RRBs (which has been delegated to Regional Offices of RBI since June 13, 2006), the role of ECs is to examine and make recommendations on applications of RRBs for opening of new branches, merger of branches, etc. Similarly, requests from RRBs for conduct of forex business as limited authorized dealers (Category-II), opening/maintaining of NRE/NRO Rupee Accounts, etc. would also be examined by Ecs.

With a view to enlarging the scope of financial inclusion, ECs have been advised to identify the uncovered district/s, if any, which could be covered by the existing RRB/s so as to persuade the concerned sponsor bank to approach the Government of India (Ministry of Finance) for extension of the area of operation of RRB/s sponsored by it. ECs have been requested to discuss and ascertain as to which RRBs are desirous of handling pension / other government business of the State Government. Regional Directors would act as a facilitator for the RRBs to undertake the aforesaid business and request the State Government to do the needful.

Considering the comprehensiveness and multiplicity of important issues being transacted by the EC, the Chairmen of RRBs have also been appointed as Members of the Committee in the respective states.

8.3 Need for Capital Adequacy

Like all other businesses, banks hold capital as a buffer against unforeseen losses. Unlike other enterprises, however, one of the main functions of banks is to perform financial intermediation between other participants in the economy. Given this key role, trust is essential. To ensure confidence and to protect the interest of depositors, banking activities are subject to licensing, to specific regulations and to supervision.

It is the supervision of banks that has given rise to regulatory capital requirements. Regulatory capital is the minimum capital that the supervisory authorities require banks to set aside in order to meet potential losses. This is meant to ensure that banks can absorb losses arising from their activities on an ongoing basis. A minimum capital adequacy ratio (ratio of capital to 'risk-weighted' assets) of 9 per cent has been prescribed for all scheduled commercial banks and also primary (urban) cooperative banks in the country under the Basel I framework. Commercial banks are also set to move over to the more sophisticated requirements under the new capital adequacy requirements (Basel II). However, no such norms have been specified for RRBs so far.

In the context of the on-going consolidation process in the RRB sector, as a result of which the RRBs are emerging as bigger and stronger banks, a need has arisen for having appropriate capital adequacy norms in their case also. Currently, in terms of provisions of the RRBs Act, 1976, a RRB can have issued capital not exceeding Rs 1 crore. Apart from this, many of the RRBs received recapitalisation support from the shareholders (Central Government, Sponsor bank and State Government) in the 1990's, which have been parked in 'Share Capital Deposit Account', pending amendment to the provisions of the Act. Further, 27 RRBs having negative net worth as on 31 March 2007 are in the process of receiving recapitalization support. However, the capital base at present is too low and with increased diversity and sophistication in their activities, RRBs will certainly need a larger capital base to be able to take the risks related to banking.

In the Mid-Term Review of Annual Policy Statement of the Reserve Bank for the year 2007-08 it was proposed that RRBs should disclose the level of Capital to Risk-weighted Assets Ratio (CRAR) as on March 31, 2008 in their Balance Sheets. Accordingly, all RRBs have been advised by the Reserve Bank to disclose their CRAR as on March 31, 2008 and thereafter every year as 'Notes on Accounts' to their Balance Sheets.

Under the proposed CRAR framework, the Balance Sheet assets and non-funded / off-balance sheet items will be assigned weights and banks have to compute the ratio of their capital funds to the aggregate of risk weighted assets and other off-balance sheet exposures. These weights have been indicated in the relative circular issued by the Reserve Bank. This is a precursor to having a CRAR prescription for RRBs and the roadmap for achieving the desired level of CRAR norms would be communicated to the RRBs in due course.