Indian
Institute of
Banking & Finance

AML-KYC AND COMPLIANCE IN BANKS

AML-KYC AND COMPLIANCE IN BANKS

This book has been published by Indian Institute of Banking & Finance.

First published, 2022

Foreword

The business of banking is highly regulated and rightly so, given the fact that the banks are at the core of the financial system as the custodians of public trust. Any deviation from the norms as prescribed by the central banks and other regulatory authorities, may lead to catastrophic consequences not only for the bank, but for the entire economy as well. Regulations are the contours within which banks have to operate, in order to ensure financial stability and protection of stakeholders' interest.

With the banking and financial services sector experiencing a paradigm shift all across the globe, fuelled by changing customer preferences towards an increasingly technology-based interface in a highly competitive market, it is of paramount importance for the banks to adhere to sound compliance and governance norms to ensure continued customer confidence and to safeguard its financial health & reputation. The regulatory environment, too, is fast-evolving with digitalization being the new-normal. In this backdrop, the importance of knowledge of the extant regulatory guidelines, especially in the area of compliance and governance, is irrefutable for the bankers.

During its 94 years of service, IIBF has emerged as a premier institute in Banking and Finance education for those employed as well as seeking employment in the sector, aiming for professional excellence. It has been a conscious endeavour on the part of the Institute to genuinely contribute to the professional skill-sets of the banking fraternity by designing contemporary and practically relatable courses.

This particular book, designed specifically for UCO Bank, has been developed with the primary objective of equipping the practising bankers with the indispensable knowledge of the AML-KYC and Compliance guidelines. The book, besides walking the readers through the myriad aspects of regulatory frameworks, also concentrates on the day-to-day applicability of the regulations and their impact through lucid and relatable case studies and scenario analyses. While designing the courseware, emphasis has been provided to augment the cognitive understanding of the subject. We believe that, for the banking and finance professionals, this book would provide a deeper insight into the letter and spirit of the regulations in a fast-evolving financial ecosystem.

The Institute acknowledges the contributions made by the resource persons in developing this book and invites suggestion for its further improvement.

Mumbai
June, 2022

Biswa Ketan Das
Chief Executive Officer

AML-KYC AND COMPLIANCE IN BANKS

Syllabus

AML-KYC

Module I: ANTI-MONEY LAUNDERING (AML)

i. Money Laundering: What is money laundering? An overview of impact on global economy, Combating financial terrorism.
ii. Money Laundering: Different Methods
iii. Money Laundering: Legislation in different countries- International Cooperation among Countries and international bodies Global efforts and co-ordination for AML and CFT
iv. Financial Intelligence Unit (FIU) – Principal Officer – Role & Responsibility
v. Basel Committee on AML and KYC
vi. Financial Action Task Force (FATF)
vii. Money Laundering and Correspondent Banking – AML structure in India – PMLA Objectives – RBI Guidelines
viii. FIU IND, ED, NIA, SFIO, IBA Working Group – Software for AML Screening
ix. Money Laundering & Correspondent Banking – Exchange Companies – Foreign Branches
x. Country Risk Categorization
xi. Monitoring of Transactions - Enhanced Due Diligence (EDD)
    - ❖ Red flag Indicators advised vide FIU /IBA – Online / Offline Scenario
    - ❖ Monitoring Accounts Transactions – Reporting Obligation Under PML Act, CTR, NPOTR, CBWTR & STR (Scrutiny & Filing)
xii. Preservation of records
xiii. Providing training to the staff & developing a KYC compliance culture
xiv. New Technologies on AML -Data Analytics and Artificial Intelligence based approach

Module II: KNOW YOUR CUSTOMER (KYC)

i. KYC– Historical Overview and Regulatory Framework
ii. KYC: Operating Guidelines- Regulatory guidelines on KYC – Important KYC framework in RBI prescriptions – Customer Profile – KYC Policies – Countries Deficient in KYC Policies, Initiatives / Directions from the RBI
iii. Customer Acceptance Policy – Customer: Definition under the KYC Principles
iv. Customer Risk Management- Categorization
    - Updation of KYC requirement as per Risk Category – On Boarding and Periodically
v. Customer Identification Procedure
    a) Types of Customers
        - ❖ Individuals – Including Joint, Minor, Pardanashin Women, Illiterates etc.
        - ❖ Legal entities- Companies, Trusts, Firms, Intermediaries, etc.
    b) Customer Due Diligence

c) KYC (OVDs) for different types of customers / accounts,
d) FATCA / CRS
e) Small accounts (Jan Dhan A/cs) – operating guidelines
f) Accounts of Politically Exposed Persons (PEPs) Residing Outside India
g) Accounts of 'non-face-to-face' Customers – Qualitative data – Joint accounts – Minor accounts
h) eKYC - Online opening of accounts- Aadhaar offline / online verification, Video KYC, CKYCR
i) Beneficial Owner

COMPLIANCE

Module III: REGULATION AND COMPLIANCE

i. Regulation in Banks
   a) Importance of Banks in the Economy
   b) Role of Banks
   c) General Principles of Bank Regulation & Important Acts applicable in India e.g. BR Act, RBI Act, Income Tax Act, Information Technology Act, UIDAI Act, Companies Act, FEMA, NI Act, etc.
   d) Regulatory Authorities & Role of Regulators
   e) Universal Functions for Financial Regulators

ii. Compliance Function in Banks
   a) Compliance risk and significance of Compliance Function
   b) Compliance policy
   c) Compliance principles, process and procedures
   d) Compliance programme & Scope of Compliance Function
   e) Role and responsibilities of Chief Compliance Officer (CCO)- including disclosure requirements

iii. Compliance Governance Structure
   a) Organizational structure- GRC framework
   b) Responsibility of the Board and Senior Management
   c) Compliance structure at the corporate office & Functional departments
   d) Compliance structure at field levels
   e) Internal controls and its importance
   f) Whistle Blower Policy Mechanism

iv. Framework for Identification of Compliance Issues & Compliance Risks
   a) Compliance culture
   b) Compliances issues
   c) Compliance risk, Inherent risk and Control risk
   d) Compliance testing

Module IV: REGULATORY COMPLIANCES

i. Exposure norms
ii. Cash Reserve Ratio (CRR) & Statutory Liquidity Ratio (SLR)
iii. Capital Adequacy
   a) Objectives/Aims of the Basel III measures
   b) Transition from Basel I to Basel III
   c) Guidelines on minimum capital requirement
   d) Capital charge for Credit, Market, Operational risk
   e) Supervisory Review and Evaluation Process (SREP)
   f) Market discipline
iv. Priority Sectors and Micro, Small & Medium Enterprises
v. Interest Rates on Advances
   a) General guidelines
   b) MCLR and external benchmark
   c) Foreign currency advances- ARR *(in lieu of LIBOR)*
vi. Prudential Norms for Income Recognition & Asset Classification and Wilful Defaulters
   a) Salient features of IRAC norms
   b) Sale of financial assets - Securitisation Company (SC)/Reconstruction Company (RC), NARCL, IDRCL
   c) IBC code, NCLT and NCLAT
   d) Wilful defaulters
vii. FX Operations under FEMA
   a) Foreign direct investment (FDI)
   b) External Commercial Borrowing
   c) Export & Import of goods & services including Trade Credits
   d) FX facilities for individuals- LRS, NRE/NRO/FCNR(B)
viii. Customer Service – Operational Aspects of banking
   a) Customer confidentiality obligations
   b) Operations in Savings & Time Deposit accounts
   c) Nomination in Accounts
   d) Cash Operations – As per Income Tax Act
   e) Garnishee Order, Seizure etc. – as per court order
   f) Demand Drafts
   g) Collection of instruments
   h) Clean note policy
   i) Safe deposit lockers
   j) Guidance to customers and disclosure of information
   k) Disclosure of Information by banks in the public domain
   l) Dealing with complaints and improving customer relations
   m) Reconciliation of transactions at ATMs failure - time limit
   n) Government business

ix. Alternative Delivery Channels
   a) Smart/debit/credit/Prepaid card business
   b) NEFT, RTGS, IMPS, UPI
   c) Automated Teller Machine (ATM)
   d) Online banking and Neo-banking

x. Fraud & Vigilance Frameworks in Banks
   a) RBI Master Circular on Frauds – Classification & Reporting
   b) RBI Guidelines on Internal Vigilance

Contents

MODULE I

ANTI-MONEY LAUNDERING (AML)

CHAPTERS

1. Money Laundering Phenomenon, its Impact and Terrorism Financing.
2. Money Laundering: Different Methods
3. Global efforts for AML and CFT by International bodies and International Cooperation among Countries
4. AML/CFT Legislation in Major Countries/Region
5. AML Legal and Institutional Framework in India
6. Money Laundering & Correspondent Banking/ Relations
7. Country Risk Categorization
8. Reporting Obligations and Transaction Monitoring

CHAPTER 1

MONEY LAUNDERING PHENOMENON, ITS IMPACT AND TERRORISM FINANCING

STRUCTURE

OBJECTIVES

Knowing about the phenomenon of money laundering, and understanding its effect on global economy, financial system, banks, and bankers. Knowing terrorism financing, and understanding distinction and commonalities between money laundering and terrorism financing.

1.1 WHAT IS MONEY LAUNDERING? ITS ORIGIN

1.1.1 Money Laundering Phenomenon

One of the reasons of engaging in any type of criminal activity is making money. Handling such money poses problems for the persons engaged in criminal activity, especially when the volumes are large. Besides, it increases the risk of their being caught by the law enforcement authorities. 'Money Laundering' is the process by which money derived from criminal activities, e.g., drug trafficking, illegal arms sales, smuggling, extortion, gambling, bootlegging, etc., ('Dirty Money' or 'Illegal Money') is so brought into the financial system as to conceal its illicit origin and to make it appear to be from licit origin ('Clean Money' or 'Legal Money').

1.1.2 Origin of Money Laundering

Money laundering has attracted attention of various governments globally in recent times, but it has been in existence since ancient times. The earliest form of money laundering was essentially trade related, when false trading modes were adopted to deal in illegal merchandise. In more recent times, it was said to be used by American gangsters dealing in banned alcoholic drinks. A Chicago gangster, set up the cash intensive business of launderettes to conceal his income derived from alcoholic drinks. Subsequently, money laundering attracted attention in the context of trading in banned drugs, and the modalities used by the high-level drug dealers to handle their earnings from the trade.

1.2 IMPACT ON GLOBAL ECONOMY

1.2.1 Cause for Concern

The concern about money laundering arises from its linkage with criminal activities. The phenomenon of illegal money entering financial system in itself is not the cause for concern. The anxiety is more about the negative effects this is likely to have on the society. Money laundering provides avenue to criminals to camouflage their illegal assets into legal form, and also deployment of their surplus funds in legal avenues that would otherwise remain idle or squandered in more super luxurious styles. In a permissive environment it could have several detrimental effects – economic, political and social.

1.2.2 Economic Effects

Unhindered conversion of illegal money to legal money could impact economy adversely. It would lead to unfair competition between honest and dishonest businesses. It could also result in distortion of prices, and crowding out of honest business. Thus, the investment climate in the economy gets dampened. Thus, there is an impeding impact on economic growth. Infusion of illegal money makes the money supply unpredictable, making it more difficult to manage monetary situation in the economy. Cross-border movement of illegal funds increases the volatility of international capital, and impacts the exchange rates, as it is not determinable from the official trade.

1.2.3 Social Effects

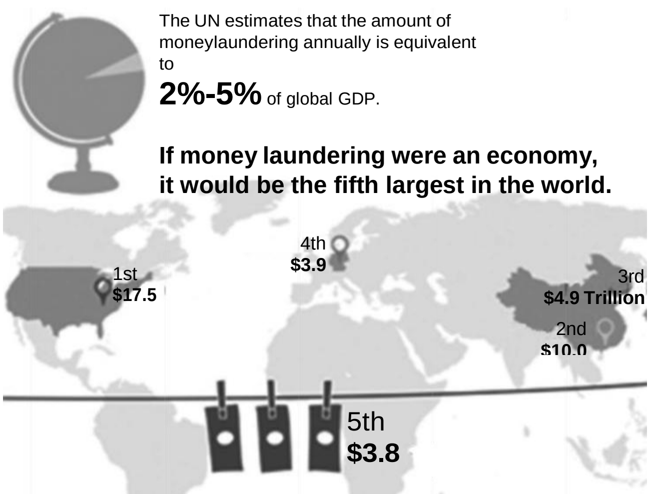
Corruption and organized crimes are two of the major concerns of several jurisdictions across the globe. Money laundering facilitates camouflaging ill-gotten wealth of corrupt officials. It facilitates structuring and perpetration of organized crimes. Thus in a jurisdiction with no control on money laundering corruption and financial frauds are likely to increase. Besides, such countries would be attractive harbors for criminals leading to deleterious effect on their social environment.

1.2.4 Political Effects

Proliferation of criminals in jurisdictions where money laundering is prevalent would lead to their gaining influence over the social and political systems. This would gradually lead to their gaining a control over the socio-political system of the country, and it would ultimately undermine its democratic system.

1.2.5 Extent of Money Laundering

Due to its very nature money laundering is not amenable to any data collection. Hence, no reliable figures are available about extent of money laundering. However, various global organizations and economic research institutes have attempted to estimate the extent of funds that would have been laundered. The first estimate of money laundering made by John Walker (University of Wollongong) in 1995 was of USD 2.8 trillion. Later, Michael Camdessus (IMF) in 1998 placed the figure at USD 1.5 trillion (about 5% of GDP). Subsequently, Buehn and Schneider estimated that in 20 OECD countries money laundering funds increased from USD 273 bn (1.33 % of GDP) in 1995 to USD 603 bn (1.74% of GDP) in 2006. A study conducted by The United Nations Office on Drugs and Crime (UNODC) estimated that funds generated by drug trafficking and organised crimes amounted to 3.6% of global GDP, with 2.7% (or USD 1.6 trillion) being laundered.



(Source: www.cebglobal.com)

Fig. 1.1 UN Estimates of Money Laundering

1.3 IMPACT ON FINANCIAL SYSTEM AND BANKS

1.3.1 Vulnerability of Financial System

Banks and financial institutions, since they deal in public money and provide a variety of services and instruments, are most vulnerable to receiving criminal money disguised in the form of genuine business. Globalisation of banking and finance coupled with technological advancement in payment systems has widened the scope for concealing criminal money and increased its mobility across borders. Absence of any preventive mechanism would expose these institutions to reputation risk, which is one of their most valuable assets. Prevalence of money laundering also enhances the risk of frauds and economic crimes, thereby impacting the soundness and stability of financial systems and the financial system of a country.

1.3.2 Impact on Reputation

Banks and other financial institutions are caught unwillingly as intermediaries in the menace of holding and transferring money derived from criminal activities, from one account to another. Criminal money moves to institutions located in areas with less controls for its tracking. Inadvertent association of these institutions with criminals and criminal money would push them into adverse publicity leading to the loss of public confidence.

1.3.3 Regulatory Action

Safety of banks depends on their functioning within a framework of high legal, professional, and ethical standards. The banks would face stringent regulatory actions for failure to check and control the criminal money entering into their system and for violation of relevant laws and regulatory guidelines. Banks and financial institutions therefore must have trained and committed staff and robust technology platforms/ software for scanning transactions.

1.4 DEFINITIONS: FROM INTERNATIONAL AGENCIES

Various international organisations that are seized with the issue of money laundering have sought to define it. A few of them have been listed below that would give an idea about various perspectives of this phenomenon.

1.4.1 United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (1988) (Vienna Convention)

‘The conversion or transfer of property, knowing that such property is derived from any [drug trafficking] offense or offenses or from an act of participation in such offense or offenses, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such an offense or offenses to evade the legal consequences of his actions;

The concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from an offense or offenses or from an act of participation in such an offense or offenses.’

‘The acquisition, possession or use of property, knowing at the time of receipt that such property was derived from an offense or offenses … or from an act of participation in such offense or offenses.'

1.4.2 Other International Definitions

'Money-laundering is the method by which criminals disguise the illegal origins of their wealth and protect their asset bases, so as to avoid the suspicion of law enforcement agencies and prevent leaving a trail of incriminating evidence.'

(United Nations Office on Drugs and Crime)

'"Money laundering" is the process by which proceeds from a criminal activity are disguised to conceal their illicit origin.'

(IMF)

'The goal of a large number of criminal acts is to generate a profit for the individual or group that carries out the act. Money laundering is the processing of these criminal proceeds to disguise their illegal origin.'

(FATF)

'Any act or attempted act to conceal or disguise the identity of illegally obtained proceeds so that they appear to have originated from legitimate sources'

(Interpol)

1.4.3 Some More Definitions

'Money is laundered to conceal criminal activity associated with it, including the crimes it generates, such as drug trafficking, or illegal tax avoidance. Money laundering is driven by criminal activities. It conceals the true source of funds, so that they can be used freely.'

(Office of the Comptroller of Currency (OCC), Washington DC, USA)

'Money laundering is the conversion of profits of illegal activities into financial assets which appear to have legitimate origins.'

(US Senate's Sub-committee on Narcotics and Terrorism)

'The concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from serious crime.'

(Article 1 of the EC Directive of March 1992)

'Money Laundering is the process by which criminal proceeds are sanitised to disguise their illicit origins. Acquisitive criminals will attempt to distance themselves from their crimes by finding safe havens for their profits where they can avoid confiscation orders, and where those proceeds can be made to appear legitimate.'

(The Crown Prosecution Service, UK)

1.5 MONEY LAUNDERING AND ITS IMPACT ON BANKS: SOME EXAMPLES

1.5.1 Bank of Credit and Commerce International

Established in the 1970s, the Bank of Credit and Commerce International (BCCI) emerged as one of the world's largest privately owned financial institutions, with operations in over 70 countries. BCCI was found to have engaged in a number of illicit activities, including money laundering. It had been wholly indiscriminate about its clients, which included traffickers, terrorists, dictators, fraud merchants, arms dealers, and other organised crime groups. The bank's operation was made up of multiple layers holding companies, affiliates, subsidiaries, etc. related to one another that was too complex to be noticed readily. It was thus able to evade usual restrictions on the movement of capital and goods. Exploiting the facilities of offshore financial centres, shell companies, and political influence, BCCI was not accountable to any jurisdiction or regulations. In July 1991, assets of BCCI worth more than US $ 12 billion were seized after regulators discovered evidence of widespread fraud.

BCCI case points out a number of important issues for bankers: bankers should be careful about knowing correspondent banks, carefully screen potential major shareholders, pay attention to the quality and extent of supervision foreign banks receive in their home countries, and be aware that asset forfeiture laws put bankers at the risk of having accounts frozen or seized.

1.5.2 European Union Bank of Antigua

The European Union Bank (EUB) initially registered as an offshore bank in Antigua in June 1994, launched its website in September 1995, and claimed to be the first Internet-based bank with facilities for customers to create and manage accounts online via the Internet. In 1996, it claimed to have a deposit base of US $ 2.8 million and 144 accounts with account holders spread across 43 countries. The bank's advertisement was explicitly aimed at people seeking to evade taxes or find a haven for dirty money where it would be beyond the reach of law-enforcement authorities. Customers could open numbered accounts, in which the customer's identity is known only by a EUB private banker or coded accounts (numbered accounts those are operated by password rather than signature). In July 1997, the EUB collapsed and the bank officials disappeared along with the deposits.

1.5.3 Riggs Bank (USA) (Pinochet)

Augusto Pinochet, the former dictator of Chile, has been widely accused of corruption and illegal arms sales since 1973. A recent report has revealed that Riggs Bank (Washington DC-based with branches in the surrounding metropolitan area, and offices around the world) helped Pinochet disguise millions of dollars that had been stolen from the Chilean people. By hiding accounts from US Federal Regulators, Riggs Bank illegally allowed Pinochet to retain access to much of his fortune. The bank and Allbritton family, the people who controlled the Riggs Bank, agreed to pay US $ 9 million to Pinochet victims for concealing and illegally facilitating movement of Pinochet money.

1.5.4 Riggs Bank (USA) (Mbasogo)

Investigations into the accounts of Riggs Bank in July 2004 revealed that the accounts of the embassy to the United States of Equatorial Guinea were allowed to make large withdrawals without properly notifying federal authorities. At least US $ 35 million were siphoned off by long-time dictator of Equatorial Guinea, Teodoro Obiang Nguema Mbasogo, his family and senior officials of his regime. Subsequently, Riggs Bank pleaded guilty and had to pay a US $ 16 million fine for violations of the US Bank Secrecy Act in February 2005.

1.5.5 Fraudulent Encashment of Cheques – KYC Issues

In August 2013, RBI received a complaint from a reputed statutory organisation through which the details of a fraud perpetrated in five large banks, with the connivance of certain officials of the statutory organization, came to its notice. The fraudsters had managed to open fictitious accounts in the name of the statutory organisation in the above five banks and operated the accounts mainly for encashing cheques/demand drafts/postal orders of which they were not the rightful owners, for periods ranging from one month to two years, without being detected by the banks. A scrutiny done by RBI in these banks revealed non-adherence to certain aspects of Know Your Customer (KYC) norms like customer identification and acceptance procedure, and non-adherence to instructions on monitoring of transactions in customer accounts. Consequently, RBI levied penalties of Rs. 50 lakhs and Rs. 25 lakhs on two banks; and cautioned three other banks.

1.5.6 Fraudulent Overdraft against FDs – KYC Issues

In July 2014, consequent upon a complaint received from a private organisation, a scrutiny of fixed deposit accounts opened in its name in Mumbai based branches of certain public sector banks was undertaken. In view of further such complaints, a wider thematic review was conducted by RBI covering 12 branches of 11 Public Sector Banks. This scrutiny revealed non-adherence to certain aspects of KYC norms of the Reserve Bank like customer identification and acceptance procedure, non-adherence to the Reserve Bank’s instructions on monitoring of transactions in customer accounts, and opening of fixed deposit accounts and granting overdrafts there against without due diligence or process, etc. Consequently, RBI levied penalties of Rs.1.5 crore each on three banks, and cautioned eight other banks.

1.5.7 Trade Based Money Laundering Investigations (October 2015)

1.5.7.1 Remittances for Fake Imports through a Public Sector Bank

During 2015, ED and CBI both took action on their investigations in suspected money laundering transactions and between them arrested ten persons – of which three were bank officials whom these agencies suspected of having aided the money laundering transactions. Between July 2014 and July 2015, through a branch of a Public Sector Bank nearly 8000 illegal remittances worth about Rs.6000 crores were made by many companies in India to a foreign destination, as payment for imports that did not take place. All these transactions were below the threshold value. Several of the companies were ‘shell companies’, as also the entities. Of this amount around 6.5% was deposited in the said accounts in cash, while the remaining amount was received through other banking channels. These transactions may have covered several banks. Serious Frauds Investigation Office is also investigating into the case. This bank has been penalized by both the RBI and FIU-India for violations of various regulatory and statutory norms related to AML/KYC measures.

1.5.7.2 Remittances for Fake Imports through Eight Banks

In the second week of October 2015, the ED took action in another forex transaction matter in which an individual was suspected of having transferred around Rs.500 crores (between 2006 and 2010) through 70 fake bank accounts opened in 7 banks. He was also remitting money to two entities abroad as payment for imports. The amount was further remitted to another international destination. The amounts remitted were deposited in cash. The individual held 66 fake bank accounts in just one bank, besides having fake accounts in several other banks.

1.5.8 Lessons for Banks and Bankers

Banking Regulators and law enforcement agencies have become stringent in enforcing AML/CFT related regulations. Not only they are more probing but are also adopting stricter approach in determining the punitive actions against erring bankers. In certain countries, especially the US and the UK, the regulators, besides taking actions against institutions, are also taking actions against the individual employees responsible for letting the violations take place.

Consequences of laxity in implementation of measures for compliance with the legal and regulatory provisions could therefore be serious. These would not only result in heavy penalties, but also grave strictures by the law enforcement agencies. This could lead to significant reputation loss for the institutions. Such eventualities would have detrimental impact on the businesses of the institutions, and also on their ability to attract global investment. Besides, lapses in customer identification and/or in monitoring transactions can possibly lead to not only money laundering problems, but also to other frauds of various kinds thereby increasing operational loss of the institutions.

Not only the institutions, even their employees are exposed to several risks arising from failures in compliance. Besides, facing personal strictures and fines, they also run the risk of facing imprisonment under legal provisions. Reputations of individuals' subject to any of such actions would also be impacted adversely and harm their future careers.

1.6 TERRORISM FINANCING

1.6.1 Terrorist Financing Phenomenon

Terrorist financing refers to mobilising or providing funds with the intention that they may be used to support terrorist acts or organizations. Funds for terrorism activities may stem from both legal and illicit sources. Those involved in the financing of terrorism do not necessarily seek to conceal the sources of the money, but to conceal both the financing and the nature of the financed activity. Terrorism activities per se do not require large quantum of funds. However, creating, running and maintaining the organisations for carrying out terrorist activities require substantial funds.

1.6.2 Definition

As per the UN's International Convention for the Suppression of the Financing of Terrorism (1999):

Any person commits an offense within the meaning of this Convention if that person by any means, directly or indirectly, unlawfully and willingly, provides or collects funds with the intention that they should be used or in the knowledge that they are to be used, in full or in part, in order to carry out:

(a) An act which constitutes an offence within the scope of and as defined in one of the treaties; or

(b) Any other act intended to cause death or serious bodily injury to a civilian, or to any other person not taking any active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing an act.

For an act to constitute an offense set forth above, it shall not be necessary that the funds were actually used to carry out an offense referred to in (a) or (b).

1.6.3 Differences in Perspectives

Not all countries that have adopted the convention agree on what actions constitute terrorism. The meaning of terrorism is not universally accepted due to significant political, religious and national implications that differ from country to country.

1.6.4 Money Laundering and Terrorist Financing

These are two different phenomena. In money laundering the source of funds is illegal and concealed, and the use of funds is legal; whereas in terrorism financing the source of funds may be illicit or legal but the use is criminal and is sought to be concealed. However, in both the cases there is an illegitimate use of the financial sector using similar or identical processes. The techniques used to launder money are essentially the same as those used to conceal the sources of, and uses for terrorist financing. There are also situations when funds raised through criminal activities are diverted for terrorism financing using similar techniques. Therefore, the measures taken for prevention of money laundering would also help detect and prevent terrorism financing related transactions.

1.7 LET US SUM UP

This chapter broadly dealt with the phenomenon of money laundering (ML), its initial stages world over; how these practices impact global economy; and its serious and visible effects on social and political environment. Further, ML practices in a jurisdiction significantly impact the Financial and Banking system of the geography. Banks / FIs, while facing the challenges have learnt lot many lessons for upgrading the solutions for the issues. Various international fora and agencies have defined money laundering phenomenon with different perspectives. Banks and financial institutions are also abused for financing terrorism (TF). The phenomenon of ML and TF are different but the modalities adopted for both purposes are similar.

1.8 CHECK YOUR PROGRESS

1. What is Money Laundering?
   (a) Money Laundering is type of investment to earn good returns.
   (b) People use this process for ensuring long term gains.
   (c) Phrase Money Laundering is described for conversion of dirty money to clean money.
   (d) Money Laundering is the process followed by Corporates to make bulk payments.

2. What is meant by TBML?
   (a) Tangible Basis of Money Lending
   (b) Trader’s Bank for Multiple Lending
   (c) Trade Basis for Money Laundering
   (d) Trade Based Money Laundering

1.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (c); **2.** (d)

CHAPTER 2

MONEY LAUNDERING: DIFFERENT METHODS

STRUCTURE

2.1 Money Laundering Process
2.2 Terrorism Financing
2.3 Common Sources of Illegal Money
2.4 Methods/Modes Used for Money Laundering/Terrorism Financing
2.5 Sensitive Avenues for Money Laundering/Terrorism Financing
2.6 Let us Sum up
2.7 Check Your Progress
2.8 Answers to 'Check your Progress'

OBJECTIVES

Knowing about Money Laundering Cycle, and Terrorism Financing purposes. Understanding how banking products and services are used by money launderers and terrorists. Knowing features of sensitive avenues used for money laundering and terrorism financing.

2.1 MONEY LAUNDERING PROCESS

2.1.1 Nature of Money Laundering Process

Money laundering is a diverse, and often a complex process. Depending on the sources of illegal funds, manner of their receipt, quantum of funds, the geographical spread of the activities and the actors involved the modalities of money laundering are conceived and adopted. The range of sophistication, and complexity in money laundering scheme is virtually infinite, and is limited only by the creative imagination and expertise of criminals. A financial institution may be used at any point in the money laundering process.

2.1.2 Basic Money Laundering Cycle

Illegal funds are usually generated in cash form be it ransom money received in case of kidnapping, or the amount received by a contract killer, or say the proceeds of illegal sale of drugs. This cash amount is sought to be transformed into legal funds, which would be substantially in the banking system. Thus the traditional methodology developed for money laundering basically involves three independent steps that often occur simultaneously, as mentioned below:

- Placement - Physically placing (i.e., depositing) the cash funds into banking system.
- Layering - Distancing the funds placed into banking system from their origins, through creation of various layers of financial transactions so that the initial entry of placement stage gets obscured.
- Integration - Accumulating the funds scattered over various accounts, and may be across several banks, at one or two points having an apparently legitimate form/purpose.

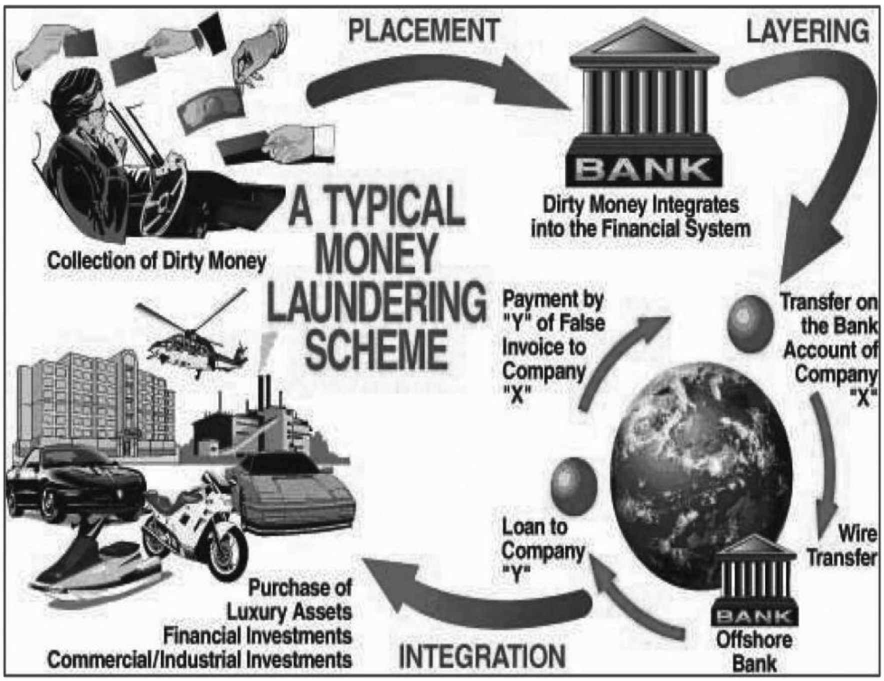
Thereafter the 'legal' funds could be invested in legal avenues or spent on super luxuries. Figure 2.1 below depicts the typical money laundering cycle.

2.1.2.1 Placement

This is generally the first stage in money laundering cycle, when the funds generated through illegal activities are introduced into the legal financial system. Typically, this is done through cash deposits in local financial institutions, or else smuggled out across the borders to a safer jurisdiction for depositing in foreign financial institutions. This poses some difficulties due to provisions of reporting requirements for cash transactions above certain threshold. Hence, at this stage typically multiple accounts are used, and through these multiple transactions carried out. Such accounts could be spread in different branches of a bank or of several banks. Besides, the launderers have been innovating new techniques to avoid getting reported under such provisions.

2.1.2.2 Layering

After introducing funds into the financial system, the launderer seeks to obscure the initial entry points from the eyes of the investigators. Layering, implying creation of layers of transactions, is the technique used for covering up the initial transactions. This is done by carrying out numerous transactions for moving the funds through different accounts, in several names and in various financial institutions. These transactions could even involve cross border transfers. These transactions usually would be in the form of structured/fake deals in prevalent business activities. These are designed to frustrate tracking of the source and nature of funds and their ownership. As high value transactions are monitored by banks closely, launderers pay particular attention to structuring these transactions deftly. Given the large number of transfer transactions of values of trillions of dollars passing through the global financial system, it is easy for launderers to slip through their illegitimate transactions unnoticed. Moreover, the information technology developments resulting in quick electronic fund transfers that can be initiated by the customer remotely through netbanking, have been a boon to the launderers.



(Source: UNODC)

Figure 2.1 Typical Money Laundering Cycle

2.1.2.3 Integration

This is the final stage in the money laundering cycle. It is the stage where the money moves into legal avenues to emerge as legitimate money and integrate into the financial system. These avenues would depend on the quantum of funds involved, the launderer's need for the funds and the objective of deployment. Typically, these avenues could be stocks, commodities, futures, investments in real estate, gold, etc. Where the objective is long term deployment of the funds, these could be invested in business activities like construction and real estate development, film making, etc. At this stage, the launderer has accomplished the objective.

2.1.3 Learning for Bankers

This analysis of typical money laundering cycle helps us to formulate an approach for detection of such illegitimate transactions. Banks are used by customers for financial transactions that would serve some bona fide or legal purpose. Having knowledge about the customers and their activities would help the banker to determine the patterns of their transactions. Spotting mismatches in the pattern of actual transactions of a customer with that evident from the customer's profile is possible with appropriate strategies and measures. At 'Placement' stage, since it involves cash it is relatively easier to detect unusual/ illegitimate transactions. At 'Layering' stage too being alert to the transaction pattern of the customer and insight into funds movement for various business activities enable detection of unusual transactions. At the 'Integration' stage it is extremely difficult for banks/financial institutions to distinguish between legal and illegal money.

2.2 TERRORISM FINANCING

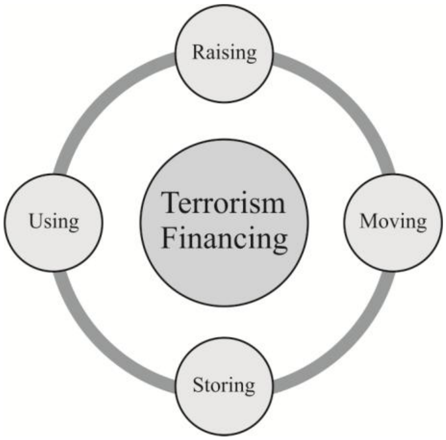
2.2.1 Features of Terrorism Financing

Terrorism Financing has two dimensions. One, funds needed to carry out specific terrorist action, say planting a few bombs in some local trains in Mumbai. Such actions do not require significant funds, given the modalities adopted for these. However, since such actions often involve persons in different locations and often different nations movement of funds is needed across these locations. Second, most terrorism activities across the globe are being carried out by organisations set up for the purpose, and these often ascribe certain 'higher ideals' like religion or political affiliations to such actions. These organisations need large amount of funds for enrolling and training their cadres, procuring weapons and other ammunitions, building up network, reconnaissance activities, publicity network for mobilizing mass support. Besides, often these organisations operate covertly under the guise of certain legitimate activities, typically social welfare, charitable activities, medical facilities, etc.

2.2.2 Financing of Terrorist Acts

Financing of individual terrorist act would need nominal amounts. These are usually transferred guised as personal remittances from the funding location to the target destination. The source of fund could be in cash or from an existing bank account. Often, the remitters and the beneficiaries could be innocent persons, who are not aware of the real purpose, and carry out the transactions for some nominal commissions paid to them. Due to their low value, these transactions are extremely difficult to notice. The terrorist attacks per se do not require large quantum of funds. However, various related activities like creating, running and maintaining the organisations for carrying out terrorist activities require substantial funds. Terrorist organisations therefore spend considerable efforts and time for raising material resources and funds for meeting the financial requirements for these activities. Many of these organisations are active in several countries and hence their financial transactions span across several countries. Moreover, the large terrorist organisations are typically funded by their sympathisers, both individuals and organisations, located in different countries. Thus, the financial transactions of terrorist organisations have similar features as of any commercial organisations. The funding cycle of a terrorist organisation can be depicted as shown in Fig. 2.2.

Figure. 2.2 Terrorism Financing Stages



2.2.3 Financing of Terrorists

There are three types of principal sources for terrorist financing:

(i) State - financing: This happens in case of state sponsorship of terrorism. In such cases separate entities are created with organizational and financial support of the State. These organizations are outwardly distanced from the state and typically engaged in some charitable/social activities on significant scale. Quantum of funds involved is substantial, and these would be received in the form of grants or indirectly as donations.

(ii) Legitimate Modes: These organisations could receive funds in the form of contributions or donations from businesses, individuals, or some charity funds for their declared activities.

(iii) Private Funding: Another source of funding for terrorists is funds raised through criminal activities. These are such criminal activities that involve large funds like bank robberies, drug trafficking, kidnapping, extortion, etc.

2.2.4 Learning for Bankers

Remittance transactions for the purpose of financing specific terrorist acts are of low value. Hence for tracking such transactions different modalities are required. The challenge is greater because very little information is available on the techniques adopted by the terrorists for this purpose. Paying attention to the locations and certain types of customers may be useful. Timely intervention in such transactions may be useful to the government intelligence and security agencies.

As regards terrorist organizations, due diligence and appropriate transaction monitoring by banks can enable them to provide very useful information to the concerned agencies that may help in detection of organisations covertly engaged in terrorist activities.

It is important for banks to have appropriate controls to avoid getting into a situation when its name gets associated with organisations or persons found guilty of terrorist activities thereby causing severe damage to the reputation of the bank.

2.3 COMMON SOURCES OF ILLEGAL MONEY

2.3.1 Typical Sources

Following are some of the most common criminal activities that generate illegal money.

- Drug trafficking
- Organised crime, e.g., extortion, prostitution, loan sharking, kidnapping, contract killing, gambling, protection money, adulteration, bank frauds, corruption, etc.
- Slush funds maintained by big corporations, e.g., bribery, payment to political parties, politicians, etc.
- International trafficking in arms
- International trafficking in human beings
- Smuggling

2.3.2 Tax Evasion

In addition, in recent years focus of governments on tax evasion has increased, perhaps arising from detection of such cases based on reports in respect of suspicious transactions. This is so because, the modalities adopted for evasion of tax on legal income are similar to those adopted by criminals to launder their illegal money. There is however still divergence of views among various countries on considering tax evasion as a predicate offence for money laundering.

2.4 METHODS/MODES USED FOR MONEY LAUNDERING/TERRORISM FINANCING

The Joint Money Laundering Steering Group, London has listed a few techniques commonly used by money launderers all over the world which are reproduced below, along with certain other methods in vogue.

2.4.1 Using Normal Banking Services

2.4.1.1 Deposit Structuring/Smurfing

The most common manner of introducing cash in financial system is by depositing it in amounts below the reporting threshold. Hence, in India since Rs. 10 lakhs is the reporting requirement, the amounts deposited would be such that they do not cross this amount. To enable handling of higher amount of funds a number of accounts are used instead of one or two accounts. In another variant, the deposits may be made by a large number of apparently unconnected depositors. The money is then generally transferred to another account. The money keeps revolving among several accounts. Countries or locations to which these funds are transferred, often find the funds being promptly removed as cash from the recipient accounts.

2.4.1.2 Multiple Tier of Accounts

In this technique, the funds are passed through multiple accounts by splitting them into two or more portions at each stage. Depending on the number of splits and the number of tiers the accounts at the base of the triangular structure could be large. Such a complex structure makes it very difficult to trace the origin of funds.

2.4.1.3 Funnel Accounts

In this variant, a bank account is opened for the purpose of deposits of dirty money to be made by several persons usually below the reporting threshold, say Rs.10 lakh. These amounts are immediately withdrawn from the account at the distant locations.

2.4.1.4 Contra Transactions

Sometimes to show heavy turnover in accounts, some amount is transferred from one account to another account, followed by an equal amount transferred from the recipient account to the originating account. Such transactions may be repeated several times during a day, over several days or even few months. The real purpose of such transactions is difficult to understand, but there would be no commercial or economic purpose for these.

2.4.1.5 Bank Drafts and Similar Instruments

Bank drafts, money orders and cashiers' cheques, purchased for cash, are useful for laundering purposes because they provide an instrument drawn on a respectable bank or other credit institutions, and thus break the money trail. This reduces the ability of the law enforcement authorities to seek a judicial order to appropriate such funds.

2.4.1.6 Cash Deposits followed by Transfers

Often for laundering huge amount of funds, large cash deposits are made in the account say by drug traffickers or others who may have smuggled this out of the country where the crime originated. Such deposits are usually quickly followed by a transfer to another jurisdiction (which may or may not be the original country where the crime was committed), in the guise of some genuine business transaction, thus lowering the risk of seizure.

2.4.1.7 Connected Accounts

Another modality followed is accounts held in the names of relatives, associates, or other persons operating on behalf of the criminal i.e. benami accounts. Similarly, services of professionals such as lawyers are used for the purpose of opening and operating accounts, keeping the identity of the real owner of funds hidden. This modality could also use shell companies, almost always incorporated in another jurisdiction, or offshore incorporation agents. These techniques are often combined with several layers of transactions and the use of multiple accounts.

2.4.1.8 *Front Companies*

Use of companies engaged in selling goods and providing services having large volume of business often cash dealings are used for mingling of dirty money along with their legitimate business dealings. Similarly, entities like banks, casinos, brokerage firms, etc. may be used. Identification requirements at least make it difficult for criminals to open accounts with false names, and hence preference for using existing companies as front.

2.4.1.9 *Legitimate Accounts*

Individuals may run a number of accounts with several banks. It is not unusual for accounts with one bank to be used for domestic purposes, while accounts with another are for ‘business purposes’. Into the former, salaries or benefits may be paid, while the latter account will be used for money transfers and cheque payments. Terrorist often use existing accounts of individuals not connected with them – ‘money mules’. This could be sometimes done for payment of a commission.

2.4.1.10 *Dormant Accounts*

On occasions, dormant accounts have been used to create a purported customer relationship, upon which additional frauds may be perpetrated. Facilities can be accessed, including bank loans, the repayment instalments of which will invariably not be met. Dormant accounts have also been used to receive monies from support members abroad. In one example, a terrorist used a number of banks, holding an account in each of them. Two of the accounts contained a minimal sum, believed to be for two purposes: firstly, to keep the account open, and secondly, to ensure that undue attention was not drawn to it. At a strategic time, a transfer was received into the account, to enable the purchase of terrorist material. The sum was eroded by a daily removal of the maximum cash amount from the automatic teller machines. This continued until the entire transfer sum had been removed, that took almost two months. Dormant accounts are also attractive to terrorists.

2.4.1.11 *Wire Transfers*

These can be effected through banks or wire transfer companies. The experience of law enforcement suggests that banks or wire transfer companies based in retail outlets containing video cameras, are used to a much lesser extent than those where the wire transfer service is franchised to a small, more localised unit. However, the extent to which these facilities are used is also determined by the ease of both sending and receiving the money. The cases where companies do not request documentation, and require only the use of a pre-agreed question and answer prior to the release of the transferred sum, particularly attract money launderers.

2.4.2 Using Special Types of Accounts

2.4.2.1 *Collection Accounts*

Collection accounts are widely used by different ethnic groups in a foreign country to remit funds home. Immigrants deposit small amounts in a single account, and the accumulated funds are then sent abroad in a single transaction. Often, a foreign account receives payments from a number of apparently unconnected accounts in the source country. Whilst this is legitimate purpose for the foreign immigrants, and labourers it can be, and is, used by criminal groups to launder their illegitimate funds.

2.4.2.2 Payable-through Accounts

Payable-through accounts are accounts maintained at financial institutions by foreign banks or corporations. The foreign bank funnels the deposits and cheques of its customers (usually individuals, or businesses located outside the country) into this single account it holds at the local bank. The foreign customers have signing authority for the account as sub-account holders, and can thereby conduct normal international banking activities. Many banks offering these types of accounts have been unable to verify or provide any information on many customers using these accounts. These accounts pose a challenge to 'know your customer' policies and requirements, and suspicious activity reporting guidelines.

2.4.3 Using Cross Border Trade/Loans

2.4.3.1 Back-to-Back Loans

Back-to-back loan arrangements can be used for cash smuggling. A money launderer transfers his/her criminal proceeds to another country as security or guarantee for a bank loan, which is then sent back to the original country. This method not only gives laundered money the appearance of a genuine loan, but often provides tax advantages.

2.4.3.2 International Trade/ Trade Finance

International trade in goods and services can be used either as a cover for money laundering or as the laundering mechanism itself. This is essentially done by creating difference in the real value of goods exchanged and the financial transaction value by manipulating the quantity or quality or description of goods. This facilitates transfer of additional amounts between the countries. This additional amount is settled among the concerned parties separately. A trader may pay a large sum of money (from the proceeds of illegal activity) for goods which are worthless and are subsequently thrown away or sold on cheaply (often as part of an invoice manipulation scheme to move money). This additional amount remitted is then credited to the launderer's account in the other country. Another mode is, illegal proceeds are used to buy high value assets such as luxury cars, aeroplanes or boats, which are then exported to third countries. Trade/invoice manipulation is one way in which agents and others engaged in alternative remittance systems settle the balance between them. It is often easier for them to engage in trade deals, as opposed to money transfers. They will also avail of usual trade finance services to maintain a façade of genuineness.

2.4.4 Using Entities in Lax Jurisdictions

2.4.4.1 Offshore Banks

There are centres where regulatory controls are few with tax benefits and secrecy protection. Many banks have flourished in these centres accepting money liberally, which facilitated money laundering. The major centres include Singapore, Hong Kong, Bahamas, Bahrain, Cayman Islands, Switzerland, etc. Deposits in these banks could be in cash smuggled into these countries from other countries, or through remittances under guise of genuine business transactions in the accounts of entities established for laundering purpose.

2.4.4.2 Shell Companies

A shell company is just that - a shell where no real business is conducted. They appear on paper, but may not physically exist. If at all any of these exists physically, they may not be engaged in manufacturing or trading operations. They are used to create the appearance of legitimate transactions through false invoices and financial statements. They also enter into financial activities such as getting loans against securities acquired from dirty money and paying taxes on profits. There are even shell banks that look like banks but not engaged in real banking activities. A shell bank (or company) can be a convenient vehicle to launder money. It conceals the identity of the beneficial owner of the funds, and the company records are often more difficult for law enforcement to access because they are offshore held by professionals who claim secrecy, or the professionals who run the company may act on remote and anonymous instructions. Such companies are used at the placement stage, to receive deposits of cash which are then often sent to another country, or at the integration stage, for example to purchase real estate.

2.4.5 Using Cards/Remittance Products

2.4.5.1 Credit and Debit Cards

Structured cash payment for outstanding credit card balances is the most common use of credit cards for money laundering. These could be with relatively large sums as payments, and in some instances, cash payments from third parties. Another method is to use cash advances from credit card accounts to purchase cashiers' cheques, or to wire funds to foreign destinations. On some occasions, cash advances are deposited into savings or current accounts. These could be used by terrorist in a manner that at the point of usage, they are not noticed or caught on a CCTV that could lead to their detection in later investigations.

2.4.5.2 Pre-paid Cards

Prepaid cards are a boon to the criminals who desire anonymity. Forex prepaid cards have made it possible to have cash funds available at call anywhere in the world and at any point of time. These usually have lower thresholds than those for credit cards, thus restricting the value of funds available. However, for financing of terrorist acts this is not a constraint. Terrorists find it useful to avail these, as these are not linked to any bank account. They can be used for procuring cash at locations across but near international border of the country where the target destination is located.

2.4.5.3 Bureaux De Change (Money Changers)

Bureaux De Change (or equivalent) services - such as telegraphic transfer facilities, and exchange services - which can be used to buy or sell foreign currencies, to consolidate small denomination bank notes into larger ones, or to exchange financial instruments such as travelers' cheques, Euro cheques, money orders, and personal cheques are attractive to money launderers. The degree of regulation over these businesses is often less stringent than that of traditional financial institutions. Their staff skills are lower, and systems and procedures relatively lax. Criminals therefore tend to uses these, especially in jurisdictions where they are not heavily regulated.

2.4.6 Using Other Remittance Service Providers

2.4.6.1 Remittance Services

Remittance systems operate in a variety of ways. Often, the remittance business receives cash, which it transfers through the banking system to another account held by an associated company in the foreign jurisdiction. There, the money can be made available to the ultimate recipient. Another technique commonly used by money remitters and currency exchanges, is for the criminal organisation to receive the funds at the destination country in the local currency, which is then sold to foreign businessmen who need the currency to fund legitimate purchases of goods for export. Remittance services are a feature of many ethnic groups; they often charge a lower commission rate than banks for transferring money to another country, and have a long history of being used to transfer money between countries. These services have also been used for money laundering, since they are often subject to few, if any, regulatory requirements as compared to banks. Terrorists also find it useful for their transactions that are of low value and where covering identities is crucial.

2.4.6.2 Alternative Remittance Systems/ Value Transfer Systems

These systems commonly involve transfer of value between countries, but outside the legitimate banking system. The 'broker', who may be a financial institution such as a remittance company, or an ordinary shop selling goods, has an arrangement with a corresponding business in another country. The two businesses have customers who want funds in the other country, and after taking their commission, the two brokers will match the amounts required by their respective customers. The details (which are usually minimal) of the recipients of the funds, are faxed or conveyed through a telephone call.

Settlement of the net amount owed by one business to the other may not, however, always take place between the two businesses directly. It may be done by one of the businesses settling an amount owed by the other businesses to a third party, or by the amount being placed or deposited elsewhere for the benefit of the second business.

Often there is no, or little, physical movement of currency across the border and a lack of formality with regard to verification and record-keeping. Normally, money transfer takes place by coded information being passed through couriers, letters or faxes, followed by telephone confirmation. Almost any document which carries an identifiable number can be used for this purpose. Because there is no recognisable audit trail, the launderer's chance of remaining undetected, or avoiding confiscation, is significantly increased.

This is another avenue that is useful for terrorists for transfer of funds clandestinely.

2.4.6.3 Hawala System

It is an alternative remittance system that operates outside the control of the government allowing for undocumented deposits, withdrawals, and transfers. These are trust based systems that leave no paper trail. Money is transferred via a network of hawala brokers. A customer approaches a hawala broker in one city, and gives a sum of money to be transferred to a recipient in another, usually a foreign city. The hawala broker calls another hawala broker in the recipient's city, gives disposition instructions of the funds. This is prevalent in certain countries of South Asia. This channel provides total anonymity, and hence is useful for funding of terrorist activity through illegal funds across borders.

2.4.7 Third Party Products/New Technology

2.4.7.1 Insurance Policies

General insurance policies provide an attractive laundering avenue; putting an expensive asset on cover, paying a large premium by bank transfer, followed by early cancellation of cover, requesting the refund remittance to be made to another bank in another country.

2.4.7.2 Emerging Technologies

The use of Internet for banking services is growing considerably and rapidly, with an increasing range of services becoming available (including savings and deposit accounts, full cheque accounts, electronic fund transfers). These are now being joined combined with Internet-based stockbroking. It is an attraction to the launderer in the absence of a face-to-face contact. Now, credit and financial institutions offer electronic money by way of a card-based electronic purse. Whilst the size/value of such purses is restricted by regulatory requirement, the opportunity to purchase such electronic money for cash, and then to use it to purchase assets, albeit modest, or obtain a refund by cheque, does provide an opportunity for structured placement.

2.4.8 Cybercrime & Cryptocurrency

2.4.8.1 Cybercrime

With growing use of technology in commercial and financial transactions, the potential opportunity for cyber criminals has also grown substantially. FinTech has in fact changed the classical first stage of money laundering i.e. in the form of cash. Cybercrimes in fact generate criminal funds within the financial system and route those funds through various stages at super-fast speed to the integration or deployment stage. This could be equally true of the low value phishing or vishing scams that siphon out small amounts of few thousands or a couple of lakhs, as also of very high value cyber-attacks like that on the Central Bank of Bangladesh.

2.4.8.2 Cryptocurrency

Crypto currencies are growing at a fast pace. They have not only drawn attention of speculative investors and traders, but more importantly of criminals. The use of crypto currencies in illicit trade and money laundering activities is growing consistently and rapidly. They have also been used by cyber-criminals. FIU efforts uncovered frauds using virtual assets, carrying out SWIFT heists and operating business email compromise schemes, among others.

As per statistics, the number of cryptocurrencies as at end-February 2022 were 10,397 as against just a handful of coins in 2013. However, top 20 of these cryptocurrencies make up 90% of the total value of cryptocurrencies. Even amongst the latter, Bitcoins have the predominant share. Crypto coins other than the Bitcoins are called Altcoins. There are several other types of virtual assets like Tokens, Non-Fungible Tokens (NFT), Stablecoins, etc.

Reuters has reported that cryptocurrency-linked crime surged to a record high in 2021 in terms of value, with illegal addresses receiving $14 billion in digital currencies, up 79% from $7.8 billion in 2020.

2.5 SENSITIVE AVENUES FOR MONEY LAUNDERING/TERRORISM FINANCING

2.5.1 Gold and Diamond Markets

There are significant differences between the gold and diamond markets. Gold is worth much more per unit of weight, and there is a constant market for it. The purity of gold is easy to determine, and assay marks are well understood and available to see. Diamonds, on the other hand, are more complex; individual diamonds can be worth much more than an equivalent weight of gold, but there has to be the 'right' buyer for a particular diamond. Besides, a diamond is not divisible i.e. a diamond worth say $100,000, cannot be cut in two halves worth $50,000 each. Valuation of diamonds is a much more complex process than gold; it involves specialised training, without any guarantee that a sale can be arranged.

2.5.1.1 Gold Market

The advantages that gold provides are attractive to the money launderer, in particular its high intrinsic value, convertibility, and the potential anonymity in transfers. Most laundering schemes involving gold are linked to drug trafficking, corruption, organised criminal activities, and illegal trade in merchandise and goods. The gold itself may be the proceeds of crime that needs to be laundered if, for example, it has been stolen or smuggled by creating a system of false invoicing. Certain societies have high demand for gold due to cultural or religious significance attached to it, and hence are heavy importers providing avenue for its smuggling. Besides, due to its high value gold is also used for structuring transactions that serve as a cover for laundering operation.

2.5.1.2 Diamond Market

The illegal trade in diamonds is important in certain areas of the world, and some terrorist groups are believed to be using diamonds from these regions to finance their activities. The ease with which diamonds can be hidden and transported, and the high value per gram for some stones, make diamonds attractive for the criminal's exploitation for profit. As with gold, the simplest typology involving diamonds consists of the direct purchase of diamonds with criminal proceeds. Other common typologies using diamond trading activity include retail foreign exchange transactions, purchasing of gaming chips at casinos, forged or fraudulent invoicing, and co-mingling of legitimate and illicit proceeds in the accounts of diamond trading companies.

2.5.2 PEPs/ Corruption

Instances of persons in charge of governing a country and senior government officials involved in corruption and other types of proceeds generating crime are no longer rare occurrences. In the past few years, several high visibility corruption cases involving corrupt politicians and others laundering significant criminal proceeds have been detected and investigated.

2.5.3 Misuse of Non-Profit Organisations (NPOs) and Charities

Non-Profit Organisation structure has been found to be very useful by terrorist outfits for carrying out their nefarious activities clandestinely. The misuse of NPOs by terrorist groups can take many forms. One, an NPO set up with a stated charitable purpose, but it actually exists only to channel funds to a terrorist organisation. In another form, an NPO with a humanitarian or charitable purpose is infiltrated by the terrorists and their supporters, often without the knowledge of the donors, or the members of staff, or management. In another mode, the organisation serves as an intermediary or cover for the movement of funds, usually on an international basis. In some cases, the NPO support function extends to the movement and logistical support of the terrorists themselves to raise money.

2.6 LET US SUM UP

This chapter broadly dealt with various money laundering methods and processes generally used by the criminals engaged in such practices. The ML cycle usually followed has three stages i.e. Placement, Layering and Integration. Different methods of ML may be used for different sources of illegal money. Uses of various types of bank accounts, schemes and remittance linked banking channels, some avenues being misused for terror funding.

2.7 CHECK YOUR PROGRESS

1. The traditional methods for ML, still in use for illegal funds, are ---------------.
    (a) Avoiding banking channels
    (b) Maintaining bank accounts in fictitious names
    (c) Placement, Layering and Integration of funds
    (d) Using cash operations without banking facility

2. Money laundering is a matter of serious concern; it affects a country's economy adversely. Which one of the following statements is incorrect?
   (a) It affects a country's revenue.
   (b) It affects the social structure, and also leads to corruption and organised crimes.
   (c) It affects the political system as criminals try to get support from leaders who are in power.
   (d) It increases money flow in the country to push middle level economic activities.

2.8 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (c); **2.** (d)

CHAPTER 3

GLOBAL EFFORTS FOR AML/ CFT BY INTERNATIONAL BODIES AND INTERNATIONAL COOPERATION AMONG COUNTRIES

STRUCTURE

OBJECTIVES

Knowing about the initiatives taken by various international organisations, viz. UN, IMF, BCBS and Wolfsberg Group for dealing with the ML and FT, including international co-operation and co-ordination. Getting a glimpse of evolution of the Standards for AML/CFT by Basel Committee on Banking Supervision. Knowing about the FATF and FTAF Style Regional Bodies. Understanding FATF Standards for Anti-money laundering, Combating Financing of Terrorism and Prevention of Proliferation of Weapons of Mass Destruction.

3.1 ENGAGEMENT OF INTERNATIONAL ORGANISATIONS

Money laundering and Terrorism are major global problems that have engaged the attention of all major primary international organisations. The extent of increase in these activities has made these organisations to continuously evolve standards and procedures for dealing with them. The need for coordination of efforts in dealing with these problems has been appreciated by various organisations. One of the earliest such initiatives was undertaken by the Committee of Ministers of the Council of Europe in June 1980. In its report the Committee of Ministers concluded that "... the banking system can play a highly effective preventive role while the cooperation of the banks also assists in the repression of such criminal acts by the judicial authorities and the police". Initially the menace of drug trafficking attracted the attention of the United Nations and other international bodies. Subsequently, other criminal activities were also included in the efforts to curb money laundering.

3.2 UNITED NATIONS INITIATIVES

3.2.1 The Vienna Convention - 1988

In 1988, at Vienna, the United Nations Convention against, illicit Traffic in Narcotic Drugs and Psychotropic Substances of 1988 mandated The United Nations Office on Drugs and Crime to establish a program for measures to be adopted by various countries for preventing drug trafficking. The measures forming the Convention also included having laws declaring as an offence conversion or transfer of any property known to be from drug trafficking or related offences, and concealing illicit origin, transfer or movement of property derived from such offences. Provision of mutual legal assistance, transfer of proceedings and other forms of co-operation among nations were also included. This essentially was the beginning of establishing legal regime for prevention of money laundering.

3.2.2 Political Declaration - 1998

The mandate to UNDC was strengthened in 1998 by the Political Declaration and the measures for countering money-laundering adopted by the General Assembly at its twentieth special session, which broadened the scope of the mandate to cover all serious crime, not just drug-related offences.

3.2.3 The Palermo Convention - 2003

In 2000, at Palermo, the UN adopted the International Convention Against Transnational Organised Crime. This included measures to fight organized crimes and required enactment of domestic laws for this purpose. Certain provisions included were making money laundering a criminal offence, and to make all serious crimes as predicate offence. Besides, it also required establishment of a regulatory regime for detecting money laundering, suspicious transaction reporting, customer identification and record keeping. Further, it called upon co-operation and exchange of information among administrative, regulatory, law enforcement and other agencies at national and international levels.

3.3 INTERNATIONAL MONETARY FUND (IMF)

IMF in view of its universal membership, surveillance functions and financial sector expertise made itself a partner in global initiatives for combating money laundering and also terrorism financing. In 2000, IMF took steps in this direction by initiating Offshore Financial Centre assessment. IMF dovetailed assessment of member countries with FATF Standards into its Financial Sector Assessment Program. It also included AML/CFT technical assistance into its regular activities. IMF is also active in studying international practices in implementing AML/CFT regimes that is useful in providing policy advice and technical assistance.

3.4 BASEL COMMITTEE ON BANKING SUPERVISION

The BCBS is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. It has published several documents related to prevention of money laundering and customer due diligence.

3.4.1 Prevention of Criminal Use of the Banking System for the Purpose of Money-Laundering (December 1988) (Since superseded)

Public confidence in banks, and hence their stability, can be undermined by adverse publicity as a result of inadvertent association by banks with criminals. In addition, banks may lay themselves open to direct losses from fraud, either through negligence in screening undesirable customers or where the integrity of their own officers has been undermined through association with criminals. For these reasons the members of the BASEL Committee consider that banking supervisors have a general role to encourage ethical standards of professional conduct among banks and other financial institutions.

In view of the reputation risk and fraud risk faced by the banks due to their inadvertent association with criminals, BCBS published a Statement containing ethical principles recommending the banks to ensure the following:

- All persons conducting business with their institutions are properly identified;
- Transactions that do not appear legitimate are discouraged; and
- Cooperation with law enforcement agencies is achieved.

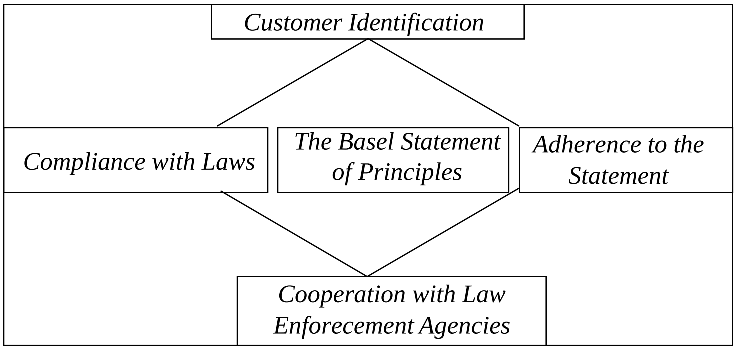


Figure 3.1 BASEL Principles Chart

3.4.2 Core Principles for Effective Banking Supervision (September 1997)

BCBS, in pursuance of the call of Lyon G-7 Summit in June 1996 for action for strengthening financial systems in various countries in the world, came out with a document on the Core Principles for Effective Banking Supervision in September 1997. One of the 25 Core Principles laid down in this paper pertains to KYC as indicated below:

> *"15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements."*

These Principles have been reviewed several times, the last being in September 2012. The revised set contains 29 Principles. The principle pertaining to KYC has been retained in a revised form as under:

> *"Principle 29 – Abuse of financial services: The supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities."*

3.4.3 Sharing of Financial Records between Jurisdictions in Connection with the Fight against Terrorist Financing (April 2002)

Based on discussions among bank supervisors and legal experts of G10 central banks, BCBS issued guidelines on "Sharing of financial records between jurisdictions in connection with the fight against terrorist financing". The paper recognizes that given the size and geographical scope of the international financial system it was imperative to significantly improve coordination and collaboration between all the parties involved, if measures to identify and prevent terrorist financing are to succeed.

The paper covered two mechanisms for information flows:

(a) from a governmental body in one country to a governmental body in another country, using an official gateway or some less formal channel, and
(b) within a single financial group (i.e. between a financial entity operating in one country and its head office or parent institution in a different country).

3.4.4 General Guide to Account Opening and Customer Identification

In October 2001, BCBS had published a Paper on 'Customer Due Diligence for Banks' which has since been superseded by its Paper on 'Sound Management of Risks related to Money Laundering and Financing of Terrorism (January 2014)'. It contained general guidelines for the following:

- Customer acceptance policy
- Customer identification
- Ongoing monitoring of accounts and transactions
- Risk Management
- KYC standards in cross border context

In February 2003, BCBS published 'General Guide to Account Opening and Customer Identification' as an attachment to this Paper. It focuses on some of the mechanisms that banks can use in developing an effective customer identification programme. It contains guidance on operational aspects of customer identification, and also information requirements for natural and juridical persons of various types.

RBI incorporated the above guidelines in their notifications for KYC AML and issued Master Direction on KYC 2016 advising these as key elements, accordingly, Regulated Entities (REs (REs) have been directed to formulate their own KYC AML Policy keeping these ingredients, re-defined as under:

- Customer acceptance policy
- Risk Management
- Customer identification
- Monitoring of transactions

3.4.5 Due Diligence and Transparency Regarding Cover Payment Messages Related to Cross Border Wire Transfers (May 2009)

Given the need to exercise greater care in respect of cross border transactions BCBS issued guidelines on 'Due Diligence and Transparency Regarding Cover Payment Messages Related to Cross Border Wire Transfers'. These guidelines seek to enhance transparency in payment messages related to cover payments. They contain norms on the information to be included in the payment messages, need for mechanisms to ensure inclusion of such information, and its use for AML/CFT purposes.

3.4.6 Sound Management of Risks Related to Money Laundering and Financing of Terrorism (January 2014, Revised July 2020)

Consequent upon FATF reviewing its 40+9 Recommendations and publishing the revised FATF Standards, BCBS published a paper on 'Sound Management of Risks Related to

Money Laundering and Financing of Terrorism' in January 2014. This is meant to support implementation of the FATF standards by exploring complementary areas. These guidelines embody both the FATF standards and the Basel Core Principles for banks operating across borders and fit into the overall framework of banking supervision. This document merges and supersedes two previous BCBS publications viz. Customer Due Diligence for Banks (October 2001), and Consolidated KYC Risk Management (October 2004). These guidelines containing distinct parts meant specifically for banks, banking groups and banking supervisors, and are a comprehensive guide for banks for taking appropriate measures for implementation of FATF recommendations. They also cover issues pertaining to AML/ CFT in a group-wide and cross-border context. Besides, in view of an increased focus on the usage by banks of third parties to introduce business, and the provision of correspondent banking services specific guidelines for these situations have been included.

Following are the main requirements enunciated in this guidance note.

Assessment and understanding of ML/TF Risks	• To be carried out at the country, sectoral, bank and business relationship level, and to apply appropriate level of mitigation.
Proper governance Arrangements	• To include that the board of directors to approve and oversee the policies for risk, risk management and compliance for ML/TF risks
Three lines of defence	• First line of defence – Business units – in charge of identifying, assessing and controlling the risks of their business • Second line of defence – chief officer in charge of AML/CFT, the compliance function but also human resources or technology • Third line of defence – the internal audit function.
Transaction monitoring System	• Adequate system with respect to its size, its activities and complexity as well as the risks present in the bank. • For most banks, especially those which are internationally active, effective monitoring is likely to necessitate the automation of the monitoring process.
Customer acceptance policy	• Basic due diligence for all customers and commensurate due diligence as the level of risk associated with the customer varies. • Customer and beneficial owner identification, verification and risk profiling using reliable, independent source documents, data or information.
Ongoing monitoring	• In relation to all business relationships and transactions based on risk as identified. • To have appropriate integrated management information systems, based on materiality and risks to provide both

	business units and risk and compliance officers timely information.
Customer and beneficial owner identification, verification and risk profiling	• A systematic procedure for identifying and verifying its customers and, where applicable, any person acting on their behalf and any beneficial owner(s). • A bank should use information to build an understanding of the customer's profile and behaviour. • To conduct due diligence on its customers sufficient to develop customer risk profiles.
Management of information	• Record-keeping: all information obtained in the context of CDD is recorded • Updating of information: by undertaking regular reviews of existing records and updating the CDD information • Supplying information to the supervisors – to demonstrate to its supervisors, on request, the adequacy of its assessment, management and mitigation of ML/FT risks.
Reporting suspicious transactions and asset freezing	• Reporting to prescribed authority. • Asset freezing as per decisions made by the competent authority
Group-wide and cross-border context	• To coordinate and apply policies and procedures on a group-wide basis. • Thorough understanding of all the risks associated with its customers across the group. • Monitoring and evaluating the AML/CFT standards in place in the jurisdiction of the referring bank. • Coordination of information-sharing in the Group, taking into account issues and obligations related to local data protection and privacy laws and regulations.

3.5 THE FINANCIAL ACTION TASK FORCE (FATF)

In response to the increasing concern over money laundering specifically in respect of the growing drug problem, the FATF was established at the G-7 Economic Summit held in Paris in 1989. It is an inter- governmental body whose purpose is to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system.

The FATF comprises 37 member jurisdictions and 2 regional organisations, total 39 members (as at March 2022), representing most major financial centres in all parts of the globe. Also, it has several regional/global organisations as associate members. Besides, it has several international organisations associated as observers. Today the FATF's work primarily focuses on the main areas depicted in Fig. 3.2 below to identify and respond to threats to the integrity of the international financial system.

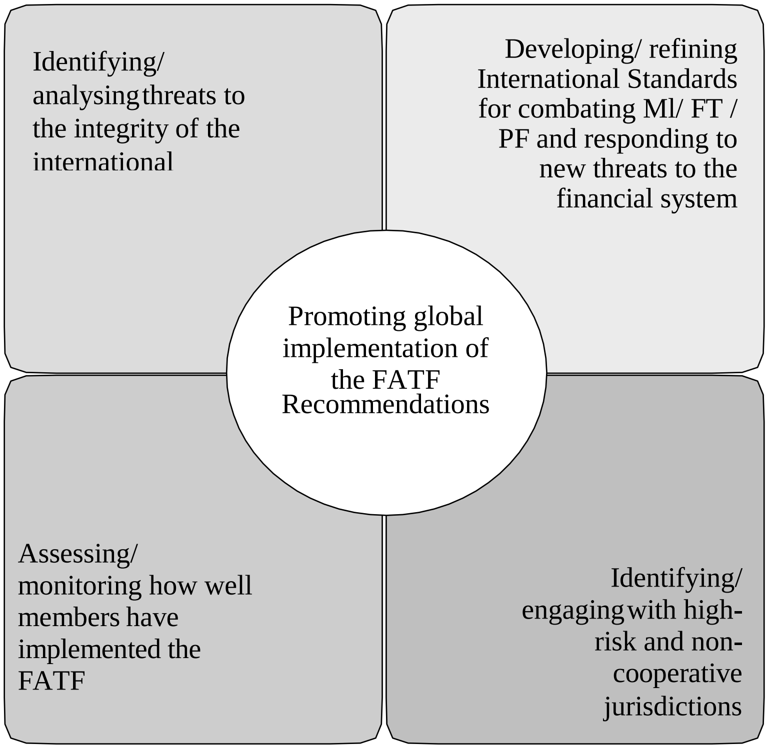


Fig. 3.2 Focus Areas for FATF

3.5.1 FATF Standards

FATF Recommendations have over the period become the core of international measures in AML and CFT areas, and have become Standards for this purpose. They form the core of FATF work. In April 1990, 'Forty Recommendations' on measures for prevention of money laundering were adopted. These were aimed at providing measures that would help detect, prevent and punish the abuse of the international financial system for money laundering. Subsequently, in 2001, Special Nine Recommendations to combat terrorist financing were established. In 2003, the standards for money laundering predicate offences and customer due diligence requirements were strengthened. In 2005 it addressed the threat posed by cash couriers by introducing measures to detect physical cross-border transportation of cash and bearer monetary instruments. United Nations Security Council Resolution 1617 (2005) strongly urged to implement FATF's 40 Recommendations on ML and 9 special recommendations on on TF.

In 2012, these Recommendations were revised and published as "International Standards on Combating Money Laundering and The Financing of Terrorism & Proliferation". The These FATF Standards updated upto Mar' 2022 are enumerated at Appendix.1. The FATF recommendations cover various aspects that require actions to be taken at various levels viz. the Governments, the Financial Regulators, the banks and the financial institutions. These Recommendations are constantly reviewed and amplified as considered appropriate in the light of emerging and new risks identified. For instance, the aspects related to virtual assets including cryptocurrencies have been incorporated. Similarly, the need for asking legal persons to keep and provide information on beneficial owners, and for such information to be recorded by the registries has been added to the relevant Recommendations.

The salient points of those recommendations that pertain to banks are given in Table 3.1 below.

Table 3.1 FATF Recommendations - Applicable for Banks

Recommendation No./Major Requirement	
1. Assessing risks & applying a risk-based approach	
Assess Risks	To assess and take effective action to mitigate ML/TF risks.
Higher Risks	Adequately address them.
10. Customer due diligence	
Prohibitions	Accounts: Anonymous/Fictitious names
Stages for CDD	• Establishing business relations; • Occasional transactions, • Doubtful identity, • Suspicious transactions
CDD measures	• Verify Identity of customer/beneficial owner, • Ascertain the purpose/nature of relationship. • Ongoing scrutiny of transactions • Can do soon after establishing relationship, if effective control on ML/TF risks.
CDD – Not Possible	• Not to open the account/or perform the transaction; • Terminate relationship; • Consider making a STR.
11. Record keeping	
Transaction records	• 5 years from date
CDD records	• 5 years after the end of relationship/date of occasional transaction.
12. Politically exposed persons	
Foreign PEPs (Customer/ Beneficial Owner)/Family Members/Close Associates	• Systems to determine whether a PEP • Senior management approval for relationships • Ascertain source of funds • Enhanced ongoing monitoring
Domestic PEPs (Customer/ Beneficial Owner)/Person entrusted	• To determine whether a PEP • Similar measures as for Foreign PEPs

with prominent function by an international organisation/Family Members/Close Associates	
13. Correspondent banking	
Cross Border Correspondent Banking/ Similar Arrangements – Additional Measures	• Gather sufficient information • Assess its AML/CFT controls; • Senior Management approval • Understand the respective responsibilities,
Payable-through accounts	• To be satisfied - Correspondent conducted CDD on the customers with access to their accounts • Is able to provide CDD information on request
Shell Banks	• Prohibited from relationship with shell banks. • Satisfy themselves that respondent banks do not permit their accounts to be used by shell banks.
15. New technologies	
	• Assess ML/TF risks pertaining to – • Development of new products/new business practices/new delivery mechanisms. • Use of new/developing technologies for both new/and pre-existing products. • To be done prior to launch/use of the new products, business practices/ technologies. • Take measures to manage/mitigate those risks.
16. Wire transfers	
Wire transfers	• Include required/accurate originator/beneficiary information • Measures, if detected without required originator/beneficiary information
Freezing/Prohibitions	• Freezing action/prohibition on from conducting transactions with designated persons/entities (UNSCR Resolution 1267 (1999)/1373(2001)
17. Reliance on third parties	
Reliance on third parties	• Can rely on third parties for some of CDD • Ultimate responsibility for CDD with the FI
Criteria	• Immediately obtain the necessary information of the CDD measures. • To satisfy that copies of documents will be available from the third party. • (c) The third party to be regulated, supervised or monitored for, and capable of CDD and record-keeping • (d) Decide countries where the third party can be used, consider information on the country risk.

18. Internal controls and foreign branches and subsidiaries	
	• Implement programmes against ML-TF. • Implement group-wide programmes against ML-TF • Foreign branches/majority owned subsidiaries to apply AML/CFT measures consistent with the home country requirements.
21. Tipping-off and confidentiality	
Financial institutions/ directors/officers and employees	• Protection from criminal/civil liability for breach of any confidentiality, if reported their suspicions in good faith to the FIU • Prohibited from disclosing ("tipping-off") that a STR or related information is being filed with the FIU.

3.5.3 FATF's Statements Highlighting Deficiencies in the AML/CFT Systems in Certain Jurisdictions

The FATF undertakes ongoing reviews of the progress made in AML /CFT regimes of certain identified countries against the standards prescribed by it and issues advisory for the international community highlighting weaknesses in the AML /CFT regimes of various countries. Based on the review it publishes two lists of countries thrice every year with updated categorisation.

The lists of FATF high and other monitored jurisdictions can be obtained on the website https://www.fatf-gafi.org/publications/high-risk-and-other-monitored-jurisdictions/ .

(i) ***High Risk Jurisdictions subject to a Call for Action ("Black List")***: This contains jurisdictions with strategic deficiencies in anti-money laundering/countering the financing of terrorism measures. It denotes that FATF members and other jurisdictions need to apply counter-measures to protect the international financial system from the ongoing and substantial money laundering and financing of terrorism (ML/FT) risks.

(ii) ***Jurisdiction under Increased Monitoring ("Grey List")***: This contains jurisdictions identified with strategic deficiencies, for which they have committed to resolve swiftly the identified strategic deficiencies within agreed timeframes.

During the reviews made, those countries that show adequate progress in remediating the deficiencies are removed from the list. On the other hand, in case during review and mutual evaluation, if it is found that certain residual deficiencies continue to persist or certain other risk factors that are not addressed come to light for certain country, it is added to the list.

Jurisdictions that have made adequate progress and achieved the desired level of implementation of the FATF standards are removed from FATF's on-Going AML/CFT Compliance Process.

3.5.4 High Risk Sectors/Activities

FATF has been engaged in research of vulnerabilities of specific sectors/activities so as to develop policy responses to these. Through one of the studies, proliferation of weapons of mass destruction was identified as a threat. It led to the inclusion of the financing of proliferation in the FATF Recommendation adopted in 2012. Some of the typology studies conducted by FATF are football sector (2009), free trade zones (2010), corruption (2011) legal professionals (2013), non-profit organisations and the diamond sector (2014).

3.5.5 Mutual Evaluation of Countries

FATF introduced the procedure of mutual evaluation of various countries. This methodology has been revised in October 2013 for the fourth round of evaluation. The mutual evaluation now includes:

(a) ***Technical Compliance*** – Ratings to indicate how well a country has implemented the technical requirements of the FATF Recommendations (compliant; largely compliant; partially compliant; non-compliant)

(b) ***Effectiveness*** – Ratings to indicate a country's level of effectiveness on each of the eleven Immediate Outcomes, ranging from high level of effectiveness to low level of effectiveness.

Each of the eleven immediate outcomes represents one of the key goals, which an effective AML/CFT system should achieve. During the assessment, various components of the AML/CFT measures are looked at to ascertain how they interact and whether they give the expected results. There is also a follow-up process to ensure that countries take measures to address the weaknesses in their systems.

By the end of 2020-21 Plenary Year FATF had published Mutual Evaluation Reports of 28 of its 37 member countries based on the Fourth Round Evaluation Methodology. These reports demonstrate that commitment to technical compliance with the FATF standards is high. On 76% of the Recommendations the countries were Largely Compliant (LC) or Compliant (C). On effectiveness 45% of Immediate Outcomes were assessed as achieved to a high or substantial extent. For 46% of Immediate Outcomes the countries were moderately effective. The distribution of assessment for Technical Compliance and For Effectiveness, for the 28 countries evaluated till then, is shown in Fig. 3.3 and Fig. 3.4 respectively.

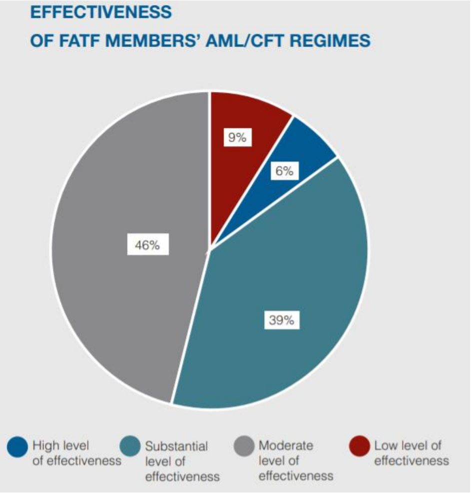


Fig 3.3 Technical Compliance Status

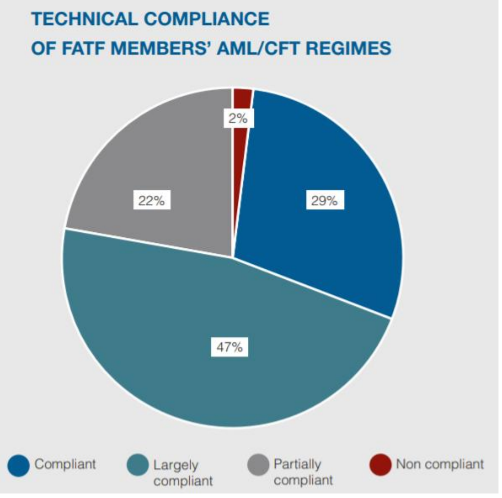


Fig. 3.4 Effectiveness Status

(Source: FATF Annual Report 2020-21)

3.5.6 FATF-STYLE REGIONAL BODIES

While FATF is the international body for AML/CFT standards, considering their extensive occurrence and diverse complexities in different regions, several initiatives have also been taken on regional levels. There are several regional bodies that are engaged in activities similar to FATF and support the efforts of FATF actively. These agencies also join FATF in its exercise of evaluation of various jurisdictions.

3.5.7 Asia/Pacific Group on Money Laundering (APG)

The Asia/Pacific Group on Money Laundering (APG) is an autonomous and collaborative inter-governmental organisation founded in February 1997 in Bangkok, Thailand consisting of 41 member jurisdictions regionally focused within the Asia-Pacific, and a number of international and regional observers. The purpose of the APG is to facilitate the adoption, implementation and enforcement of internationally accepted anti-money laundering and anti-terrorist financing standards set out in the recommendations of the Financial Action Task Force (FATF). The APG allows regional factors to be taken into account in the implementation of anti-money laundering and anti-terrorist financing measures, and provides for peer review by means of a mutual evaluation process.

3.5.8 Caribbean Financial Action Task Force (CFATF)

The Caribbean Financial Action Task Force (CFATF) is an organisation with membership of 24 countries (as of March 2022) of the Caribbean Basin. In May 1990, representatives from the Caribbean and from Central America met and identified 19 issues specific to the region, which were adopted in November 1992. It issues public statement on jurisdictions reviewed for measures taken by them for addressing the deficiencies identified in mutual evaluations of these jurisdictions.

3.5.9 Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL)

The Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) is a monitoring body of the Council of Europe entrusted with the task of assessing compliance with the principal international standards to counter money laundering and the financing of terrorism, and the effectiveness of their implementation, as well as with the task of making recommendations to national authorities in respect of necessary improvements to their systems.

3.5.10 Eurasian Group (EAG)

The Eurasian group on combating money laundering and financing of terrorism (EAG) is a FATF-style regional body comprising Belarus, China, Kazakhstan, Kyrgyzstan, India, Russia, Tajikistan, Turkmenistan and Uzbekistan, and 15 more countries and 23 international and regional organizations have observer status within the EAG. The EAG supports countries in the region to create an appropriate legal and institutional framework combating money laundering and terrorist financing in line with FATF standards.

3.5.11 Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG)

Established in August 1999, it has 19 member states of the region. It also has a number of regional and international observers. It has carried out several mutual evaluations.

3.5.12 Financial Action Task Force of Latin America (GAFILAT)

(formerly known as Financial Action Task Force of South America (GAFISUD))

Established in December 2000, it has 17 member states, and 6 States and 9 organisations as observers.

3.5.13 Governmental Action Group against Money Laundering in West Africa (GIABA)

It is an institution of the Economic Community of West African States (ECOWAS) responsible for facilitating the adoption and implementation of Anti-Money Laundering (AML) and Counter-Financing of Terrorism (CFT) in West Africa. It is also a FATF-Styled Regional Body (FSRB) working with its member States to ensure compliance with international AML/CFT standards. It has 16 member states.

3.5.14 Middle East and North Africa Financial Action Task Force (MENAFATF)

Established in November 2004, it has 21 member States, and 6 States and 11 organisations as observers.

3.5.15 Task Force on Money Laundering in Central Africa (GABAC)

(Groupe d'Action contre le blanchiment d'Argent en Afrique Centrale (GABAC))

It is a body of the Economic and Monetary Community of Central Africa. It was established in 2000, and was recognized as an FSRB in 2015. Its objectives are assessing the compliance of its members against the FATF Standards, provide technical assistance to its member States and facilitate international co-operation. It has 7 countries and 4 organisations as members. Besides, it has 5 organisations as observers.

3.5.16 Group of International Finance Centre Supervisors (GIFCS)

(Formerly Offshore Group of Banking Supervisors (OGBS))

At instance of the BCBS, in October 1980, Offshore Group of Banking Supervisors was formed of the authorities in the identified offshore finance centres. Its objective is to cooperate with relevant international organizations in setting and promoting the implementation of international standards for cross-border banking supervision, and for combating money laundering and terrorist financing. Its role has since expanded to cover the regulation of trust and company service providers, and most recently the regulation of hedge funds. It has observer status with the Financial Action Task Force on Money Laundering and Terrorist Financing, and has a close working relationship with the Basel Committee.

3.6 THE WOLFSBERG GROUP

The Wolfsberg Group is an association of 13 global banks formed with the objective to develop frameworks and guidance for the management of financial crime risks, particularly with respect to KYC/AML/CFT policies. It was formed in the year 2000, primarily to work on the AML guidelines for private banking. The Group has worked on several aspects of AML/KYC practices and framed guidelines to help banks and financial institutions in implementation of AML/CFT measures.

3.6.1 Correspondent Banking Guidelines

One of its significant work is its guidelines on Correspondent Banking Due Diligence along with associating with development of 'Due Diligence Registry' for financial institutions, and an AML Questionnaire that would provide the counterparty bank essential information on the KYC/AML policies of the financial institutions.

3.7 FINANCIAL INTELLIGENCE UNITS (FIU)

Consequent to development of anti- money laundering techniques including reporting of suspicious transactions, the need was felt for an agency to receive, analyze, and disseminate financial information to combat money laundering. This led to establishment of Financial Intelligence Units in several countries, in the early nineties. The main objectives of setting FIUs are as follows:

- Law enforcement agencies had limited access to relevant financial information.
- To engage the financial system in the efforts to combat money laundering.
- To report suspect financial transactions by financial institutions to a central agency for assessing and processing reported transactions.

In 2003, while reviewing the 40 Recommendations, FATF included explicitly recommendations on the establishment and functioning of FIUs. The primary purpose of FIUs is to collect reports of transactions that are likely to be related to ML/TF, analyse these and provide appropriate information to law enforcing agencies that could be helpful in detecting money laundering or criminal activities. In 1996, Egmont Group formalised following definition of FIU:

> *"A central, national agency responsible for receiving (and as permitted, requesting) analysing, and disseminating to the competent authorities, disclosures of financial information:*
>
> *(i) concerning suspected proceeds of crime, or*
>
> *(ii) required by national legislation or regulation, in order to combat money laundering."*

There are four FIU models in existence. The basic aspects of the four models are as follows:

(i) **Judicial Model**: It is established within judicial branch of the government. The suspicious financial activity is reported to an investigative agency of the country.

(ii) **Law Enforcement Model**: In this model there may be more than one law enforcement agencies that also look into money laundering offences.

(iii) **Administrative Model**: A centralised independent body is created to act as a link between the financial sector and the law enforcement authorities.

(iv) **Hybrid Model**: In this model FIU is a disclosure intermediary and also serves as a bridge for both judicial and law enforcement authorities.

3.8 THE EGMONT GROUP OF FINANCIAL INTELLIGENCE UNITS

Recognising the importance of international co-operation, an informal network of FIUs was initiated. This has developed into The Egmont Group, and the FATF 2012 Standards require that every FIU becomes its member. The objective of the Group is to find ways to promote the development of FIUs and to cooperate, especially in the areas of information exchange, training and the sharing of expertise.

It has published 'Operational Guidance for FIUs' in addition to the 'Egmont Charter' and the 'Egmont Principles for Information Exchange'. It currently (March 2022) has 167 members.

Egmont Group comprises following groups:

i. Heads of Financial Intelligence Units (HoFIU): They form the main governing body of Egmont Group. They meet annually during the Egmont Group Plenary meeting.
ii. Egmont Committee (EC): This is the coordination mechanism for HoFIU and Working Groups. It assists Egmont Group in its activities.
iii. Working Groups (WG): There are four working Groups devoted to specific topics. The four groups are as follows:
    a. Information Exchange Working Group (IEWG)
    b. Membership, Support, and Compliance Working Group (MSCWG)
    c. Policy and Procedures Working Group (PPWG)
    d. Technical Assistance and Training Working Group (TATWG)
iv. Regional Groups (RG): These groups help Egmont Group in meeting its objectives.
v. Egmont Group Secretariat (EGS): It is based in Canada and it provides assistance to the HoFIU, EC, WG and RG.
vi. Egmont Centre of FIU Excellence and Leadership (ECOFEL): This is an organ, created in April 2018, that assist FIUs to strive towards excellence.

3.9 LET US SUM UP

This chapter gives overview about

- ❖ Global initiatives of various international agencies in respect of AML & CFT measures.
- ❖ Successive guidelines issued by BCBS on customer due diligence, in the context of money laundering and terrorist funding, in line with their core principles of banking supervision for managing risks.
- ❖ Current Guidance note of BCBS about Sound Management of Risks Related to Money Laundering and Financing of Terrorism.
- ❖ Functions of FATF, and about various FSRBs that support FATF in AML/CFT measures
- ❖ FATF Recommendations for managing ML/TF/PF crimes to be followed by various countries,
- ❖ Guidance and norms issued by The Wolfsberg Group in respect of various aspects related to AML/ CFT and Correspondent Banking relationship.

3.10 CHECK YOUR PROGRESS

1. Initial steps at international level for prevention of money laundering were taken by _____.
   (a) International Monetary Fund- IMF
   (b) Non Aligned Movement- NAM
   (c) United Nations
   (d) Group of Allied Countries

2. Which is the organisation that sets the global standards for managing ML/TF/FC risks?
   (a) International Monetary Fund
   (b) The Wolfsberg Group
   (c) Basel Committee on Banking Supervision
   (d) Financial Action Task Force

3. FATF standards now include _____ recommendations.
   (a) 39
   (b) 40*
   (c) 26 for banks & 12 for FIs
   (d) 30 principals and 8 special

4. FATF reviews periodically selected countries posing high risk and having weak AML/CFT jurisdiction which are grouped in _____Lists.
   (a) White & Red
   (b) Grey & Red
   (c) Red & Green
   (d) Black & Grey*

3.11 ANSWERS TO CHECK YOUR PROGRESS

1. (c); **2.** (d); **3.** (b); **4.** (d)

APPENDIX 1

List of FATF Recommendations (Updated March 2022)

Number	
A – AML/CFT POLICIES AND COORDINATION	
1	Assessing risks & applying a risk-based approach *
2	National cooperation and coordination *
B – MONEY LAUNDERING AND CONFISCATION	
3	Money laundering offence *
4	Confiscation and provisional measures *
C – TERRORIST FINANCING AND FINANCING OF PROLIFERATION	
5	Terrorist financing offence *
6	Targeted financial sanctions related to terrorism & terrorist financing *
7	Targeted financial sanctions related to proliferation *
8	Non-profit organisations *
D – PREVENTIVE MEASURES	
9	Financial institution secrecy laws
	Customer due diligence and record keeping
10	Customer due diligence *
11	Record keeping
	Additional measures for specific customers and activities
12	Politically exposed persons *
13	Correspondent banking *
14	Money or value transfer services *
15	New technologies *
16	Wire transfers *
	Reliance, Controls and Financial Groups
17	Reliance on third parties *
18	Internal controls and foreign branches and subsidiaries *
19	Higher-risk countries *
	Reporting of suspicious transactions
20	Reporting of suspicious transactions *
21	Tipping-off and confidentiality
	Designated non-financial Businesses and Professions (DNFBPs)
22	DNFBPs: Customer due diligence *

23	DNFBPs: Other measures *
E – TRANSPARENCY AND BENEFICIAL OWNERSHIP OF LEGAL PERSONS AND ARRANGEMENTS	
24	Transparency and beneficial ownership of legal persons *
25	Transparency and beneficial ownership of legal arrangements *
F – POWERS AND RESPONSIBILITIES OF COMPETENT AUTHORITIES AND OTHER INSTITUTIONAL MEASURES	
	Regulation and Supervision
26	Regulation and supervision of financial institutions *
27	Powers of supervisors
28	Regulation and supervision of DNFBPs *
	Operational and Law Enforcement
29	Financial intelligence units *
30	Responsibilities of law enforcement and investigative authorities *
31	Powers of law enforcement and investigative authorities
32	Cash couriers *
	General Requirements
33	Statistics
34	Guidance and feedback
	Sanctions
35	Sanctions
G – INTERNATIONAL COOPERATION	
36	International instruments
37	Mutual legal assistance
38	Mutual legal assistance: freezing and confiscation *
39	Extradition
40	Other forms of international cooperation *
* These Recommendations are supplemented by Interpretive Notes to be read in conjunction with the respective Recommendations.	

Brief Synopsis of FATF Recommendations

A. AML/CFT POLICIES AND COORDINATION

1. Assessing risks and applying a risk-based approach

- ❖ Countries should identify, assess, and understand the money laundering and terrorist financing risks for the country.
- ❖ Countries should apply a risk-based approach (RBA) to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified.
- ❖ Countries should require financial institutions and designated non-financial businesses and professions (DNFBPs) to identify, assess and take effective action to mitigate their money laundering and terrorist financing risks.

2. National cooperation and coordination

- ❖ Countries should have national AML/CFT policies, based on the risks identified, which should be regularly reviewed. Should ensure compatibility of AML/CFT requirements and data protection and privacy rules, and should promote domestic inter-agency information sharing.

B. MONEY LAUNDERING AND CONFISCATION

3. Money laundering offence

- ❖ Countries should criminalise money laundering on the basis of the Vienna Convention and the Palermo Convention.
- ❖ Countries should apply the crime of money laundering to all serious offences, with a view to including the widest range of predicate offences.

4. Confiscation and provisional measures

- ❖ Countries should adopt measures including legislative measures, to freeze or seize and confiscate: (a) property laundered, (b) proceeds from, or instrumentalities used in or intended for use in money laundering or predicate offences, (c) property that is the proceeds of, or used in, or intended or allocated for use in, the financing of terrorism, terrorist acts or terrorist organisations, or (d) property of corresponding value.

C. TERRORIST FINANCING AND FINANCING OF PROLIFERATION

5. Terrorist financing offence

- ❖ Countries should criminalise terrorist financing and also the financing of terrorist organisations and individual terrorists.
- ❖ Countries should ensure that such offences are designated as money laundering predicate offences.

6. Targeted financial sanctions related to terrorism and terrorist financing

- ❖ Countries should implement targeted financial sanctions regimes to comply with United Nations Security Council resolutions relating to the prevention and suppression of terrorism and terrorist financing; including in accordance with resolution 1267 (1999) and its successor resolutions; or (ii) designated by that country pursuant to resolution 1373 (2001).

7. **Targeted financial sanctions related to proliferation**
   - ❖ Countries should implement targeted financial sanctions to comply with United Nations Security Council resolutions relating to the prevention, suppression and disruption of proliferation of weapons of mass destruction and its financing.

8. **Non-profit organisations**
   - ❖ Countries should review the adequacy of laws and regulations that relate to entities that can be abused for the financing of terrorism. Non-profit organisations are particularly vulnerable, and countries should ensure that they cannot be misused. Specific subset of NPOs to be subject to supervision and monitoring.

D. PREVENTIVE MEASURES

9. **Financial institution secrecy laws**
   - ❖ Countries should ensure that financial institution secrecy laws do not inhibit implementation of the FATF Recommendations.

CUSTOMER DUE DILIGENCE AND RECORD-KEEPING

10. **Customer due diligence**
    - ❖ Financial institutions should be prohibited from keeping anonymous accounts or accounts in obviously fictitious names.
    - ❖ Financial institutions should be required to undertake customer due diligence (CDD) measures for establishing business relations or conducting a transaction above a threshold value.
    - ❖ The CDD measures include identifying the customer and the beneficial owner, know the purpose of relation.
    - ❖ To apply CDD measures using a risk-based approach (RBA).
    - ❖ Where unable to comply applicable requirements not to open the account, commence business relations or perform the transaction; or to terminate the business relationship; and consider making a suspicious transactions report in relation to the customer.
    - ❖ Apply to all new customers, and to existing customers on the basis of materiality and risk.

11. **Record-keeping**
    - ❖ To maintain, for at least five years, all necessary records on transactions, both domestic and international, sufficient to 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 criminal activity.
    - ❖ To keep all records obtained through CDD measures (e.g. copies or records of official identification documents like passports, identity cards, driving licences or similar documents), account files and business correspondence, including the results of any analysis undertaken for at least five years after the business relationship is ended, or after the date of the occasional transaction.

ADDITIONAL MEASURES FOR SPECIFIC CUSTOMERS AND ACTIVITIES

12. Politically exposed persons

- ❖ In relation to foreign politically exposed persons (PEPs) in addition to performing normal customer due diligence measures, to take reasonable measures to establish the source of wealth and source of funds; and obtain senior management approval for establishing (or continuing, for existing customers) such business relationships.
- ❖ The requirements for all types of PEP should also apply to family members or close associates of such PEPs.

13. Correspondent banking

- ❖ Financial institutions should be required, in relation to cross-border correspondent banking and other similar relationships, in addition to performing normal customer due diligence measures, to gather sufficient information about a respondent institution to assess its AML/ CFT controls and practices.
- ❖ With respect to "payable-through accounts", be satisfied that the respondent bank has conducted CDD on the customers having direct access to accounts of the correspondent bank, and that it is able to provide relevant CDD information upon request to the correspondent bank.
- ❖ Financial institutions should be prohibited from entering into, or continuing, a correspondent banking relationship with shell banks.

14. Money or value transfer services

- ❖ To ensure that natural or legal persons that provide money or value transfer services (MVTS) are licensed or registered, and subject to effective systems for monitoring and ensuring compliance with the relevant measures called for in the FATF Recommendations.
- ❖ MVTS providers that use agents include them in their AML/CFT programmes and monitor them for compliance with these programmes.

15. New technologies

- ❖ To identify and assess the money laundering or terrorist financing risks that may arise in relation to (a) the development of new products and new business practices, including new delivery mechanisms, and (b) the use of new or developing technologies for both new and pre-existing products. AML/CFT requirements also apply in the context of virtual assets.

16. Wire transfers

- ❖ To include required and accurate originator information, and required beneficiary information, on wire transfers and related messages, and that the information remains with the wire transfer or related message throughout the payment chain.
- ❖ To ensure that, in the context of processing wire transfers, take freezing action and prohibit conducting transactions with designated persons and entities, United Nations Security Council resolutions, 1267 (1999) and its successor resolutions, and resolution 1373(2001), relating to the prevention and suppression of terrorism and terrorist financing.

RELIANCE, CONTROLS AND FINANCIAL GROUPS

17. Reliance on third parties

- ❖ May rely on third parties to perform some elements of the CDD measures or to introduce business, provided that they meet laid down criteria. The ultimate responsibility for CDD measures remains with the financial institution relying on the third party.

18. Internal controls and foreign branches and subsidiaries

- ❖ Financial institutions to implement programmes against money laundering and terrorist financing.
- ❖ Financial institutions to ensure that their foreign branches and majority-owned subsidiaries apply AML/CFT measures consistent with the home country requirements.

19. Higher-risk countries

- ❖ Financial institutions to apply enhanced due diligence measures to business relationships and transactions with natural and legal persons, and financial institutions, from countries for which this is called for by the FATF.

REPORTING OF SUSPICIOUS TRANSACTIONS

20. Reporting of suspicious transactions

- ❖ If a financial institution suspects or has reasonable grounds to suspect that funds are the proceeds of a criminal activity, or are related to terrorist financing, it should be required, by law, to report promptly its suspicions to the financial intelligence unit (FIU).

21. Tipping-off and confidentiality

- ❖ Financial institutions, their directors, officers and employees should be protected from criminal and civil liability for breach of any restriction on disclosure of information in good faith to the FIU.
- ❖ Financial institutions, their directors, officers and employees should be prohibited by law from disclosing ("tipping-off") the fact that a suspicious transaction report (STR) or related information is being filed with the FIU.

DESIGNATED NON-FINANCIAL BUSINESSES AND PROFESSIONS

22. DNFBPs: customer due diligence

- ❖ The customer due diligence and record-keeping requirements, apply to designated non-financial businesses and professions (DNFBPs) in specified situations. DNFBPS should apply group-wide programmes.
- ❖ DNFBPs – Casinos, Real estate agents, Dealers in precious metals and dealers in precious stones, Lawyers, notaries, other independent legal professionals and accountants, and Trust and company service providers.

23. DNFBPs: Other measures

- ❖ The requirements of foreign branches obligations, measures against high risk

E. TRANSPARENCY AND BENEFICIAL OWNERSHIP OF LEGAL PERSONS AND ARRANGEMENTS

24. Transparency and beneficial ownership of legal persons

- ❖ To prevent the misuse of legal persons for money laundering or terrorist financing, ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons.

25. Transparency and beneficial ownership of legal arrangements

- ❖ To take measures to prevent the misuse of legal arrangements for money laundering or terrorist financing, ensure that there is adequate, accurate and timely information on express trusts, including information on the settlor, trustee and beneficiaries.

F. POWERS AND RESPONSIBILITIES OF COMPETENT AUTHORITIES, AND OTHER INSTITUTIONAL MEASURES

REGULATION AND SUPERVISION

26. Regulation and supervision of financial institutions

- ❖ Financial institutions to be subject to adequate regulation and supervision and are effectively implementing the FATF Recommendations.
- ❖ At a minimum, where financial institutions provide a service of money or value transfer, or of money or currency changing, they should be licensed or registered, and subject to effective systems for monitoring and ensuring compliance with national AML/CFT requirements.

27. Powers of supervisors

- ❖ Supervisors should have adequate powers to supervise or monitor, and ensure compliance by, financial institutions with requirements to combat money laundering and terrorist financing, including the authority to conduct inspections.

28. Regulation and supervision of DNFBPs

- ❖ Designated non-financial businesses and professions should be subject to regulatory and supervisory measures.

OPERATIONAL AND LAW ENFORCEMENT

29. Financial intelligence units

- ❖ Countries should establish a financial intelligence unit (FIU) that serves as a national centre for the receipt and analysis of: (a) suspicious transaction reports; and (b) other information relevant to money laundering, associated predicate offences and terrorist financing, and for the dissemination of the results of that analysis.

30. Responsibilities of law enforcement and investigative authorities

- ❖ Countries should ensure that designated law enforcement authorities have responsibility for money laundering and terrorist financing investigations within the framework of national AML/CFT policies.
- ❖ Countries should ensure that, when necessary, cooperative investigations with appropriate competent authorities in other countries take place.

31. Powers of law enforcement and investigative authorities

- ❖ When conducting investigations of money laundering, associated predicate offences and terrorist financing, competent authorities should be able to obtain access to all necessary documents and information for use in those investigations, and in prosecutions and related actions. This should include powers to use compulsory measures for the production of records held by financial institutions, DNFBPs and other natural or legal persons, for the search of persons and premises, for taking witness statements, and for the seizure and obtaining of evidence.

32. Cash couriers

- ❖ Countries should have measures in place to detect the physical cross-border transportation of currency and bearer negotiable instruments, including through a declaration system and/or disclosure system.

GENERAL REQUIREMENTS

33. Statistics

- ❖ Countries should maintain comprehensive statistics on matters relevant to the effectiveness and efficiency of their AML/CFT systems.

34. Guidance and feedback

- ❖ The competent authorities, supervisors and SRBs should establish guidelines, and provide feedback, which will assist financial institutions and DNFBPs.

SANCTIONS

35. Sanctions

- ❖ Countries should ensure that there is a range of effective, proportionate and dissuasive sanctions, available to deal with natural or legal persons that fail to comply with AML/ CFT requirements.

G. INTERNATIONAL COOPERATION

36. International instruments

- ❖ Countries should take immediate steps to become party to and implement fully the Vienna Convention, 1988; the Palermo Convention, 2000; the United Nations Convention against Corruption, 2003; and the Terrorist Financing Convention, 1999.

37. Mutual legal assistance

- ❖ Countries should rapidly, constructively and effectively provide the widest possible range of mutual legal assistance in relation to money laundering, associated predicate offences and terrorist financing investigations, prosecutions, and related proceedings.
- ❖ Countries should render mutual legal assistance, notwithstanding the absence of dual criminality, if the assistance does not involve coercive actions.

38. Mutual legal assistance: freezing and confiscation

- ❖ Countries should ensure that they have the authority to take expeditious action in response to requests by foreign countries to identify, freeze, seize and confiscate property laundered; proceeds from money laundering, predicate offences and terrorist financing; instrumentalities used in, or intended for use in, the commission of these offences; or property of corresponding value.

39. Extradition

- ❖ Countries should constructively and effectively execute extradition requests in relation to money laundering and terrorist financing, without undue delay.

40. Other forms of international cooperation

- ❖ Countries should ensure that their competent authorities can rapidly, constructively and effectively provide the widest range of international cooperation in relation to money laundering, associated predicate offences and terrorist financing.

CHAPTER 4

AML/CFT LEGISLATION IN MAJOR COUNTRIES

STRUCTURE

OBJECTIVES

To get a flavour of laws related to prevention of money laundering and terrorism financing in the EU, the USA, the UK and Australia.

4.1 AML LEGISLATION AT NATIONAL LEVEL

While most of the nations of the world have subscribed to the principles, charter, guidelines issued by different international bodies, legislation at national level has happened in a widely varying manner. It has been impacted due to several factors, such as, social, political and economic systems and practices. The extant stage of legislation in several areas could impact the measures to be taken, and the manner of legislating to meet the international requirements. Given below are highlights of the laws in few countries/regions.

4.2 COUNCIL OF EUROPE CONVENTIONS (CE)

Council of Europe set up in 1949 has 47 member States. It has established over 200 conventions covering various socio-economic aspects of global importance. The problems of money laundering and terrorism have also engaged the attention of the CE.

(a) *European Convention on the Suppression of Terrorism (1977)*

The Council of Europe established a convention in 1977 containing measures to be taken for combating terrorism. This convention sought to facilitate extradition of persons having committed acts of terrorism. It lists the offences should not be considered as political offences, or as offences connected with political offences, or as offences inspired by political motives. In 2003, this Convention was amended for expanding the list of offences to be "depoliticised".

(b) *European Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime (1993)*

With a view to facilitate international co-operation and mutual assistance in investigating crime and tracking and seizing of the funds involved a Convention was established in 1993. It requires the member States to criminalise the laundering of the proceeds of crime; and to confiscate the instrumentalities and proceeds (or property the value of which corresponds to such proceeds). It provided for the following modalities –

- forms of investigative assistance (for example, assistance in procuring evidence, transfer of information to another State without a request, adoption of common investigative techniques, lifting of bank secrecy etc.);
- provisional measures: freezing of bank accounts, seizure of property to prevent its removal;
- measures to confiscate the proceeds of crime: enforcement by the requested State of a confiscation order made abroad and institution by the requested State of domestic proceedings leading to confiscation at the request of another State.

The European Union adopted the first anti-money laundering Directive in 1990. It

mandated the requirement of customer due diligence, monitoring transactions and reporting suspicious transactions. This legislation has been constantly revised.
In 2015, the EU adopted a modernised regulatory framework encompassing the Fourth anti-money laundering Directive and Regulation on information on the payer accompanying transfers of funds. In June 2018 the Fifth anti-money laundering Directive brought further changes, made effective from January 2020.

4.3 THE UNITED STATES OF AMERICA

The legal framework for AML/CFT in The United States of America consist of the undermentioned laws, among which the Bank Secrecy Act (1970) is the most notable. The USA PATRIOT Act is another key legislation in this framework.

(a) *Bank Secrecy Act (1970) (BSA)*
It provides for following obligations/measures:
- Record keeping and reporting by private individuals, banks and other financial institutions
- To help identify the movement of currency/monetary instruments moving into or out of the United States or deposited in financial institutions
- For banks – Reporting, KYC, and Transaction records maintenance

(b) *Money Laundering Control Act (1986)*
This law contains following provisions:
- For money laundering as a federal crime
- Prohibiting structured transactions
- Civil and criminal forfeiture
- Banks to have procedures to meet obligations

(c) *Anti-Drug Abuse Act of 1988*
It contained certain provisions that amplified ML/TF related provisions of other laws:
- Reporting requirements also for businesses such as car dealers and real estate dealers.
- Identity requirement for monetary instruments over $3,000

(d) *Annunzio-Wylie Anti-Money Laundering Act (1992)*
It strengthened the BSA. It provides for following:
- Strengthened the sanctions for BSA violations
- Suspicious Activity Reports
- Verification and recordkeeping for wire transfers
- Establishing Bank Secrecy Act Advisory Group (BSAAG)

(e) *Money Laundering Suppression Act (1994)*
It introduced further measures for AML:
- Banking agencies to enhance training, and test AML awareness
- Banking agencies to enhance procedures for referring to law enforcement agencies
- Registration of Money Services Business (MSB)

- Operating an unregistered MSB a federal crime
- States to adopt uniform laws for MSBs

(f) *Money Laundering and Financial Crimes Strategy Act (1998)*
It introduced further measures:

- Banking agencies to develop AML training for examiners
- National Money Laundering Strategy
- High Intensity Money Laundering and Related Financial Crime Area (HIFCA) Task Forces – to concentrate law enforcement efforts in zones/businesses where money laundering is prevalent

(g) *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act)*
This is the key legislation for dealing with Terrorism. It contains following:

- Criminalized the financing of terrorism
- Strengthened customer identification procedures
- Prohibited dealing with foreign shell banks
- Due diligence procedures (and enhanced due diligence for foreign correspondent and private banking accounts)
- Improved information sharing between financial institutions and the U.S. government
- Voluntary information sharing among financial institutions
- Imposing "special measures" on jurisdictions, institutions, or transactions of "primary money laundering concern"
- Bank's AML record a criterion – bank mergers, acquisitions, and other business combinations

(h) *Intelligence Reform & Terrorism Prevention Act of 2004*
This Act amended BSA to provide for reporting of cross-border wire transfer of funds.

4.4 THE UNITED KINGDOM

The legal framework for AML/CFT in the United Kingdom comprises of the four undermentioned laws.

(a) *The Proceeds of Crime Act 2002 (Amended by the Crime and Courts Act 2013 and the Serious Crime Act 2015)*
This law contains the provisions for seizure and confiscation of the proceeds of crime and defines crime for this purpose. It declares Money Laundering as a criminal act and defines Money Laundering. Accordingly, any act of concealing criminal property, or acquisition, use retention or control of criminal property and/ or of arrangement for facilitating these, constitutes a money laundering offence.

(b) *The Money Laundering Regulations 2007*
This Regulations lay down various measures to be taken by the financial businesses and other designated businesses for countering ML/FT. These also apply to non-financial services viz. auditors, insolvency practitioners, tax advisers, legal professionals, trust or company service providers, estate agents, high value dealers, and casinos.

(c) *The Terrorism Act 2000 (Amended by the Anti-Terrorism, Crime and Security Act 2001, the Terrorism Act 2006 and the Terrorism Act 2000 and Proceeds of Crime Act 2002 (Amendment) Regulations 2007)*
This law replaced the Prevention of Terrorism Act of 1989 (which was to be renewed by the Parliament every year), and the Northern Ireland (Emergency Provisions) of 1996. It also replaced four sections of the Criminal Justice (Terrorism and Conspiracy) Act 1998. This is a permanent law and contains provisions for proscribing terrorist organisations, fund raising for terrorism, training in firearms for terrorism purposes.

(d) *Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (Amended by The Money Laundering and Terrorist Financing (Amendment) Regulations 2019)*
These regulations have tightened controls in the private sector and introduced the need for firms to implement a written AML/CFT risk assessment. It extends the scope of regulated industries and changes the way customer due diligence and enhanced due diligence is conducted. Businesses carrying out certain crypto asset activities have been covered under the Regulations. These require inclusion of new high-risk factors and seek additional information and monitoring in certain cases.

4.5 AUSTRALIA

Australia has put in place Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/ CTF Act). It lays down five obligations on regulated businesses – enrolment with AUSTRAC, having an AML/CTF program, customer due diligence, reporting, and record keeping. The procedural requirements are laid down in the Anti-Money Laundering and Counter Terrorism Financing Rules Instrument 2007 (No 1). Besides, a specific regulation Anti-Money Laundering and Counter-Terrorism Financing (Iran Countermeasures) Regulation 2014, was enacted for differentiated provisions in respect of transactions with Iran. This Act provides for regulations to be made which prohibit or regulate the entering into of transactions with residents of prescribed foreign countries. The AML/CTF Act has been amended several times.

4.6 LET US SUM UP

Various countries have put in place their own laws for AML/CFT measures based on FATF Recommendations. Laws of various countries have same main elements but differ in details on account of several socio-economic factors, political conditions and jurisprudence of each country. In the USA, among major laws are the BSA and the PATRIOT Act. In the UK, the Proceeds of Crime Act and the Terrorism Act are the main laws. In Australia, the AML/ CTF Act is the main law. In the EU, Anti Money Laundering Directives form the main law.

4.7 CHECK YOUR PROGRESS

1. Anti-Money Laundering directives are of _____.
   (a) Australia
   (b) UK
   (c) The USA
   (d) European Union

2. The USA Patriot Act has provisions for ______.
   (a) prohibiting sharing of information among financial institutions
   (b) voluntary sharing of information among financial institutions
   (c) prohibiting considering AML record of a bank while granting regulatory approvals
   (d) sharing of information by financial institutions with FATF

4.8 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d); **2.** (b)

CHAPTER 5

AML LEGAL AND INSTITUTIONAL FRAMEWORK IN INDIA

STRUCTURE

OBJECTIVES

To get an overview of the organization framework in India for AML/CFT purposes. To know about the laws in India for prevention of money laundering and combating terrorism financing. To learn about the role and activities of FIU-IND. To get an idea about India's association with international bodies.

5.1 ORGANISATION FRAMEWORK IN INDIA FOR AML/CFT

Keeping in view various guidelines, laws and standards related to AML/CFT, an elaborate organizational set up has been put in place in India for addressing ML/FT concerns. The set-up is aimed at effective implementation of the provisions of various laws, and is also designed to update the provisions in the light of merging risks. India is a member of FATF and also several regional organisations. The central functions related to co-ordination with these bodies fall under the Ministry of Finance. As regards terrorism related measures, these are connected with internal security and hence these fall in the purview of Ministry of Home Affairs.

5.2 AML RELATED SET-UP

5.2.1 Ministry of Finance – FATF Cell

For the purpose of coordinating with FATF and ensuring that appropriate actions are taken in the country for implementing FATF recommendations, a distinct FATF Cell is functioning under the Department of Economic Affairs in the Ministry of Finance. This Cell handles the tasks related to evaluation of India by FATF and Regional bodies in respect of implementation of PMLA. The Cell seeks to ensure that India is assessed at a high level during these evaluations, as they impact India's standing in the International financial markets.

5.2.2 Ministry of Finance – Financial Intelligence Unit – India (FIU-IND)

Financial Intelligence Unit - India (FIU-IND) is the central national agency responsible for receiving, processing, analyzing and disseminating information relating to suspect financial transactions to enforcement agencies and foreign FIUs. It is also responsible for coordinating and strengthening efforts of national and international intelligence, investigations and enforcement agencies in pursuing the global efforts against money and related crimes. The responsibility of ensuring ongoing implementation of the FATF recommendations in the country especially those pertaining to money laundering rests with Financial Intelligence Unit – India.

Financial Intelligence Unit-India (FIU-IND) was set up by GOI vide O.M. dated 18th November 2004 under the Department of Revenue in the Ministry of Finance. FIU-IND is, however, an independent body reporting to the Economic Intelligence Council (EIC) headed by the Finance Minister. FIU-IND is the fulcrum of all AML related activities in the country.

5.2.2.1 Mission Statement and Organization Vision

The mission statement of FIU-IND is – *"To provide quality financial intelligence for safeguarding the financial system from the abuses of money laundering, terrorism financing and other economic offences."*

FIU-IND has stated its Organisation Vision as – *"To become a highly agile and trusted organization that is globally recognized as an efficient and effective Financial Intelligence Unit."*

FIU-IND has set three strategic objectives in order to achieve its mission:
• Combating Money Laundering, Financing of Terrorism and other economic offences
• Deterring Money Laundering and Countering Financing of Terrorism
• Building and strengthening organizational capacity

In order to achieve its objectives of combating and deterring money laundering, financing of terrorism and economic offences and building and strengthening organizational capacity for these, following thrust areas have been identified by FIU-IND:

a. Effective collection, analysis and dissemination of information
b. Enhanced domestic and international cooperation
c. Building capacity of reporting entities
d. Ensuring compliance to reporting obligations under PMLA
e. Building organizational resources
f. Strengthening IT infrastructure

5.2.2.2 Functions of FIU-IND

The main functions of FIU-IND are to receive the various transaction reports from the reporting entities, analyse them, and disseminate financial information to the intelligence and/or law enforcement agencies like Enforcement Directorate, Department of Revenue Intelligence, etc. The functions of FIU-IND are as follows:

(i) *Collection of Information*: Act as the central reception point for receiving Cash Transaction reports (CTRs), Cross Border Wire Transfer Reports (CBWTRs), Suspicious Transaction Reports (STRs), and Reports on Purchase or Sale of Immovable Property (IPRs)from various reporting entities.
(ii) *Analysis of Information*: Analyze received information in order to uncover patterns of transactions suggesting suspicion of money laundering and related crimes.
(iii) *Sharing of Information*: Share information with national intelligence/law enforcement agencies, national regulatory authorities and foreign Financial Intelligence Units.
(iv) *Act as Central Repository*: Establish and maintain national data base on cash transactions and suspicious transactions on the basis of reports received from reporting entities.
(v) *Coordination*: Coordinate and strengthen collection and sharing of financial intelligence through an effective national, regional and global network to combat money laundering and related crimes.

(vi) *Research and Analysis*: Monitor and identify strategic key areas on money laundering trends, typologies and developments.

5.2.2.3 *Initiatives of FIU-IND*

In October 2012, FIU-IND launched its Information Technology system 'FINnet' for online reporting by the reporting entities using 'FINgate' portal. FIU-IND uses FINCore for processing the reports received from the reporting entities. The processing capabilities are robust and of high degree capable of linking all relevant reports available in the database using rules of identity and relationship resolution. FIU-IND began a project for upgrading the portal with several additional features, and much higher analytical capabilities. FINnet 2.0 has been made partly operational in early 2022, and is expected to be fully functional in early 2023.

5.2.2.4 *Processing/ Sharing of Information*

FIU-IND examines a case emerging from a suspicious transaction report not merely on the information received in that report but also all relevant information/reports furnished by other reporting entities and/or in cash transaction report. In this manner, there is significant value addition before any information is disseminated to the partner agencies.

(i) *Suspicious Transactions Reports (STRs)*: The number of STRs received, analysed and disseminated by FIU-IND has shown increasing trend. Focused attention on thrust areas ensured that there was consistent improvement in the quality of reporting. The data on receipt of STRs from 2016-17 to 2020-21 are given in Table 5.1 below. Majority of STRs submitted were in respect of transactions that appeared to be made in circumstances of unusual or unjustified complexity, and those appeared to have no economic rationale or bonafide purpose.

Table 5.1 Receipt of Suspicious Transactions Reports

Reporting Entity Type	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**
Banks	361215	1343720	274756	316343	205145
Financial Institutions	94837	84781	33817	226400	NA
Intermediaries	16954	7839	14589	4270	NA
Total	**473006**	**1436340**	**323162**	**547013**	**602057**

The factors considered for determining whether STR is to be disseminated and to which agency are mainly the following:

- Type of suspicion and nature of suspected offence
- Value and pattern of transaction, and value and pattern of transaction in linked reports
- Linkage with other information, and earlier information from domestic agencies or foreign FIUs

The data on dissemination of STRs from 2016-17 to 2020-21 are given in Table 5.2 below.

Table 5.2 Number of STRs Disseminated

Agencies	2016-17	2017-18	2082-19	2019-20	2020-21
Law Enforcement Agencies	63466	71313	96432	102641	123616
Intelligence Agencies	1735	808	3021	7077	11353
Regulators & Others	1504	1276	1671	3230	2421
Total	**156978**	**65022**	**76920**	**66170**	**137390**

(An STR may be disseminated to more than one agency. Hence the totals do not match, and the figures for Law Enforcement Agencies for certain years exceed the total number.)

In view of large number of STRs being filed by RE's, and as FIU-IND is always looking to prioritise certain STRs for processing and dissemination, RE's have been asked to intimate important STRs separately to FIU. During FY 2019-20, 161 STRs and in FY 2020-21, 979 STRs were separately intimated to FIU-IND by the RE's. These STRs were processed and disseminated to the LEAs on priority. These STRs are processed by a distinct vertical in FIU viz. Important Cases Division.

(ii) *Cash Transactions Reports (CTRs):* These reports based on the threshold value of cash transactions form substantial information received by FIU-IND. These reports provide useful information for linking with STRs that is useful for further investigations. Majority of CTRs are from the public sector banks. The data on receipt of CTRs from 2016-17 to 2020-21 are given in Table 5.3 below.

Table 5.3 Number of CTRs Received

Reporting Entity Type	2016-17	2017-18	2018-19	2019-20	2020-21
Public Sector Banks	10,40,667	87,74,954	84,31,594	96,85,711	77,82,519
Indian Private Banks	42,42,521	34,96,477	40,87,238	43,03,428	37,84,912
Private Foreign Banks	51,593	22,657	24,741	27,358	29,806
Other Banks	12,28,389	10,70,388	14,31,824	14,43,307	13,37,513
Total	**1,59,29,176**	**1,33,64,476**	**1,39,75,397**	**1,54,59,804**	**129,34,750**

CTRs have been used by FIU for multiple purposes as indicated below:

- ❖ Processing of STRs
- ❖ Processing of request for information from LEAs/ IAs and Foreign FIUs
- ❖ CTR Analysis related to
    - o High Risk Businesses
    - o High Risk Geographic locations
    - o Threshold Analysis (High Value Transaction)
- ❖ Recovery of uncollected tax demand
- ❖ Matching of Annual Information Repot (AIR) of high-value transactions reported by various government authorities and financial institutions with CTR database to find out incidence of cash transaction near the date of property purchase and sale
- ❖ Identification of high-risk non-filers and stop filers and defaulters of obligations under the provisions of Income tax, GST and Customs etc.
- ❖ Analysis of cases of financial crimes reported in Media

(iii) *Cross Border Wire Transfer Reports (CBWTRs)*: These reports are in respect of all cross border wire transfers of more than ₹5 lakhs or its equivalent in foreign currency, where either the origin or destination of the fund is in India. Such transfers may be for any purpose and between any parties. The data on receipt of CBWTRs from 2016-17 to 2020-21 are given in Table 5.4 below. The surge in the numbers of CBWTRs during last 2 years is on account of re-filing after issuance of instructions to REs. A strategic analysis of CBWTR data carried out in FY 2019-20 to examine the effectiveness and reporting compliance of CBWTRs concluded that several REs had not submitted complete information as available with them. Based on this analysis, a guidance note was issued to the REs in response to which a large number of CBWTRs were re-filed in FY 2020-21.

Table 5.4 Number of CBWTRs Received

Year	**Number**
2016-17	90,91,149
2017-18	94,07,903
2018-19	1,07,19,253
2019-20	3,95,53,003
2020-21	3,61,24,141

(iv) *NPO Transaction Reports (NTRs))*: These reports are in respect of all receipts by non-profit organizations of value more than ₹10 lakh. The data on receipt of NTRs from 2016-17 to 2020-21 are given in Table 5.5 below.

Table 5.5 Number of NTRs Received

Year	Number
2016-17	6,78,786
2017-18	4,95,243
2018-19	4,39,412
2019-20	9,40,882
2020-21	7,91,307

(v) *Counterfeit Currency Reports (CCRs*: Reporting entities are required to report all cash transactions, where forged or counterfeit currency notes or bank notes have been used as genuine or where any forgery of a valuable security or a document has taken place. The data on receipt of CCRs from 2016-17 to 2020-21 are given in Table 5.6 below.

Table 5.6 Number of CCRs Received

Reporting Entity Type	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**
Public Sector Banks	1,01,167	60,768	32,347	25,476	15,960
Indian Private Banks	5,92,677	2,52,213	2,64,223	2,26,469	163,752
Private Foreign Banks	14,361	2,127	1,466	1,054	681
Other Banks	6,930	25,303	38,687	9,165	7,791
Total	**7,33,508**	**3,53,795**	**3,31,682**	**2,62,164**	**1,88,184**

(Source: The figures for various reports and certain other information is primarily from the Annual Report (2020-21), FIU-India)

5.2.2.5 Measures for Improved Compliance with PMLA

One of the functions of FIU-IND is to ensure compliance with PMLA obligations by the reporting entities. For this purpose, FIU has adopted a multi-pronged approach. The strategy of FIU-IND comprised the measures enumerated below:

(i) *Increasing awareness for enhanced voluntary compliance* – through outreach programs organized by the regulators, associations, etc.; encourage professional institutes to offer courses on AML/ CFT; encourage reporting entities to organize training programs for their employees; increase awareness about high-risk scenarios detected.

(ii) *Regular review meetings for ensuring reporting* – sector-specific meetings in co-ordination with the regulator; individual meetings with reporting entities needing attention; sensitize senior management; regular feedback to reporting entities about the quality.

(iii) *Detecting contraventions in reporting* – obtain information on contraventions of PMLA identified in investigations conducted by law enforcement agencies; on receiving a report for transactions involving a number of financial sector entities, examine if the other reporting entities have reported the transactions; identify the reporting entities requiring a detailed review or an onsite inspection.

(iv) *Imposing varying levels of sanctions on the reporting entities* – provide opportunity to rectify the mistakes; warn and advise the measures required to ensure compliance; for continued or serious contraventions impose fines; continue to monitor for 6 months to one year.

(v) *Incidence of penalties imposed* -During FY 2019-20, FIU issued show cause notices to 82 reporting entities. FIU passed 17 orders imposing aggregate penalty ₹19.46 crore. Corresponding figures for 2020-21 are – 27 show cause notices, passed 17 penalty orders and imposed monetary penalty aggregating INR 1.5 crores.

(vi) *Enhancing IT capabilities* - FIU has launched Project FINnet 2.0 with advanced capabilities and upgraded features.

(vii) *Educational initiative* - FIU has also launched a Learning Management System for the staff of Regulators and Reporting Entities registered on the FINnet 2.0.

(viii) *Red flag indicators development and rationalisation* - FIU-IND has focused on developing Red Flag Indicators for different sectors in order to facilitate the process of STR reporting. It has issued guidance note for RE's seeking to:

- Create a common and shared understanding about the STR detection and reporting systems.
- Provide indicative lists of high risk customers, products, services and geographies.
- Provide commonly used alerts for detection of suspicious transactions.
- Provide guidance for alert management and preparation of STRs.

(ix) *Providing specific guidance related to specific themes* - Following are various Guidance notes issued by FIU for the RE's:

- Detecting suspicious TBML transactions (2015)
- Guidance Note on effective process of STRs detection and reporting for co-operative banks (2016)
- Guidance Note on effective process of STRs detection and reporting for scheduled commercial banks (2017/2018)
- Guidelines on detecting suspicious transactions related to Terror Financing/ NGOs/ FICN (2018)
- Guidelines on detecting suspicious transactions related to finance components of Afghan drug business (2018)

(x) *Undertaking research based on quantitative and qualitative data available* - Strategic Analysis Lab (SAL) has been envisioned to act as a focused group dedicated to providing strategic support to FIU-IND by conducting research in the Anti- Money Laundering (AML) space and exploring innovation in this domain.

5.2.3 Directorate of Enforcement (ED)

The Directorate of Enforcement was established in 1956 and has been responsible for enforcement of the Foreign Exchange Regulation Act, 1973, and later Foreign Exchange Management Act, 1999. After promulgation of the Prevention of Money Laundering Act, 2002, enforcement of certain provisions of the Act was entrusted with the ED. It is under the control of the Department of Revenue.

Following are the main functions of the ED:

(i) To collect, develop and disseminate intelligence relating to violations of FEMA, 1999

(ii) To investigate suspected violations of the provisions of the FEMA, 1999 such as "hawala" foreign exchange racketeering, non-realization of export proceeds, non-repatriation of foreign exchange and other forms of violations under FEMA, 1999.

(iii) To adjudicate cases of violations of the erstwhile FERA, 1973 and FEMA, 1999

(iv) To process cases for preventive detention under the Conservation of Foreign Exchange and Prevention of Smuggling Activities Act (COFEPOSA)

(v) To undertake survey, search, seizure, arrest, prosecution action etc. against offender of PMLA offence.

5.2.4 Serious Frauds Investigation Office (SIFO)

Serious Frauds Investigation Office (SIFO) has been set up under Ministry of Corporate Affairs for detecting and prosecuting or recommending for prosecution white-collar crimes/frauds. It is therefore consisting of experts in the field of accountancy, forensic auditing, law, information technology, investigation, company law, capital market and taxation.

SIFO takes up matters related to the following for investigations:

- ❖ Complexity and having inter-departmental and multi-disciplinary ramifications;
- ❖ Substantial involvement of public interest to be judged by size, either in terms of monetary misappropriation or in terms of persons affected, and;
- ❖ The possibility of investigation leading to or contributing towards a clear improvement in systems, laws or procedures.

SFIO investigates serious cases of fraud received from Department of Company Affairs.

5.3 CFT RELATED SET-UP – NATIONAL INVESTIGATION AGENCY

India has been a victim of terrorism for several years. There have been large number of incidents of terrorist attacks of various natures viz. those in the militancy and insurgency affected areas, those in areas affected by Left Wing Extremism, terrorist attacks and bomb blasts, etc., in various parts of the hinterland and major cities, etc. Many of these incidents have had complex inter-state and international linkages. These are also possibly connected with other activities like the smuggling of arms and drugs, pushing in and circulation of fake Indian currency, infiltration from across the borders, etc. In view of this National Investigation Agency (NIA) has been set up for investigation of offences related to terrorism and certain other Acts, which have national ramifications, under the National Investigation Agency Act, 2008. NIA is functioning as the Central Counter Terrorism Law Enforcement Agency in India. NIA is required to investigate and prosecute offences affecting the sovereignty, security and integrity of India, friendly relations with foreign States and offences under Acts enacted to implement international treaties, agreements, conventions and resolutions of the United Nations and other international organizations.

5.4 NATIONAL ML/TF RISK ASSESSMENT SET-UP

In pursuance of the Risk Based Approach adopted for FATF Standards of 2012, in 2013, FATF issued Guidance document on National AML/CFT Risk Assessment. For the purpose of carrying out National Risk Assessment in accordance with the said guidance a AML Steering Committee (AML-SC) was constituted in the Department of Revenue, Ministry of Finance in February, 2012.

The terms of reference of the committee included:

(a) To conduct periodic assessments of money laundering risks with regard to various financial products and services, financial sectors, geographies and jurisdictions.
(b) To conduct objective assessment of the effectiveness of the implementation of the Prevention of Money Laundering Act and to identify possible legislative and administrative deficiencies.
(c) Following are various agencies and the Central Government Departments associated in National Risk Assessment:
    (i) Department of Revenue
    (ii) Department of Economic Affairs (DEA)
    (iii) Enforcement Directorate (ED)
    (iv) Financial Intelligence Unit-India (FIUIND)
    (v) Central Board of Direct Taxes
    (vi) Directorate General of Revenue Intelligence (DGRI)
    (vii) Directorate General of Central Excise Intelligence
    (viii) Directorate General of Foreign Trade
    (ix) Serious Frauds Investigation Office
    (x) Reserve Bank of India (RBI)
    (xi) Securities and Exchange Board of India (SEBI)
    (xii) Insurance Regulatory and Development Authority (IRDA)

During 2013-14, Sector-specific Working Groups (SWGs) for the banking, insurance and capital market sectors were formed under the chairmanship of the concerned Regulator to carry out risk assessment of the respective sector. These SWGs have members drawn from LEAs, Regulators, FlU and industry associations.

In August 2015, the government decided to set up a Working Group (WG) of leading agencies for a 'National Risk Assessment' of various sectors, based on a methodology formed by the World Bank. The WG was assisted by eight teams — one each for threat from terrorist financing, vulnerability assessment for terrorism financing, banking sector, insurance sector, capital market section, other financial institutions, DNFPBS and financial inclusion. Other than Department of Revenue, other Ministry/Departments/ agencies to be part of the WG are the Ministry of Home Affairs, Ministry of Corporate Affairs, I-T Department, Financial Intelligence Unit, National Investigation Agency, RBI, SEBI, Insurance Regulatory and Development Authority of India.

5.5 ASSOCIATION WITH INTERNATIONAL/ REGIONAL BODIES

India has been associated with various International agencies working in AML/CFT arena. India was initially associated with FATF as an observer and it became a member of FATF on June 25th, 2010. Similarly, India was initially associated with EAG as an observer and in December 2010, it became a member of EAG. India became a member of APG in March, 1998. India was co-chair of APG for the period 2010-12. FIU- IND has also provided an expert in the Mutual Evaluation Working Group (MEWG) of the APG to oversee various mutual evaluations conducted by APG of its member countries.

FIU-India became a member of the Egmont Group in May, 2007. FIU-IND is one of the two regional representatives of the Asia region, along with Qatar, in the Egmont Committee. FIU-IND has played an active role in the activities of the Egmont Group participating in the meetings of Working Groups such as the Membership Support & Compliance working group (MSCWG), Information Exchange Working Group (IEWG) and Policy & Procedure Working Group (PPWG) of the Egmont Group.

FIU-IND has also been representing India in the meetings of the Sub-Group on Combating Financing of Terrorism of the Bay of Bengal Initiative for Multi Sectoral Technical and Economic Cooperation (BIMSTEC), which is an international organisation involving a group of countries in South Asia and South East Asia.

5.6 INTERNATIONAL CO-OPERATION/ BILATERAL AGREEMENTS

FIU-IND does not require any Memorandum of Understanding with foreign FlUs for exchange of information, and can do so on the basis of reciprocity. However, in order to enhance the level of co- operation and to provide a structured framework for better understanding it has been active in associating with the FIUs of other countries, with whom India has significant commercial relationships. It has entered into bilateral Memorandum of Understanding (MoU) with various FIUs.

The exchange of information with various FIUs is at a moderate level, as will be seen from the data given in Table 5.7 below.

Table 5.7 Exchange of Information with Foreign FIUs

Status of Action Taken	2016-17	2017-18	2018-19	2019-20	2020-21
Requests Received from Foreign FIUs	123	109	111	135	137
Requests sent to Foreign FIUs	138	177	288	485	405
Spontaneous Referrals Received from Foreign FIUs	125	129	160	180	209

(Source: Annual Report (2020-21), FIU-India)

FIU-IND is also represented in the India-Russia-USA Trilateral Working Group on Financial aspects of Afghan Drug Trade, for exchanging information on drug related offences.
FIU-IND provided technical assistance to FlU- Bhutan for establishing an electronic reporting system. The necessary hardware for technical solution has been made available to FlU-Bhutan.
FIU-IND participates in the Joint Working Groups (JWGs) on Counter Terrorism set up by the Government of India with various countries for evaluating the AML/CFT vulnerabilities and national risk assessment for the country.

5.7 SOME PENAL ACTIONS BY FIU-INDIA

FIU-IND in pursuance of its obligation under the PMLA monitors compliance by RE's with their obligations under PMLA. In situations, that reflect serious and significant non-compliances it takes penal measures including levy of monetary penalties.

Let us look at a few such instances.
(a) ***Order of 29th July 2019:***
(i) Penalty: ₹15,62,90,000/-
Non-compliances:

- ❖ Failure to file certain threshold based reports,
- ❖ Failure to file certain threshold based reports accurately and/or within timeline prescribed
- ❖ Failure to file suspicious transaction reports timely and accurately,
- ❖ Failure to evolve and implement effective internal mechanism for threshold based reports and suspicious transactions reports,
- ❖ Failure to submit correct data to FIU-IND

(ii) Penal action: Warning issued
Non-compliances:

- ❖ Failure to identify and verify beneficial owner in accounts of several of its customers
- ❖ Failure to enable system to record any suspicious pattern where multiple transactions just
- ❖ Below the threshold were attempted / undertaken by walk in customers,
- ❖ Failure to carry out any risk assessment and to identify and assess its money laundering and terrorist financing risk for products, services, delivery channels or geographies / locations,
- ❖ Failure to fully implement a client due diligence programme specifically with regard to identification of beneficial owner details and risk assessment.

(b) ***Order of 19th March 2019***:
Penalty: ₹3,00,000/-
Non-compliances:

- ❖ Failure to have effective mechanism for detecting all suspicious transactions
- ❖ Failure to identify and verify ultimate beneficial owner for trust, legal entities, and similar other customers
- ❖ Failure to fully implement Client Due Diligence Programme, specifically for screening against latest UNSC sanctions list

Observations:
"….it would be worthwhile to state that Bank X is one of the oldest public sector banks and as such it must act as a torchbearer of the AML compliance in the country. Given the fact that the Bank is at the forefront of banking operations in India, the Bank does not have any dearth of resources or capacity for statutory compliances in respect of AML. I also note that the Bank has claimed to have taken several remedial measures to improve its AML systems. ………….
However, considering that the non-compliances, as enumerated above, were continuing till pointed out during the review by FIU-IND despite statutory obligations and keeping in mind that the penalty for the said failures and non-compliance has to be effective, proportionate and dissuasive ………. impose a monetary penalty on the Bank in the manner as detailed….."

(c) ***Order of 27th March 2018***:
Penalty: ₹9,00,00,000/-
Non-compliances:

- ❖ Failure to have effective internal system for disposal of alerts, and for detecting and reporting suspicious transactions
- ❖ Failure in carrying out effective customer due diligence for certain accounts
- ❖ Delayed filing of certain Electronic Fund Transfer reports
- ❖ Failure to file Electronic Transfer Reports in certain accounts
- ❖ Non-filing of integrally connected CTRs in certain accounts

- ❖ Not filing STRs in certain new accounts belonging to one family despite large number of CTRs
- ❖ Improper STRs in certain accounts and delayed filing in certain accounts

Observations:
"*…The question that the Bank should ask itself is – does the policy and procedure adopted by the Bank ensure effective compliance with the requirements of the provisions of the Act and the Rules thereunder? Does it ensure integrity of the financial system in the face of growing malaise of money laundering? Does it have the ability to timely detect and thwart that have potential of money laundering and terror financing? The answer to all these questions is no. ………*"
"*Considering that these failures were deliberate and wilful and keeping in mind that the interdiction for the said failures and non-compliance has to be effective, proportionate and dissuasive, I, ………. Hereby impose monetary penalty on the Bank in the manner as detailed ……*"

5.8 PREVENTION OF MONEY LAUNDERING ACT, 2002 (PMLA)- SALIENT POINTS

5.8.1 Overview of the Act

The Prevention of Money Laundering Act, 2002 was enacted to implement the resolution and declaration made under the Political Declaration and Global Programme of Action against Money Laundering adopted by the General Assembly of the United Nations in 1998. It was enacted in 2003 and brought into force on 1st July 2005. It criminalises money laundering, prescribes punishment for the same, provides for attachment, seizure and confiscation of property obtained or derived, directly or indirectly, from or involved in money laundering.

PMLA incorporates two different sets of provisions one relating to maintenance and submission of information by the reporting entities to FIU and the second relating to investigations into cases of money laundering and powers of search, seizure, collection of evidence, prosecution, etc. The Director, FIU-IND is the relevant authority for enforcement of the provisions relating to maintenance of records and filing of information by the reporting entities.

It defines money laundering offence, specifies the predicate offences, and prescribes the obligations of financial institutions and designated non-financial businesses and professions. It also prescribes the penal provisions for non fulfilment of obligations under PMLA. The Act also spells out the framework of organization for overseeing its implementation.

The provisions of the PMLA apply to various businesses in the financial sector like banks, insurance companies, mutual funds, stock brokers, merchant banks, etc. and also certain non-financial businesses and persons. The entities undertaking the activities that are covered under the Act are referred to as Reporting Entities (RE).

Detailed procedural requirements for meeting the requirements of PMLA have been spelt out in the Prevention of Money Laundering (Maintenance of Records) Rules.

5.8.2 Amendments to the Act

A comprehensive evaluation of the country's legislative and administrative framework for prevention of money laundering and countering the financing of terrorism was made by the FATF in November/ December, 2009. PMLA was amended in 2005 and thereafter in 2009 and 2013 to overcome the difficulties being faced in its enforcement and to conform to the international standards. Thereafter it has been amended several times to enhance the AML measures.

5.8.2.1 Important Amendments PMLA

Some of the important amendments made in the PMLA are given below:

a. *Money Laundering Offence Definition*: The offence of Money laundering now includes concealment, possession, acquisition and use of the proceeds of crime as criminal activities for money laundering in line with Palermo Convention.

b. *Punishment for Money Laundering*: The punishment provisions now provide for fine proportionate to the gravity of the offence, without any ceiling. Also, it is now provided that the prosecution or conviction of any legal juridical person shall not be contingent on the prosecution or conviction of any individual.

c. *Removing monetary threshold for investigating the offence*: The offences in Part B (that had monetary threshold of Rupees 30 lakh) of the schedule have been moved to Part A (that has no monetary ceiling).

d. *Inclusion in Scheduled Offences*: Certain offences under the Companies Act, the Customs Act, and the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act.

e. *Strengthening obligations of Reporting Entity*: Section 12 now clearly specifies the obligations of a reporting entity viz. to maintain records of all transactions including transactions reported to FIU-IND, identify the beneficial owner of its clients, maintain records of identity of such beneficial owners and keep the information maintained, furnished or verified confidential. Section 11A has been added specifying the mode of identity of clients and beneficial owners by the RE. Section 12 AA lays down the requirements of enhanced due diligence in respect of specified transactions.

5.8.2.1.1 Additional Financial Sector Entities

The following have been added under the PMLA:

i. Entities regulated by the Forward Market Commission (Commodity Exchanges)
ii. Members of Commodity Exchanges (Commodity Brokers)

iii. Entities regulated by the Pension Fund Regulatory Authority (Pension funds)
iv. Recognized stock exchanges under Securities Contracts (Regulation)Act
v. India Post, which provides a number of financial services

5.8.2.1.2 Additional Non-Financial Businesses and Professions

A new category of entities i.e. "person carrying on designated business or profession" created to cover the following:

i. Registrar or Sub-Registrar appointed under section 6 of the Registration Act, 1908
ii. Real estate agents,
iii. Dealers in precious metals, precious stones and other high value goods and,
iv. Persons engaged in safekeeping and administration of cash and liquid securities on behalf of other persons.

5.8.2.1.3 Measures for Effective Compliance

More powers have been given to FIU to ensure compliance, viz. the Director, FIU-IND can call for records of transactions or any additional information; the reporting entity to maintain confidentiality of the requests from FlU; imposition of sanctions on Designated Director or any of the employees of the reporting entity; range of sanctions are wider.

5.8.2.1.4 Protection from Civil or Criminal Proceedings:

The directors as well as employees of a reporting entity are protected from criminal and civil liability for disclosure of information to FlU-lND.

5.8.2.1.5 Authorities to Assist in the Enforcement:

Following Department/organisations have been included in the list of officers designated to assist the authorities in the enforcement:

a) Insurance Regulatory and Development Authority
b) Department of Posts
c) Pension Fund Regulatory and Development Authority
d) Registrar or Sub-Registrar (under section 6 of the Registration Act, 1908)
e) Registering authority empowered to register motor vehicles
f) Recognised stock exchange
g) The Institute of Chartered Accounts of India
h) The Institute of Cost and Works Accountants of India
i) The Institute of Company Secretaries of India

5.8.3 Reporting Entity

Under section 2(wa) of the PMLA Reporting Entity has been defined as follows:
"reporting entity" means a banking company, financial institution, intermediary or a person carrying on a designated business or profession.

Reporting entities are those entities that are engaged in the businesses/professions specified in the PMLA and are required to comply with various obligations specified in it.

5.8.4 Obligations of Reporting Entities – Banks

The Act specifies following obligations of banks, financial institutions and other intermediaries in Sections 12 and 13 (Chapter IV) and in Section 11A (Chapter III).

(i) To maintain records of all transactions adequate for reconstruction of the individual transactions for 5 years from the transaction date.

(ii) To report to Director, FIU transactions (attempted or executed) of the specified nature and value.

(iii) To verify the identity of its customers, and the beneficial owners through specified modes.

(iv) To undertake enhanced due diligence prior to the commencement of each specified transaction.

(v) To maintain records of identity documents of the customers and beneficial owners, account files and business correspondence of the customers for five years from the date on which the account has been closed or the relationship ended.

(vi) To keep the information gathered as confidential.

(vii) To provide to the Director – FIU any information called by him, and to keep this as confidential.

5.8.5 Corrective/Punitive Actions for Non-compliance

In case of failure to comply with any of the aforesaid obligations, the Director, FIU may take punitive/ corrective actions, as prescribed under the Act, against the bank, the designated director, and any employee of the bank. Section 13 of the Act prescribes the following actions that may be taken against an erring bank/person:

a. Issuance of a warning
b. Asking to take remedial actions.
c. Asking to report to the Director, FIU remedial measures taken
d. Monetary penalty on the reporting entity or the Designated Director or any employee. This penalty can be minimum Rs.10000, and maximum Rs.100000 for each failure.

5.8.6 Offence of Money Laundering

Section 3 of the Act defines the offence of money laundering as follows:

> *"Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property shall be guilty of offence of money-laundering.*
>
> *Explanation. —For the removal of doubts, it is hereby clarified that, —*
> *(i) a person shall be guilty of offence of money-laundering if such person is found to have directly or indirectly attempted to indulge or knowingly assisted or knowingly is a party or is actually involved in one or more of the following*

processes or activities connected with proceeds of crime, namely: —

(a) concealment; or

(b) possession; or

(c) acquisition; or

(d) use; or

(e) projecting as untainted property; or

(f) claiming as untainted property,

in any manner whatsoever;

(ii) the process or activity connected with proceeds of crime is a continuing activity and continues till such time a person is directly or indirectly enjoying the proceeds of crime by its concealment or possession or acquisition or use or projecting it as untainted property or claiming it as untainted property in any manner whatsoever."

An offence under the PMLA is cognizable and non-bailable.

It may be worth examining this definition little incisively. It will be seen that the offence of money- laundering covers not just actual money-laundering act, but also any direct or indirect attempt to do so, or association with/ assistance for such an act. Besides, the use or projection of or claim of proceeds of crime as untainted property is also included as an offence of money-laundering. In view of such a wide scope of this definition, bankers need to be diligent in taking various measures as per legal/ regulatory requirements. Negligence on the part of any bank employee in implementing various measures is fraught with the risk of being suspected of complicity with money laundering activities.

5.8.7 Punishment for the Offence of Money Laundering

Section 4 of the Act prescribes the punishment for money-laundering offence as follows:

> *"Whoever commits the offence of money-laundering shall be punishable with rigorous imprisonment for a term which shall not be less than three years but which may extend to seven years and shall also be liable to fine.*
>
> *Provided that where the proceeds of crime involved in money-laundering relates to any offence specified under paragraph 2 of Part A of the Schedule, the provisions of this section shall have effect as if for the words "which may extend to seven years", the words "which may extend to ten years" had been substituted."*

5.8.8 Predicate Offences for the Offence of Money Laundering

The Act contains a Schedule enumerating various offences under various other laws including Indian Penal Code. These offences referred to as 'Scheduled Offence' in PMLA are the predicate offences for determining money laundering offence under PMLA. In other words, a property is taken to be derived form a crime, if it is derived from any of the scheduled offence in PMLA.

There are three parts of the Schedule – Part A incorporates crimes against the state, terrorism, drug related crimes, and other crimes against property & individuals, economic crimes, etc., Part B covers the offence under the Customs Act, 1962 (if the total value involved in such offences is Rs. 1 crore or more) and Part C includes cross-border crimes.

5.8.9 Other Provisions of PMLA

The Director has been empowered by PMLA to attach and to freeze any property involved in money laundering. Section 5 of the Act contains provisions in this regard. There are provisions for adjudication in respect of property attached under the Act. The Act also contains provisions for confiscation of tainted property irrespective of conviction for money laundering, its vesting in Central Government and its management. The Act provides for committing of cases to Special Court, and for appeal against the order of Appellate Tribunal to the Supreme Court.

PMLA also contains provisions for reciprocal arrangements with other countries in respect of assistance in certain matters and procedure for attachment and confiscation of Property, and also for transfer of accused persons.

PMLA empowers an authority (authorised by the Central Government) for carrying out searches and also make seizures in relation to investigations related to suspected money laundering offence. Powers to issue summons are also vested with the authority.

Another notable feature of PMLA is that it has an overriding effect above any other statute.

5.9 PREVENTION OF MONEY LAUNDERING (MAINTENANCE OF RECORDS) RULES, 2005 (PMLR)

5.9.1 Purpose of the Rules

Various procedural requirements to give effect to the provisions of PMLA have been prescribed in the 'Prevention of Money Laundering (Maintenance of Records) Rules' which were made effective from 1st July 2005. These rules are significant for the banks in designing their procedures and systems, and putting in place appropriate organisational set-up related to KYC/AML aspects.

5.9.2 Amendments of the Rules

The PML Rules have been amended several times, the last being in December 2020, to give effect to the changes made in the PMLA and revised FATF Standards.

5.9.2.1 Important Amendments

Some of the important amendments to the Rules are given below.

(i) Certain definitions have been modified like Client Due Diligence, Officially Valid Documents, and Transactions. Some definitions have been added, e.g. Designated Director.

(ii) For Cash Transactions Report, the term ‘series of integrally connected transactions’ clarified.
(iii) New Reports have been added, viz. Cross Border Wire Transactions, and Non-profit Organisations Transactions.
(iv) Filing of Counterfeit Currency Report modified to monthly from as and when.
(v) Delay in submission of reports made a violation of PMLA.
(vi) Client due diligence requirements modified to provide for – Verification of identity within reason- able time; reliance on third party; rules for determining of beneficial owners; risk based approach, CDD for existing clients.
(vii) Additional documents included for simplified due diligence.
(viii) Included provision for closure of an existing account where the records of KYC documents are not available with the banks.
(ix) Included provisions for Central KYC Registry and procedure for the same.
(x) Digital KYC Procedure added.
(xi) Acceptance of “equivalent e-KYC document’ for Officially Valid Documents (OVD) included, OVDs redefined, e-KYC Authentication (Aadhaar based) permitted.
(xii) Identification procedure to be used for beneficial owners of depository receipts or equity shares in another permitted jurisdiction of a company incorporated in India specified.
(xiii) Additions to ‘Regulators’ specified in PMLR: the Central Board of Indirect Taxes and Customs, constituted under Central Boards of Revenue Act, 1963, with respect to the dealers in precious metals and precious stones; and the Central Board of Indirect Taxes and Customs, constituted under Central Boards of Revenue Act, 1963, with respect to the real estate agents.

5.9.3 Salient Provisions of the Rules

The salient provisions of these rules are given below.

(i) *Client Due Diligence*: Specifies the client due diligence norms for account-based relationship and while conducting transactions for non-account holders. Also, it specifies the document requirements for individuals and different types of entities.
(ii) *Officially Valid Document*: Specifies documents for the purpose of identity and address proof for verification. Additional documents have been specified for only address proof in case current address is different.
(iii) *Digital KYC:* Procedure for obtaining officially valid document and live photograph of the customer through an application for the purpose.
(iv) *Beneficial Owners:* Norms for determining beneficial owners for various legal persons and legal arrangements/
(v) *Central KYC Records Registry*: Provision for a Central KYC Records Registry for receiving and storing the KYC records in digital form, and assigning a unique Know Your Client (KYC) Identifier to every client.
(vi) *Reporting Requirements*: Specifies the requirements of periodical reports to FIU-IND, and also suspicious transaction reports, including timelines for these.

(vii) *Suspicious Transaction*: Specifies nature of transactions for which suspicious transaction report is required to be filed.

(viii) *Transaction*: Specifies types of business transactions that are to be considered for the purpose of suspicious transaction report.

(ix) *Records containing Information*: Prescribes particulars to be included in transaction records.

(x) *Maintenance of records of identity of clients and transactions (nature and value)*: Specifies the period for record retention, and the types of records to be maintained for client identification, and various types of transactions.

(xi) *Designated Director*: A whole time director designated by a bank and entrusted with the responsibility of ensuring that the bank fulfils the obligations specified under Chapter 4.

(xii) *Principal Officer*: An officer designated by a bank and entrusted with the responsibility of ensuring timely submission of reports/information to the FIU-IND.

(xiii) *Small Account:* Provisions for small accounts including procedure and restrictions.

(xiv) *Risk Assessment:* Requirement to assess ML/TF risks arising from clients, countries or geographic areas, and products, services, transactions or delivery channels.

PML Rules form the basis for the RBI Guidelines on KYC/AML to banks.

5.10 UNLAWFUL ACTIVITIES (PREVENTION) ACT, 1967

5.10.1 Overview of UAPA

Unlawful Activities (Prevention) Act, 1967 was amended by the Unlawful Activities (Prevention) Amendment Act, 2008 to include legislative measures for combating financing of terrorism in terms of UN Security Council Resolution 1267 and 1373. UAPA criminalizes terrorist acts and raising of funds for terrorist acts. It also provides for attachment of and seizure of properties connected with terrorist activities or organisations. The Act was amended in 2004, 2008, 2013 and 2019 to make it more effective in preventing unlawful activities and meet the standards of the FATF. The Unlawful Activities (Prevention) Act, 1967 has been amended to include the offences pertaining to terrorism and terrorism financing as crimes.

5.10.2 Offence of Terrorist Act (Terrorism)

Section 15 of the Act defines 'terrorist act' as stated below. The Act specifies that the expressions "terrorism" and "terrorist" shall be construed accordingly.

"Terrorist act—

(1)] Whoever does any act with intent to threaten or likely to threaten the unity, integrity, security 4[, economic security,] or sovereignty of India or with intent to strike terror or likely to strike terror in the people or any section of the people in India or in any foreign country,

a) *by using bombs, dynamite or other explosive substances or inflammable substances or firearms or other lethal weapons or poisonous or noxious gases or other chemicals or by any other substances (whether biological radioactive, nuclear or otherwise) of a hazardous nature or by any other means of whatever nature to cause or likely to cause--*
   (i) death of, or injuries to, any person or persons; or
   (ii) loss of, or damage to, or destruction of, property; or
   (iii) disruption of any supplies or services essential to the life of the community in India or in any foreign country; or
   (iiia) damage to, the monetary stability of India by way of production or smuggling or circulation of high quality counterfeit Indian paper currency, coin or of any other material; or
   (iv) damage or destruction of any property in India or in a foreign country used or intended to be used for the defence of India or in connection with any other purposes of the Government of India, any State Government or any of their agencies; or
b) *overawes by means of criminal force or the show of criminal force or attempts to do so or causes death of any public functionary or attempts to cause death of any public functionary; or*
c) *detains, kidnaps or abducts any person and threatens to kill or injure such person or does any other act in order to compel the Government of India, any State Government or the Government of a foreign country or an international or inter-governmental organisation or any other person to do or abstain from doing any act; or commits a terrorist act.*

Explanation-- For the purpose of this sub-section,
a) *"public functionary" means the constitutional authorities or any other functionary notified in the Official Gazette by the Central Government as public functionary;*
b) *"high quality counterfeit Indian currency" means the counterfeit currency as may be declared after examination by an authorised or notified forensic authority that such currency imitates or compromises with the key security features as specified in the Third Schedule."*

(2) The terrorist act includes an act which constitutes an offence within the scope of, and as defined in any of the treaties specified in the Second Schedule."

Section 16 of the Act prescribes punishment for terrorist act, as stated below.

"Punishment for terrorist act--(1) Whoever commits a terrorist act shall--
a) *if such act has resulted in the death of any person, be punishable with death or imprisonment for life, and shall also be liable to fine;*
b) *in any other case, be punishable with imprisonment for a term which shall not be less than five years but which may extend to imprisonment for life, and shall also be liable to fine."*

5.10.3 Offence of Raising Funds for a Terrorist Organisation

Section 40 of UAPA criminalizes raising of funds for terrorist organizations and reads as under:

> *"40. Offence of raising fund for a terrorist organization– (1) A person commits the offence of raising fund for a terrorist organisation, who, with intention to further the activity of a terrorist organisation, –*
>
> (a) *invites another person to provide money or other property, and intends that it should be used, or has reasonable cause to suspect that it might be used, for the purposes of terrorism; or*
>
> (b) *receives money or other property, and intends that it should be used, or has reasonable cause to suspect that it might be used, for the purposes of terrorism; or*
>
> (c) *provides money or other property, and knows, or has reasonable cause to suspect, that it would or might be used for the purposes of terrorism.*
>
> *Explanation – For the purposes of this sub-section, a reference to provide money or other property includes –*
>
> (a) *of its being given, lent or otherwise made available, whether or not for consideration; or*
>
> (b) *raising, collecting or providing funds through production or smuggling or circulation of high quality counterfeit Indian currency*
>
> (2) *A person, who commits the offence of raising fund for a terrorist organisation under sub-section (1), shall be punishable with imprisonment for a term not exceeding fourteen years, or with fine, or with both."*

Section 17 of the Act prescribes punishment for raising funds for terrorist act, as stated below.

"Punishment for raising funds for terrorist act.--Whoever, in India or in a foreign country, directly or indirectly, raises or provides funds or collects funds, whether from a legitimate or illegitimate source, from any person or persons or attempts to provide to, or raises or collects funds for any person or persons, knowing that such funds are likely to be used, in full or in part by such person or persons or by a terrorist organisation or by a terrorist gang or by an individual terrorist to commit a terrorist act, notwithstanding whether such funds were actually used or not for commission of such act, shall be punishable with imprisonment for a term which shall not be less than five years but which may extend to imprisonment for life, and shall also be liable to fine."

5.10.4 Powers to Attach/ Freeze Funds or Financial Assets of Specified Individuals/ Entities

By virtue of Section 51A of UAPA, the Central Government is empowered to freeze, seize or attach funds of and/or prevent entry into or transit through India, any individual or entities that are suspected to be engaged in terrorism. Section 51A reads as under:

"51A. For the prevention of, and for coping with terrorist activities, the Central Government shall have power to –

(a) *freeze, seize or attach funds and other financial assets or economic resources held by, on behalf of or at the direction of the individuals or entities listed in the Schedule to the order, or any other person engaged in or suspected to be engaged in terrorism;*

(b) *prohibit any individual or entity from making any funds, financial assets or economic resources or related services available for the benefit of the individuals or entities listed in the schedule to the order, or any other person engaged in or suspected to be engaged in terrorism;*

(c) *prevent the entry into or the transit through India of individuals listed in the schedule to the order or any other person engaged in or suspected to be engaged in terrorism"*

Procedural details for the purpose of giving effect to these legal provisions, are contained in an order were issued by the Government of India in August 2009. This was subsequently substituted by the Order dated 2nd February, 2021 on Procedure for implementation of Section 51A of the Unlawful Activities (Prevention) Act, 1967. This order stipulates reporting requirements for banks and other financial institutions in respect of transactions pertaining to individuals or entities contained in the schedule to the order, and freezing of the related funds. Ministry of Home Affairs has declared 32 entities as banned organisations, and the organisations listed in the Schedule to the U.N. Prevention and Suppression of Terrorism (Implementation of Security Council Resolutions) Order, 2007 made under section 2 of the United Nations (Security Council) Act, 1947(43 of 1947) and amended from time to time.

5.11 SOME ENFORCEMENT CASES OF PMLA

Prevention of Money Laundering act has been on the statute books for nearly two decades. In the initial phase actions under this law was almost non-existent, in as much as there was no prosecution initiated. Since, however, there has been some momentum, and a few convictions have also taken place.

5.11.1 Prosecutions and Convictions under PMLA

- As per the submissions made by the Central Govt. in the Supreme Court, in February 2022, 4,850 cases have been taken up for investigation under the Prevention of Money Laundering Act (PMLA) in the last 17 years and proceeds of crime of Rs 98,368 crore were identified and attached under the provision of the law.
- Further, investigation in 57 cases of terror and Naxal financing has resulted in the identification of proceeds of crime of Rs 1,249 crore and attachment of proceeds of crime of Rs 982 crore, that is 256 properties, and filing of 37 prosecution complaints and conviction of two terrorists under the PMLA.

- Out of the Rs 98,368 crore which were identified and attached, proceeds of crime of Rs 55,899 crore have been confirmed by the adjudicating authority. Proceeds of crime of Rs 853.16 crore had been confiscated to the Central government under the orders of the competent court.

In the batch of matters, pending consideration before the Supreme Court bench, involved estimated laundering was over Rs 67,000 crore. Timely actions led to attachment of assets worth of Rs 19,111.20 crore out of total fraud of Rs 22,585.83 crore by some fugitive offenders..*(Source: Website of the Pioneer – dailypioneer.com)*

5.11.2 Convictions under PMLA

(a) **Rose Valley Money Laundering Case**

In February 2021, the Special PMLA court in Kolkata convicted a Rose Valley official Arun Mukherjee, in the Rose Valley money laundering case, sentencing him to 7-year imprisonment and levied a fine of ₹2.5 lakh. It was alleged that Rose Valley Real Estate Construction Limited and its Associate Companies repeatedly floated Secured Non-Convertible Debentures in several years and issued to more than 49 persons in each financial year and illegally raised Rs 12.82 Crores from over 2500 persons. The money so acquired were laundered by investing the same in various movable properties. Under PMLA 14 fixed deposits of Rs 12 crores were attached. Two accused persons, Shri Gautam Kundu and Shri Amit Banerjee, were arrested in 2015. Shri Arun Mukherjee, who was Debenture Trustee, had pleaded guilty for the offence of money laundering before the Special Court under PMLA in Kolkata.

(Source: Website of Businessworld – businessworld.in)

(b) **Galaxy Impex Money Laundering Case**

In November 2021, K Liakath Ali, a Chennai based importer, was convicted by the Special PMLA court in Chennai and was sentenced to 7-year imprisonment and levied a fine of ₹1 crore, and additional 1-year imprisonment on not paying the fine. K Liakath Ali made foreign outward remittance of USD 28 lakh, about ₹18.66 crore, through a bank branch in Chennai. He opened a current account in the name of Galaxy Impex company by submitting forged identity documents and the transfers were carried out without disclosing the beneficial owner either within the country or abroad. He was arrested in 2017 under the provisions of PMLA.

(Source: Website of DTNEXT – dtnext.in)

(c) **Drug Related Money Laundering Case**

In March 2017, a special CBI Court convicted Allauddin Sheikh in a drug case sentencing him to eight years of rigorous imprisonment and a fine of Rs. 2 lakh. The Narcotics Control Bureau (NCB) had seized 3.950 kg of opium from his possession, and 25.450 kg of opium and 550 kg of poppy husk from his residence. He had traded in opium on regular basis. The Enforcement Directorate had filed an Enforcement Case Information Report (ECIR), in the matter, in 2011. The ED filed the charge sheet in 2016, and had attached Allauddin's assets (about 152 decimals of land) worth about Rs 30 lakh. This was the highest sentence awarded under PMLA till that time.

(Source: Website of Businessworld – businessworld.in)

(d) **Hari Naryan Rai Money Laundering Case**
In January 2017, the first money laundering conviction took place, when a Special Court at Ranchi convicted former Jharkhand Minister Shri Hari Narayan Rai sentencing him to 7 years' rigorous imprisonment and a fine of Rs. 5 lakh, and not paying the fine further RI of 18 months. Shri Rai, former state Chief Minister Madhu Koda's cabinet colleague, was convicted for laundering funds to the tune of over Rs 3.72 crore. He was holding the portfolios like Tourism Development, Urban Development, Rural Works and Forests, and was also in the Cabinets of other Chief Minsters namely, Arjun Munda and Shibu Soren. During the period 2005-08, he had laundered his illegal income, made by misappropriation of public money, through purchase and acquisition of various assets and using the same for his personal benefits. He established a construction company under the name Ms Mahamaya Construction Pvt. Ltd. (of his wife Sushila Devi and others), Ms Maa Gauri Construction (of his brother Sanjay K Rai and others) and Ms Baba Basuki Dairy Firm (of his wife and brother). He laundered huge money in the name of the said companies/firms and projected them as untainted money. The scam was unearthed in September 2009, and several arrests were made and assets worth hundreds of crores were attached.
(Source: Website of Businessworld – businessworld.in)

(e) **Lashkar-e-Taiba (LeT) Terrorist Money Laundering case**
In February 2018, the Enforcement Directorate (ED) has secured a second major conviction under the Prevention of Money Laundering Act (PMLA), 2002, this time of Lashkar-e-Taiba (LeT) terrorist Bilal Ahmed Quta. He has been sentenced to seven years' imprisonment, by a Special Court in Bengaluru. he was part of a conspiracy from 2001 to 2007 to wage war against the country. The Karnataka Police arrested and registered a case against him.
(Source: Website of The Hindu – thehindu.com)

5.12 RBI GUIDELINES

5.12.1 Authority of Regulator under PMLA

Section 2 (fa) of PMLA defines Regulator as follows:

> *"Regulator" means a person or an authority or a Government which is vested with the power to license, authorise, register, regulate or supervise the activity of 36a[reporting entities or the Director as may be notified by the Government for a specific reporting entity or a class of reporting entities or for a specific purpose."*

The Act provides that the Regulator shall issue guidelines to reporting entities for meeting their various obligations. These include areas like obtaining client information, maintaining record, risk assessment, detection of suspicious transactions, reporting of information, confidentiality, etc.

5.12.2 RBI Guidelines for Regulated Entities

RBI has issued from time to time comprehensive guidelines for banks and other entities regulated by it for measures to be taken for the purpose of KYC/AML/CFT. While the guidelines issued by the erstwhile Department of Banking Operations & Development (now Department of Banking Regulations i.e. DBR) formed the main framework, specific guidelines covering activities like Money Transfer Services, Money Changing Activities of Authorised Persons, etc. were also issued. With effect from July 2015, consolidated KYC/AML Guidelines issued by DBR are applicable to all the entities.

Master Directions – Know Your Customer (KYC) norms issued vide Master Direction on 25.2.2016 (last updated as on 10.05.2021) contain RBI's comprehensive guidelines. These guidelines cover the following broad areas:

a. Definitions – Customers, Officially Valid Documents, etc.
b. KYC Policy
c. Money Laundering and Terrorist Financing Risk Assessment
d. Customer Acceptance Policy
e. Customer Identification Procedure
f. Customer Due Diligence Requirements – for various types of customers, for new technology products, for special arrangements, etc.
g. Beneficial Owners Identification
h. Digital KYC Process and Video based Customer Identification Process
i. CDD Procedure and sharing KYC information with Central KYC Records Registry (CKYCR)
j. Reporting requirement under Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS)
k. Monitoring of Transactions – Ongoing Monitoring
l. Risk Management – Risk Based Approach
m. Correspondent Banks
n. Wire Transfer
o. Maintenance of KYC documents and preservation period
p. Combating Financing of Terrorism
q. Reporting Requirements
r. General Guidelines – Confidentiality, Technology requirement, Sensitising employees

These guidelines are enhanced or modified to align with any subsequent changes in legal provisions or other developments that have an impact on KYC/AML/CFT measures. Details of RBI guidelines are included in the respective sections discussing the abovementioned areas. RBI had encouraged IBA to examine KYC/AML aspects and evolve detailed operational guidelines for banks covering major areas of customer due diligence and transaction monitoring.

5.13 IBA GUIDELINES

IBA at the behest of RBI has taken several initiatives in the area of KYC/AML. Various Working Groups of bankers set up by RBI have studied these areas and submitted their recommendations for the measures that banks may adopt in the areas of customer due diligence, and transaction monitoring. RBI has advised banks to take cognizance of these guidelines. Following are the reports of IBA Working Groups:

(i) Know Your Customer Standards and Anti Money Laundering Measures Guidance Notes for Banks – March 2005

(ii) Know your Customer (KYC) Standards and Anti-Money Laundering measures (AML) – Guidance notes for Banks – October 2005, July 2009, and January 2012

(iii) Report of the IBA Working Group on Anti-Money Laundering Guidelines for Banks in India – December 2001

(iv) Report of the IBA Working Group on Parameters for Risk Based Transaction Monitoring – March 2011

(v) Know Your Customer Standards and Anti Money Laundering Measures Guidance Notes for Banks – July 2020

Details of IBA guidelines are included in the respective sections discussing the abovementioned areas.

5.14 LET US SUM UP

This chapter gives an overview of the organisational framework in India for from AML/ CFT perspective. This comprises – the Ministry of Finance, Central Govt., the FIU, the Enforcement Directorate, the National Investigation Agencies, other law enforcement agencies, the sectorial regulators, the players in the financial sectors and the designated businesses and professions. The role and functions of FIU have been dealt with, as also the role of various agencies. Overview of PMLA and PMLR has been covered. Besides, terrorist financing offence under UAPA Act has been discussed. An overview of Master Directions of RBI and Guidelines issued by IBA has been covered.

5.15 CHECK YOUR PROGRESS

1. The operational instructions regarding the obligations of the Reporting Entities stipulated under the Prevention of Money Laundering Act have been primarily laid down in __________.
   (a) Prevention of Money laundering (Maintenance of Records) Rules
   (b) RBI Master Direction – Know Your Customer
   (c) IBA Guidelines on AML/ KYC
   (d) None of the above

2. FIU- IND reports to _________.
   (a) Central Bureau of Investigation
   (b) Financial Action Task Force (FATF)
   (c) Economic Intelligence Council headed by Finance Minister
   (d) Reserve Bank of India

3. Which one of the following categories is not reporting entities under PMLA?
   (a) Public Sector Banks
   (b) Self-help Groups
   (c) Regional Rural Banks
   (d) Payment Banks

5.16 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a); **2.** (c); **3.** (b)

CHAPTER 6

MONEY LAUNDERING & CORRESPONDENT BANKING RELATIONS

STRUCTURE

6.1 Definition
6.2 Diligence on Correspondent Bank
6.3 Shell Bank
6.4 FATF Identified Countries
6.5 Exchange Houses
6.6 Foreign Branches
6.7 Let us Sum up
6.8 Check Your Progress
6.9 Answers to 'Check Your Progress'

OBJECTIVES

Understanding the importance of correspondent banks in the context of AML measures. Knowing the aspects to be looked into while establishing relationship with a correspondent Bank. Knowing the applicability of KYC/AML regime for foreign branches.

6.1 DEFINITION

Correspondent banking is the provision of banking services by one bank (the 'correspondent bank') to another bank (the 'respondent bank'). These services may include cash/funds management, international wire transfers, drawing arrangements for demand drafts and mail transfers, payable- through-accounts, cheques clearing etc.

6.2 DILIGENCE ON CORRESPONDENT BANK

6.2.1 Scope of Diligence

With substantial increase in the volume and complexity of international cross-border transactions and with technological innovations facilitating extremely quick/real-time transactions, the interdependence of banks has also become critical. Banks are also required to gather sufficient information to understand fully the nature of business of the correspondent/respondent bank. Normally, each bank evaluates its correspondent bank in terms of the following parameters:

(a) Nature of business of the bank
(b) Information on management
(c) Major business activities
(d) Mutual business value
(e) Quality of transactions
(f) Business activities
(g) Customer mix and transactions
(h) Geographies covered
(i) Operating processes
(j) Ethical values
(k) Management capability
(l) Level of AML/CFT compliance
(m) KYC/AML policies and processes
(n) Purpose of opening an account
(o) Information and identity of any third party that will use the account
(p) Regulatory/supervisory framework in their country

The correspondent bank should also ensure that the respondent bank is able to provide, on request, customer profile and transaction data, immediately.

6.2.2 Regulatory Actions

Similarly, banks should try to ascertain from publicly available information, on whether the other bank has been subjected to any serious money laundering or terrorist financing investigation or regulatory action. The central banks in some countries place such information on their websites.

6.2.3 Establishing New Relationship

6.2.3.1 Due Diligence

When first establishing the relationship with a correspondent bank, it is important to undertake the due diligence covering various parameters. The exercise should also cover search in the Banker's Almanac, study of its published statements like Annual reports, etc.; study of the legal and regulatory framework for KYC/AML in the home country of the correspondent bank.

6.2.3.2 Approval for Relationship

Banks shall have a policy approved by their Boards, or by a committee headed by the Chairman/CEO/MD to lay down parameters for approving correspondent banking relationships. While it is desirable that such relationships should be established only with the approval of the Bank's Board, in case the Board desires to delegate power to an administrative authority for such approval, it may do so to a committee of the Bank after laying down parameters for approving such relationships.

6.2.3.3 Parameters for Correspondent Relationships

Parameters for approval of correspondent relationship could include the following:

(i) Post facto approval of the Board at its next meeting shall be obtained for the proposals approved by the Committee.
(ii) The responsibilities of each bank with whom correspondent banking relationship is established shall be clearly documented.
(iii) In the case of payable-through-accounts, the correspondent bank shall be satisfied that the respondent bank has verified the identity of the customers having direct access to the accounts and is undertaking on-going 'due diligence' on them.
(iv) The correspondent bank shall ensure that the respondent bank is able to provide the relevant customer identification data immediately on request.
(v) Banks shall be cautious with correspondent banks located in jurisdictions which have strategic deficiencies or have not made sufficient progress in implementation of FATF Recommendations.
(vi) Banks shall ensure that respondent banks have KYC/AML policies and procedures in place and apply enhanced 'due diligence' procedures for transactions carried out through the correspondent accounts.

Besides the abovementioned parameters, those indicated in other paragraphs in this Chapter are important parameters.

6.2.4 Review of Relationship – Due Diligence

Due diligence on correspondent banks is an ongoing exercise; it is usually done on an annual basis. In case of existing correspondent relationship apart from examining the updated information on various parameters the experience with the correspondent is an important input. The following aspects will have a bearing on the relationship:

- Quality of transactions originated by the correspondent: Whether any major or frequent ML/TF concerns arose?

- Information contained in the wire transfers: Whether meeting the regulatory requirements properly? Or, frequent gaps noticed?
- Response to inquiries for additional information: Whether provided promptly and completely? Or, delayed/avoided or not properly provided?
- Concerns about Trade Based Money Laundering: Whether large proportion of transactions aroused suspicion and required filing of STR? Whether most of the transactions pertain to dubious jurisdictions?

If on conducting the review (or even in between) if there are serious concerns about the quality of transactions put through by the correspondent, the relationship may be considered for exit.

6.2.5 Independent Transaction Due Diligence

The correspondent bank relationship came under close study when money laundering processes exploited it. A bank cannot merely presume due diligence being performed by its correspondent bank in a transaction that comes from it, but it should do its own independent due diligence examination. In the process, if it has some concerns, supplementary information should be sought from the correspondent about such transactions.

6.3 SHELL BANK

A 'Shell Bank' can be defined as a bank which is incorporated in a country where it has no physical presence and is not affiliated to any regulated financial group. Shell Banks are not permitted to operate in India.

Banks should refuse to enter into a correspondent relationship with a 'Shell Bank'. Banks should also guard against establishing relationships with foreign banks/financial institutions that may permit their accounts to be used by Shell Banks.

6.4 FATF IDENTIFIED COUNTRIES

Banks should be extremely cautious while establishing continuing relationships with respondent banks located in countries with poor KYC standards and countries identified as 'non-cooperative' in the fight against money laundering and terrorist financing.

They should ensure that their respondent banks have anti-money laundering policies and procedures in place, and apply enhanced 'due diligence' procedures for transactions carried out through the correspondent accounts also.

6.5 EXCHANGE HOUSES

Relationships with Exchange Companies are generally popular in view of the NRI business that may flow through them. The above will apply, mutatis mutandis, to dealings with Exchange Companies, too. It has to be ensured that the Exchange Company has adequate strengths to prevent fraudulent or money laundering fund transfers.

6.6 FOREIGN BRANCHES

Indian banks that operate abroad through branches, subsidiaries or joint ventures are sensitised to anti- money laundering measures. Foreign offices/overseas subsidiaries of a bank are subject to dual regulations in certain aspects. These offices will be subjected to the KYC/AML regime of both the home country and the host country. Hence these offices will be required to follow the KYC/AML guidelines and measures which are more stringent.

These Indian establishments must have adequate track of the KYC AML guidelines towards host countries and formulate and update their policy with due timelines. The KYC AML policy for all jurisdictions should be vetted by the concerned host country (local) compliance professionals (audit firms) and should be approved by the Boards at least on annual basis.

While it would be advisable to avoid jurisdictions that have high ML/TF risks, such presence may be necessary for facilitating genuine commerce and trade with these jurisdictions. In such cases, appropriate measures to manage higher risks must be taken. If the local laws of the jurisdiction prohibit implementation of KYC/AML guidelines or Indian legal requirements in this context, it is important to notify RBI about this.

6.7 LET US SUM UP

This chapter deals with due diligence parameters related to correspondent banking, and exchange houses. The need for avoiding relationships with shell banks is discussed. The compliance approach for AML & CFT measures in overseas establishments of Indian Banks is also discussed.

6.8 CHECK YOUR PROGRESS

1. Correspondent banking is defined as_____.
   (a) one bank providing banking services to another bank.
   (b) A bank corresponds with another bank effectively.
   (c) Query of one bank is responded to by another bank under an arrangement.
   (d) None of the above

2. A shell bank is a bank that __________.
   (a) is incorporated in a state where is has an address and office but no employee.
   (b) operates in a country with one office only.
   (c) is incorporated in a country where it has no physical presence.
   (d) is incorporated in a country but does not report to the regulator.

6.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a) **2.** (c)

CHAPTER 7

COUNTRY RISK CATEGORISATION

STRUCTURE

OBJECTIVES

Understanding the effect of jurisdictions on money laundering risk. Knowing about identified high risk countries by FATF and countries under Sanctions. Understanding country risk categorization modality.

7.1 COUNTRY RISK AND MONEY LAUNDERING

One of the significant aspects of money laundering is movement of illegal funds across jurisdictions. Typically, moving such funds outside the jurisdiction in which these were generated provides a safety cover to the criminals, as it makes extremely difficult and cumbersome to link the funds with the crime. There are two major dimensions of country risk from the perspective of money laundering.

7.1.1 Financial Regulatory Regime

The financial sector regulatory regimes in various countries differ widely in their scope, characteristic, and rigors. Besides, there are several countries that have not accepted the international norms for AML/ CFT, and even among the countries that have agreed to adopt these have done so to widely varying degrees. Thus, money launderers design their strategies in such a manner that they can use jurisdictions that are safer. Such countries have been identified by various international bodies, since several years. After the formation of FATF, one of its primary activity has been to identify such weak countries and regularly review the position in these.

7.1.2 Social/Criminal Environment

Second important dimension, of country risk is the social/criminal environment of the country. Those jurisdictions where crime is widely prevalent are the most likely places from where the money laundering process will begin. Hence the financial institutions in these jurisdictions with weaker law and order are exposed to higher ML/TF risks. So are the jurisdictions that have commercial/financial dealings with such jurisdictions. UN has identified several countries in connection with certain criminal activities, and imposed certain sanctions on several countries. Similarly, some of the advanced countries have placed country sanctions based on their own criteria.

7.2 COUNTRIES DEFICIENT IN AML REGIME – FATF

7.2.1 Country Review by FATF

FATF continuously monitors the steps taken by various jurisdictions across the globe in adopting the AML/CFT standards issued by it. It has in the process identified several countries where the AML/CFT regime is not satisfactory. The FATF reviews the jurisdictions based on threats, vulnerabilities, or particular risks. The criteria for placing a country under the review process are as follows:

- It does not participate in a FATF-style regional body (FSRB) or does not allow mutual evaluation results to be published in a timely manner; or
- It is nominated by a FATF member or an FSRB. The nomination is based on specific money laundering, terrorist financing, or proliferation financing risks or threats coming to the attention of delegations; or

- It has achieved poor results on its mutual evaluation, specifically:
    - i. it has 20 or more non-Compliant (NC) or Partially Compliance (PC) ratings for technical compliance; or
    - ii. It is rated NC/PC on 3 or more of the following Recommendations: 3, 5, 6, 10, 11, and 20; or
    - iii. It has a low or moderate level of effectiveness for 9 or more of the 11 Immediate Outcomes, with a minimum of two lows; or
    - iv. It has a low level of effectiveness for 6 or more of the 11 Immediate Outcomes.

With a view to enabling various jurisdictions to tailor their measures according to the degree of risk associated with dealing with different countries, and also to focus their own attention to varying degree, FATF has classified these countries in two major groups and publishes two public statements:

(i) High-Risk Jurisdictions subject to a Call for Action

(ii) Jurisdictions under Increased Monitoring

FATF updates thrice a year i.e. in February, June, and October the list of these two groups with its advisory on each of the countries in these groups.

7.2.2 High-Risk Jurisdictions subject to a Call for Action (4th March 2022)

This statement (previously called 'Public Statement') issued by FATF comprises such countries that have significant strategic deficiencies in their regimes to counter money laundering, terrorist financing, and financing of proliferation. This list is now generally referred to as 'Black List'.

FATF urges all jurisdictions to apply enhanced due diligence, and in the most serious cases, countries are called upon to apply counter-measures. This statement also includes such jurisdictions regarding which FATF has concerns about ML/TF activities emanating therefrom. Since February 2020, in light of the COVID-19 pandemic, the FATF has paused the review process for countries in the list of High-Risk Jurisdictions subject to a Call for Action. In its Statement issued on 4th March 2022, FATF has included the undermentioned two countries mentioned below (as per the 21st February 2020 Statement).

1. Democratic People's Republic of Korea (DPRK)
2. Iran

Iran and North Korea are identified as the riskiest countries and FATF advisory to its member countries as also to other jurisdictions is to apply counter-measures (i.e. controls/sanctions) in respect of dealings or transactions with these. In respect of both these countries FATF has advised all jurisdictions to:

1. To advise their financial institutions to give special attention to business relationships and transactions with them, including their companies and financial institutions;

2. To apply effective counter-measures to protect their financial sectors from money laundering and financing of terrorism (ML/FT) risks emanating from them;
3. To protect against correspondent relationships being used to bypass or evade counter-measures and risk mitigation practices.

7.2.3 Jurisdictions under Increased Monitoring (4th March 2022)

The jurisdictions in this group are those that are actively working with the FATF to address strategic deficiencies in their regimes. These are such jurisdictions that have it means the country has committed to resolve swiftly the identified strategic deficiencies within agreed timeframes and is subject to increased monitoring. This list is often externally referred to as the "Grey List". FATF and the FATF-style regional bodies (FSRBs) continue to work with such jurisdictions and report on the progress made in addressing the identified deficiencies. The FATF does not call for the application of enhanced due diligence measures to be applied to these jurisdictions, but encourages its members and all jurisdictions to take into account the information presented in its statement about these jurisdictions.

As per FATF Statement of 4th March 2022, there were undermentioned 23 jurisdictions continuing under review in this category. In view of the Covid 19 pandemic situation, FATF had provided some flexibility to the jurisdictions not facing immediate deadlines to report progress on a voluntary basis. Thus for several countries the status based on their June 2021 report was continued in the March 2022 statement. Since, October 2021 Statement, in the March 2022 Statement, United Arab Emirates was added and Zimbabwe removed.

1. Albania	9. Mali	17. Senegal
2. Barbados	10. Malta	18. South Sudan
3. Burkina Faso	11. Morocco	19. Syria
4. Cambodia	12. Myanmar	20. Turkey
5. Cayman Islands	13. Nicaragua	21. Uganda
6. Haiti	14. Pakistan	22. United Arab Emirates
7. Jamaica	15. Panama	23. Yemen
8. Jordan	16. Philippines	

7.3 COUNTRIES UNDER UN EMBARGO

UN under its charter is authorized to take certain measures for maintaining or restoring international peace and security. It is also authorized to call upon its members to adopt various measures against certain jurisdictions. UN Security Council has passed resolutions for sanctions in respect of several nations, besides passing two specific resolutions for countering terrorism activities that cover individuals/entities. The measures specified include mainly arms embargo, ban on travel, assets freeze, and transfer freeze.

7.4 COUNTRIES UNDER SANCTIONS BY US, UK, EU

Major developed countries have their own review systems and impose sanctions on various countries for several reasons, including terrorism, violation of human rights, etc. Major sanctions are those by the United States of America (USA), United Kingdom (UK) and European Union (EU). These sanctions of individual countries bind the citizens or enterprises of the respective country or the individuals or enterprises that live or operate from that country. Hence, for instance, a bank with a branch in the USA will need to abide with the US sanctions to avoid being penalized for violation thereof. However, even those banks that do not have presence in the USA need to take cognizance of these sanctions, if they handle transactions with the US, to avoid violation of any US Sanctions program.

7.4.1 US Sanctions

Office of Foreign Assets and Control (OFAC), which is a Dept. of the US Treasury, administers a number of US economic sanctions, and embargoes. There are three major categories of US Sanctions:

(a) Comprehensive Sanctions Programs: Under these programs countries with the longest-standing sanctions against them include Cuba, Iran, North Korea, and Syria. Under these programs practically no transactions can be undertaken, except that which are permitted specifically by General License, or are permitted under Special permission from the authority.

(b) Sectoral Sanctions Programs: These sanctions pertain to restrictions related to certain activities or sectors in the sanction country. Thus, any type of transaction pertaining to the restricted sector may be prohibited, while other transactions/deals are permitted as usual. Russia was placed under sectoral Ukraine/Russia-related sanctions program in response to the actions and polices of the Government of the Russian Federation, including the purported annexation of the Crimea region of Ukraine,

(c) Non-comprehensive Sanctions Programs: These generally include restrictions on dealing with certain identified individuals or entities from the concerned countries, whose name is then included in the consolidated list of Specially Designated Nationals (SDN list). In these cases, there is no restriction except for dealing with the SDN entities/individuals.

Countries other than those under comprehensive sanctions are mainly: Afghanistan, Balkans, Belarus, Myanmar, Central African Republic, Democratic Republic of the Congo, Ethiopia, Hong Kong, Iraq, Lebanon, Libya, Mali, Nicaragua, North Korea, Sudan and Darfur, South Sudan, Ukraine/Russia, Venezuela, Yemen, and Zimbabwe.

7.4.2 UK Sanctions

UK and EU have arms and weapons embargo against several countries. Besides, UK has trade sanctions in respect of few countries under which there are certain trade activities prohibited. These pertain to Lebanon, Syria and Iran. UK also has the list of individuals or entities for which any transaction is prohibited. This list is managed by the HMT (Her Majesty's Treasury).

7.4.3 EU Sanctions

As referred to above there are several jurisdictions under arms embargo under EU's directive. Besides, several EU directives impose restrictions on several countries like Iran, Iraq, Lebanon, Liberia, Somalia, Syria, Ukraine, and Zimbabwe.

7.5 RISK CATEGORISATION OF COUNTRIES

ML/TF risks vary significantly in various countries. There are several factors that affect the degree of ML/TF risks inherent in a country. Most notably, the legal and regulatory framework for AML/CFT is an important factor affecting this risk. For managing ML/TF risk effectively, it is important that banks factor in the country ML/TF risk for customer risk categorization as also for monitoring of cross-border transactions. Statistical data and adequate information for various parameters (like amount of money laundered, or money generated through arms trafficking, ransom amount raised, no. of terrorism related incidents, etc.) that would be direct indicators for ML/TF are difficult to get. Therefore, other indirect indicators could be used for this purpose. These could be FATF listing, Country sanctions, Tax Haven, Proliferation, Drugs and human trafficking, Terrorism sensitive areas, Known terrorism locations, etc. Based on these parameters the countries could be classified in 3 or 5 risk categories. An indicative list of high/ medium risk countries is given at Appendix 2.

7.6 LET US SUM UP

This chapter deals with jurisdiction impacting money laundering risks. FATF review identifies geographies deficient in AML regime. Few details about countries under UN embargo and sanctions, accordingly effect on their risk category.

7.7 CHECK YOUR PROGRESS

1. FATF has identified TWO countries as the riskiest countries. Please choose the correct answer from the following pairs of countries.
   (a) Somalia and North Korea
   (b) Iran and Syria
   (c) North Korea and Iran
   (d) North Korea and Cuba

2. What is meant by OFAC?
   (a) Office for Foreign Accounts and Control
   (b) Office of Foreign Assets and Control
   (c) Organisation for Foreign Accounts Control
   (d) Officially Funded Assets for Commission

7.8 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (c) **2.** (b)

APPENDIX 2

Indicative List of High / Medium Risk Countries / Jurisdictions

1. Countries subject to sanctions, embargoes or similar measures in the United Nations Security Council Resolutions (“UNSCR”).
2. Jurisdictions identified in FATF public statement as having substantial money laundering and terrorist financing (ML / FT) risks (www.fatf-gafi.org)
3. Jurisdictions identified in FATF public statement with strategic AML / CFT deficiencies (www. fatf-gafi.org)
4. Tax havens or countries that are known for highly secretive banking and corporate law practices
5. Countries identified by credible sources as lacking appropriate AML / CFT laws, regulations and other measures.
6. Countries identified by credible sources as providing funding or support for terrorist activities that have designated terrorist organisations operating within them.
7. Countries identified by credible sources as having significant levels of criminal activity.
8. Countries identified by the bank as high-risk because of its prior experiences, transaction history, or other factors (e.g. legal considerations, or allegations of official corruption

CHAPTER 8

REPORTING OBLIGATIONS AND TRANSACTION MONITORING

STRUCTURE

8.1 Reporting Obligations of Banks
8.2 Salient Aspects of Reporting
8.3 Transaction Monitoring
8.4 STR Typologies
8.5 AML Monitoring & Fraud Prevention
8.6 Common Precautions for New Accounts
8.7 Let us Sum up
8.8 Check Your Progress
8.9 Answer to 'Check Your Progress'

Appendix

3. Transaction Monitoring
4. Parameters For Risk Based Transaction Monitoring

OBJECTIVES

Knowing about the reporting obligations of banks under PML Act. Knowing the distinctive features of CTR, NTR, CBWTR, CCR and STR. Understanding the steps banks need to take for meeting these obligations. To know about the use of AML software. To know about STR typologies.

8.1 REPORTING OBLIGATIONS OF BANKS

8.1.1 PMLA/PMLR Stipulations

As we have seen, PMLA prescribes that banks are required to provide information on transactions to the Director, FIU-IND. Sec. 12(1) (b) of the PMLA states that every reporting entity shall –

> *"furnish to the Director within such time as may be prescribed, information relating to such transactions, whether attempted or executed, the nature and value of which may be prescribed;"*

The details of the reports required to be submitted to FIU-IND are spelt out in Rules 3 and 7 of the PMLR.

8.1.1.1 Reports to be Submitted

The reports required to be submitted by banks to FIU-IND are as indicated in Table 8.1 below.

Table 8.1 Reports to FIU-India

S. No.	Report	Transactions to be Reported	Periodicity	Timeline
1	Cash Transactions Report (CTR)	i. All cash transactions of more than Rs. 10 lakh or its equivalent in foreign currency; ii. All series of cash transactions integrally connected to each other (individually of below ₹10 lakh or its equivalent in foreign currency) within a month, and the monthly aggregate exceeds ₹10 lakh or its equivalent in foreign currency;	Monthly	By 15th of next month
2	Suspicious Transactions Report (STR)	All suspicious transactions whether or not made in cash and by way of various types of transactions enumerated in Rule 3 (D)	As and when	Within 7 days of a transaction determined as Suspicious
3	Counterfeit Currency Report (CCR)	All cash transactions where counterfeit currency notes have been used or where any forgery of a valuable security or a document has	Monthly	By 15th of next month

		taken place facilitating the transactions.		
4	Non-Profit Organisation Transaction Report (NTR)	All transactions involving receipts of more than ₹ 10 lakh by non-profit organisations, or its equivalent in foreign currency	Monthly	By 15th of next month
5	Cross Border Wire Transfer Report (CBTR)	All cross border wire transfers of more than ₹ 5 lakh or its equivalent in foreign currency where either the origin or destination of fund is in India	Monthly	By 15th of next month

8.1.1.2 Delays/Non or Improper Submission

Rule 8(4) of PMLR states that a delay of each day in not reporting a transaction will be considered a separate violation. It implies that non-submission or delayed submission or incomplete reports may result in the various penal actions by the Director, FIU-IND, including levy of monetary penalty.

8.1.1.3 Proper Internal Mechanism

Rule 7(3) of PMLR also requires reporting entities to have an appropriate internal mechanism to detect the transactions of the nature indicated above, in accordance with the regulatory guidelines and for furnishing the above Reports to FIU-IND. Where a bank does not have proper systems, procedures and adequate organizational set-up, it may be subject to penal actions by the Director, FIU-IND.

8.1.2 RBI Guidelines

RBI has issued certain guidelines to enable banks to compile the aforesaid Reports required to be submitted by banks under PMLA. RBI's current guidelines are contained in the Master Directions – Know Your Customer (KYC) norms dated 25th Feb. 2016 (updated May 10, 2021)

- ❖ The reporting formats prescribed, and Report Generation Utility and Report Validation Utility developed by FIU-IND shall be taken note of.
- ❖ The editable electronic utilities to file electronic Cash Transaction Reports (CTR) / Suspicious Transaction Reports (STR) which FIU-IND has placed on its website shall be made use of by REs which are yet to install/adopt suitable technological tools for extracting CTR/STR from their live transaction data.
- ❖ The Principal Officers of those REs, whose all branches are not fully computerized, shall have suitable arrangement to cull out the transaction details from branches which are not yet computerized and to feed the data into an electronic file with the help of the editable electronic utilities of CTR/STR as have been made available by FIU-IND.

8.1.2.1 Suspicious Transactions Report (STRs)

a. Robust software, throwing alerts when the transactions are inconsistent with risk categorization and updated profile of the customers shall be put in to use as a part of effective identification and reporting of suspicious transactions.
b. STRs are to be filed where banks have reasonable ground to believe that the transaction involves proceeds of crime, irrespective of the amount involved.
c. Abandoned/aborted transactions should be reported as STR, irrespective of their value.
d. Reason for considering a transaction to be of suspicious nature should be recorded by the Principal Officer in writing.
e. There should be no undue delay in arriving at a conclusion on a transaction report received from the branch or any other office.
f. For generation of alerts pertaining to suspicious transactions and the indicative list of suspicious activities, parameters for Risk Based Transaction Monitoring and alert indicators are given in Appendix 4.
g. As a part of transaction monitoring mechanism an appropriate software application should be put in place to throw alerts when the transactions are inconsistent with risk categorization and updated profile of the customers, for effective identification and reporting of suspicious transaction.
h. No restriction should be put on operations in the accounts for which STR has been filed.
i. There should be no tipping off to the customer regarding STR at any stage or level. The information about filing STR is to be kept confidential.

8.1.2.2 Counterfeit Currency Report (CCRs)

Apart from reporting particulars of cash transactions in which counterfeit notes are detected, the cash transactions for which forgery of valuable security or documents has taken place also need to be reported. These may be reported to FIU-IND in plain text form.

8.1.2.3 Non-Profit Organisation Transaction Report (NTR)

For the purpose of Non-Profit Organisation Transaction Report NPO means any entity that is registered as a trust or a society under the Societies Registration Act, 1860 or any similar State legislation, or a company registered under Section 8 of the Companies Act, 2013 (erstwhile Section 25 of Companies Act, 1956)

8.1.2.4 Cross Border Wire Transfer Report (CBWTRs)

Cross Border Wire Transfer Report (CBTR) is required to be filed for all cross-border wire transfers above the threshold value where either the origin of the funds is in India or the destination of the funds is in India.

8.2 SALIENT ASPECTS OF REPORTING

8.2.1 Nature of FIU Reports

In order to meet the reporting obligations under the PMLA, monitoring the transactions is undertaken for customers as essential measure, so that the relevant transactions are identified.

8.2.1.1 Rule Based – Threshold Value

It will be observed that out of the five reports stipulated under PMLA, four are rule based reports. Three reports (viz. CTR, NTR and CBTR) require reporting of transactions of specific nature and of above specified threshold value. These are therefore easily amenable to system based generation. In banks having core banking system, these can be generated centrally at the Head Office unit. Those banks that do not have core banking system will need to put in place appropriate system for generation and compilation of relevant transactions at the branch level, and reporting of these to the Head Office. At the Head Office the consolidated report for the bank as a whole will need to be compiled.

8.2.1.2 Rule Based – Event of Counterfeit Notes/ Forged Security

CCR is based on the specific event of detection of counterfeit currency notes, or an event of use of forgery of documents or valuable documents for cash transactions. This would require having an appropriate mechanism for reporting of such transactions to the Head Office, for compilation of the Bank level reporting. It may be noted that CCR reported to FIU is distinct from and in addition to the reports submitted to RBI.

8.2.1.3 Norm Based – Judgment of Genuineness

The fifth report, viz. STR, is not a rule based but a norm based report. This calls for a judgment on the part of the bank officials about genuineness of the transactions. It requires taking a call on whether the available information both quantitative and qualitative indicates likelihood of the transaction not being for a bonafide purpose.

8.2.1.4 Distinct Utility of Various Reports

While other reports (i.e. CTR, NTR and CBTR) provide FIU-IND with huge amount of information on the three significant categories of transactions taking place through the banking system viz. cash transactions, transactions in the accounts of NPOs, and cross border transactions; these reports include substantial proportion of genuine transactions. Hence these reports by themselves have limited value from the AML perspective. STRs are of primary importance for FIU-IND in detection of cases that would be useful for feeding to Law Enforcement Agencies (LEAs), because these contain information about such transactions that have been identified as being unusual in nature. The information in the other reports are useful in supplementing the information provided in STR, and in arriving at a conclusion for reporting these to LEAs. Hence, submission of STR is an important and onerous responsibility on the banks. It requires extensive monitoring of transactions and also appropriate due diligence on customers to take an informed view in this regard.

8.2.2 Cash Transaction Reports

Certain aspects that need to be ensured in filing of CTR are as discussed below.

8.2.2.1 Integrally Connected Transactions

CTRs should include (apart from the individual transactions of more than Rs.10 lakh, integrally connected transactions with aggregate value exceeding Rs.10 lakh within a month. Integrally connected cash transactions to be reported are the transactions that satisfy the following criteria:

- They are in cash.
- All the transactions are of same nature (i.e. either credit or debit), that is the receipts and the payments from the customer are considered separately.
- They take place during the same calendar month.
- The sum of such transactions is more than Rs 10 lakh. If there is/are individual transaction(s) of more than Rs.10 lakh, then other cash transactions (even if their total is less than Rs. 10 lakh) are to be included.
- They are done by a customer, acting in same capacity. For example, deposits by Mr. X in his personal savings account, and cash deposits in a firm M/s. XYZ, in which he is a partner will not be counted together for this purpose. However, cash deposits in his proprietary firm M/s. XX should be clubbed with deposits in his savings account. Thus transactions across all accounts of the customer will be included.
- Transactions done for different purposes by the same customer need to be clubbed together. For example, Mr. X deposits Rs.7 lakh cash in his savings account, and purchases DDs of Rs.4 lakh in cash. All these transactions will be counted together for this purpose.
- Individual transactions of less than Rs. 50,000/- are not to be reported, but they must be counted for determining the inclusion of 'integrally connected transactions' and in the aggregate cash receipt/ payment, as the case may be.

8.2.2.2 Transactions between internal accounts

Only the transactions which are for the customers are to be reported. The transactions between the internal accounts of the Bank are not to be reported.

8.2.2.3 Branch-wise Reports

Where CTR is generated centrally by banks for branches having Core Banking System, these should be done branch-wise. A copy of the monthly CTRs filed for a branch should be available at the branch for production to the auditors/inspectors. For branches not covered under CBS, the branches must forward CTRs to the Principal Officer for onward submission to the FIU-IND, along with the summary for the Bank as a whole.

8.2.3 Other Rule Based Reports

8.2.3.1 Non-Profit Organisations Transactions Report (NTR)

In this report all individual receipts of more than Rs.10 lakh in the accounts of Non-Profit Organisations are to be reported.

- *Definition*: For the purpose of reporting in NTR a non-profit organization (NPO) is an entity that that is registered as a trust or a society under the Societies Registration Act, 1860 or any similar State legislation or a company registered under Section 8 of the Companies Act, 2013 (erstwhile Section 25 of Companies Act, 1956)). Hence, the accounts of such entities need to be categorized distinctly.
- *Foreign Contribution Regulations Act Requirement (FCRA)*: Another aspect to be monitored for accounts of NPOs is receipt of foreign contributions. Trusts require specific approval from the Ministry of Home Affairs (MHA), Govt. of India for accepting donations/contributions from overseas donors. Thus donations from foreign sources can be credited only in the specific bank account mentioned in the permission letter issued by the MHA and is restricted by the amount specified in it.

8.2.3.2 Cross Border Wire Transfers Report (CBTR)

In this report all cross-border transfers of over Rs. 5 lakh each are required to be reported. In other words, all inward or outward forex remittances above the threshold value will be reported, irrespective of the purpose of such transactions. Typically, these transactions will include remittances made for the following purposes:

- Payments for imports/exports of goods and services
- Investments by residents in non-resident entities
- Loans by residents to non-resident individuals/entities
- Investments by non-residents in resident entities
- Loans by non-residents to resident individuals/entities
- Receipts from overseas by residents for miscellaneous purposes
- Remittances by residents to overseas for miscellaneous purposes

8.2.3.3 Counterfeit Currency Report (CCR)

Counterfeit Currency Report covers two aspects namely, (i) Reporting of counterfeit notes detected during the month, and (ii) Reporting any cash transaction in which forged document or fake valuable security was used.

(i) *Reporting Counterfeit Notes*: This is to be reported on monthly basis through the FinNET portal. There is no threshold value prescribed for reporting, hence even one note would need to be re- ported. Care needs to be taken that the data on counterfeit notes is accurately compiled. Banks are required to submit reports on counterfeit notes to Police and RBI also. The data in various reports should be reconciled.

(ii) *Fake Valuable Security/Forged Document*: Any event in which cash transactions take place involving fake security or forged document is required to be reported to FIU-Ind, irrespective of the value of the transaction. There is neither a format for this report, nor any provision for its submission through the portal. Hence, a report in text form may be prepared and sent to the Director, FIU-Ind.

Detection and Impounding of Counterfeit Notes

Banknotes tendered over the counter shall be examined for authenticity through machines. Similarly, banknotes received directly at the back office / currency chest through bulk tenders shall also be examined through machines. No credit to customer’s account is to be given for Counterfeit Notes, if any, detected in the tender received over the counter or at the back-office / currency chest. In no case, the Counterfeit Notes shall be returned to the tenderer or destroyed by the bank branches. Failure of the banks to impound Counterfeit Notes detected at their end will be construed as wilful involvement of the bank concerned in circulating Counterfeit Notes and penalty will be imposed. Notes determined as counterfeit shall be stamped as "COUNTERFEIT NOTE" and impounded in the prescribed format. Each such impounded note shall be recorded under authentication, in a separate register. When a banknote tendered at the counter of a bank branch / back office and currency chest is found to be counterfeit, an acknowledgement receipt in the prescribed format must be issued to the tenderer, after stamping the note. The receipt, in running serial numbers, shall be authenticated by the cashier and tenderer. Notice to this effect shall be displayed prominently at the offices / branches for information of the public. The receipt is to be issued even in cases where the tenderer is unwilling to countersign it. For cases of detection of Counterfeit Notes up to four (04) pieces in a single transaction, a consolidated report in the prescribed format shall be sent by the Nodal Bank Officer to the police authorities or the Nodal Police Station, along with the suspect Counterfeit Notes, at the end of the month. For cases of detection of Counterfeit Notes of five (05) or more pieces in a single transaction, the Counterfeit Notes shall be forwarded **immediately** by the Nodal Bank Officer to the local police authorities or the Nodal Police Station for investigation by filing FIR in the prescribed format. A copy of the monthly consolidated report / FIR shall be sent to the Forged Note Vigilance Cell constituted at the Head Office of the bank. Acknowledgement of the police authorities concerned has to be obtained for note/s forwarded to them (both for consolidated monthly statement and for filing of FIR). If the Counterfeit Notes are sent to the police by insured post, acknowledgement of receipt thereof by the police shall be invariably obtained and kept on record. A proper follow-up of receipt of acknowledgement from the police authorities is necessary. 5.5 In order to facilitate identification of people abetting circulation of Counterfeit Notes, banks are advised to cover the banking hall / area and counters under CCTV surveillance and preserve the recording as per their internal policy.

8.2.4 Suspicious Transaction Reports

Suspicious Transaction Reports are the keystone of the entire AML/CFT regime. It is the intelligence that is gathered through these, that enables FIU to provide appropriate information to the relevant law enforcing agencies. Hence these are the most valuable reports for the FIU and the LEAs. On the other hand, these are reports that take the maximum resources of the reporting entities, i.e. banks, etc. Also, the sole objective of the entire exercise of due diligence, risk profiling of customer, review and updating of due diligence, and transaction monitoring is the ability to detect and report suspicious transactions. To gain insight into STRs, there is a need to understand certain terms/aspects clearly.

8.2.4.1 Transaction – Definition

Rule 2(h) of PML Rules defines 'transaction' for the purpose of AML/CFT. As per this definition "a purchase, sale, loan, pledge, gift, transfer, delivery or the arrangement thereof" will be covered as a 'transaction'. Apart from this generic definition, the rule specifies certain nature of activities that are included as a transaction. It will be observed that apart from the usual banking activities of deposits, advances, remittances, LCs, BGs, trade transactions, etc. other types of services or business lines are also included. Some of such activities are safe deposit locker; any fiduciary relationship; establishing or creating a legal person or legal arrangement; any payment made or received under any obligation; etc.

8.2.4.2 Suspicious Transaction – Definition

Rule 2(g) of PML Rules defines 'suspicious transaction' for the purpose of reporting as STR. This contains following essential elements:

- Pertains to all types of transactions as defined under PMLR (Paragraph 10.2.4.1)
- All transactions whether done in cash or through any other mode are covered.
- Attempted transactions that are not pursued by the customer are also covered.
- Any transaction that (i) falls in any of the above category, and (ii) 'to a person acting in good faith' seems to meet any of the undermentioned criteria is determined as 'suspicious'.
    - Reasonable suspicion of proceeds of an offence (included in PMLA) being involved, regardless of the value; or
    - Appears of unusual or unjustified complexity; or
    - Appears to have no economic rationale or bonafide purpose; or
    - Reasonable suspicion of pertaining to financing of terrorism.

8.2.4.3 Suspicious Transaction Report – Distinctive Features

- *Determining Criteria – Suspicion*: Important points to note are that for the purpose of 'suspicious transaction' the value of the transaction, the mode of transaction, and whether transaction has actually occurred are not relevant. The sole criterion is the suspicion arising on the purpose of the transaction being not bonafide/legitimate. Thus reporting of STR requires taking a view on the real intentions of the transactions, which could be substantially different from the ostensible purpose declared by the customer, and deciding about its genuineness. There are no rules to arrive at a conclusion, though there are some indicators for guidance. There will be certain grounds of suspicion or otherwise that are used while arriving at the decision. For instance, a housewife holding a savings account receives daily several remittances from various cities in two States, and every day transfers the amount to one or more accounts out of a set of three current accounts. This could raise some doubts about the purpose both of the receipts and the payments. On the other hand, a retail grocery shop-owner depositing cash daily in his current account and making several remittances during a week within reasonable value range would seem to be bonafide.

- *Non-fund Based Services*: Another aspect to remember is that even non-fund based transactions or merely para banking services are covered. In such activities too, bankers will come across situation that will arouse suspicion. For instance, if a customer who is employed in a store as a salesman comes and operates the safe deposit locker on daily basis will raise doubts in the mind of any prudent person. On the other hand, a diamond trader visiting to operate his locker twice a day would not be a matter of concern.
- *Transaction Value*: For a suspicious transaction, no monetary threshold has been prescribed. Thus technically, a transaction of even one rupee would be reportable, if found to be suspicious. In fact, in case of terrorism financing substantial portion of the transactions would be of small value, especially those related to immediate and direct expenses for the purpose of specific terrorist attack. Hence, low value remittances would rather be of limited value in respect of money laundering, except when a large number of such transactions are mutually connected. However, a solitary remittance of low value may be adequate to provide enough funds for an IED explosion in a market place, and hence is significant from STR purposes.
- *Non-monetary Transaction*: Even certain transaction that by themselves do not pertain to movement of funds and hence there is no transaction value for these. For example, forming a network of several companies or trusts does not have any intrinsic monetary value ascribed to it. Such transactions may also arouse some suspicion about their bonafide and hence would be subject to STR process.
- *Attempted Transaction*: Another significant point to note is that PML Rules require the banks to report even such matters where the customer does not actually conduct certain transaction that he inquired about, if there is a suspicion that the intended transaction was with the objective of money laundering. In other words, even 'attempted transactions' are required to be reported as STR. At- tempted transaction has not been defined either in the PML Act or in the PML Rules. But given the experience of the banks, in the matter of Cobrapost episode, when several banks have been penalised by FIU-IND for not reporting those incidents under STR, in the category of Attempted Transaction, it is advisable to report as STR any incidents where inquiries by walk-in customers arouse suspicion about the proposed transactions.

8.3 TRANSACTION MONITORING

8.3.1 Objectives and Norms for Monitoring

Effective AML/CFT measures require ongoing monitoring of customer transactions. The two primary objectives of transaction monitoring are:

- To ensure that the transactions are consistent with the customer's profile
- To enable submission of the prescribed reports to FIU-IND.

Monitoring all the transactions passing through a bank with same degree of diligence would not be practical. It is therefore necessary to adopt certain norms that would help in effective monitoring for meeting the above objectives. Hence, Risk based approach (RBA) need to be adopted by banks/ financial institutions. FATF Recommendations therefore underscore reporting entities should adopt RBA in their AML regime. RBA implies adopting more intense monitoring for high risk customers, e.g. PEPs, Corporates with complex structures, business entities having operations in several countries, etc. Similarly, RBA may be adopted for the products/ services – with closer monitoring of transactions that pose higher risk, e.g. imports remittances, foreign direct investment, transactions in commodities derivatives, diamond trade transactions, etc. Some other situations calling for more intense approach could be those stated below.

- Unusual transactions with no apparent economic rationale or legitimate purpose.
- Large and complex transactions
- Transactions exceeding the prescribing thresholds or just below the thresholds
- Cash transactions not consistent with the normal activity of the customer
- High or very quick turnover in the account not consistent with the balance maintained in the account.

Guidelines for transaction monitoring contained in IBA - Know your Customer (KYC) Norms & and Anti-Money Laundering Measures (AML) Guidance Notes for Banks – July 2020 are reproduced at Appendix 3.

8.3.2 Methods for Monitoring

There are various modes for monitoring transactions. Banks need to adopt appropriate modalities. Usually, these would be combination of several methods that can be classified as under:

8.3.2.1 Observation Based

Staff at branches and operating units can come across situations when they notice transactions that are unusual or customer behavior that is suspicious. Suitable mechanism for reporting of such indicators noticed by the branches/operating units to the AML cells for further examination and processing. There are certain identified patterns that can serve as indicators. It may be mentioned that this is the primary method for identifying 'attempted transactions' and reporting them to FIU-IND. An elaborate list of such indicators is contained in the Report of the IBA Working Group on Parameters for Risk Based Transaction Monitoring.

Following are some of the indicators that could be useful in monitoring:

- Customer does not open account after knowing KYC requirements
- Customer did not complete transaction after queries such source of funds etc.
- Customer is accompanied by unrelated individuals.
- Customer gives false identification documents or documents that appears to be counterfeited,
  altered or inaccurate
- Customer uses complex legal structures or where it is difficult to identify the beneficial owner
- Match of customer details with persons reported in local media/open source for criminal offences

- Foreign remittance received by NPO not approved by FCRA
- Complaint received from public for abuse of account for committing fraud etc.

It will be clear from the foregoing that the first line of defence viz. the business and the operations has a significant role in transaction monitoring. In fact, sales and execution of any transaction is carried out by the first line after appropriate scrutiny. During this process, the focus is on respective regulatory compliance, legal authority, and arithmetical accuracy to execute the transaction in an error-free and risk-free manner. Simultaneously, ML/TF perspective may be included during the scrutiny by the first line. This approach would greatly enhance the effectiveness of transaction monitoring for the bank. Thus transaction due diligence during its execution is important strategy for AML.

8.3.2.2 Exception Report Based

Another modality for identification of suspicious transactions is to analyse reports of transactions extracted from the Core Banking System and other processing applications used by a bank, based on certain criteria. The transactions contained in such exception reports are examined in the context of the customer profile, the transaction pattern of the customer over a time period, and the pattern of the exception transactions. Where required separate inquiries are carried out to gain better understanding of the transactions and ascertain if these relate to legitimate business/other needs of the customer.

8.3.2.3 AML Software Based

The following characteristics of banking business make it extremely difficult to monitor customer trans- actions effectively, merely through manual processes:

- Large number of customer relationships
- Large number of transactions
- Various kinds of products and services
- Wide range of complexity of products and services
- Money launderers adopt various complex techniques
- Straight through processing of several transactions
- Customer initiated transactions processed without manual intervention

Hence banks need to have appropriate AML software for analysing the transactions carried out in its core banking system and other ancillary transaction processing applications. Adopting software has the following benefits:

- Exhaustive coverage of all transactions
- Thorough scrutiny of transactions based on rules capable of detecting various patterns
- Linking various types of transactions of the same customer
- Linking transactions in various connected accounts of the customer

In view of the foregoing, RBI has stipulated in its KYC Directions that robust software, throwing alerts when the transactions are inconsistent with risk categorization and updated profile of the customers shall be put into use. The nature of software in terms of its features and processing capabilities to be used by different banks will be different. It will depend on the nature of business of the bank/ financial institution mainly in terms of its products portfolio, volume of transactions, value of transactions, its customers' composition and the number of customers.

8.3.2.4 Rules for Generation of Alerts

The effective use of AML software is highly dependent on the rules deployed in it for generation of alerts. These should be of wide range so that various transaction patterns are captured. On the other hand, to enable meaningful analysis of the alerts generated it is essential that the number of alerts generated is not too large. For this purpose, the transaction values used for filtering need to be decided based on the experience and the business pattern actually occurring. RBI had advised banks to adopt the scenarios recommended by the IBA Working Group (barring few of them)

Some of the scenarios included in the said report are:

- Match of customer details with individuals/entities on various lists:
  (i) UNSCR Lists,
  (ii) designated individuals/entities under UAPA,
  (iii) TF suspects/criminals on lists of Interpol, EU, OFAC, Commercial lists (World-Check, Factiva, LexisNexis, Dun & Bradstreet etc.)
- High value cash/non-cash deposits/withdrawals in a day/month
- Sudden high value transaction for the client
- High level activity in a new account
- High cash activity inconsistent with profile
- Splitting of cash deposits below threshold values
- Routing of funds through multiple accounts
- One to many/many to one transfers
- Repeated small value withdrawals in sensitive locations
- Large debit balance in credit card
- Large value card transactions for purchase of high value goods
- Repeated small value cash withdrawals against international card
- Repayment of loan in cash
- Premature closure of large FDR through PO/DD
- Frequent locker operations
- Inward remittance inconsistent with client profile
- High value cash transactions by dealer in precious metal or stone
- High value transactions with tax havens

8.3.2.5 Specific Rules for Trade Based Money Laundering (TBML)

Substantial portion of money laundering is trade based. Hence those banks that handle global transactions need to take specific steps for monitoring of such transactions. These transactions have distinctive characteristics and therefore indicators of dubious transactions are different. The basic principle though remains the same to judge whether the pattern fits the normal pattern. Some of the major rules that can be used for detecting suspicious trade based transactions are enumerated below:

- Inward remittance immediately withdrawn/transferred from the account
- Customer in high risk business
- Accounts used only for advance remittances and closed in short period
- Amount of advance not in line with trade practice
- Transactions pertaining to intangibles like e-codes, PIN, specialized software, etc.
- High proportion of high seas sales/merchanting trades
- Fund transfers through exchange centres despite having bank accounts
- Description of goods vague
- Documents look suspicious prima facie
- Import payments against very old bills without justification/documents
- Originator/beneficiary information missing in wire transfers
- Repeated amendment in LCs without justification
- Value/quantity of goods not readily ascertainable
- Repeated import and export of same item of high value
- LC has unusual/non-standard clauses/conditions

It will be observed that for effective monitoring of trade transactions, wider range of information need to be captured. Also, careful scrutiny of the trade documents related to the transactions is important. It will be important to develop systems to capture wide range of trade related information in the software applications used for trade transactions, to enable effective use of AML application for detecting likely suspicious transactions.

8.3.2.6 Analysis of Alerts

Not all alerts generated by AML software are related to suspicious transactions, these only throw up potentially suspicious transactions. These need to be examined and analysed for the purpose of weeding out the 'false positives' i.e. those pertaining to the usual business transactions that happen to fall in the patterns adopted for money laundering. This exercise is done by the AML analysts based on their examination of the customer profiles, transaction history of the customer, and any other business relations of the customer with the bank. Hence ready availability of all this information in the core banking system or any other application(s) will make the exercise more effective and meaningful.

8.3.2.7 Fine Tuning of Alerts Generation

With a view to bring down the number of false positives following techniques may be adopted:

- *White Listing*: To avoid alerts pertaining to the accounts that are found to be genuine being thrown up repeatedly, such accounts could be whitelisted and thus the alerts for these suppressed for certain rules.
- *Rules Management*: The Rules for different types of products will be different due to different product characteristics. The rules could also be made more elaborate by distinguishing them for various types of customers based on their profiles, risk category, etc. Besides, the rules should also take into account the STR typologies. Another dimension that could be used for differentiating rules is places. Deploying

different sets of rules formed based on these various factors would result in more relevant alerts and thus help in reducing false positives, more particularly simply worthless alerts. It should also help in reducing the chances of 'false negatives' occurring especially due to high threshold values.

- *Threshold Setting*: The number of alerts generated for a given type of transaction, in case of most of the system based rules, is a function of the threshold value defined in the rule. The decision of threshold value is therefore crucial and impacts effectiveness of monitoring to a great extent. It is advisable to determine thresholds for various rules using statistical analysis for historical data of transactions, with different threshold values and compare the rusting alerts generated for different threshold values with the past data of alerts generated and processed, and STRs filed, and STRs not filed (due to lack of alerts) if such instances have come to light.

8.3.2.8 Advanced Technology for Transaction Monitoring

As stated earlier, the nature of software to be used depends on the business profile of the bank. In case of larger size banks with numerous transactions it would be important to use more advanced IT capabilities. Artificial intelligence and machine learning technologies can be deployed for more efficient and effective monitoring. Robotic process automation is another technology that can make the entire alert handling process more efficient by undertaking especially first level filtering of alerts.

These technologies enable use of data science analysis techniques, and also making use of digital foot prints connected with transactions for detecting transactions that prima facie appear to be out of trend or tune. Besides, extensive historical analysis helps in more precise flagging of doubtful transactions. Some of the key aspects that result in more rigorous transaction monitoring are:

- Network analysis
- Fuzzy-matching algorithms and intelligent scoring
- Alert consolidation
- Peer-group and historical anomalies detection
- Serving multiple servers securely
- Automated alerts processing/ initial closure
- Real-time monitoring of transactions
- Real-time alert investigation
- Analysis and linking of unstructured data

8.3.3 STR Propositions and Approval

All cases that are identified as potentially suspicious (viz. references by the branches, transactions in exception report analysis, and alerts remaining after weeding out) are examined in detail by the analysts based on various transaction documents available, and supplementary information sought from the customer through various channels. The analysts then form a view, and prepare the case recommending filing of STR or otherwise spelling out the grounds for the same. The decision for filing STR is required to be taken by the Principal Officer identifying the Grounds of Suspicion; hence the propositions for STR filing are sent to the Principal Officer containing the Grounds of Suspicion.

8.3.3.1 Preparation and Filing of STRs

The banks need to provide complete and accurate information in the STRs. These should capture all information of all accounts, individuals, entities related to the suspicion. Key identifiers such as PAN, ID number, Date of Birth also need to be included. Essential information in the STRs is covered under Grounds of Suspicion. These should cover comprehensive information along with the background of the relationship with the customer. This is very valuable to FIU-IND in taking a view on the STRs; and in their decision for reference to the Law Enforcement Agencies. These could also be useful in investigations carried out by the Law Enforcement Agencies. Thereafter STRs are filed on the portal provided for FIU reporting.

8.4 STR TYPOLOGIES

As we have seen earlier money launderers use variety of methods. There are certain typologies that have been more widely prevalent. Let us have a look at some of the typologies that have been noticed in suspected money laundering cases.

8.4.1 Cases with Inland Transactions

(i) Common Remitters/Shell Entities

M/s. XYZ Ltd. (Directors – Mr. A and Mr. B) declared its activity as Trader when opening a current account. After negligible activity in the account for about 18 months, several high value internal transfers were received in the account from the accounts of eight private limited companies, and some RTGS credits from two companies over a period of 10 months. The amounts were immediately remitted by RTGS to four firms, and some amounts were transferred to three of the eight accounts from which transfers were received.

During the same period, high value RTGS were received from the same remitters in the current account of M/s. PQR Ltd. (Directors – Mr. C and Mr. D). This account was opened at the same branch (around same time) with declared activity of the company as Trader. The funds were immediately remitted by RTGS to several other entities, and internally transferred to several entities with the same bank.

Field inquiries revealed that the two companies did not exist at the given addresses.

Indicators:

- Sudden spurt in the activities in the accounts.
- Inward RTGS receipts immediately remitted to the accounts of other entities with the same bank,
  and other banks.
- Remittances received from same remitters in both the accounts.
- The companies were no more at the given addresses.

(ii) Multiple Level Marketing (MLM) Related Activity

Mr. A has opened a savings account, declaring his occupation as a salaried employee. Within the first 3 months there were multiple small value cash deposits in the account with aggregate value exceeding one and a half times the annual income declared by Mr. A. The funds were withdrawn immediately after deposits as multiple DDs favouring M/S. XYZ Ltd.

Inquiries revealed that cash deposits were amounts received from the buyers of garments from M/s. XYZ Ltd. Internet search revealed that M/s. XYZ Ltd. was engaged in MLM type activity and there were numerous customer complaints against the company.

Indicators:

- Numerous small cash deposits in savings account of an individual.
- Multiple DDs issued from the same account favouring same person on the same day.
- Transaction pattern not matching a salaried employee's profile.
- Inquiries revealing linkage with an entity engaged in MLM activity.
- Complaints in public domain against the said entity.

(iii) Multiple Shell Entities

M/s. XYZ Ltd. (Directors – Mr. A and Mr. B) opened a current account, declaring the activity as Trader (supplier of cloth). Same persons were also directors of three other companies, M/s. ABC Ltd., M/s. DEF Ltd. and M/s. PQR Ltd. having current accounts with the same branch. Around the same time, a current account of M/s. LMN Ltd. (Directors Mr. C and Mr. D), declaring the activity as Trader (supplier of cloth), was also opened at the branch. Mr. C and Mr. D were also the directors of three other companies M/s. STR Ltd., M/s. GHI Ltd. and M/s. JKL Ltd. having current accounts with the same branch. All the companies had given the same address, and same email ID.

Within five weeks of opening the account of M/s. XYZ Ltd. the credits exceeded 60% of the annual turnover declared by the company.

Investigations revealed that there were cash deposits of less than Rs.10 lakh, in the accounts of seven (excluding M/s. XYZ Ltd.) out of the eight accounts. From these accounts, the funds were transferred to the account of M/s. XYZ Ltd. with the same branch, and some amount remitted as NEFT to the account of M/s. XYZ Ltd. with another bank. From the account of M/s. XYZ Ltd. RTGS remittances were sent to three companies having account with other banks.

During field inquiries, none of the companies were found at the address provided, nor were the directors found at their respective residence addresses. All the four directors had provided driving licences as ID proof, which did not exist on the RTO records.

Indicators:

- Cash deposits in multiple accounts just below the threshold value (Rs.10 lakh).
- Funds from all these accounts were immediately transferred into a single account.

- From this account the funds were immediately transferred out.
- No other business related transactions noticed in these accounts.
- Common addresses for all the eight companies.
- Common email ID for all the entities.
- Companies not found at the given address, indicating these are shell companies.
- The directors not found at the given addresses.
- ID proofs provided by the directors were found to be fake.

(iv) Benami Entity/MLM Activity

M/s. ABC (Proprietor – Mr. A) opened a current account, declaring the activity as Trader. Over a period of 18 months the aggregate credits in the account were over 6 times the declared annual turnover. During this period over 5700 cheques of small value all in round amounts like Rs.1250, Rs.2000, Rs.2250, etc. were deposited. Of these nearly 20% of the cheques bounced (for reasons reason Funds Insufficient/ Payment stopped by Drawer/Drawers Signature Differs, etc.). Nearly 80% of the amount is withdrawn in cash, and the balance amount was paid out through cheques/NEFT.

There was no trace of the entity at the communication address provided. The proprietor over phone call (his cellphone) gave another contact address. At this address, the office of a company with similar name was found, where Mr. A was employed as a manager.

Indicators:

- Multiple cheques of small round amounts deposited.
- Very large number for cheques received.
- High proportion of cheques getting bounced
- Immediate withdrawal of funds in cash.
- No other business related transactions noticed in the account.
- Firm not found at the given address.
- Mr. A, the proprietor is in employment, and gave false information, indicating it is a benami firm.
- Fixed denominations, very large number of cheques received indicates MLM activity.

(v) Shell Entities/Sudden Spurt

At a branch in jewellery market, M/s. ABC (Proprietor – Mr. A) opened a current account, declaring the activity as Import/Export. Around the same time current accounts of two other proprietorship firms were opened by different persons, all declaring their activity as import/export. One of these two accounts was of M/s. XYZ.

In the account of M/s. ABC, there were negligible activities in these accounts for nearly 30 months. Thereafter, in about 12 months there was heavy turnover in the account. The credits were through RTGS/ NEFT received from 9 entities (80%), internal transfers from two entities, and cheques deposited. The funds were immediately paid out to seven different entities through various modes viz. RTGS/NEFT/ Cheques. There was cash withdrawal of 15% of the amount. In the current account of M/s. XYZ too similar pattern of transactions was observed during the same period.

M/s. ABC and M/s. XYZ had provided the same address, and did not exist at that address. The mobile number provided for these two firms and the other firm from which funds were received in these accounts was also the same. This number belonged to one Mr. B, proprietor of one of the entities in the chain of funds movement.

Indicators:

- Spurt in the transactions in the accounts.
- Operating in high risk trade market.
- No other business related transactions in the accounts.
- Accounts being controlled and operated by a person other than the proprietor, a benami structure.
- Common address of several entities.
- Entities not being available at the address provided.
- Common mobile number for several entities.
- Contact mobile number provided of a third party i.e. not of the proprietor.

(vi) No Economic Rationale

M/s. ABC and M/s. DEF (Proprietor – Mr. A for both the firms) opened current accounts, declaring activity as Stock broking, within a month. During about 18 months the turnover in M/s. ABC was more than 6.5 times the declared turnover. The credits were through cheques deposits, internal transfers, and cash deposits. The debits were through multiple cheques issued favouring different individuals and internal transfers. In the current account of M/s. DEF similar pattern for much lower amount took place. The entities do not exist at he given address. The proprietor is not available on the given mobile number.

Indicators:

- Multiple cheques deposits in the account.
- Immediate payment of the funds received to various individuals through cheques.
- Transaction pattern not matching that of stock broker.
- No transactions related with the stock exchange
- Firms not existing at the address given.
- Proprietor not available on the mobile number.

8.4.2 Cases with Cross Border Trade Transactions

(i) Trade Based - Multiple Shell Entities

M/s. XYZ (Proprietor Mr. A) declared its activity as Importer/Exporter (Trader in Steel Coils) when opening a current account. Within first 6 months, inward RTGS remittances of high value were received in the account from seven proprietorship/partnership firms. These credits were followed by immediate outward remittances, almost entirely to four entities. On field verification exercise for confirmation it was found the firm did not exist at the address provided for opening the account, nor was the proprietor available on the mobile number given.

An exercise for dedupe revealed five current accounts in the names of entities in which Mr. A was the proprietor/a director, albeit in different names. One account was in the name of M/s. PQR, proprietorship firm of Mr. B. Mr. B's photograph was same as that of Mr. A. Four accounts were of different private limited companies, all with Mr. C as a director. Mr. C's photograph was same as that of Mr. A.

Six other current accounts were identified in which RTGS remittances were received from the same remitters. Of these, two accounts were of the remitter firms.

Indicators:

- High value remittances received in newly opened account.
- Inward RTGS receipts immediately remitted overseas.
- Remittances received from same remitters in other accounts opened by the same person with fake identities.
- Two of the remitter firms also having account and were recipient of RTGS from the other remitters.
- The firm was no more at the given address.
- The proprietor was not contactable on the mobile phone.

(ii) Trade Remittances/Unrelated Activities

M/s. ABC Ltd. (Directors – Mr. A and Mr. B) opened a current account, declaring activity as Import/ Export (Machinery, Tools and Hardware Goods). During around a year the credits in the account were significant, but less than 5% of the declared annual turnover. The credits in the account were through RTGS/NEFT from several entities. The funds were immediately remitted to overseas entities. Around 10% of the funds were remitted to domestic entities through RTGS/NEFT. The company did not exist at the given address.

Two more accounts with the branch in the name of a private limited company and a partnership firm received RTGS credits from the same remitters. In these accounts also the pattern of transactions was similar, namely inward remittances immediately followed by outward forex remittance. The private limited company did not exist the given address. The partnership firm, that had declared its activity as real estate, was found to be engaged in Garment activity. On being asked for supporting documents the firm closed the account. Other two accounts were also closed.

Indicators:

- Common remitters in the accounts of entities in different line of activity.
- Turnover in the account too low compared to the declared turnover.
- Line of activity different from that declared.
- Company not existing at the address given.
- Inward remittances immediately followed by outward forex remittance.
- Accounts closed on asking for supporting documents.

(iii) Trade Based/Account Closed in Short Span

M/s. ABC (Proprietor – Mr. A) opened a current account, declaring activity as Import of electronic goods, other cereals. The transactions in the account within three months aggregated to around 40 times the declared annual turnover. Within two months 61 outward forex remittances of over 15 times the declared annual turnover was done through the account. All the remittances were to a single entity in Hong Kong for import of electronics goods. All outward remittances were below the USD 100, 000, and no Bill of Entry was submitted for any of the transactions. The funding of the account was done predominantly by cheques and transfers (around 65%) and the balance in cash. Most of the funds, except the outward forex remittances, were withdrawn in cash. There was no transaction in the account after three months.

Indicators:

- Unrelated commodities declared for imports.
- Too high turnover in a short span.
- Very high turnover in a newly opened account.
- All remittances to one beneficiary only.
- The item of import was high risk item.
- The destination country was high risk country.
- All remittances were below USD 100000.
- Account becomes inactive within a short span.
- No other business related transactions.

8.4.3 Cases Related to Cybercrime and Crypto Currencies

(i) Ransomware Attack on Computer Systems

'Wannacry' ransom ware attack had held thousands of computer systems hostages, in 2017. The victims included hospitals, banks and businesses across the world. The victims had to pay ransom in bitcoins. These bitcoins were paid into a publicly held bitcoin wallet. Multiple transactions were undertaken to convert these into other form of assets. The new assets were then sent to virtual asset service providers/ banks for conversion into fiat currency. The funds were blocked by the authorities before the hackers could lay their hands. The total amount involved was around USD100 mn. The affected institutions were required to pay around USD8 bn as damages.

(Source: Virtual Assets: What, When, How? – Hand Guide, FATF)

(ii) Cryptocurrency (OneCoin) Euro Fraud

A company, registered in a country A in South East Europe, had four shareholders (two from the home country and two from another country B) and was in the activity of giving online tutorial packages for investing in the cryptocurrency OneCoin. One of the foreigner shareholders had criminal record and was tax defaulter in home country. Collection of data over a period of time unearthed the connection between OneCoin and another company, registered in a country C in Central America. The authorities in Country C had banned any trade with this company. The funds were remitted out from the account of the company in Country A in the garb of payment to jewelers in Country

B. OneCoin was advertised as a cryptocurrency and had billions of euros of investments from many countries all collected through education packages.
(Source: Best of Egmont Cases 2014-2020, Egmont)

(iii) Cyberattack Through SWIFT Heist

In October 2017, a large commercial bank of an Asian Country A became a victim of cyberattack. It was a multilayered and highly complex cyber-attack. By gaining entry into user accounts 31 fraudulent SWIFT transfers were executed to 21 international banks in 9 countries spread over the world. The attack was carried out over a long bank closure period due to festivals. The bank's Trade Team and Compliance teams acted swiftly and managed to have major part of the funds blocked at the recipient banks. Besides, there quick reporting to the authorities including FIU, as also co-ordination by various agencies with the counterpart agencies in the other countries resulted in blocking the remaining funds also.
(Source: Best of Egmont Cases 2014-2020, Egmont)

8.5 AML MONITORING AND FRAUD PREVENTION

8.5.1 Customer Induced Frauds

Frauds pose significant risk to banks. Transaction monitoring is also useful for fraud prevention, in addition to detection of money laundering. Some of the rules like high value transactions in newly opened accounts, transactions not matching the customer occupation or expected turnover in the account, etc. apply to both money laundering and fraudulent transactions. Besides, frauds also usually have certain patterns. Hence, specific rules could be framed for detection of such patterns. It would require integrated analysis of system generated alerts from both the perspectives i.e. frauds and money laundering. Therefore, usually it is effective for banks to have a common software and same team for handling AML and Frauds prevention monitoring.

Some of the common indicators observed in case of frauds are as follows:

- Account with short life cycle
- Initial funding amount withdrawn within few days
- Transactions usually done from other branches in the same city or in different city
- Preference for high withdrawal limit ATM cards
- High value transactions
- Quick ATM withdrawals soon after inward RTGS
- Address provided of rented premises

(i) Fraudulent RTGS – Walk-in Customer Account

A savings bank account opened by a walk-in customer at a branch. Initial funding was done by a cheque drawn on own account with another local bank. The occupation was declared as a trader. For around two months there were no transactions, except cash deposits of nominal amounts on two distant dates. These amounts were withdrawn in cash from offsite ATMs. Then a RTGS remittance for Rs. 5 lakh was received in the account. Thereafter in less than a week, there were cash withdrawals vide cheque over the counter, and through ATMs of other banks. Almost half the amount was utilized through POS transactions at a couple of merchant establishments in another city. The balance left in the account was less than Rs. 500/-. The RTGS received in the account had been effected fraudulently from the account with the remitting bank.

Indicators:

- No transaction in the account for almost two months.
- Cash deposits of nominal accounts in a trader's account.
- Amount deposited withdrawn in cash.
- Sudden high value RTGS credit, not in trend with the account transaction pattern, and in newly opened account.

(ii) Fraudulent RTGS – Current Account of Proprietorship Firm

A current account of a proprietorship firm was opened based on the KYC document of the proprietor, and two entity proofs of the firm. Initial funding was through a cheque drawn on the savings bank account of the proprietor with another bank. The activity declared was Trader. During account opening field verification was done that was positive, with an observation that the customer was operating from residence. For almost a year there have been transactions, mostly RTGS credits from one remitter. The withdrawals were in cash across the counter. During the course of a year alerts were generated for very high value credits. These were closed after observing that these were for commission payments. After a year an RTGS remittance for Rs. 5 lakh was received for credit in the account. Bulk of this amount was withdrawn in cash across the counter, and the balance through ATM withdrawals. Two weeks after the RTGS of Rs. 5 lakh the remitting bank informed that the same was done fraudulently from an account with them. Customer's voter ID card details were not available on the website.

Indicators:

- No commercial place of business for garment trade is unusual.
- Transaction pattern in the account and customer activity apparently not matching.
- All withdrawals in cash are unusual for any business entity.

(iii) Current Account of Proprietorship Firm

A current account of a proprietorship firm is opened, as garment trader with initial funding from the proprietor's savings account with another bank. Several NEFT credits received in the account towards duty drawback credits. There was no usual trading related transactions in the account. Export documents submitted by the customer on inquiries indicated export of cotton and polyester, not related to the line of business of the customer. Customs department advised to block the account.

(iv) Money Mules: Operations in Accounts

Criminals often use money mules to transfer the proceeds of frauds or for being used for criminal or terrorist activities. They engage third parties ("money mules") who get paid some commission for enabling access to such funds by permitting use of their accounts.

They are usually recruited through spam emails or recruitment advertisements, etc. These third parties could be innocent persons or may be conniving with the fraudsters.

Some indicators of use of money mules for accounts are:

- Transactions are always done through third parties,
- Customer/beneficiary is not contactable
- Customer/beneficiary is unwilling to meet
- Customer/beneficiary is uncomfortable providing transaction related information
- Transactions are not in line with the customer profile and business
- Complaints are received from customers/non customers claiming deposit into accounts in response to offers for job, awards, gift, lottery, inheritance etc.

Banks need to be cautious about these, while adherence to the KYC guidelines and transaction monitoring will minimize the possibility of this, wherever there is suspicion of use of money mules, STRs should be filed.

8.5.2 Staff Related Frauds

Banks deal in large amount of funds, and hence are vulnerable to internal frauds too. Therefore, banks have strong systems for controls and checks. Nevertheless, due to certain infirmities and given human nature, internal frauds do take place.

Some of the indicators that arouse suspicion of internal frauds are as follows:

- Lavish lifestyle.
- Avoidance of long leave/vacation.
- Repeated negligence in the observance of rules.
- Depositing money on behalf of customers, frequently.

Certain mitigants for internal frauds that are adopted by banks are periodical job rotations, compulsory annual leave, etc.

8.5.3 Staff Callousness

Sometimes bank staff may unintentionally and unknowingly abet the frauds by fraudulent customers by discussing about the Bank's policies and procedures with outsiders. Staff needs to be sensitized about the need to maintain confidentiality about the Bank's systems and procedures and the rationale for them. Sharing this with the customers and outsiders would erode their effectiveness, as a fraudster would be able to evolve methods to circumvent them.

8.6 COMMON PRECAUTIONS FOR NEW ACCOUNTS

Over the years some of the common precautionary measures that banks have adopted in respect of new accounts are enumerated here.

- 'New Account' notation on the cheques.
- System generated alerts on 'new account'.
- Payment above certain amounts passed at higher level.

- Large value transactions – greater scrutiny.
- Instruments dated prior to account opening date – to be deeply probed.
- Inquiries with the drawer/drawee bank.

8.7 LET US SUM UP

This chapter deals with reporting obligations of REs to the FIUs. Res are required to submit various types of reports such as CTR, NPOTR, CBWTR, CCR, STR. Monitoring of various transactions in, accordance with guidelines of FIU and IBA is important for filing various reports. For this purpose, banks may adopt mechanism for utilisation of ML software and proper matrix for different scenario to generate alerts for enabling needful scrutiny.

8.8 CHECK YOUR PROGRESS

1. Counterfeit Currency Report to FIU pertains to __________.
   (a) counterfeit currency of the value of ₹10 lakh or above detected during a month
   (b) only counterfeit currency detected of any value
   (c) fake valuable security
   (d) counterfeit currency detected, and cash transactions where forged document or fake valuable security is involved

2. Which one of the following features applies to accounts of ‘money mules’?
   (a) These are KYC non-compliant accounts.
   (b) Third parties obtain control over bank accounts surreptitiously.
   (c) The account holder voluntarily permits third party to use the account for its financial transactions.
   (d) None of the above.

8.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d); **2.** (c)

APPENDIX 3

Transaction Monitoring

1. What is Transaction Monitoring?

RBI guidelines require that Banks should exercise ongoing due diligence with respect to the business relationship with every client and closely examine the transactions in order to ensure that they are consistent with their knowledge of the client, his business and risk profile and where necessary, the source of funds.

As mentioned in Chapter on reporting requirements, banks are required to report suspicious transactions to the FIU-IND. This requires the Banks to put in place a formal process for identifying suspicious transactions and a procedure for reporting the same internally. This process is known as transaction monitoring.

Monitoring customer activity helps identify unusual activity. If unusual activities cannot be rationally explained, they may involve money laundering or terrorist financing. Monitoring customer activity and transactions that take place throughout a relationship helps the banks to know their customers, assess risk and provides greater assurance that the Bank is not being used for the purposes of financial crime. Thus monitoring means analysis of a customer's transactions to detect whether the transactions appear to be suspicious from an AML or CFT perspective.

Suspicious transactions are reported to the Financial Intelligence Unit, India (FIU-IND).

2. Methods of Monitoring

i) **Observation:** The staff at the bank's branches may at the time of processing the transaction or otherwise come across certain transactions not in line with the profile of the customer. Certain behaviour displayed by the customer during their interactions with such customer may also lead to suspicion. Banks may advise their branch staff to report such instances to the principal officers / his representatives so that additional due diligence may be done on same.

ii) **Analysis of Exception Reports**: Banks may have in place a system of generation of exception reports at branches or at the central office to examine accounts based on certain threshold limits. Suitable due diligence may be conducted for these accounts and accounts concluded to be suspicious may be reported to the FIU-IND through the principal officer.

ii) **AML Software**: Banks may have an AML software to generate alerts / exceptions and then channel these alerts for suitable due diligence and reporting. Alerts concluded to be suspicious might be reported to the FIU-IND through the principal officer. RBI vide its circular dated May 22, 2008, as a part of transaction monitoring mechanism, requires banks to put in place an appropriate software application to throw alerts when the transactions are inconsistent with risk categorization and updated profile of customers.

3. **What is a suspicious transaction?**

As per PMLA Rule 2 (g) suspicious transaction means a transaction whether or not made in cash which to a person acting in good faith –

a. gives rise to reasonable ground of suspicion that it may involve the proceeds of crime or
b. appears to be made in circumstances of unusual or unjustified complexity or
c. appears to have no economic rationale or bonafide purpose
d. gives rise to a reasonable ground of suspicion that it may involve financing of the activities relating to terrorism

"Explanation: Transaction involving financing of the activities relating to terrorism includes transaction involving funds suspected to be linked or related to, or to be used for terrorism, terrorist act or by a terrorist, terrorist organisation or those who finance or are attempting to financing of terrorism."

In determining whether the transaction is suspicious or not, Banks needs to have regard to the IBA Report on Parameters for Risk based Transaction Monitoring updated in July 2020.

Complex transactions having no economic rationale or bonafide purpose, concluded to be suspicious, need to be reported to FIU-IND. Banks need to put in place suitable systems to identify and report such transactions through transaction monitoring.

4. **What are the essentials of transaction monitoring process?**

An effective transaction monitoring process should contain the following necessary elements:

Identification of Exceptional Transactions: Recognition of suspicious transaction requires the banks to know which transactions it should analyze from the huge number of transactions they process. Therefore, based on above Indicators of suspicion, banks need to devise business rules based on value, number and frequency. In advanced stages of an AML program, Banks may use customer profiles and historical activity to alert them on suspicion. Banks may also use predictive modeling at mature stages of AML implementation. This involves analyzing the salient features of suspicious activity reported in STRs by the bank and devise scenarios involving such features.

Analysis of transactions / available customer information: This involves scrutiny of the transactions carried out by the customer over a longer period of time, the basic KYC information available in the bank's systems as also checking on any unusual patterns or complexity in the transaction

Enhanced Due Diligence: In case the bank requires additional information on the customer for concluding the suspicion or otherwise, it may conduct an enhanced due diligence through the Branch manager or any other bank official having knowledge of the customer. Based on such customer information, objective parameters, judgment of business group, and banker's prudence, Banks arrive at a conclusion whether the transaction is suspicious or not. Some of the objective parameters which can be used for enhanced due diligence could be:

a. Customer location
b. Financial status
c. Nature of business
d. Purpose of transaction

Confirmation of Suspicion: In case the above process leads the Bank to conclude that transaction is suspicious, then the same would be reported to the principal officer who on confirmation of the suspicion would file a report onward to the FIU-IND in an STR

5. Who should perform transaction monitoring?

Depending on the structure of the Bank, transaction monitoring may be either be based at branches or at centralized location. Alerts / exceptions generated may be filtered by a central unit and then forwarded to business units / branches having knowledge about the customer. In case of Branches not on core banking these exception reports / alerts may be generated at the branch and analysed by the branch manager or designated officer.

6. What types of rules should be used for generation of exception?

Banks may as per their internal policy in this regard and based on their assessment of risk use following types of rules based on threshold limits or patterns for generation of exception reports / alerts:

1. Pure thresholds:
   Large Value Cash Transactions
   Large Value Non Cash Transactions
   Large Volume of Transactions
   Large Value transaction in dormant accounts
   Large number of remittances
   Large value of remittances
2. Pattern Checks:
   Single remitter transmitting funds to multiple beneficiaries
   Multiple remitters transmitting funds to single beneficiary
   Multiple accounts of the same customer
   Any other pattern, which appears unusual, based on banks experience
   Profile based Alerts
   Significant deviation from known transaction profile of customer

Note: Above are purely indicative in nature. Fine-tuning of these may be done based on typologies observed during the course of time

7. What is white listing? How does a bank manage white listing?

With threshold-based alerts, there may be instances where the same customer accounts repeatedly hit the threshold limit to generate alerts. This results in a large number of repeated alerts involving the same accounts. To deal with such situations the AML software provide a false positive manager which allows accounts to be white listed for a specified period of time if they are found to be non-suspicious after due diligence.

8. Do banks need to Report attempted ML transactions?

RBI circular No DBOD.AML.BC.No.85/14.01.001/2007-08 dated May 22, 2008 has advised banks that in case a transaction is abandoned / aborted by customers on being asked to give some details or provide documents, it should report all attempted transactions in STRs even if not completed by customers irrespective of the amount of transaction. Thus banks may need to issue instructions to its branches to note above during course of customer interaction.

9. Do banks need to File repeat STR?

In case one STR has already been filed for a particular account and fresh alerts pertaining to the same account are observed, the Bank needs to exercise judgment as to whether it requires to be reported considering following factors:

- Has any additional ground of suspicion which has not been reported earlier, been discovered.
- Is the Alert value / volume / frequency substantially high as compared to the earlier STR?

10. How should Banks deal with reported accounts?

Reported accounts are required to be put on enhanced monitoring. These accounts should be classified as high risk. In case significant activity is observed in such accounts, a repeat STR may be triggered. In case the STR is repeatedly reported, banks may consider closing the account. However, customer should not be tipped off.

11. What is the key to an effective transaction monitoring process?

The following are key requirements of any transaction monitoring system:

1. Performing sufficient due diligence on the customer
2. Documenting reasons for arriving at conclusion of alert / exception as suspicious / non suspicious.

12. Is it necessary to have software for AML transaction monitoring?

The RBI circular dated May 22, 2008 requires banks to have suitable software to throw alerts for transaction monitoring. Thus it is an important requirement for robust transaction monitoring system, especially in view of the high number of transactions that the banks handle every day, which is making it increasingly difficult to monitor these through manual methods.

13. How does AML software operate?

An AML software solution provides the interface wherein data from Core Banking System is uploaded into it on a periodical basis. Based on this information the software generates alerts, which need to be investigated by the Bank.

14. What are the features that should be available while selecting AML software?

Following are the minimum features which should be available as part of any AML software:

1. Cash Transaction Report: The system should be capable of generating automated Cash Transaction Reports to the Financial Intelligence Unit. It should also be up gradable to carry out online reporting as and when required by FIU-IND.
2. Customer Risk Categorization: The system may develop suitable measures for automated customer risk categorization based on available parameters of customer information through the software. However, this feature may need to be augmented with suitable manual interventions also to support each Bank's database profile (i.e. data for historical accounts, available profile of customers, etc.).
3. Alerts Generation / Rule Engine: The system should be capable of generating alerts based on rules specified therein. The alerts should be capable of being configured based on varied criteria such as customer segment, product type, and customer risk.
4. Case Management: The system should be flexible enough to be customized to suit the bank's requirement. The case management consists of features such as assignment / reassignment, attachment facility, making comments and flexible templates for recording due diligence.
5. Investigation Tools: AML systems also have features for user to carry out multi-dimensional analysis of data, viewing customer information, linked accounts, details of transactions
6. Suspicious Transaction Report: The software should be capable of generating auto populated suspicious transaction reports for reporting of suspicious transactions to the Financial Intelligence Unit
7. Reports: The software should be able to generate various transaction reports as also management information reports.

Besides above any software should be compatible with the core banking system and scalable and up gradable to meet the changing face of banking.

15. How can Banks institutions effectively implement AML monitoring software?

Immediate fallout of AML software implementation could be a very large number of alerts. Banks would need to fine-tune the systems and processes during the initial implementation phase. The AML and technology departments would need to work together to ensure stabilization of the system in the initial phases.

16. How can bank carry out due diligence without tipping off the customer?

As a general practice Banks are advised by RBI not to put any restrictions on operations in the accounts where an STR has been made. However, in case any restrictions are placed it should be ensured that there is no tipping off to the customer at any level.

Although the definition of tipping off has not been specified, tipping off would mean informing/ communicating to the customer that his account has been or would be reported for suspicious activity to the regulators / FIU-IND.

Merely seeking information about a particular transaction, as part of the due diligence should not tantamount to tipping off. This is so because most customers are well aware of the statute on money laundering and legal provisions involving obligations of banks thereon. Some of the suggestions to avoid tipping off are:

1. Due diligence should be preferably by way of pretext sales calls.
2. No statement should be made, which cautions or warns the customer.
3. AML triggers / rules / reporting thresholds and internal monitoring processes should not be discussed with the customers.
4. The conclusion that has been arrived at after making the necessary enquiries should not be revealed to the customer.

(Source: IBA - Know your Customer (KYC) Norms & and Anti-Money Laundering Measures (AML) Guidance Notes for Banks – July 2020)

APPENDIX 4

Parameters for Risk Based Transaction Monitoring

A. Transactions involving Large Amounts of Cash

(i) Exchanging an unusually large amount of small denomination notes for those of higher denomination;

(ii) Purchasing or selling of foreign currencies in substantial amounts by cash settlement despite the customer having an account with the bank;

(iii) Frequent withdrawal of large amounts by means of cheques, including traveler's cheques;

(iv) Frequent withdrawal of large cash amounts that do not appear to be justified by the customer's business activity;

(v) Large cash withdrawals from a previously dormant / inactive account or from an account which has just received an unexpected large credit from abroad;

(vi) Company transactions, both deposits and withdrawals, that are denominated by unusually large amounts of cash, rather than by way of debits and credits normally associated with the normal commercial operations of the company, e.g. cheques, letters of credit, bills of exchange etc.;

(vii) Depositing cash by means of numerous credit slips by a customer such that the amount of each deposit is not substantial, but the total of which is substantial.

B. Transactions that do not make Economic Sense

(i) A customer having a large number of accounts with the same bank, with frequent transfers between different accounts;

(ii) Transactions in which assets are withdrawn immediately after being deposited, unless the customer's business activities furnish a plausible reason for immediate withdrawal. Activities not consistent with the Customer's Business

(iii) Corporate accounts where deposits or withdrawals are primarily in cash rather than cheques.

(iv) Corporate accounts where deposits & withdrawals by cheque / telegraphic transfers / foreign inward remittances / any other means are received from / made to sources apparently unconnected with the corporate business activity / dealings.

(v) Unusual applications for DD / TT / PO against cash.

(vi) Accounts with large volume of credits through DD / TT / PO whereas the nature of business does not justify such credits.

(vii) Retail deposit of many cheques but rare withdrawals for daily operations.

C. Attempts to avoid Reporting / Record-keeping Requirements

(i) A customer who is reluctant to provide information needed for a mandatory report, to have the report filed or to proceed with a transaction after being informed that the report must be filed.

(ii) Any individual or group that coerces / induces or attempts to coerce / induce a bank employee not to file any reports or any other forms.

(iii) An account where there are several cash deposits / withdrawals below a specified threshold level to avoid filing of reports that may be necessary in case of transactions above the threshold level, as the customer intentionally splits the transaction into smaller amounts for the purpose of avoiding the threshold limit.

D. Unusual Activities

(i) An account of a customer who does not reside / have office near the branch even though there are bank branches near his residence / office

(ii) A customer who often visits the safe deposit area immediately before making cash deposits, especially deposits just under the threshold level.

(iii) Funds coming from the list of countries / centers, which are known for money laundering.

E. Customer who provides Insufficient or Suspicious Information

(i) A customer / company who is reluctant to provide complete information regarding the purpose of the business, prior banking relationships, officers or directors, or its locations.

(ii) A customer / company who is reluctant to reveal details about its activities or to provide financial statements.

(iii) A customer who has no record of past or present employment but makes frequent large transactions.

G. Certain Suspicious Funds Transfer Activities

(i) Sending or receiving frequent or large volumes of remittances to / from countries outside India.

(ii) Receiving large TT / DD remittances from various centers and remitting the consolidated amount to a different account / center on the same day leaving minimum balance in the account.

(iii) Maintaining multiple accounts, transferring money among the accounts and using one account as a master account for wire / funds transfer.

H. Certain Bank Employees arousing Suspicion

(i) An employee whose lavish lifestyle cannot be supported by his or her salary

(ii) Negligence of employees / wilful blindness is reported repeatedly.

I. Miscellaneous:

Bank no longer knows the true identity. When a bank believes that it would no longer be satisfied that it knows the true identity of the account holder. Some examples of suspicious activities / transactions to be monitored by the operating staff -

- Large Cash Transactions
- Multiple accounts under the same name
- Frequently converting large amounts of currency from small to large denomination notes
- Placing funds in term Deposits and using them as security for more loans Large deposits immediately followed by wire transfers sudden surge in activity level same funds being moved repeatedly among several accounts

- Multiple deposits of money orders, Banker's cheques, drafts of third parties
- Multiple deposits of Banker's cheques, demand drafts, cross / bearer cheques of third parties into the account followed by immediate cash withdrawals
- Transactions inconsistent with the purpose of the account
- Maintaining a low or overdrawn balance with high activity

J. Check list for preventing money-laundering activities:

- A customer maintains multiple accounts, transfer money among the accounts and uses one account as a master account from which wire / funds transfer originates or into which wire / funds transfer are received (a customer deposits funds in several accounts, usually in amounts below a specified threshold and the funds are then consolidated into one master account and wired outside the country).
- A customer regularly depositing or withdrawing large amounts by a wire transfer to, from, or through countries that are known sources of narcotics or where Bank secrecy laws facilitate laundering money.
- A customer sends and receives wire transfers (from financial haven countries) particularly if there is no apparent business reason for such transfers and is not consistent with the customer's business or history.
- A customer receiving many small incoming wire transfer of funds or deposits of cheques and money orders, then orders large outgoing wire transfers to another city or country.
- A customer experiences increased wire activity when previously there has been no regular wire activity.
- Loan proceeds unexpectedly are wired or mailed to an offshore Bank or third party.
- A business customer uses or evidences or sudden increase in wire transfer to send and receive large amounts of money, internationally and / or domestically and such transfers are not consistent with the customer's history.
- Deposits of currency or monetary instruments into the account of a domestic trade or business, which in turn are quickly wire transferred abroad or moved among other accounts for no particular business purpose.
- Sending or receiving frequent or large volumes of wire transfers to and from offshore institutions.
- Instructing the Bank to transfer funds abroad and to expect an equal incoming wire transfer from other sources.
- Wiring cash or proceeds of a cash deposit to another country without changing the form of the currency.
- Receiving wire transfers and immediately purchasing monetary instruments prepared for payment to a third party.
- Periodic wire transfers from a person's account/s to Bank haven countries.
- A customer pays for a large (international or domestic) wire transfers using multiple monetary instruments drawn on several financial institutions.
- A customer or a non-customer receives incoming or makes outgoing wire transfers involving currency amounts just below a specified threshold, or that involve numerous Bank or travelers cheques.

- A customer or a non-customer receives incoming wire transfers from the Bank to 'Pay upon proper identification' or to convert the funds to bankers' cheques and mail them to the customer or non-customer, when
    - The amount is very large (say over Rs.10 lakhs)
    - The amount is just under a specified threshold (to be decided by the Bank based on local regulations, if any)
    - The funds come from a foreign country or
    - Such transactions occur repeatedly.
- A customer or a non-customer arranges large wire transfers out of the country which are paid for by multiple Bankers' cheques (just under a specified threshold)
- A Non-customer sends numerous wire transfers using currency amounts just below a specified threshold limit.

MODULE II

KYC- KNOW YOUR CUSTOMER

CHAPTERS

CHAPTER 9

KYC POLICY AND CUSTOMER ACCEPTANCE

STRUCTURE

9.1 Genesis of KYC
9.2 Need for KYC Policy
9.3 Elements of KYC Policy
9.4 Customer Acceptance Policy
9.5 Let us Sum up
9.6 Check Your Progress
9.7 Answers to 'Check Your Progress'

OBJECTIVES

Knowing about evolution of KYC practice. Understanding the need for KYC Policy, its key elements and contents. Knowing about one of the key elements of KYC policy i.e. Customer Acceptance Policy. The norms for on-boarding and establishing account as well as transaction based relationship with the customer.

9.1 GENESIS OF KYC

9.1.1 Practice of Introduction

Primary banking business is accepting deposits and lending, hence knowing a customer has been a fundamental requirement for enabling banks to conduct their business. With the expansion of banking and introduction of negotiable instruments, the practice of obtaining introduction before accepting a person as customer was formalized. This practice became the basis for establishing a banker-customer relationship. Earlier, though introduction was not mandatory for opening a bank account, there would be certain restrictions on such accounts; especially no cheque facility would be given. For borrowers, banks have always conducted due diligence with a view to mitigating credit risk.

9.1.2 Proposition of Customer Due Diligence

As the abuse of banks by money launderers gained significant proportions, various international agencies that were engaged in studying this menace recommended that banks/financial institutions should carry out 'customer due diligence' before undertaking any transaction for them. Thus 'due diligence' that was found useful for assessing and mitigating credit risk was proposed to be utilized to assess and mitigate ML, FT and frauds risks from customers. Nature of due diligence for this purpose would be substantially different, and it would encompass the entire customer base of banks.

As discussed earlier following the Vienna Convention in 1988, FATF was formed for suggesting measures for prevention of money laundering. In 1990, among the 40 recommendations of FATF, customer due diligence was one of the most important recommendation. In 2001, BCBS published detailed guidance for banks on customer due diligence.

Before we delve deeply into KYC, it should be remembered that rigors of the KYC process are meant to weed the undesirable customers out and to protect the good ones (and the banks). The KYC processes are only to ensure that our banking operations are safe and clean to help clients and bank personnel to conduct business, with comfort and confidence. It is essential to emphasise this point here, so that this basic banking principle is never undermined.

9.2 NEED FOR KYC POLICY

The obligations of banks under PMLA are very onerous and have enterprise-wide applicability. For effectively implementing the KYC/AML guidelines, it is important for banks to develop comprehensive internal guidelines in this regard. RBI has therefore advised all RE's / banks to frame KYC Policy incorporating the guidelines issued vide Master Direction - Know Your Customer (KYC) Direction, 2016 and subsequent updates, last up to May 2021. The KYC Policy serves as the framework for the bank within which its products and processes are knit from the perspective of KYC/AML requirements. Given the international impact of KYC/AML measures adopted by individual banks, RBI has directed that the KYC Policy is needed to be approved by the Board of Directors of the banks.

9.2.1 Periodical Review

As the countermeasures for AML/CFT are continually being reviewed and enhanced by the international agencies. In view of these changes and also based on the incidence of ML and TF in the country the RBI also revises the regulatory guidelines. There are also amendments made to PML Act and PML Rules, in order to align them with the international guidelines and/or observations made during FATF Assessments. Hence, the banks have been advised to disseminate the changes, guidelines etc. as and when these are notified and Banks' Boards must ensure to review their KYC Policy at least once in a year by incorporating all the changes pertaining to regulatory guidelines /legal aspects.

9.3 ELEMENTS OF KYC POLICY

9.3.1 RBI Guidelines

RBI has advised that following four key elements must be included in the KYC Policy of the banks:

(i) Customer Acceptance Policy (CAP)
(ii) Risk Management
(iii) Customer Identification Procedures (CIP)
(iv) Monitoring of Transactions

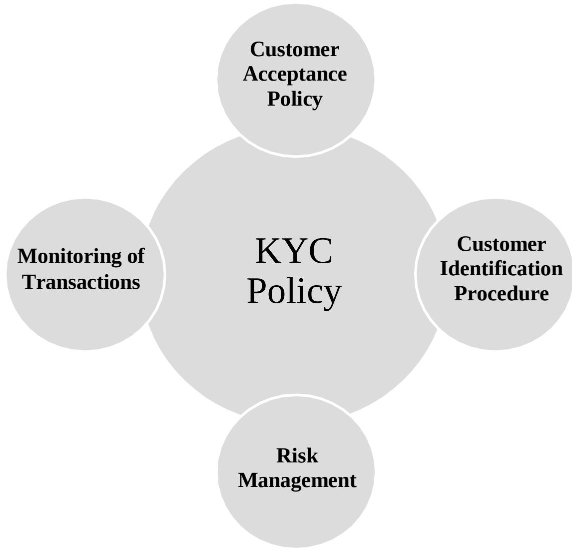


Fig. 9.1 Elements of KYC Policy

These elements shall be discussed in detail, herein and in the subsequent Chapters.

9.3.2 Contents of the Policy

The KYC Policy must contain all the legal and regulatory requirements pertaining to the four elements stated above. Each bank will need to tailor the contents according to its own businesses and locations. For example, a co-operative bank that is present only in a few cities in a single state, and does not handle cross border transactions will not be required to include requirements pertaining to the correspondent banking arrangements with overseas banks. On the other hand, in case of a bank with overseas presence having establishments in several countries, the Policy should indicate and include host country requirements separately applicable to its branches/operations in each country. It should also indicate clearly which of the legal/regulatory requirements pertaining to India, if any, will not be followed by the overseas offices on account of host country /local restrictions, and the measures that would be taken to manage the differential approach. Besides, such a bank will also need to have separate KYC policies of each of the jurisdiction where it has a presence. The banks who undertake para-banking activities will need to include their approach in case of Third Party Products sales, and any specific requirements stipulated by the respective regulator, viz. SEBI for mutual funds distribution, IRDA for insurance sales, etc.

9.3.3 Compliance of KYC Policy

Compliance with KYC Policy by all concerned throughout the organization is essential for ensuring effective ML/ TF risks mitigation. With this in view the Policy should include certain aspects of roles and responsibilities of various functions or functionaries. This should cover even the Board and Senior Management, as also the business and operations functionaries at various levels. Following are certain key aspects to be included in the KYC Policy in this regard:

- ❖ Specifying 'Senior Management' for the purpose of KYC compliance
- ❖ Allocation of responsibility for implementation of policies and procedures
- ❖ Independent evaluation of the Compliance functions of policies and procedures, including legal and regulatory requirements
- ❖ Verification of KYC/AML policies and procedures by Concurrent / Internal Audit
- ❖ Quarterly reports on compliance to the Audit Committee

Banks (REs) should ensure that decision-making functions of determining compliance with KYC norms are not outsourced.

9.3.4 Process Manuals

The KYC Policy is an overall framework having the legal/regulatory requirements. There should be separate KYC/AML process manuals that should contain the operating instructions and the procedures to be followed for implementing various measures for AML/CFT. These manuals need to be so designed that the actions to be taken by various functional units, at various levels and for various products are clearly spelt out. For this purpose, there could be separate manuals according to business or product lines covering the entire cycle from end-to-end that is from customer sourcing to reporting of suspicious transactions and review of relationship, when necessary. Alternatively, the process manual could contain separate sections for different business lines.

9.4 CUSTOMER ACCEPTANCE POLICY

The best way for banks to mitigate ML/TF/Frauds risks would be to deal with genuine customers, and to avoid customers whose credentials are suspect or known to be of criminal background. For this purpose, the banks need to have a policy laying down clear parameters for acceptance of customers. This element is the bedrock of the KYC Policy. The following aspects need to be included in the Customer Acceptance Policy.

9.4.1 Prohibitions

- ➢ Rule 9(11) of PML Rules prescribes that banks should not open or keep:
  - An anonymous account
  - An account in fictitious names
  - An account on behalf of other persons whose identity has not been disclosed or cannot be verified

9.4.2 RBI Guidelines

RBI Guidelines stipulate the following norms: regarding customer acceptance.

- ➢ Opening an account in benami name is not permitted.
- ➢ No account should be opened in which bank is unable to apply appropriate CDD measures, either due to non-cooperation of the customer or non-reliability of the documents/ information furnished by the customer.
- ➢ No transaction or account based relationship should be undertaken without following the CDD procedure.

- Banks shall apply the CDD procedures at the UCIC Level (Unique Customer Identification Code). Accordingly, if an existing KYC compliant customer intends to open another accounts, there should be no need for a fresh CDD exercise.
- CDD procedure should be followed for all the joint account holders while opening a joint account.
- Banks should permit a customer to act on behalf of another person/ entity only by clearly spelling out the circumstances.
- Identity of the customer should not match with any person or entity; whose name appears in the sanctions lists circulated by the RBI. Banks should ensure to put in place as suitable system to check and keep record of the same.
- While obtaining PAN (Permanent Account Number) from a customer, its online verification should be ensured.
- Where an equivalent e-document is obtained from the customer, Bank should verify the digital signature as per provisions of Information Technology Act 2000 (21 of 2000)
- Banks should also not open accounts for the entities appearing in the Schedule to the Unlawful Activities Prevention Act, 1967.
- Banks could also consider not opening an account or provide any service to any person or entity whose name appears on other negative lists like:
  - FIU Alert lists
  - Caution Advices issued by RBI
  - Criminal lists of various Law Enforcement Authorities viz. CBI, EOW, ED, DRI, etc.
  - ECGC Caution List
  - Sanctions lists of various countries, say USA, UK, EU, etc. (particularly AD banks handling cross-border transactions)
- These restrictions will apply for account based relationship as well as providing any other service.
- If an existing customer is found to fall in any of the stated categories, the relationship will be reviewed and terminated.

9.4.3 Documents/ Information Requirements

Basic due diligence required for all customers, and commensurate due diligence as the level of risk associated with the customer varies is to be specified.

- The documents/information to be collected from various types of customers in line with the legal/ regulatory requirements.
- Documents/information considered essential for determining genuineness of customer and his activity depending on perceived risk.
- Circumstances where a customer will be permitted to act on behalf of another person/entity, which should be in conformity with the established law and practice of banking.
- The mandatory information to be sought for KYC purpose while opening an account and during the periodic updation, should be specified.
- Optional/ additional information, should be obtained with the explicit consent of the customer after the account is opened.

9.4.4 Customer Risk Categorisation

- Each customer should be assessed as per ML / TF risks guidelines and parameters of the same must be clearly stated / spelt out, while preparing customer profiling (customer profile sheet)
- Accordingly, the risk categories (Low, Medium, High) should be assigned,

9.4.5 Approval Authority

Provisions may be included for approval at higher levels for establishing customer relationship, whether for opening an account or transacting other business, in respect of certain categories of customers carrying high risk or having complex arrangements.

9.4.6 Not to be Restrictive

The policy should not be too restrictive. It should not lead to denying banking facility to members of the general public, especially those, who are financially or socially disadvantaged.

9.5 LET US SUM UP

This chapter deals with evolution of KYC practice. The need to have a KYC Policy and the elements of KYC policy. Legal and regulatory guidelines for customer acceptance keeping in view the ML/ TF risk aspects have also been discussed.

9.6 CHECK YOUR PROGRESS

1. KYC Policy must contain certain specified elements. Which of the following is not one of those elements?
   (a) Risk Management
   (b) Monitoring of Transactions
   (c) Customer Acceptance Policy
   (d) Customer Credit Rating

2. KYC policy should contain Customer acceptance norms. Which of the following norms can be included in the KYC Policy?
   (a) Banks should conduct a transaction for any person applying for it.
   (b) Banks should permit to accept as customer who possess some documents.
   (c) Banks should open an account for a person only if it can apply CDD procedures properly.
   (d) The policy should be restrictive so that bank may open account selectively.

9.7 ANSWERS TO CHECK YOUR PROGRESS

1. (d); **2.** (c)

CHAPTER 10

ML/TF RISK ASSESSMENT & CUSTOMER RISK CATEGORISATION

STRUCTURE

10.1 Risk Based Approach for KYC/AML
10.2 Customer Risk Profiles
10.3 Risk Rating Model/System
10.4 Product Risk Categorisation
10.5 Review of Risk Categorisation
10.6 Let us Sum up
10.7 Check your Progress
10.8 Answers to 'Check Your Progress'

Appendix

5. Indicative List of High / Medium Risk Customers
6. Indicative List of High / Medium Products & Services

OBJECTIVES

Knowing about risk assessment and risk categorisation of the customer by adopting risk based approach for customer identification, the process to be undertaken at the time of on-boarding of the customer and performing periodic review.

10.1 RISK BASED APPROACH FOR KYC/AML

Rule 9 (13) of the PML (Maintenance of Records) Rules, 2005 requires every RE to carry out risk assessment to identify, assess and take effective measures to mitigate its money laundering and terrorist financing risk for clients, countries or geographic areas, products, services, transactions or delivery channels that is consistent with any national risk assessment conducted by a body or authority duly notified by the Central Government. The risk assessment shall be documented, consider the relevant risk factors before determining the level of overall risk and the appropriate level and type of mitigation to be applied, kept up to date. The FATF has advocated a Risk Based Approach (RBA).

Risk based approach has been made the basis of KYC/AML regulations with the objective of ensuring effective and efficient implementation of the suggested measures. Customer risk categorization is its key component. The primary objective of customer risk categorization is that the banks can suitably modulate their efforts for AML/CFT.

There are two broad levels at which firms conduct their risk assessments.

(i) Enterprise-wide Risk Assessment (EWRA)
(ii) Customer Risk Categorisation

Following are the basic tenets of risk based approach:

- *Factors impacting ML/TF risks*: The five major factors that impact ML/TF risks are enumerated in Figure 10.1 below.

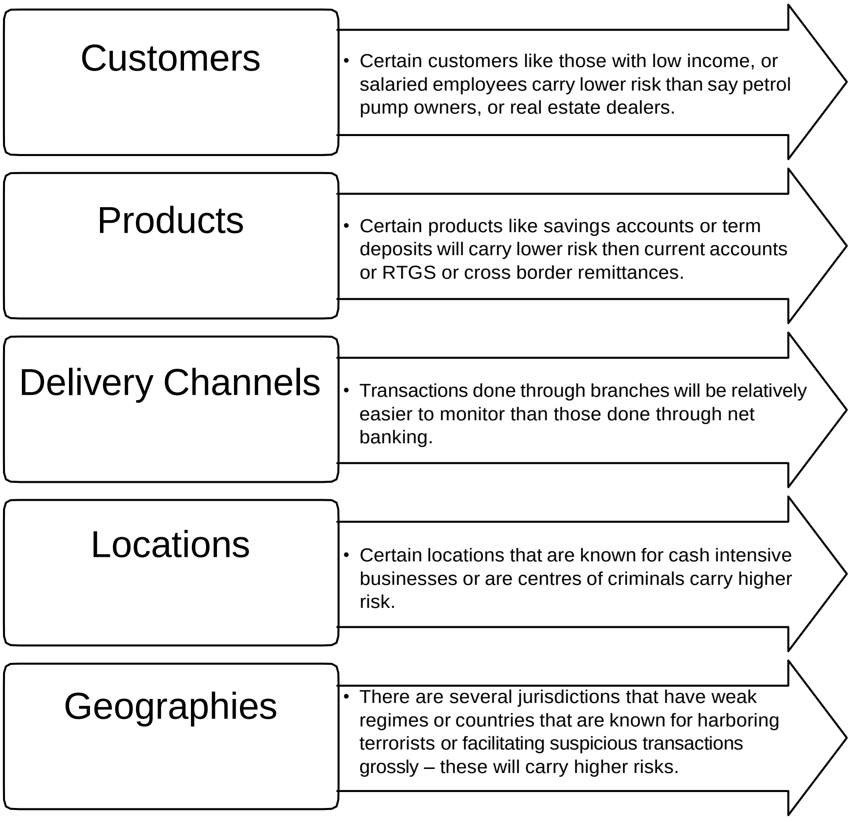


Fig. 10.1 Factors Impacting ML/TF Risks

The customer risk categorization shall be discussed herein, and other four factors shall be discussed in little more detail separately.

- *Risk Categories*: The objective of risk categorization is to allocate resources suitably. Hence, the number of risk categories could be determined by each bank for itself. However, since the regulatory norms have been calibrated based on three risk categories (viz. high, medium and low), these would be the minimum categories. For better differentiation of AML measures, some banks may consider having higher number of categories say up to five.
- *Differential Measures*: Following KYC/AML measures are differentiated according to the risk category with more intense approach being followed for higher risk categories.
  - Customer Identification and Due Diligence
  - Customer KYC/Profile Monitoring/Updation
  - Transaction Monitoring

10.2 CUSTOMER RISK PROFILES

The ML/TF risk that a customer carries depends on several characteristics of the customer's profile. These parameters can be selected as a first step in the process of selection which would determine customer risk.

Entity Parameters	• Constitution; Customer's background; Social status
Geographic Parameters	• Country of Residence; Country of Origin; Country of Incorporation; Location of Customer; Location of customer's clients
Financial Parameters	• Financial Status; Expected Annual Income; Expected Annual Turnover in the Account; Expected Annual Value of Other Services
Activity Parameters	• Occupation; Profession; Employment; Business Activity
Linkage Parameters	• Sources of funds receipt; Mode of Payments
Relationship Parameters	• Banking Accounts Held; Banking Services Availed; Para Banking Services Availed

Fig. 10.2 Customer Characteristics Impacting Risk category

Some of the significant characteristics are as indicated in Fig. 10.2 above. Apart from these certain other parameters impacting customer risk category are the account status, vintage of account, presence in caution lists, media reports, etc.

10.3 RISK RATING MODEL/SYSTEM

For an objective risk classification that would capture various parameters, a risk rating model with well thought out scores and weightages needs to be developed. The number of parameters actually used in the model would depend on the following aspects of the customer base of the bank:

- Size of customer base
- Range of customer types
- Range of customers' businesses
- Geographical spread
- Any cross border activities

Another important aspect in determining inputs for the model will be the data actually obtained and captured in customer profiles. The entire exercise could be automated in the core banking system with the risk rating getting auto generated on completion of the customer profile in the system.

10.3.1 Determining Risk Rating

Any risk rating model would be score based with the rating getting assigned on the basis of the aggregate score computed based on the profile inputs. Customer risk category therefore is not based on any single factor like the business or financial status of the customer, but is resultant of several factors. Nevertheless, it is observed that in certain cases one single factor has a predominant influence on the risk category, thus becoming almost the sole determinant for the risk category. For example, a diamond trader will be intuitively categorized under high risk category due to special features of the trade and the product itself. The model can therefore include certain overriding factors that can assign a higher or lower risk based on some typical parameter value. Also, a facility to manually override the risk category with appropriate controls and checks can be built in. While in line with RBI guidelines the risk category should be determined based on multiple factors, for the purpose of getting a feel of risk differentiation, some illustrative examples of customers in various risk categories are given below: Besides, a more elaborate indicative list of high/ medium risk customers is given at Appendix 5.

10.3.2 Low Risk Customers

Low income persons like hawkers, plumbers, cobblers; Pensioners; salaried persons (not in senior management controlling positions); housewives from low/middle income families; Non-Profit Organisations promoted by the United Nations Organisation; etc.

10.3.3 Medium Risk Customers

Real Estate Agents; Restaurants; Electronic goods merchants; Cloth merchants; Travel and Tours agencies; Transport Companies; etc.

10.3.4 High Risk Customers

Diamond merchants, Arms dealers, Real estate Developers, Promoters of corporate groups, persons in senior controlling executive positions in the private sector, Importers and Exporters; politically exposed persons; Non Profit Organisations; etc.

10.3.5 Customer Profile Contents

Banks are required to maintain a profile of each customer for effective implementation of AML/CFT measures. These profiles also need to be kept regularly updated. The contents of customer profiles would depend on the customer risk category, and the characteristics of each customer. With the introduction of Central KYC Records Registry, the basic templates for customer information have been standardized for being obtained when opening an account. Hence, the information contained in these templates will form the basic customer profile requirement. It will be useful to study these templates, and understand the basic minimum information required. Banks are required to obtain additional information as per the customer’s business relations, complexity, etc. An additional requirement for customer profile arises from the Foreign Tax Compliance Act of the USA, and the Common Reporting Standards accepted internationally. These require obtaining information about tax residency status of customers to enable appropriate reporting under these provisions. This information can also be useful in monitoring for AML/ CFT purposes.

10.3.6 Customer Privacy Aspects

Banks are bound by the norms and provision of maintaining confidentiality about the customer's information of any nature that they come have access to. The banks therefore are expected to collect only that much information that would help them in taking appropriate decision in respect of customer's identity and business. Any additional information if desired by some bank, needs to be obtained separately specifically advising the customer about the purpose for which it is being collected.

Information collected should not be divulged to others, nor put to use for commercial purposes. Strict privacy should be maintained. Banks could include these aspects in their KYC policy document.

10.4 PRODUCT RISK CATEGORISATION

ML/TF risks of a bank is impacted by the products and services offered by it. The ML/TF risks inherent in various products/services vary depending on their features. Following are certain basic factors that could have bearing on ML/TF risks:

- Flexibility of deposits/withdrawals
- Amount of cash transactions permitted
- Restriction on source of funds
- Providing anonymity to the customer
- Domestic/cross-border
- Types of users permitted
- Transaction values permitted
- Flexibility of tenor
- Ease of identification and detection
- Number of parties involved
- Combination/complexity of products

Based on these parameters various products could be categorized into different categorized like high, medium and low. Suggested risk categories for some illustrative products are indicated in the Table below. Besides, an elaborate list of high/ medium risk products and services is given at Appendix 6.

Table 10.1 Risk Category of Products

Risk Category	**Products/Services**
Low	Term loan against Assets, Consumer loans, Fixed deposits
Medium	Non-resident Fixed deposits, Credit Cards, Demand Loan
High	Cash Credit, Project loan, Diamond Dollar Account

New Technology Products: Typically, the new technology products would carry relatively higher risks. Innovations in Information Technology has enabled banks to offer products to consumers that provide anonymity, facilitate access from anywhere, are delivered in straight through processing. For instance, card products enable availability of funds practically anywhere across the globe, and are easily amenable to use by third parties, viz. individuals other than who were sold these for their own use. Such products obviously carry higher risk. Another example is remittances through net banking. These enable funds transfer in quick time and without the customer interaction with any bank executive. It renders pre-execution monitoring difficult, thereby increasing the inherent ML risk.

10.4.1 Delivery Channels Risk Categorisation

Another factor contributing to the ML/TF risks of banks is delivery channels. The way banks source and deliver their services have become widely varied and quite complex. While direct contact by bank staff with the customer at the branches continues to be used, there are various other ways that are used by banks.

10.4.1.1 Modes of Sourcing Customers

- Direct Sales Agents
- Partner Agencies (e.g. Microfinance Institutions, AD II Dealers, Co-operative banks)
- Business Correspondents
- Netbanking – Own website
- Netbanking – Social Websites
- Mobile banking

10.4.1.2 Modes of Delivery of Services

- ATM Machines
- Partner Agencies (e.g. Microfinance Institutions, AD II Dealers, Co-operative banks)
- Business Correspondents
- Point of Sales – Merchant Establishments
- Phone banking
- Netbanking – Own website
- Netbanking – Social Websites
- Mobile banking
- Outsource Agents (e.g. for CMS services)

10.4.1.3 Parameters Impacting Risk in Delivery Channels/ Sourcing Modes

Some of the parameters that impact the inherent ML/TF risk in delivery channels/sourcing mode are:

- Ease of customer verification by bank staff
- Interaction of bank staff with the customer
- Involvement of intermediaries
- Adequacy of information and documents for the transactions

Based on these the risk category of various channels can be determined. Suggested risk category of some of the channels is indicated below:

- Branch – Low
- ATMs – Medium
- Phone banking – High

10.5 REVIEW OF CUSTOMER RISK CATEGORISATION

In the current age changes happen rapidly and nothing is static. This applies to bank customers too. Do not expect the customer behaviors to be set in a pattern permanently. It could change swiftly. Hence there is a need to review on an ongoing basis. Hence customer risk category will need to be reviewed regularly.

10.5.1 Periodic Review

RBI guidelines require that risk category of customers should be reviewed at a frequency of not more than 6 months based on the transactions of the customer with the bank. This could be largely automated using suitable software and configuring a matrix putting parameters and thresholds about business activity, credits in accounts etc.

10.5.2 Event based Review

In addition to this there can be several indicators requiring review of customer risk category. This could be required if at any time doubt arises about the customer's identity, or the customer's activity, or about any transaction(s) carried out by the customer. These would require having a relook at the customer's profile and move the customer to higher risk category if considered appropriate. Some of the situations that may require moving a customer to higher risk category are:

- Demographic Details: Moving to high risk country
- Account status: Dormant to sudden activity
- Account vintage: Just new
- Appears in negative lists
- Becomes a PEP
- Transactions: Sudden spurt, Unusual transactions, Complex transactions, AML Alerts, etc.
- Suspicious Transaction Report (STR) filed

10.5.3 Periodic Updation

RBI KYC Directions has defined "Periodic Updation" as follows:

"'Periodic Updation' means steps taken to ensure that documents, data or information collected under the CDD process is kept up-to-date and relevant by undertaking reviews of existing records at periodicity prescribed by the Reserve Bank."

The purpose of this exercise is to ensure that the bank's awareness about its customers does not become too stale for effective AML monitoring. banks are required to carry out periodical due diligence and updation of KYC information. The requirements in this respect are as indicated below.

10.5.4 Periodicity

The prescribed periodicities for various risk categories, are given as follows:

Table 10.2 Periodicity for KYC Updation

Risk Category	Periodicity (At least every)
High	Two years
Medium	Eight years
Low	Ten years

These time limits will apply from the date of account opening or last KYC updation.

10.5.5 KYC Updation Requirements

The basic requirement of KYC updation is to reconfirm the identity, address and other particulars of the customer. Other measures may be taken depending on risk profile of the customer, and when the client due diligence measures were last undertaken. In case of minors, fresh photographs should be obtained when he becomes major and Re-KYC exercise must be undertaken. Banks have been facing several challenges in compliance with this requirement due to mainly two factors: one, constraint in reaching huge number of customers located over long distances, and second, customer's apathy in responding to the banks' calls for documents and information. With a view to make the exercise less onerous, the RBI has laid down several electronic modes for this purpose. The salient aspects of the RBI Guidelines for re-KYC modes are given below. For details in this regard please refer to RBI Master Direction – Know Your Customer Directions 2016.

10.5.6 Individual Customers

These have been subdivided in three groups and different procedures have been laid down for each category.

(i) *No change in KYC information*:

Where the customer's KYC information has not changed, a self-declaration from the customer in this regard is adequate. This declaration may be received through any of the following modes –

- ❖ In person from the customer either at the branch or at the customer's residence/ office
- ❖ Through courier or postal mail
- ❖ Through customer's email-id registered with the RE,
- ❖ Through customer's mobile number registered with the RE,
- ❖ Through ATMs,
- ❖ Through other digital channels (such as online banking / internet banking, mobile application of RE),

(ii) *Change in address:*

If there is a change only in the address details of the customer, a self-declaration of the new address is to be obtained. This may be received through any of the modes stated above. The new address should be verified through positive confirmation within two months, by means such as address verification letter, contact point verification, deliverables etc.

Reporting Entities have the discretion to obtain copy of OVD or deemed OVD or the equivalent e-documents as a proof of the new address, if so provided in the KYC policy of the bank.

(iii) *Accounts of Minors Turning Major*:

For accounts of customers who were minors when the account was opened, fresh photograph of the customer must be obtained when the customer has become major. Also, the set of CDD documents available will be verified to ensure that they meet the current requirements. Fresh KYC may be carried out where the RE considers it necessary.

10.5.7 Customers (Other Than Individuals)

(i) *No change in KYC information*:

For such Legal Entities for whom there is no change in KYC information. a self-declaration in this regard shall be obtained from the LE customer. This will comprise a letter from the authorised official and the Board Resolution. These may be received through any of the modes stated above. The Beneficial ownership (BO) information must be verified at this stage to ensure that the information available on records is updated and correct. For Legal Entities, Chartered Accountant's latest certificate in the matter must be taken confirming BO details.

(ii) C*hange in KYC information*:

In case of change in KYC information, RE shall undertake the KYC process equivalent to that applicable for onboarding a new LE customer.

10.5.8 Additional measures

Certain other aspects related to periodic updation exercise are stated below:

(i) To ensure that the KYC documents of the customer as per the current CDD standards are available, irrespective of no change in any information.

(ii) To ensure that the documents are still current, if the document has expired, the KYC process equivalent to that applicable for on-boarding new customer should be carried out.

(iii) To verify the PAN details of the customer with the issuing authority or the intermediary providing such services.

(iv) Acknowledgment indicating the date of receipt of the documents/ self-declaration should be given to the customer. Also, after promptly updating the data in the records, an intimation to be given to the customer regarding updated status.

(v) Facility to furnish self-declaration or documents at any branch of the bank should be given.

(vi) Policy for KYC updation should be transparent.

(vii) Adverse action against the customer should be avoided unless specifically provided for by the Regulations.

10.5.9 Adopting Higher Level Measures

The Reporting Entities at their discretion adopt more rigorous approach than specified by RBI. For this, the KYC Policy of the RE, duly approved by the Board of Directors, should specify those procedures to be carried out. Some of the measures that could be included are mentioned below:

- ❖ Obtaining recent photograph
- ❖ Physical presence of the customer for updation
- ❖ Periodic updation only in the branch where account is maintained
- ❖ More frequent periodicity of KYC updation

10.6 LET US SUM UP

This Chapter deals with all requisite / important parameters about risk assessment / categorisation such as-

- Adoption of risk based approach for KYC /AML measures at the time of on-boarding of the customer,
- Carrying out risk assessment at enterprise level,
- Risk rating model to be designed to prepare Customer Profile sheets for categorising and assigning risk to each customer, accordingly contents and modalities to be decided,
- Periodic updation of customers' profile / documents as per risk category,

10.7 CHECK YOUR PROGRESS

1. Risk assessment classifies the customers in different risk categories. These categories are ___.
   (a) Sensitive, Medium, Low - decreasing
   (b) High, Medium, Low
   (c) Very High, Simplified, Low-increasing
   (d) Good, Fair, Watchful

2. Risk based approach for AML/CFT measures has been advocated by _____.
   (a) Govt. of India
   (b) United Nations
   (c) FATF
   (d) CBI

3. Which one of the following parameters for risk categorisation is primary?
   (a) Caste & age
   (b) Educational qualification
   (c) Residence location - Rural, Urban of Metro
   (d) Occupation

10.8 ANSWERS TO CHECK YOUR PROGRESS

1. (b); **2.** (c); **3.** (d)

APPENDIX 5
Indicative List of High / Medium Risk Customers

A. Characteristics of High Risk Customers:

1. Individuals and entities in various United Nations' Security Council Resolutions (UNSCRs) such as UN 1267 etc.
2. Individuals or entities listed in the schedule to the order under section 51A of the Unlawful Activities (Prevention) Act, 1967 relating to the purposes of prevention of, and for coping with terrorist activities
3. Individuals and entities in watch lists issued by Interpol and other similar international organizations
4. Customers with dubious reputation as per public information available or commercially available watch lists
5. Individuals and entities specifically identified by regulators, FIU and other competent authorities as high-risk
6. Customers conducting their business relationship or transactions in unusual circumstances, such as significant and unexplained geographic distance between the institution and the location of the customer, frequent and unexplained movement of accounts to different institutions, frequent and unexplained movement of funds between institutions in various geographic locations etc.
7. Customers based in high risk countries / jurisdictions or locations
8. Politically exposed persons (PEPs) of foreign origin, customers who are close relatives of PEPs and accounts of which a PEP is the ultimate beneficial owner;
9. Non-resident customers and foreign nationals
10. Embassies / Consulates
11. Off-shore (foreign) corporation / business
12. Non face-to-face customers
13. High net worth individuals
14. Firms with 'sleeping partners'
15. Companies having close family shareholding or beneficial ownership
16. Complex business ownership structures, which can make it easier to conceal underlying beneficiaries, where there is no legitimate commercial rationale
17. Shell companies which have no physical presence in the country in which it is incorporated. The existence simply of a local agent or low level staff does not constitute physical presence
18. Investment Management / Money Management Company / Personal Investment Company
19. Accounts for "gatekeepers" such as accountants, lawyers, or other professionals for their clients where the identity of the underlying client is not disclosed to the financial institution.

20. Client Accounts managed by professional service providers such as law firms, accountants, agents, brokers, fund managers, trustees, custodians, etc.

21. Trusts, charities, NGOs / NPOs (especially those operating on a "cross-border" basis) unregulated clubs and organizations receiving donations (excluding NPOs / NGOs promoted by United Nations or its agencies)
22. Money Service Business: including seller of: Money Orders / Travelers' Checks / Money Transmission / Check Cashing / Currency Dealing or Exchange
23. Business accepting third party checks (except supermarkets or retail stores that accept payroll checks / cash payroll checks)
24. Gambling / gaming including "Junket Operators" arranging gambling tours
25. Dealers in high value or precious goods (e.g. jewel, gem and precious metals dealers, art and antique dealers and auction houses, estate agents and real estate brokers).
26. Customers engaged in a business which is associated with higher levels of corruption (e.g., arms manufacturers, dealers and intermediaries.
27. Customers engaged in industries that might relate to nuclear proliferation activities or explosives.
28. Customers that may appear to be Multi-level marketing companies etc.

B. Characteristics of Medium Risk Customers:
1. Non-Bank Financial Institution
2. Stock brokerage
3. Import / Export
4. Gas Station
5. Car / Boat / Plane Dealership
6. Electronics (wholesale)
7. Travel agency
8. Used car sales
9. Telemarketers
10. Providers of telecommunications service, internet cafe, IDD call service, phone cards, phone center
11. Dot-com company or internet business
12. Pawnshops
13. Auctioneers
14. Cash-Intensive Businesses such as restaurants, retail shops, parking garages, fast food stores, movie theaters, etc.
15. Sole Practitioners or Law Firms (small, little known)
16. Notaries (small, little known)
17. Secretarial Firms (small, little known)
18. Accountants (small, little known firms)
19. Venture capital companies

APPENDIX 6
Indicative List of High / Medium Products & Services

A. Products & Services

1. Electronic funds payment services such as Electronic cash (e.g., stored value and payroll cards), funds transfers (domestic and international), etc.
2. Electronic banking
3. Private banking (domestic and international)
4. Trust and asset management services
5. Monetary instruments such as Travelers' Cheque
6. Foreign correspondent accounts
7. Trade finance (such as letters of credit)
8. Special use or concentration accounts
9. Lending activities, particularly loans secured by cash collateral and marketable securities
10. Non-deposit account services such as Non-deposit investment products and Insurance
11. Transactions undertaken for non-account holders (occasional customers)
12. Provision of safe custody and safety deposit boxes
13. Currency exchange transactions
14. Project financing of sensitive industries in high-risk jurisdictions
15. Trade finance services and transactions involving high-risk jurisdictions
16. Services offering anonymity or involving third parties
17. Services involving banknote and precious metal trading and delivery
18. Services offering cash, monetary or bearer instruments; cross-border transactions, etc.

B. Locations

1. Locations within the country known as high risk for terrorist incidents or terrorist financing activities (e.g. sensitive locations / cities and affected districts)
2. Locations identified by credible sources as having significant levels of criminal, terrorist, terrorist financing activity.
3. Locations identified by the bank as high-risk because of its prior experiences, transaction history, or other factors.

CHAPTER 11

CUSTOMER IDENTIFICATION PROCESS (CIP)

STRUCTURE

OBJECTIVES

Knowing about the distinct requirements for KYC AML compliance applicable to various customer types as per their constitution and in case of certain products such as non-customers, walk in customers, e-KYC processes. Knowing about FATCA, and reporting requirements for FATCA/ CRS.

11.1 CUSTOMER DUE DILIGENCE (CDD)

Establishing identity of the customer is only the first step in KYC; the goal of KYC is the Customer Due Diligence. Customer due diligence includes any measure undertaken by a financial institution:

- To collect and verify information and positively establish the identity of a customer
- To understand the nature of activities of the customer and satisfy that these are legitimate.

Since the ultimate goal is to satisfy about the true identity and actual activity of the customer, apart from obtaining documents, it is important to independently verify these through various modes, like:

- Actual field visits,
- Inquiries with neighbours,
- Inquiries with customers/suppliers
- Interaction with other acquaintances
- Scanning media reports, etc.

The extent of information obtained, additional documents collected, and independent inquiries/research conducted will depend on the level of risks perceived. The higher the risk, the more intense will be the due diligence exercise. There are therefore typically three types of due diligence modes.

11.1.1 Basic/ Normal Due Diligence

This would include:

- Obtaining the prescribed KYC documents, and
- Collecting basic information about the customer as required for the type of customer.

The information at the minimum should include apart from the basic identifiers particulars of activities/ occupation, expected turnover in the account, expected average balance, average income, and types of services expected to be used. This will be typically, applicable to customers in Medium Risk Category. Depending on the level of income, the nature of business activity, and the types of products to be availed as indicated there could be need to get further information.

It is not sufficient to have generic description of activity but it should be specific that would help in determining expected transaction pattern in the account of the customer and also the products or services that would of use to the customer.

For example, 'self-employed' does not provide any clue about likely transaction pattern in the account. On the other hand, 'chartered accountant' would clearly help in determining that the receipts are likely to be lumpy on three or four occasions in a year, when the clients would pay the professional fees; whereas payments would be recurring for various utilities, salaries, office rent, self-expenses, etc. The ability to do so is important from AML monitoring perspective, and hence collection of adequate and sufficient information is important.

11.1.2 Simplified Due Diligence

For certain sets of customers belonging to Self-Help Groups and NBFCs, simplified due diligence can be used. Kindly refer to the latest Master Direction issued by RBI on Know Your Customer (KYC) for further details.

11.1.2.1 Financial Inclusion

There are certain categories of persons who do not have and are not in a position to procure any of the OVDs even from the enhanced list. With a view to KYC procedure not resulting in 'financial exclusion' for these persons, certain relaxations from these norms have been made from time to time. Scheme of opening of Small Accounts for such category of people, is an effective way to ensure Financial Inclusion.

11.1.2.2 Obtaining Introduction

Current regulatory or legal requirements do not prescribe obtaining an introduction for opening a bank account, hence banks should not insist for introduction of the prospective customer by an existing customer. If provided by a customer, it may be treated as a part of additional due diligence carried out.

11.1.3 Enhanced Due Diligence

It would be necessary to undertake additional due diligence measures, in addition to the Normal DD in several cases, especially in case of high risk customers or during the course of monitoring of transactions, certain alerts are received as per Red Flag Indicators. These would comprise enhanced due diligence. Such additional measures would vary widely depending on the level of risk perceived. In certain cases, enhanced due diligence would be required for a particular product say outward remittances for imports; or for a particular customer group say opening accounts of Non-residents accounts. Some of the additional measures could be as indicated below:

- Collecting copies of financial statements, business licenses/registrations, etc.
- Obtaining information of organization set-up, network of offices/plants, major customers/suppliers
- Obtaining details of manufacturing/trading activities
- Making inquiries with the customers/suppliers
- Media research for the entity, beneficial owners, associates, etc.

11.1.4 Screening of Customers

As discussed earlier the banks are prohibited from opening accounts of or provide any other service to certain individuals/entities; and also as a matter of caution would not establish any business relation with individuals/entities with criminal background, etc.. For this purpose, it is essential for the banks to have a screening process for its prospective/existing customers as an integral part of customer due diligence. This process will mainly consist of the following steps:

- Determine the list of various sanctions lists that the bank would use for screening of its prospective/existing customers.
- The sanctions lists advised by RBI and any alert lists advised by FIU will be mandatorily included for this purpose.
- To have an arrangement for keeping these lists updated. This can be quite an onerous task as these
  lists are modified by the concerned agencies on as and when basis.
- The screening process has to be mandatorily carried out for all the customers, irrespective of their risk category, before establishing any relationship with them.
- Even the existing customers need to be screened against the incremental records in various lists to ensure that any existing customer of the bank is not included in these categories.
- To ensure effective screening, the banks need to have an appropriate IT application for undertaking the required screening, that would throw up possible name matches based on the rules for certain parameters matching.
- These alerts of matches are then required to be scrutinized carefully manually to weed out false positives. In case any match is found, opening an account or undertaking a transaction is refused.
- Usually, the banks prefer to engage professional entities who make available various lists updated practically on real time basis. There are several service providers that make available suitable plat- form for name matching process along with the inventory of the suite of lists that a bank wishes to subscribe to, and keep them on real time basis.

Guidelines for name screening against negative lists contained in IBA-Know your Customer (KYC) Norms & and Anti-Money Laundering Measures (AML) Guidance Notes for Banks – July 2020 are reproduced at Appendix 7.

11.1.5 Field Verification

Customer identification is the key of KYC process. For this purpose, obtaining officially valid documents is the basic step. However, reliance on the documents alone is not advisable, as there are certain risks associated with documents. True identity of an individual or an entity can be better ascertained through checking their credentials independently. Depending on the customer risk category, the nature and the value of transactions, the location, etc. the extent and nature of field verification would be determined. Field verification comprises the following:

- Visits to residence, and place of work.
- Inquiries with the neighbours, colleagues, employers, etc.

- Visits to offices(s), any outlets/branches, factories/workshops, etc.
- Inquiries with the customers, suppliers, other business associates, etc.
- Observing for signs of any unusual or abnormal conduct, appearances, etc.

11.1.6 Other Modalities of Customer Due diligence

Apart from field verification customer due diligence may include several other investigation modes. The extent to which due diligence will be carried out, as already discussed, depends on the extent and the nature of risks perceived. There can be no standardized list of due diligence techniques; one can adopt any innovative and simple technique that effectively serves the objectives of verifying the required aspects.
Some of the techniques that can be used are enumerated below:

- Intelligent conversation with the customer covering various aspects.
- Obtaining additional documents/information (including those pertaining to income or business financials).
- Telephonic inquiries with social or business contacts, etc.
- Media search on the internet for any information.
- Studying the documents, and financial/other information provided by the customer.
- Information on the characteristics of the industry or activity the customer is engaged in.
- Matching the customer's turnover and other financials with the industry level data.

11.1.7 Customer Acting on Behalf of Others

There may be certain situations when the person dealing with bank is acting on behalf of another entity or person. While a legal arrangement would have been put in place for this purpose, banks should ascertain the reasons for such an arrangement and record the same.

11.1.8 Customer Due diligence – Concerns

There could be situations when banks are unable to carry out the required due diligence due to various reasons like –

- Unable to verify the identity
- Obtain required documents due to customer non-cooperation
- Non reliability of the documents provided

In such situations banks should not open an account for the customer; and in case of an existing account consider closing such an account.

11.1.9 Cases of Customer Due Diligence

Taking appropriate precautions at the stage of opening an account, and even during the course of relationship whenever any suspicion arises, is an important element of customer due diligence. Let us see some incidents in this connection.

(i) ***Doubtful PAN Card***

A customer submits papers for opening of savings bank account. KYC documents given are PAN Card and Voter ID Card. During the second level scrutiny, the executive notices from the PAN card copy that it appeared to be broken. He also notices that the photographs on the PAN and the Account Opening Form did not appear to be the same. Due to suspicion, field verification was done during which the house of the applicant was not traceable at the address provided, nor did the people in the vicinity identify the applicant. On contacting the applicant on his cell, he did not respond to the queries and said he did not wish to open the account.

(ii) ***Not Residing at Given Address***

A customer submits papers for opening of savings bank account. KYC document given is Driving Licence and declaration of his communication address. During verification check, it was learnt that the customer was no more residing at the given address. The executive who had sourced the account had met the customer at that address, but outside the apartment.

(iii) ***Original Document Not Available***

A customer submits papers for opening of savings bank account, and a current account in the name of his proprietorship firm. KYC documents given were PAN card and Driving licence of the proprietor, and one entity proof for the firm. During verification scrutiny, the executive noticed that the driving license seemed to be different from usual. During field verification, the applicant met at his residence and he advised that his office was in a commercial complex in a prime locality. He showed two documents when asked for the original driving licence, but both were coloured Xerox copy. Besides, the particulars of name and address on both the documents were different.

(iv) ***Birth Certificate Altered***

A customer submits papers for opening of savings bank account of his minor daughter, along with her birth certificate. During verification scrutiny, the sourcing executive noticed unevenness in the font of the name and date of birth. De-dupe exercise revealed existing account of the guardian, and his one minor daughter. Comparison of the birth certificate given for the existing account and that given now revealed that both were copies of the same document as serial nos. and other particulars were identical. The name and the date of birth were altered to enable opening of another account in a different name.

11.2 UNIQUE CUSTOMER IDENTIFICATION CODE (UCIC)

There is one aspect which is common between marketing and ML risk mitigation and both seek to focus on the customer holistically. The AML/CFT measures are oriented towards the customer and not on the product or business line basis. For this purpose, it is important that the banks have an integrated view of the activities of every customer and the banks are required to take the following steps in this regard:

- Assign a Unique Customer Identification Code (UCIC) to each customer
- While on-boarding a new customer, de-duplication exercise should be undertaken based on certain unique identifiers (like date of birth, PAN, mobile number, etc.) apart from the name.
- Link various accounts, services used by the customer that may reside in different systems through the UCIC.

UCIC apart from facilitating better monitoring of customer's business activities with the bank and thus improving its effectiveness, is also useful in maintaining the customer profile with minimal efforts for the bank and lesser botheration for the customer. Repeated demands on the customer for submission of KYC documents/information every time she/he seek to avail a different product or service will be obviated.

11.2.1 Requirement of PAN

For new accounts, the PAN or Form 60 (those who do not submit PAN) is mandatory. After obtaining the PAN, it is to be verified on Income Tax website. REs have been instructed to implement such system for online verification of PAN. The new customer, if he/ she informs about non-possession of PAN, in such case Form 60 is to be obtained from those individuals and the Form 60 is needed to be uploaded on Income Tax website and REs must make suitable arrangements in their system for such upload.

For existing customers PAN/ Form 60 as applicable is required to be obtained by the date to be specified by the Central Govt. For those customers who do not provide the same, the operations should be ceased temporarily, after giving due notice to the customer. It implies temporary suspension of all transactions or activities for the customer, except recovery in the loan accounts. The operations should be resumed on client submitting the document. The date for this purpose is yet to be notified.

However, the KYC Policy of REs can contain provisions for reliefs to such customers who are unable to provide PAN/ Form 60 owing to injury, illness or infirmity on account of old age or otherwise, and such like causes. Such accounts shall be under enhanced monitoring. This, however, does not imply complete waiver of submission of PAN or Form 60 bu such customers.

On a customer refusing, in writing, to provide PAN/ Form 60, the account should be closed and the dues to the customer paid, after proper identification.

11.3 CUSTOMER IDENTIFICATION

As we have seen the fundamental basis of KYC/AML measures is dealing with genuine customers, and customer identification and customer due diligence are the first and most crucial steps for this. Various international guidelines and domestic regulations like FATF Recommendations, BCBS Guidance, PML Act and Rules and IBA guidelines have laid emphasis on these and prescribed the fundamental requisites for customer identification and also customer due diligence. All these important and essential guidelines shall be discussed the details, herein and the next chapters. Before that we need to understand who are included as 'customer' from KYC perspective.

11.3.1 Definitions for KYC

11.3.1.1 Customer

The term customer for the purpose of KYC is wider than the traditional meaning it has. For the purpose of KYC, RBI has defined a customer as –

> *"a person who is engaged in a financial transaction or activity with a reporting entity and includes a person on whose behalf the person who is engaged in the transaction or activity, is acting."*

Accordingly, the purpose of application of KYC norms on the customer who is not just the person directly dealing with the Bank, but also includes those persons who may be connected with the transactions in any other capacity. These could be the persons who own the entity for which the transaction is being conducted, or they could be the beneficiaries of the transactions which are routed through the accounts of intermediaries.

11.3.1.2 Person

In terms of PML Act a 'person' includes:

(i) an individual
(ii) a Hindu undivided family
(iii) a company
(iv) a firm
(v) an association of persons or a body of individuals, whether incorporated or not
(vi) every artificial juridical person, not falling within any one of the above persons (I to v)
(vii) any agency, office or branch owned or controlled by any of the above persons (i to vi)

11.4 BENEFICIAL OWNER

For effective AML/CFT measures, it is important to know the individuals (i.e. natural persons) who are transacting through the bank. However, bulk of the banking transactions are not for natural persons, but for juridical person. With a view to ensure that the key individuals connected with any banking business done by an entity are known to the banks, the concept of 'beneficial owner' has been used. Certain norms have been prescribed for determination of beneficial owner in various types of entities, and in case of complex structures the norm to be used has also been laid down. Rule 9(3) of PMLR specifies the norms for determination of beneficial owner for various categories of customers.

11.4.1 Basic Criteria/Concepts

- *Natural Person*: A beneficial owner has to be a natural person. A juridical person does not qualify to be a 'beneficial owner' in this context.
- *Criteria for Being Beneficial Owner*: A natural person fulfilling any one of the following criteria, whether alone singly or in concert with another natural person, and though whatever means or arrangement, will be beneficial owner:
  - Having ownership of certain threshold value
  - Enjoying benefit of certain threshold value
  - Exercising control over the entity
- *Chain Ownership:* The definition of 'beneficial owner' implies that in case of entities the banks are expected to examine their holding structure tree down to the level where they can be reasonably satisfied that the natural persons who qualify as 'beneficial owners' of the entity have been determined and identified. There could be certain arrangements where this could become too onerous, or seemingly impossible. Such cases naturally will need to be dealt with greater caution and circumspect.
- *Senior Managing Official:* If in certain cases (for a company/a partnership firm/an

association) it is found that the arrangement is so complex that no beneficial person is identifiable fitting the prescribed norms, the natural person who 'holds the position of senior managing official' is to be treated as 'the beneficial owner' of the entity.

11.4.1.1 Norms for Determining

The specific norms prescribed for various types of entities are enumerated in Table 11.1.

Table 11.1 Norms for Beneficial Owners Determination

S. No.	**Type of Entity**	**Criteria**	**Threshold Value**
(i)	Company (Any one of (a) or (b))	❖ Has a 'controlling ownership interest' (whether acting alone or together, or through one or more juridical person) *Controlling ownership interest*: ownership of or entitlement to shares or capital or profits of or above the threshold value.	More than 25%
		❖ Exercises 'control' through other means *Control*: It includes the following: • right to appoint majority of the directors, or • right to control the management or policy decisions This could be by virtue of: • their shareholding or • management rights or • shareholder's agreements or • voting agreements	
(ii)	Partnership Firm	Has ownership of/entitlement to capital or profits (whether acting alone or together, or through one or more juridical person)	More than 15%
(iii)	Limited liability Partnership (LLP)*	Has ownership of/entitlement to capital or profits (whether acting alone or together, or through one or more juridical person)	More Than 15%
(iv)	Unincorporated Association or Body of individuals	Has ownership of or entitlement to the property or capital or profits	More than 15%

(v)	Trust	(a) Author (b) Trustee (c) Beneficiaries with interest* (d) Any other natural person exercising ultimate effective control over the trust through a chain of control or ownership	15% or more *
(vi)	If the customer or the owner of the controlling interest is a company listed on a stock exchange, or is a subsidiary of such a company, it is not necessary to identify and verify the identity of any shareholder or beneficial owner of such companies.		-

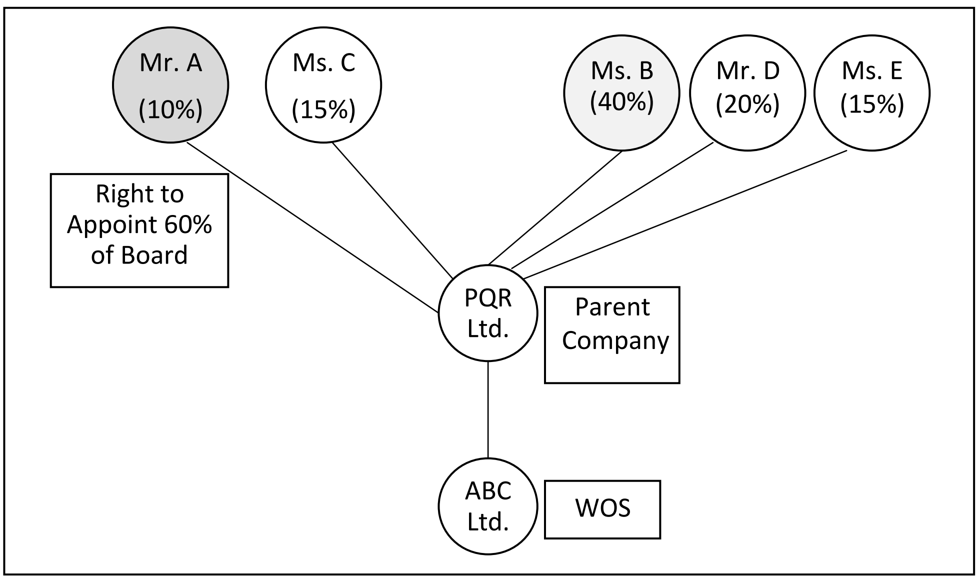
(*LLP - a Limited Liability Partnership, is a legal entity and registered under The Limited Liability Partnership Act, 2008, accordingly for identification of beneficial ownership, the norms other than company should be applied.)

11.4.1.2 Illustrations

Let us understand the application of the norms for determining beneficial owners of entities through a couple of illustrations.

(a) A company ABC Ltd. is wholly owned subsidiary of PQR Ltd. PQR Ltd. has five shareholders with shareholdings as indicated viz. Mr. A (10%), Ms. B (40%), Ms. C (15%), Mr. D (20%), Ms. E (15%). Mr. A has the right to appoint 60% of the Board members of PQR Ltd.

Chart 11.1 Determining Beneficial Owners of ABC Ltd.



PQR Ltd. is the sole shareholder of ABC Ltd. but is not a natural person.

Hence we need to look into the beneficial ownership of PQR Ltd. All five shareholders are natural persons. But only Ms. B has shareholding meeting the threshold criteria of

more than 25%. So, Ms. B is a beneficial owner of PQR Ltd. Looking further into the control of PQR Ltd. we know that Mr. A has the right to appoint 60% of the Board members, and hence has control over PQR Ltd. to that extent thus meeting the threshold criteria. Hence Mr. A is also a beneficial owner of PQR Ltd.
As ABC Ltd. is a wholly owned subsidiary of PQR Ltd., the beneficial owners of PQR Ltd. (Mr. A and Ms. B) are also the beneficial owners of ABC Ltd.

(b) Let us look at the beneficial ownership of PQR Ltd. considered in illustration (a) with some further information. On conducting further due diligence, it was learnt that Mr. D and Ms. E are husband and wife, and they act in concert for all matters connected with PQR Ltd. In the light of this information, it is observed that the joint share of Mr. D and Ms. E is 35% thus meeting the threshold criteria. Hence Mr. D and Ms. E are also beneficial owners of PQR Ltd. So, PQR Ltd. has four beneficial owners: Mr. A, Ms. B, Mr. D and Ms. E.

11.5 IDENTIFICATION REQUIREMENTS – BASICS

11.5.1 Elements of Customer Identification Procedure

The purpose of customer identification procedures is to satisfy about the genuine identity of the customer and also understand the activity of the customer to mitigate the risk of the bank being used for ML/TF purposes. The principal elements of the customer identification are:

(a) Identifying and verifying the customer and the beneficial owner, including obtaining one of the prescribed documents or modes, including obtaining any officially valid document.
(b) Obtain sufficient information to establish identity of customer (regular or occasional) to own satisfaction.
(c) Ascertain the purpose of the intended nature of the banking relationship, and understand the activity of the customer.

It is important that banks are able to satisfy the competent regulatory authorities that the extent of due diligence conducted was appropriate to the assessed risk. For this purpose, it is essential that not only the required procedures should be carried out, but also those should be recorded and also as and when required, the same can be produced, such possible documentary evidences as obtained should be preserved for prescribed period.

RBI guidelines regarding customer identification procedure have been explained in this and subsequent paragraphs. For specific RBI guidelines please refer to of Master Direction - Know Your Customer (KYC) Direction, 2016 of RBI.

11.5.2 Stages for Customer Identification

Customer identification is required to be done whenever a relationship is established with any customer for the first time, may be for opening an account or for any single transaction say making a remittance. It may also be required to be done when a need is felt about rechecking the customer information that is available with the bank. The Board approved KYC Policy, incorporating the Customer Identification Procedure should specify the various stages when customer identification exercise may be carried out. These are enumerated below.

(i) At the time of establishing an account based relationship e.g. opening a bank account, sanctioning credit facility, etc. This would also include relationships for trading in securities or derivatives.

(ii) At the time of carrying out a financial transaction, especially an international money transfer for a person who is not an account holder of the bank. This would also include carrying out due diligence for an existing customer, where a domestic transaction is of unusual nature or value.

(iii) When the bank/FI has a doubt about the authenticity or adequacy of the customer identification Data it has obtained; the same data / information needs to be re-verified mainly- -

a) at the time of selling third party products like life insurance, mutual funds, etc. as agents.

b) at the time of selling banks' own products (like pay orders, remittances, etc.), payment of dues of credit cards/sale and reloading of prepaid/travel cards and any other product for more than Rs. 50,000/-. (In case of cross-border transactions, for all transactions irrespective of value.)

c) at the time of carrying out transactions for a non-account based customer (that is a walk-in customer), of Rs. 50,000/- or more, (whether a single transaction or several seemingly connected transactions).

d) If there is doubt that a customer (account-based or walk-in) is intentionally structuring a transaction into a series of transactions below the threshold of Rs. 50,000/-.

11.5.3 Care in Information to be Obtained

It is essential to obtain certain 'mandatory' information required to apply KYC norms in all cases, which the customer is obliged to give while opening an account or during periodic updation. It may also be necessary to obtain further information for enhanced due diligence, for the transactions of unusual or complex nature. Any other information, if being collected the same must be obtained only after the account is opened and with the customer's explicit consent.

11.6 ESTABLISHING IDENTITY

11.6.1 Officially Valid Documents (OVD)

Section 11A of the PMLA specifies the base modality for identification of customers. Rule 9 of PML Rules specifies the documents to be obtained for the purpose of establishing identity of various types of customers. As discussed above, identity of individuals connected with the transactions is the key aspect. Keeping in view the purpose of establishing identity of individuals specific documents have been prescribed under PML Rules and advised vide RBI Master direction. Rule 2(d) specifies the documents enumerated in Table 3.2 below as 'officially valid document' for the purpose of establishing identity and as address proof. RBI guidelines have further amplified the legal provisions.

Table 11.2 Officially Valid Documents for Identity and Address Verification

Purpose	Description of Document
Valid For all individuals in whichever capacity (both Identity and Address Proof)	• Passport • Driving licence, • Proof of possession of Aadhaar number • Voter's Identity Card (issued by the Election Commission of India) • Job card (issued by NREGA duly signed by an officer of the State Government) • Letter issued by the National Population Register containing details of name, address
*Valid only as proof of address** *(i) For simplified measures applied*** *(ii) Where OVD does not have updated address* *** Simplified measures are applicable only in case of SHGs and certain accounts being opened by NBFCs*	• Utility bill (electricity, telephone, postpaid mobile phone, piped gas, water bill) (not more than 2 months old); • Property or Municipal Tax receipt; • Pension or family pension payment orders (PPOs) if they contain the address (for retired employees of Government Departments or Public Sector Undertakings); • Letter of allotment of accommodation from employer (by State or Central Government departments, statutory or regulatory bodies, public sector undertakings, scheduled commercial banks, financial institutions and listed companies) (Leave and license agreements with such employers allotting official accommodation). (If OVD obtained is other than Aadhaar, one of these above said documents is to be obtained for proof of current address and this is valid for three months only, within which the customer should produce an OVD with updated address.)

11.6.2 Change of Name

There are situations when a person has changed name and hence the OVD held by her/him stands in her/his earlier name. To avoid hardships to such person, PML Rules have been amended to provide for acceptance of the documents standing in old name, when the person submits an OVD along with a marriage certificate issued by the State Government or a Gazette notification indicating such a change of name.

11.6.3 Updated Address Proof

If an officially valid document furnished by the customer does not contain updated address, any of the OVDs prescribed only as address proof need to be taken. The customer is required to submit an OVD with the updated address within three months.

However, where the customer has provided Aadhaar Number as identity proof, a self-declaration by the client for the updated address (different from as per UIDAI record) is sufficient.

11.6.4 Foreign Nationals – Address Proof

There may be situations when the OVD provided by a foreign national (usually the Passport) does not contain the address. In such cases the customer needs to provide the following documents:

(i) A document issued by a Government department of the foreign jurisdiction, and

(ii) A letter issued by the Foreign Embassy or Mission in India.

11.6.5 Mode of Acceptance of OVD

Usually a self-certified copy of the OVD is obtained for records and as evidence. The copy of OVD is needed to be certified by official of Reporting Entity by writing his name and employee number. A certified copy implies comparing the copy of officially valid document with the original and recording the same on the copy by an authorised officer of the reporting entity. With all processes becoming technology driven, the PMLR authorises acceptance of e-document version of the OVDs or any other document for the purposes of KYC.

11.6.6 Validation/ Verification of Documents

The KYC documents, including the OVDs, obtained during the CDD process should be validated/ verified through the websites of the issuing authorities, wherever this facility is applicable / available. Particularly, following validation/ verification must be carried out:

- Permanent Account Number (PAN) should be verified from the verification facility of the issuing authority.
- Aadhaar number should be verified through any of the authentication/ verification mode provided by UIDAI.
- Digital signature should be verified in case of the equivalent e-document obtained.

11.7 BASIC KYC DOCUMENTS REQUIREMENTS

11.7.1 For Individuals

In case of individuals, whether as a customer, a beneficial owner, a mandate holder or an authorised signatory, the following approach is adopted:

(i) The customer may provide any one of the following:

- Aadhaar Number (either voluntarily or for availing benefit/ subsidy under any scheme even at future date)
- Proof of possession of Aadhaar (with offline verification)
- Proof of possession of Aadhaar (without offline verification)

(ii) Any other Officially Valid Document as prescribed, given as per Table 11.2

(iii) Permanent Account Number or Form 60 to be obtained mandatorily,

(iv) Any other documents related to financials status (as required by the bank) may be obtained.

It will be seen that only the first two mentioned documents are mandatory. However, the banks should in their KYC policies include the requirements for obtaining appropriate additional documents pertaining to financial status in case of customers who are not in low risk category or have high turnover in their accounts.

Photographs need to be obtained for all individuals, including for ‘pardanashin’ women. In case of accounts of juridical persons, photographs of those individuals connected with them whose KYC is required should be obtained.

(a) ***Joint Accounts***: For joint accounts, the KYC documents need to be taken for each applicant. Where the joint applicants are close relatives, for address proof the relaxed procedure indicated in paragraph 2.4.4 below may be followed.

(b) ***Minor Accounts***: In case of minor’s account the KYC requirements will need to be fulfilled for the guardian who is opening the account for the minor. The photograph of the guardian should also be obtained. However, it is advisable that the minor’s birth certificate is obtained and held on record. On the minor becoming major, her/his KYC requirements need to be completed including obtaining the photograph.

11.7.2 For Juridical Entities (Non- Individuals)

Under PML Rules and RBI guidelines, specific documentary requirements for various types of entities have been prescribed. One aspect to be noted is that in case of entities apart from the entity related documents, KYC documents for their beneficial owners, and attorney holders, viz. authorized signatories must be obtained, as in case of individuals.

11.7.3 Norms for Obtaining Documents

Requirements of submission of documents for KYC purposes frequently have resulted in certain hardships to general customers. With a view to reducing hardships to the customers several aspects have been clarified for streamlining the procedure for basic KYC documents.

- *One OVD:* Only one OVD will suffice as both identity and address proof.
- *OVD at Customer Level:* Where a customer avails multiple products, banks should not obtain OVDs for each product separately. OVD obtained for a customer will be valid for all transactions and accounts of that customer.
- *Opening New Account/Transfer of Account*: For a KYC compliant customer, fresh KYC documents should not be asked from her/him to open a new account or for transfer of existing account from one branch to another. In case of transfer, if Aadhaar as OVD on record, for the new (current) address a self-declaration by the customer will suffice, and no other document is required.
- *Use of Third Party*: There can be several situations where the banks may have to rely on third parties for the purpose of document collection and verification from the customers, especially so in case of non-resident customers. This has been permitted subject to observing following conditions:
    - Regulated: The third party must be regulated, supervised or monitored; and has

measures in place for compliance with client due diligence and record-keeping requirements in line with the requirements and obligations under the PML Act.

- *Country of Location*: The third party is not based in a country or jurisdiction assessed as high risk and
- *Availability of Information*: the information so obtained as per due diligence carried out by the third party, should necessarily be available at least within 10 days;
- *Document/Information Availability*: To satisfy itself that copies of identification data and other relevant documents relating to due diligence requirements will be made available upon request without delay;
- *Ultimate Responsibility*: The responsibility for KYC ultimately rests with the concerned banks.
- RBI has directed REs to ensure that decision-making functions of determining compliance with KYC norms are not outsourced.

11.8 NEED FOR SPECIFIC REQUIREMENTS

We have seen that AML/CFT measures can be effectively implemented if a differential risk based approach is adopted. The banks customers form the base for application of these measures. Banks cater to various types of customers, who are primarily categorized based on their constitution, and their activity. As these groups of customers have different characteristics and are subject to differing statutes and legal requirements, even KYC measures for certain groups of customers need to be different. Also, there is product-based differentiation, mainly because of different features of account based and remittance products; and products designed for a particular target group (e.g. small accounts) or subject to different legal requirements (e.g. wire transfers). PML Rules and RBI guidelines have therefore stipulated different guidelines for certain customer groups, and products.

11.8.1 Small Accounts

11.8.1.1 Purpose of Small Accounts

For financial inclusion, and for avoiding hardship to persons not having an officially valid document (OVD), a facility of ‘Small Accounts’ is created. This account serves as an interim relief for them. The procedure for this account has been prescribed in PMLR and must be followed diligently. A ‘Small Account' means a savings account which is opened in terms of subrule (5) of the PML Rules, 2005.

11.8.1.2 Features

Following are the salient features of ‘Small Account’

(a) *Type:* Savings Account
(b) *Restrictions on Credits:* Not more than ₹.1 lakh in a year
(c) *Restrictions on Withdrawals:* Not more than ₹10,000/- in a month (including transfers)
(d) *Restrictions on balance:* Not more than Rs.50,000/- at any time.
(e) *Other Restrictions:* No foreign inward remittance to be credited

11.8.1.3 Procedure for Opening

(a) *Eligible Branches*: Only Core Banking Solution (CBS) linked branches or where the restrictions on the account can be monitored before allowing a transaction should be permitted

(b) *Eligible Customers*: Any person who does not have / possess any of the OVDs as prescribed by RBI and has no other bank account.

(c) *Documents Required*: Self-attested photograph, signature/thumb print affixed on it and Account Opening Form.

(d) *Verification*: Designated Officer certifies that the person opening the account has signed/affixed thumb print in her/his presence.

11.8.1.4 Procedure for Operations

(a) *Validity Period:* Initially for 12 months.

(b) *Extension Period:* For another 12 months, provided the holder has applied for an OVD within the initial 12-month period.

(c) *Review of Account:* If no OVD provided by the customer till expiry of 24 months, the account should be reviewed with relaxations norms and operations in the accounts should be ceased. If there is no balance in the account, is should be closed. Such formulation must be incorporated in KYC Policy of the RE.

11.8.2 Specific Requirements: Select Customer Groups

Juridical Persons: There are several types of juridical persons. Most common types of juridical persons are Companies, Partnership Firms, Associations and Trusts. Specific requirements for these categories of customer groups are discussed below.

11.8.2.1 Companies

- *Characteristics*: Companies are incorporated bodies under The Companies Act 1956 or The Companies Act 2013. Thus these entities are subject to several legal requirements for incorporation and also for governance. Further, in case of companies typically ownership (by shareholders) and management (by executives) functions are segregated. This makes it important to ascertain the key persons in both the groups.
- *Documents Required*: The documents (certified copies) or the equivalent e-document needed to evidence existence of a company, and for the natural persons managing it or transacting on its behalf are as follows:
    (a) Certificate of incorporation;
    (b) Memorandum and Articles of Association;
    (c) PAN of the Company
    (d) A resolution from the Board of Directors and power of attorney granted to its managers, officers or employees to transact on its behalf, and
    (e) Documents, as specified for individuals in respect of beneficial owners, the managers, officers or employees holding an attorney to transact on its behalf.

Beneficial Owners: Beneficial owners need to be determined and identified (individual(s) having/enjoying 25% or more stake/control/benefit). This is not required to be done for listed companies or their subsidiaries. It is necessary that natural persons, as beneficial owners, are determined, where required going down the chain of corporate structure. In case of too complex structures, the person(s) who exercises control over the affairs of the company is deemed to be the beneficial owner and must be identified.

11.8.2.2 Partnership Firms

- *Characteristics*: Partnership Firms are predominantly formed under Partnership Act 1932. There is provision for registration of partnership firms. Though it is not mandatory, there are certain negative fall outs arising from non-registration.
- *Documents Required*: The documents (certified copies) or the equivalent e-document needed to evidence existence of a partner- ship firm, and for the partners and the natural persons managing it or transacting on its behalf are as follows:
  - (a) Registration certificate;
  - (b) Partnership deed;
  - (c) PAN of the Partnership firm; and
  - (d) Documents, as specified for individuals in respect of the beneficial owner, and the managers, officers or employees holding an attorney to transact on its behalf.
- *Beneficial Owners*: Beneficial owners need to be determined and identified. Individual(s) having/enjoying more than 15% control/benefit/ entitled to capital or profits and any individual exercising effective control need to be identified.

11.8.2.3 Limited Liability Partnerships (LLP)

- *Characteristics:* The LLPs are formed under the provisions of Limited Liability Partnership Act 2008. It is a body corporate formed and incorporated under the Act and a legal entity separate from its partners. It has perpetual succession. Any change in the partners of a LLP shall not affect the existence, rights or liabilities of the LLP. The provisions of Indian Partnership Act, 1932 do not apply on LLPs. An LLP shall have not less than two partners. An LLP shall have at least two partners as Designated Partners, of which at least one shall be a resident in India. The Designated partners are required to obtain Designated Partner Identification Number (DPIN) by Central Government. LLP prepares an incorporation document in terms of the Act mentioning / incorporating all details and is registered under the Act.
- *Documents Required:* The documents (certified copies) or the equivalent e-document needed to evidence existence of a Limited Liability Partnership, and for all the designated partners and the natural persons managing it or transacting on its behalf are as follows:
  - (a) Incorporation Document Registered under LLP Act 2008
  - (b) DPIN of all the Designated Partners;
  - (c) PAN of the LLP; and
  - (d) Documents, as specified for individuals in respect of the beneficial owners, the designated partners and the managers, officers or employees holding an attorney to transact on its behalf.
- *Beneficial Owners: Beneficial owners need to be determined and identified viz. those persons having stake 15% or more in LLP, and also the designated partners.*

11.8.2.4 Associations/ Body of Individuals

- *Characteristics:* Often we come across unincorporated association or a body of individuals, commonly referred to as 'Associations'. These entities are not covered by any specific law. This form is often used when a group of individuals wish to undertake certain cultural, social or professional activities together, usually not for commercial/profit making purposes. Though in the absence of any legal prescription, there is no uniformity in their set-up, but typically they all have a managing body that would take decisions. This category also includes Unregistered trusts/partnership firms/ societies.
- *Documents Required:* The documents (certified copies) or the equivalent e-document needed in case of such bodies are:
  - (a) Resolution of the managing body of such association or body of individuals;
  - (b) PAN of the Association or Body of Individuals
  - (c) Power of attorney granted to transact on its behalf;
  - (d) Documents, as specified for individuals in respect of the beneficial owners, and the managers, officers or employees holding an attorney to transact on its behalf, and
  - (e) Such information as may be required by the bank/FI to collectively establish the legal existence of such an association or body of individuals
- *Beneficial Owners:* Beneficial owners need to be determined and identified. In most cases, associations will not have any individual(s) having/enjoying 15% or more control/benefit. In such situations the individuals who are the members of the managing body and exercise control on the entity need to be determined and identified.

11.8.2.5 Trusts

- *Characteristics:* Trusts are set up for various purposes. They are broadly of two types based on beneficiaries: a) those for the benefit of a class of persons, b) those for the benefit of some specific persons. There are trusts that are created with the funds of specific individual(s). On the other hand, most public funds collect donations from various sources/donors. Typically, trusts will have trustees either named in the trust deed or which may be appointed as per the provisions in the trust deed.
- *Documents Required:* The documents (certified copies) or the equivalent e-document needed in case of such bodies are:
  - (a) Registration certificate;
  - (b) Trust deed;
  - (c) PAN of the Trust; and
  - (d) Documents, as specified for individuals in respect of beneficial owners, and the managers, officers or employees holding an attorney to transact on its behalf
- *Beneficial Owners:* Beneficial owners need to be determined and identified. Among the three categories specified viz. the author, the trustees, and the beneficiaries (with 15% or more benefit). trustees will be found in all cases and need to be identified. As for other two categories, it must be ascertained, in each case, whether these will be

applicable. Besides, any other natural person exercising ultimate effective control over the Trust needs to be identified. In all cases, it is important to ascertain the source of funds.

11.8.2.6 Juridical Persons Not Specifically Covered

- *Characteristics:* There are certain types of bodies engaged mostly in certain non-commercial, academic, administrative types of activities etc. that do not fall in any of the above stated categories. For example, these are societies, universities and local bodies like village panchayats of specific individual(s).
- *Documents Required:* The documents (certified copies) or the equivalent e-document needed in case of such bodies are:
  - (a) Document showing name of the person authorised to act on behalf of the entity;
  - (b) Documents, as specified for individuals in respect of beneficial owners (if any), and the persons holding an attorney to transact on its behalf
  - (c) Such information as may be required by the bank/FI to collectively establish the legal existence of such entity/ juridical person
- *Beneficial Owners:* Beneficial owners need to be determined and identified. In most cases, such bodies will not have any individual(s) having/enjoying 15% or more control/benefit. In such situations the individuals who are the members of the managing body and exercise control on the entity need to be determined and identified.

11.8.3 Juridical Persons – Risks and Due Diligence

11.8.3.1 Why money launderers/fraudsters use them?

It is the experience globally that juridical structure is used by both the money launderers and fraudsters for their activities. The obvious reasons are:

a) Helps in keeping key individuals behind cover;

b) Persons in the front dealing with the bank/public are paid executives, and in several cases may not be aware of the actual activities of the entity; and

c) The shareholders/partners/author/trustees could even be benami.

11.8.3.2 What types of transactions are routed through them?

In view of this, higher degree of due diligence is required for these entities. Some of the abuses of these structures are given below:

a) Hawala Transactions

b) Trade Based Money Laundering

c) Fraudulent Transactions (routing hacked RTGS, forged instruments, etc.)

d) Fraudulent claims from Government (routing tax refunds, duty drawback, other government incentives, etc.)

e) Fraudulent collection from public (MLM type activity, fake investment scheme, fake job schemes, etc.)

f) Terrorism related activities (collection of funds, under-cover networking, covert communication links to overseas entities, etc.)

11.8.3.3 Peculiar Risks of Specific entities

Corporates and Partnership firms are typically used for hawala transactions, Trade based money laundering, and various types of fraudulent activities. Associations and trusts could be generally used for hawala transactions. Trusts are generally used for hawala transactions and terrorism related activities. Use of trusts for terrorism related activities provides them an effective cover under the guise of hospitals, religious activities, orphanages, old age homes, etc.

11.8.3.4 Due Diligence Required

The due diligence exercise should aim to determine and understand the nature of its business, and its ownership and control structure. The purpose of the due diligence is:

(i) to prevent the unlawful use of legal persons and arrangements by properly assessing the money laundering and terrorist financing risks associated with the business relationship,

(ii) and to take appropriate steps to mitigate the risks.

For this purpose, obtaining information about their Name, legal form, names of the persons in senior management position, location of registered office, and location of a principal place of business, and business activity will be the basic minimum requirement. It is important to satisfy about the correctness of information. Reliance merely on the declaration of the customer or even supporting documents provided may not be sufficient, especially where the risks are perceived to be higher. There would be need for independent verification. Obviously, the degree of diligence would also depend on the nature, value, and volume of transactions that are expected to be and actually carried out. It is also important to satisfy that the transactions carried out by these entities are in tune with their activity.

11.8.4 Proprietary Firms

- *Characteristics and Risks:* This is the most prevalent form used by small business enterprises owned by an individual (the Proprietor). While from KYC perspective, the requirements are as in case of individuals, due to large scale abuse of this form for perpetrating frauds of various types e.g. routing hacked RTGS, forged instruments, routing tax refunds, duty drawback, other government incentives, MLM type activity, fake investment scheme, fake job schemes, etc. there is a need for taking additional precautions. There being no legal requirements for creation of a proprietary firm and no restriction on the number of firms a proprietor can have, this form provides the most convenient cover to a money launderer/fraudster. Hence, under RBI guidelines additional documentary requirements have been prescribed.
- *Documents and Due Diligence:* Customer identification procedure applicable to the proprietor as individual is to be followed. Additionally, any two of the prescribed documents, in the name of the firm should be taken as business activity proof. However, where a firm has only one of the said documents, and the bank is satisfied that it is not possible for the firm to have second activity proof, it can waive the

requirement of second activity proof subject to carrying out verification of activity and confirm that it has satisfied itself about the existence of the firm and also that the activity is being carried out from the stated place of business.

- *Prescribed Activity Proofs:*
  - Registration certificate (in the case of a registered concern)
  - Certificate/licence issued by the Municipal authorities under Shop & Establishment Act,
  - Sales and income tax returns
  - CST/VAT/ GST certificate (provisional/ final)
  - Certificate/registration document issued by GST /Professional Tax authorities
  - IEC (Importer Exporter Code) issued to the proprietary concern by the office of DGFT
  - Licence/certificate of practice issued in the name of the proprietary concern by any professional body incorporated under a statute.
  - Complete Income Tax return (not just the acknowledgement) in the name of the sole proprietor where the firm's income is reflected duly authenticated/acknowledged by the Income Tax Authorities.
  - Utility bills such as electricity, water, landline telephone bills, etc. in the name of proprietor / firm

11.8.5 Hindu Undivided Family

- *Characteristics and Risks:* Hindu Undivided Family is a peculiar form of juridical person that comes into being by virtue of descendance . There is no incorporation document and it can have perpetual succession as long as its members keep it active. The eldest member (traditionally a male member) is Karta, while all other members are called co-parceners. Determining the composition of an HUF is difficult and requires obtaining the family relationship information from the customer. The Karta enjoys the powers to deal with the assets of the HUF. The accounts of HUF pose similar risks as those of a partnership firm.
- *Documents and Due Diligence:* As there is no incorporation document usually a declaration from the Karta and all other coparceners, including for the minors from their guardians, is obtained. Besides, the documents as prescribed for individuals are obtained in respect of the Karta and all the coparceners. For the minor coparceners their documents should be obtained as sson as they become major.

11.9 ACCOUNTS OF CUSTOMERS OF SPECIAL CATEGORIES

11.9.1 Client Accounts Opened by Professional Intermediaries

Such accounts opened by professional intermediaries for their clients are used by these intermediaries for carrying out the transactions for its client or clients (i.e. beneficial owners) to whom the funds actually belong. There can be different types of accounts in this category, each requiring different approach. Such accounts should not be opened for professional intermediaries who are unable to share their client particulars with the bank.

11.9.1.1 Specific Beneficial Owner(s)

Where the funds of a single client are routed through an account or funds for several specific clients are routed through a sub-account for each, individual beneficial owners must be identified. Even if the funds for various beneficial owners are co-mingled in the bank account, all of them should be identified. REs may, at their discretion, rely on the 'customer due diligence' (CDD) done by an intermediary, if it is a regulated and supervised entity and has adequate systems in place to comply with the KYC requirements. The ultimate responsibility is with the RE.

11.9.1.2 Pooled Accounts

Certain entities like mutual funds or pension funds need to maintain 'pooled accounts' for conducting their business activity. These accounts can be opened in normal course taking care that the requisite due diligence of the funds is carried out, and it is verified (with documentary evidence taken) that they have the required registrations/approvals.

11.9.2 Accounts of Other Intermediaries

There are intermediaries like stock brokers who use bank accounts for carrying out regular transactions for their clients. In such cases, the banks need to rely on the 'customer due diligence' carried out by the intermediaries. The banks need to satisfy itself that the intermediary is a regulated and supervised entity and has adequate systems in place to comply with the KYC requirements of the customers. The ultimate responsibility for knowing the customer lies with the bank.

11.9.3 Trusts/Nominee or Fiduciary Accounts

Where accounts are opened under certain arrangement where the customer opening the account is acting merely in a fiduciary capacity, and the funds belong to some third party (ies), it is important to know details of such arrangements. These accounts have similar characteristics like 'Trusts' discussed above, though in some cases these may not be so well structured. Such accounts have potentially high risk of being used for ML/TF purposes.

Hence in such cases there is a need to obtain and satisfy about the following:

(i) Identity of the intermediaries
(ii) Identity of the persons (beneficiaries, fund providers, managers, etc.) for whom they are acting
(iii) Details of the nature of arrangement
(iv) Need and purpose of the arrangement

11.9.4 Politically Exposed Persons (PEPs) - Resident outside India

- *Definition and Coverage:* FATF Standards define foreign PEPs as under -
  'Foreign PEPs are individuals who are or have been entrusted with prominent public functions by a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials.'

Earlier FATF recommendations required additional diligence and processes in respect of foreign PEPs only. Revised recommendations contain similar approach in respect of domestic PEPs where high risk business relation is carried out for them. It is also recommended that similar approach as for PEPs will be applicable to their close associates and family members.

- *RBI Guidelines:* RBI KYC Directions define PEPs as follows -

  "Politically Exposed Persons" (PEPs) are individuals who are or have been entrusted with prominent public functions in a foreign country, e.g., Heads of States/Governments, senior politicians, senior government/judicial/military officers, senior executives of state-owned corporations, important political party officials, etc."

The under mentioned approach is to be followed in India.

(i) *Coverage*: Applicable to foreign PEPs, their family members and close relatives, and entities where they are beneficial owners. However, as a prudential measure several banks also include domestic PEPs in the same procedure.

(ii) *Identification*: Apart from identification as PEP that is to be done at the time of on-boarding a new customer, there should be a system in place that would enable identifying any existing customer becoming PEP.

(iii) *Due Diligence*: This includes the following: (a) gather sufficient information on the person;

(b) check all the information available on such person in the public domain; (c) verify the identity of the person; and (d) seek information about the sources of funds.

(iv) *Authority to Approve*: Decision to open an account for PEP should be taken at a senior level (to be clearly specified in the KYC Policy). In case of an existing customer or beneficial owner becoming a PEP, such approval is required for continuing the relationship.

(v) *On-going Approach*: Enhanced monitoring and enhanced CDD to be applied on an on-going basis.

11.10 OTHER TYPES OF ACCOUNTS

11.10.1 Joint Accounts/ Add-on card holders

KYC procedure needs to be carried out for each joint account holder in case of Joint Accounts, and also for each add-on card holder in case of credit cards.

11.10.2 Foreign Student Accounts

Foreign students coming to India for study will need an account for receiving funds from their home to meet their expenses. Non Resident Ordinary Accounts are permitted to be opened for them. For these accounts the following approach is to be followed. One must be cautious that the potential ML/TF risks are high in case of such accounts.

(i) *Documents*: (a) his/her passport (with visa & immigration endorsement) bearing the proof of identity and address in the home country, (b) a photograph, and (c) a letter offering admission from the educational institution in India.

(ii) *Local Address*: To obtain a declaration within 30 days of opening the account, and verify it.

(iii) *Restrictions*: During the 30 days/pending verification of address – (a) Foreign inward remittances
not exceeding USD 1,000; (b) Monthly withdrawal max. Rs. 50,000/-.

(iv) *Other Conditions*: As applicable for Non-Resident Ordinary Rupee (NRO) Accounts.

(v) *Students with Pakistani and Bangladesh nationality*: Need prior approval of the RBI for opening the account.

11.10.3 Foreign Portfolio Investors (FPIs)

Foreign Portfolio Investors are required to be registered with SEBI. FPIs registered with SEBI and subjected to KYC process by a SEBI registered Custodian/ Intermediary can open account under Portfolio Investment Scheme. Banks can rely on the KYC verification by the SEBI registered Custodian/ Intermediary as per the provisions for third party reliance under PMLR. RBI has exempted obtention of certain documents depending on the category of the FPI, at the time of opening their account, provided that these would be made available by the Custodian when required. The RBI permitted exemptions are given at Appendix 8.

11.10.4 Self Help Groups (SHGs)

SHG is another initiative for financial inclusion. Relaxation is given in KYC processes for opening accounts of SHDs, so initiative should not be hampered. There is no need to undertake CDD of all the members of a SHG for opening their savings bank accounts. CDD of all the office bearers of SHG is necessary. CDD of all the members is required at the time of credit linking.

11.10.5 New Technology and Card Products

Use of new technology based products is increasing at a fast pace. These products carry distinctive money laundering risk like anonymity provided by netbanking. Hence adequate measures for mitigating additional risk must be taken by banks. These could be closer monitoring of transactions, seeking more specific information about customer occupation, etc.

Presently, variety of card based products like debit cards, credit cards and a variety of store value cards are in vogue. These products could be used for purchase of goods and services, withdrawal of cash, and remittances, etc. Appropriate KYC/AML procedures need to be followed for these products too. KYC requirements apply to the holders of add-on and supplementary cards too. Wherever Direct Sales Agents (DSAs) are engaged for selling cards, they should also be subjected to due diligence and KYC procedures.

11.10.6 Correspondent Arrangements (of Co-operative Banks)

Certain banks provide facility to co-operative banks/societies to open accounts that are used for the purpose of issuing at par cheques to their customers (their account holders/walk-in) favoring third parties, for making their remittances. Following provisions need to be followed in respect of such arrangements, to mitigate the risk of these being abused for money laundering or terrorist financing purposes.

- Commercial banks to review and monitor each arrangement to assess various types of risks (ML, FT, Credit, Reputation)
- Maintain the right to verify the records of the client co-operative banks/societies
- Co-operative banks/societies using the facilities to use the at-par facility only for:
  (a) Own use,
  (b) For KYC compliant account holders, with transactions of Rs.50000/- or more only by debit to the accounts, and (c) For walk-in customers against cash for less than Rs.50000/- per individual.
- Co-operative banks to issue all such cheques crossed account payee, irrespective of the amount
- Co-operative banks to maintain the following:
  (a) Records of 'at par' cheques covering inter alia applicant's name and account number, beneficiary's details and date of issuance of the 'at par' cheque;
  (b) Sufficient balances/drawing arrangements with the bank for this purpose.

11.10.7 Walk-in Customers

In case of walk-in customers (i.e. those not having an account) too KYC requirements apply where the amount involved is Rs.50000/- or more. If it is suspected that a customer is intentionally structuring transactions in a manner so that individual transactions fall below the threshold, filing of STR needs to be examined. In respect of international transactions, the KYC requirements apply to the transactions of any value.

11.10.7.1 Demand Drafts/Banker's Cheque/ NEFT

Issue of demand drafts/banker's cheque or NEFT, etc. for Rs. 50,000/- and above should be only by debit to the customer's account or against cheques. These should not be against cash payment. Besides, banks should not make payment of cheques/drafts/pay orders/banker's cheques if they are presented beyond the period of three months from the date of such instrument.

11.10.8 Specific Requirements: Select Business Activities

11.10.8.1 Wire Transfers

Wire transfers are very convenient mode for transfer of funds across the world. It is a boon to trade and commerce. However, these are also very risky as money launderers and terrorists find it very convenient for their purpose. In view of this FATF has recommended minimum information that should accompany such wire transfers, and the responsibilities of various banks handling the transaction at various stages. Besides, BCBS has issued guidance note on 'Due diligence and transparency regarding cover payment messages related to cross border wire transfers'.

11.10.8.2 Domestic Wire Transfers

All domestic wire transfers (of Rs. 50000/- and above) must include accurate and meaningful originator information – name, address, and account number. The originating bank will be responsible for the KYC of the remitter. The receiving bank will be responsible for the KYC of the beneficiary of the payment.

11.10.8.3 Cross Border Wire Transfers

All cross border wire transfers must include accurate and meaningful originator information, particularly the name and address, where an account exists, its number, or a unique reference number. Certain norms to be particularly observed are:

- Appropriate information should be included in payment messages i.e. full name of beneficiary, details of beneficiary's account with clear Bank and Branch name.
- Information in payment messages should not be omitted, deleted, altered or used for the purpose of avoiding detection of that information by any other financial institution in the payment process.
- Information requested by another financial institution about the parties involved should be provided, subject to other applicable laws.

11.10.8.4 Exemptions

Interbank transfers and settlements where both the originator and beneficiary are banks or financial institutions would be exempted from the above requirements.

11.10.8.5 Responsibilities of banks in the chain

Originating banks should ensure that appropriate information accompanies wire transfers while others in the payment chain are required to monitor the payment they process based on this information. For effective monitoring banks need to have knowledge about their customer's activity. This however would not be feasible for the intermediary banks who only handle the transaction for their correspondent banks at either end. The responsibilities of various banks in the chain differ. These are indicated in the following paragraphs. Guidelines contained in this regard in IBA-Know your Customer (KYC) Norms & and Anti-Money Laundering Measures (AML) Guidance Notes for Banks – July 2020 have been reproduced at Appendix 9.

- *Ordering banks:* The ordering (originating bank) is responsible for -
  - Inclusion of complete originator information
  - Customer due diligence of the originator
  - Verification of originator information for accuracy
  - Keeping the record of the information as prescribed

Messages sent to the cover intermediary must contain – (a) the originator information (as per the local regulations – minimum name, address, and the account number or a unique reference number) and the beneficiary information (minimum name and identifier code) as well as the other beneficiary information sent directly to the bank of the beneficiary, if any. As much identity information as possible should be included in the message.

- *Intermediary banks:* Intermediary banks are merely the transit points for the funds. The responsibilities of the intermediary banks are therefore limited to the following -
  a) Primarily to ensure that all originator information that accompanies a wire transfer is retained with the transfer.
  b) Due diligence of the banks offered correspondent banking services.

c) To ensure, in real time, that required originator and beneficiary fields of cross border cover payment messages are not blank.
d) Where fields are blank, take appropriate measures, as per regulations, namely: (i) declining to process the transaction; (ii) obtaining the missing information from the originator's bank or the precedent intermediary bank; and/or (iii) filing a report of suspicious activity with local authorities
e) Document decisions taken and the reasons for them.
f) To conduct name screening in accordance with its local regulations.
g) Monitor its relationship with the correspondent banks.
h) Where the information is manifestly meaningless or incomplete it may obtain proper information from the correspondent bank, and also consider filing STR.

- *Beneficiary banks:* Beneficiary banks ultimately make the payment to the beneficiaries, who are typically their customers. The responsibilities of the beneficiary banks include-
  a) Identifying the beneficiary and verifying its identity as per the due diligence requirements.
  b) Monitoring the activities of its customer (the beneficiary).
  c) Identifying wire transfers lacking complete originator information.
  d) Transparency problems to be considered for assessing if a wire transfer or related transactions are suspicious and the need to file STR.

11.10.9 Sale of Third Party Products

Banks sell or distribute several third party products like mutual funds, life insurance, other financial products, etc. The concerned entities viz. asset management companies, life insurance companies, etc. will be responsible for the KYC/AML compliances for these customers. However, RBI has advised banks to carry out KYC procedures for customers to whom third party products are sold.

11.11 FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

"FATCA" means Foreign Account Tax Compliance Act of the United States of America (USA) which, inter alia, requires foreign financial institutions to report about financial accounts held by U.S. taxpayers or foreign entities in which U.S. taxpayers hold a substantial ownership interest.
"IGA" means Inter Governmental Agreement between the Governments of India and the USA to improve international tax compliance and to implement FATCA of the USA.

11.11.1 Features of FATCA/ CRS

Salient features of FATCA and CRS are as follows:

- US Tax department came up with FATCA guidelines in 2010 to enforce tax compliance and avoid tax evasion.
- Its main objective is to identify and prevent offshore tax avoidance by US citizens or residents. It is an attempt to track US persons earning and assets from overseas investments.
- FATCA enables financial institutions to withhold tax if the US persons refuse to meet

the documentation requirements. For this, all financial institutions registered under this act should immediately notify the US tax department when they come across US persons attempting to evade tax. Hence, all FATCA-registered banks report such account holders (with the available information) immediately. This act has a direct and profound impact on US multinationals and Foreign Financial Institutions.

- FATCA ensures tax compliance and transformation at global level.
- Indian Government signed the inter-governmental agreement (IGA) with US in year 2015 for its implementation.
- Common Reporting Standards (CRS) is an international version of FATCA. While FATCA is only for US persons, CRS is applicable for citizens of every country.
- OECD, Organisation for Economic Cooperation and Development developed the Common Reporting Standard for Automatic Exchange of Information (AEOI). The CRS mandates financial institutions across countries to provide respective tax authorities information about their citizens and their wealth overseas.
- Both FATCA & CRS require cooperation from the tax authorities from all the G20 and OECD countries
- It needs declaration for NRIs for reporting, as under-
    - Name
    - PAN
    - Address ; Place of Birth & Country of Birth
    - Nationality
    - Gross Annual Income & Occupation
    - The person whether the resident of another country?, if yes, then the country of residence, Tax ID number, and type ; Specific- US citizen, Green card holder or NRI
- Most of the information for declaration under CRS are the same as FATCA requirements,

11.11.2 FATCA/ CRS Reporting

Under FATCA and CRS, REs shall determine whether they are a Reporting Financial Institution as defined in Income Tax Rules 114F, 114G and 114H and if so, shall take following steps for complying with the reporting requirements:

a) Register on the related e-filling portal of Income Tax Department as Reporting Financial Institutions at the link https://incometaxindiaefiling.gov.in/ post login -> My Account --> Register as Reporting Financial Institution,

b) Submit online reports by using the digital signature of the 'Designated Director' by either uploading the Form 61B or 'NIL' report, for which, the schema prepared by Central Board of Direct Taxes (CBDT) shall be referred to.

c) Explanation: REs shall refer to the spot reference rates published by Foreign Exchange Dealers' Association of India (FEDAI) on their website at http://www.fedai.org.in/RevaluationRates. aspx for carrying out the due diligence procedure for the purposes of identifying reportable accounts in terms of Rule 114H.

d) Develop Information Technology (IT) framework for carrying out due diligence procedure and for recording and maintaining the same, as provided in Rule 114H.
e) Develop a system of audit for the IT framework and compliance with Rules 114F, 114G and 114H of Income Tax Rules.
f) Constitute a "High Level Monitoring Committee" under the Designated Director or any other equivalent functionary to ensure compliance.
g) Ensure compliance with updated instructions/ rules/ guidance notes/ Press releases/ issued on the subject by Central Board of Direct Taxes (CBDT) from time to time and available on the web site http://www.incometaxindia.gov.in/Pages/default.aspx. REs may take note of the following:
    i. updated Guidance Note on FATCA and CRS
    ii. a press release on 'Closure of Financial Accounts' under Rule 114H (8).

11.12 LET US SUM UP

This chapter deals with applying KYC norms for establishing Identity of the customer and carrying out Basic Due Diligence at the time of on-boarding, Customer Due Diligence towards CIP for obtaining requisite OVDs towards Proof of Identity & Proof of Address and additional documents related to different type of legal entities, guidelines / norms for opening small accounts, specific measures for walk in customers. It also covers FATCA and CRS introduced to detect tax avoidance by persons having income in foreign jurisdictions.

11.13 CHECK YOUR PROGRESS

1. What do you understand by UCIC?
    (a) Unique Customer Identification Code
    (b) Unique Customer Information Code
    (c) Unified Customer Identity Cell
    (d) Unique Codified Identity Card

2. FATCA is applicable to________.
    (a) US citizens (casually visiting India)
    (b) US persons (US citizens and / or persons residing in US)
    (c) NRIs residing in Europe & UK
    (d) Indians citizens

11.14 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a)   **2.** (b)

APPENDIX 7
Name Screening Process

Defining Name Screening
Name screening refers to the process of determining whether any of the bank's existing or potential customers are part of any blacklists or regulatory lists.

Under the risk based approach, banks should also put in place procedures for conducting enhanced due diligence in dealings with customers under certain categories, who may be perceived to pose higher risk from Money Laundering and Reputation Risk Perspective (e.g. Politically Exposed Persons (PEPs), persons, entities, located in high risk locations, etc.). Name screening is used to identify such individuals also.

Purpose of Name Screening
RBI Master Circular Guidelines on Know Your Customer (KYC) Norms / Anti Money Laundering (AML) Standards / Combating of Financing of Terrorism (CFT) / Obligations of Banks under PML Act 2002 as part of the Customer Acceptance Policy make it mandatory for banks to conduct necessary checks before opening a new account so as to ensure that the identity of the customer does not match with any person with known criminal background or with banned entities such as terrorist individuals or terrorist organizations.

Further, RBI circular notifying the rules under the Prevention of Money Laundering Act, 2002, dated February 15, 2006 indicated that the banks need to monitor transactions of the customers for the purpose of reporting suspicious transactions to the FIU-IND in the specified format named as 'Suspicious Transaction Report (STR)'. STR specifies one of the categories of suspicious transactions as "Background of the client", which means clients with suspicious background or links with known criminals.

RBI Master Circular also advises Banks that before opening any new account it should be ensured that the name/s of the proposed customer does not appear in the consolidated list of terrorist individuals and entities circulated by RBI. Further Banks should scan all existing accounts to ensure that no account is held by or linked to any of the entities or individuals included in the list.

In order to meet these regulatory objectives, name-screening process is required to be embedded as an essential element of the effective customer due diligence program. Additionally, name screening is also required to be performed at the transaction monitoring or customer review mechanism.

Apart from the regulatory requirements, name screening processes is also a safety mechanism used to guard against reputation, operational or legal risks and to prevent themselves being used as a channel for money laundering or terrorist financing purposes.

Guidelines under UAPA

RBI has also issued specific guidelines under Sec 51 of UAPA, according to which the banks on receipt of the list of individuals and entities subject to UN sanctions (referred to as designated lists) from RBI, should ensure expeditious and effective implementation of the procedure prescribed under the order in regard to freezing / unfreezing of financial assets of the designated individuals/ entities enlisted in the United Nations Security Council Resolutions (UNSCRs) and especially, in regard to funds, financial assets or economic resources or related services held in the form of bank accounts.

In terms of the order, in regard to funds, financial assets or economic resources or related services held in the form of bank accounts, the RBI would forward the designated lists to the banks requiring them to:

i. Maintain updated designated lists in electronic form and run a check on the given parameters on a regular basis to verify whether individuals or entities listed in the schedule to the Order (referred to as designated individuals / entities) are holding any funds, financial assets or economic resources or related services held in the form of bank accounts with them.
ii. In case, the particulars of any of their customers match with the particulars of designated individuals / entities, the banks shall immediately, not later than 24 hours from the time of finding out such customer, inform full particulars of the funds, financial assets or economic resources or related services held in the form of bank accounts, held by such customer on their books to the Joint Secretary (IS.I), Ministry of Home Affairs (by fax, telephone, post and e-mail).
iii. Banks shall also send by post a copy of the communication mentioned in (ii) above to the UAPA Nodal Officer of RBI (by fax, post and e-mail).
iv. Banks shall also send a copy of the communication mentioned in (ii) above to the UAPA Nodal Officer of the state / UT where the account is held as the case may be and to the Financial Intelligence Unit, India (FIU-IND).
v. In case, the match of any of the customers with the particulars of designated individuals / entities is beyond doubt, the banks would prevent designated persons from conducting financial transactions, under intimation to Joint Secretary (IS-I), Ministry of Home Affairs (by fax, telephone, post and e-mail).
vi. Banks shall also file a Suspicious Transaction Report (STR) with FIU-IND covering all transactions in the accounts covered by paragraph (ii) above, carried through or attempted, as per the prescribed format.

Scope of Screening

Name screening process should be performed for the following types of transactions:

i. New customers should be screened at the time of opening of accounts.
ii. Screening of legacy customers, i.e. screening of the bank's existing customers at regular intervals.

iii. Employees are required to be screened as a part of their pre-recruitment process, besides screening the existing employees at regular intervals. Vendors and contractual staff may also be included as a part of the screening.

iv. Counter parties to the cross border transactions (i.e. remitters, beneficiaries, intermediary banks, other intermediaries, etc.) in remittance or trade transactions need to be screened.

v. It also needs to be a part of the enhanced due diligence for high-risk customers or suspicious transactions review.

Negative Lists to use for Name Screening

As per extant RBI guidelines, banks are required to ensure that before opening any new accounts, proposed customers do not appear in the United Nations' List under Security Council Resolutions (mainly 1267 and such others as may be specified by RBI from time to time) and the terrorist lists circulated by RBI. All the UN resolutions published by RBI should be made available at the branches or the relevant processing centers where the account opening and transaction processing takes place.

Other lists issued by enforcement agencies may also be included in the negative lists suite, such as: Interpol Most Wanted, Central Bureau of Investigation, Lists issued under other Resolutions by United Nations, Names notified by RBI / FIU under UAPA, etc.

RBI Master Direction 2016 have specified 2 such lists, details as under:

(a) The **"ISIL (Da'esh) & Al-Qaida Sanctions List",** which includes names of individuals and entities associated with the Al-Qaida. The updated ISIL & Al-Qaida Sanctions List is available at https://www.un.org/sc/suborg/sites/www.un.org.sc.suborg/files/1267.pdf

(b) The "**1988 Sanctions List",** consisting of individuals (Section A of the consolidated list) and entities (Section B) associated with the Taliban which is available at http://www.un.org/sc/ committees/ 1988/list.shtml.

Banks may also follow a risk-based approach and depending upon jurisdictions in which they operate, they may include foreign regulators' / enforcement agencies negative lists for name screening purposes.

Need for Software

In order to perform the name screening function in a timely manner and reduce dependency on manual processes, it is desirable that the name screening function be performed in an automated manner. Extent of automation would depend upon the following factors:

a. risk policy of the institution
b. volume of transactions
c. Turn-around time available for processing of transactions
d. availability of resources (capital, manpower, etc.)

Before establishing the name screening systems, following preparatory steps are required to be in place:

- Determine the category of lists to be included in screening universe.
- Decide about the timing of screening of transactions.
- Establish due diligence procedures and the process of conducting due diligence on the probable matches.
- Establish reporting procedures for confirmed matches.
- Estimate the number of matches at each stage and capacities concerned departments appropriately.

Selection of software and database vendors may involve following steps:

- Due diligence on the service provider
- Evaluation of logic used in name matching
- Check for suitability of workflow and modes of name screening (on-line, batch upload, etc.)
- Compatibility of database formats with the software
- Lists and category of names covered by the vendor
- Check for the frequency of updates being provided by the vendor and integration of the software to apply updates.
- Request a demonstration for usability, presentation and compatibility on formats provided by the Bank.
- Conduct pre-selection user level tests against simulated data to understand the functionality in full and likely impact on the systems.

Components of a Name Screening System & Process

A typical name screening system will comprise of the following elements:

i. Database: The name screening software will scan the names against a database of derogatory lists, which the Bank will decide to use for scrubbing its customers or transactions. The lists may contain the following categories:
   - Regulatory lists
   - Politically Exposed Persons (PEPs) list
   - Other high risk categories' list

The Bank may decide to prepare and maintain its own list or subscribe to the lists provided by external vendors

ii. Application: It refers to the software application which will consist of following components
   - Name matching engine
   - Work flow tools
   - report generation utility for control and audit purposes
   - Front end interface for users and administrator
   - Interface with payment gateway or core banking system, etc.

Logic used for Name Screening

Name screening software's use different logic for searching a match against the negative list. Commonly used logic is fuzzy logic algorithms like Levenshetin or phonetic algorithms like Soundex.

Based upon the degree of closeness to the source name against a probable negative listed person, system allocates a score to the match. Based on the nearness of the match, the algorithm would arrive at the score of the match. Minimum value of the match score is 1 and 100 is the maximum score. A match score of 100 indicates an exact match.

System can be configured to ignore matches below a certain threshold.

Loose or tight matching logic can also be applied to arrive at the right balance of false positives as per Bank's own judgment. The process of fixing the threshold or matching logic should be done after detailed tests and should be controlled at the Principal Officer level.

Dealing with Name Matches

The name screening application provides a list of the probable matches; which contain the source data against the probable names matching in the negative lists with their details (such as name, age / date of birth, address, nationality, offence, listing authority, etc.). A confirmed name match is termed as a 'true positive match' whereas others are termed as 'true negative match'.

A 'false positive match' is the matching of two individuals having different identities. Conversely, 'false negative match' indicates matching of the same individual but adjudged as a false match. 'False positive' requires additional research but the 'false negative' might trigger an investigation, penalties, legal fees, reputation damage, etc.

Due to the negative correlation and probable risks, systems and processes should be designed to eliminate 'false positives' but not at the cost of 'false negatives'.

The following grid can be used to determine a 'true' or 'false' match:

Details	**Criteria**
Date of Birth	Any two details to match with name (listed name or alias)
Place of Birth	
City	
Nationality	
Passport No; SSN; Driving License; etc.	Single match

False positives can be reduced by deploying white-listing functionality. It refers to the process of adding a customer to the accept list against the given negative listed persons. If the same customer is scanned subsequently, the system will not show a match against the previously white-listed profiles against that customer. Any changes in the white-listed customer record or entity listing should trigger the screening process afresh.

Reporting confirmed matches on Regulatory Lists

Once it is concluded that the match found is ‘true’, following actionable are suggested. However, these are indicative steps only and may vary depending upon the Bank’s policy in this regard:

Match against	Suggested Action
Individuals or Entities	• Stop the transaction or account opening activity. (If account is already opened, close the account.)
	• Report
Banks / Country	• As per the Bank’s risk based policy, respective sanction program being adhered to by the Bank and applicable regulations.

In addition to the details of the matched entity, the account opening and customer identification documents also need to be forwarded to the Principal Officer.

Roles and Responsibility of the Principal Officer

The Principal Officer of the bank is the single point contact for reporting of suspicious transactions to FIU-IND and / or RBI. Thus, all internal cases should culminate at Principal Officer’s office for onward reporting by the Bank.

Based on the review of the relevant documents, the Principal Officer shall decide whether the transaction or account or applicant needs to be reported to the appropriate authorities. The reports shall be in the format prescribed by the FIU-IND.

Once the Principal Officer concludes a transaction / customer to be suspicious, he is responsible to report the case in Suspicious Transaction Report (STR) format within 7 working days (after confirmation of suspicion) to the Director, FIU-IND in the STR format.

Identification and reporting of matches against UNSCR / UAPA lists

The following process needs to be followed for matches against individuals / entities listed in UNSCR / UAPA:

i. Confirmed matches identified by the designated operations units shall be escalated to the MLRO.
ii. In case, a confirmed match is identified at a pre-transaction stage, the banks are required to prevent such financial transactions and keep the transaction on hold. Users should immediately inform the MLRO and simultaneously file STR in the prescribed manner on the same day.
iii. The Bank is required to report the transactions with confirmed matches within 24 hours of identification of such matches. Thus, efficiency in reporting by the users is of

utmost importance. The users are recommended to report such incidents over telephone (mobile or landline), besides other means.

iv. The MLRO shall examine the reported transactions and conduct necessary due diligence. On confirmation of the matches, reports shall be submitted to the designated authorities, notified as under:
   - Joint Secretary (IS.I), Ministry of Home Affairs, New Delhi (Fax no. 011-23092569; Telephone no. 011-23092736; e-mail id: jsis@nic.in).
   - UAPA Nodal Officer of RBI, Chief General Manager, Department of Banking Operations And Development, Central Office, Reserve Bank of India, Anti Money Laundering Division Central Office Building, 13th Floor, Shahid Bhagat Singh Marg, Fort, Mumbai 400 001 and also by fax at 022 022701239
   - UAPA nodal officer of the state / UT where the account is held.
   - Financial Intelligence Unit, New Delhi.

MLRO shall be designated as the single point of contact for reporting or correspondence with the regulatory agencies in this regard. Any orders / notices / letters under UAPA (including freezing / unfreezing orders under UAPA), which may be received by the branches / field functionaries directly, should be brought to the notice of MLRO immediately. Any freezing / unfreeze orders should be authorised by MLRO, before giving effect to them.

Guidelines to avoid Tipping Off

RBI guidelines require that Banks and their employees should keep the fact of furnishing of STR strictly confidential, as required under PML Rules.

PMLA mandates that the STR related information should not be revealed to the customers to avoid prejudicing or affecting an investigation, which may be initiated by the law enforcement agencies.

Thus, it is essential that all of the aforesaid activities of reporting of the confirmed matches are kept strictly confidential.

Records of all such reports and investigations should be kept securely and separately so as not to mix with general transactional data. Custody of such records may be entrusted with staff of sufficient seniority or responsibility.

Customers should not be informed of any such reports in any circumstances to avoid TIPPING OFF' offence.

Due Diligence Procedures for High Risk Category Matches

While the process stated in point no. 1 to 10 is followed for screening against regulatory lists. The same process can be observed for identification of High Risk Customers (like Politically Exposed Persons (PEPs) matches, Fraudsters, etc.).

As per extant guidelines, PEPs are defined as the individuals who are or have been entrusted prominent public functions in a foreign country, e.g. Heads of States or of Governments, senior politicians, senior government / judicial / military officers, senior executives of state owned corporations, important political party officials, etc. PEPs' definition includes the family members or close relatives of the individuals identified as above.

The regulatory guidelines mandate that the Banks should classify such customers in higher risk category. Higher level of scrutiny or enhanced due diligence (EDD) should be conducted while enrolling such customers and accounts should be monitored closely for transaction monitoring purposes and review of KYC at regular intervals. The decision to open PEPs' or any other high- risk account should be taken at a senior level, preferably in concurrence with Principal Officer.

Suggested EDD measures for PEP customers include the following:

- checking for any adverse information on such individuals or entities available in public domain,
- checking for sources of funds proposed to be routed / invested through the bank,
- tighter threshold for monitoring of transactions through these accounts, frequent review of relationships and accounts for keeping KYC information up-to-date.

(Source: IBA - Know your Customer (KYC) Norms & and Anti-Money Laundering Measures (AML) Guidance Notes for Banks - July 2020)

APPENDIX 8
KYC Documents for Eligible FPIs under PIS

		FPI Type		
Document Type		**Category I**	**Category II**	**Category III**
Entity Level	Constitutive Documents (Memorandum and Articles of Association, Certificate of Incorporation etc.)	Mandatory	Mandatory	Mandatory
	Proof of Address	Mandatory (Power of Attorney {PoA} mentioning the address is acceptable as address proof)	Mandatory (Power of Attorney mentioning the address is acceptable as address proof)	Mandatory other than Power of Attorney
	PAN	Mandatory	Mandatory	Mandatory
	Financial Data	Exempted *	Exempted *	Mandatory
	BI Registration Certificate	Mandatory	Mandatory	Mandatory
	Board Resolution @@	Exempted *	Mandatory	Mandatory
Senior Management (Whole Time Directors/ Partners/ Trustees/etc.)	List	Mandatory	Mandatory	Mandatory
	Proof of Identity	Exempted *	Exempted *	Entity declares* on letter head full name, nationality, date of birth or submits photo identity proof
	Proof of Address	Exempted *	Exempted *	Declaration on Letter Head *
	Photographs	Exempted	Exempted	Exempted *
	List and Signatures	Mandatory – list of Global Custodian signatories can be given in case of PoA to Global	Mandatory – list of Global Custodian signatories can be given in case of	Mandatory

Authorized Signatories		Custodian	PoA to Global Custodian	
	Proof of Identity	Exempted *	Exempted *	Mandatory
	Proof of Address	Exempted *	Exempted *	Declaration on Letter Head *
	Photographs	Exempted	Exempted	Exempted *
Ultimate Beneficial Owner (UBO)	List	Exempted *	Mandatory (can declare "no UBO over 25%")	Mandatory
	Proof of Identity	Exempted *	Exempted *	Mandatory
	Proof of Address	Exempted *	Exempted *	Declaration on Letter Head *
	Photographs	Exempted	Exempted	Exempted *

* Not required while opening the bank account. However, FPIs concerned may submit an undertaking that upon demand by Regulators/Law Enforcement Agencies the relative document/s would be submitted to the bank.

@@ FPIs from certain jurisdictions where the practice of passing Board Resolution for the purpose of opening bank accounts etc. is not in vogue, may submit 'Power of Attorney granted to Global Custodian/Local Custodian, in lieu of Board Resolution

Category	**Eligible Foreign Investors**
I.	Government and Government related foreign investors such as Foreign Central Banks, Governmental Agencies, Sovereign Wealth Funds, International/Multilateral Organizations/Agencies.
II.	a) Appropriately regulated broad based funds such as Mutual Funds, Investment Trusts, Insurance/Reinsurance Companies, Other Broad Based Funds etc. b) Appropriately regulated entities such as Banks, Asset Management Companies, Investment Managers/ Advisors, Portfolio Managers etc. c) Broad based funds whose investment manager is appropriately regulated. d) University Funds and Pension Funds. e) University related Endowments already registered with SEBI as FII/Sub Account.
III.	All other eligible foreign investors investing in India under PIS route not eligible under Category I and II such as Endowments, Charitable Societies/Trust, Foundations, Corporate Bodies, Trusts, Individuals, Family Offices, etc.

(Source: RBI Master Direction – Know Your Customer 2016)

APPENDIX 9
Wire Transfers – FATF SR VII Compliance

1. Banks use wire transfers as an expeditious method for transferring funds between bank accounts. The wire transfer could be domestic or cross border. The beneficiary and originator could also be the same person.
2. Domestic wire transfer means any wire transfer where the originator and beneficiary are located within the same country. A transaction involving a chain of wire transfers that take place within the borders of a single country is domestic wire transfer even though the system used for effecting the transaction is located outside the country.
3. Cross-border transfer means any wire transfer where the originator and the beneficiary bank or financial institution are located in different countries. It may include any chain of wire transfers that has at least one cross-border element.
4. Wire transfers, because of its capability of transferring funds instantaneously between geographies, have become the preferred mode of transfer of funds across the globe. In addition, because of the lesser human intervention in the transfer and hence lesser scrutiny, it also becomes a preferred route for criminals and terrorists to transfer their funds. To address this, FATF in its Special Recommendations to combat terrorist financing made recommendations of some minimum requirements for the wire transfers. RBI vide its circular dated 13 April 2007 implemented the recommendations in the banks in India.
5. Requirements for Domestic Transactions
    a. Information accompanying all domestic wire transfers of Rs.50000/-(Rupees Fifty Thousand) and above must include complete originator information i.e. name, address and account number etc., unless full originator information can be made available to the beneficiary bank by other means.
    b. If a bank has reason to believe that a customer is intentionally structuring wire transfer to below Rs.50000/- (Rupees Fifty Thousand) to several beneficiaries in order to avoid reporting or monitoring, the bank must insist on complete customer identification before effecting the transfer. In case of no cooperation from the customer, efforts should be made to establish his identity and Suspicious Transaction Report (STR) should be made to FIU-IND.
    c. When a credit or debit card is used to effect money transfer, necessary information as (a) above should be included in the message.
6. Requirements for Cross-border Transactions
    a. All cross-border wire transfers must be accompanied by accurate and meaningful originator information.
    b. Information accompanying cross-border wire transfers must contain the name and address of the originator and where an account exists, the number of that account. In the absence of an account, a unique reference number, as prevalent in the country concerned, must be included.
    c. Where several individual transfers from a single originator are bundled in a batch file for transmission to beneficiaries in another country, they may be exempted

from including full originator information, provided they include the originator's account number or unique reference number as at (b) above.

7. Inter-bank transfers and settlements where both the originator and beneficiary are banks or financial institutions are exempted from the above requirements.

8. Role of Ordering, Intermediary and Beneficiary Banks

i. Ordering Bank

An ordering bank is the one that originates a wire transfer as per the order placed by its customer. The ordering bank must ensure that qualifying wire transfers contain complete originator information. The bank must also verify and preserve the information at least for a period of ten years.

ii. Intermediary Bank

For both cross-border and domestic wire transfers, a bank processing an intermediary element of a chain of wire transfers must ensure that all originator information accompanying a wire transfer is retained with the transfer. Where technical limitations prevent full originator information accompanying a cross-border wire transfer from remaining with a related domestic wire transfer, a record must be kept at least for ten years (as required under Prevention of Money Laundering Act, 2002) by the receiving intermediary bank of all the information received from the ordering bank.

iii. Beneficiary Bank

A beneficiary bank should have effective risk-based procedures in place to identify wire transfers lacking complete originator information. The lack of complete originator information may be considered as a factor in assessing whether a wire transfer or related transactions are suspicious and whether they should be reported to the Financial Intelligence Unit-India. The beneficiary bank should also take up the matter with the ordering bank if a transaction is not accompanied by detailed information of the fund remitter. If the ordering bank fails to furnish information on the remitter, the beneficiary bank should consider restricting or even terminating its business relationship with the ordering bank.

9. While the information as required above will enable banks to furnish the details to authorities in an expeditious manner for investigation or prosecution of money laundering or terrorist financing cases, the beneficiary banks also should analyse the data to find out any unusual / suspicious activities which they may consider reporting to the FIU-IND India.

(Source: IBA - Know your Customer (KYC) Norms & and Anti-Money Laundering Measures (AML) Guidance Notes for Banks – July 2020)

CHAPTER 12

OTHER MODES OF CUSTOMER IDENTIFICATION, CKYCR & MAINTAINING RECORDS

STRUCTURE

12.1 Non-Face-To-Face Customers
12.2 e-KYC–Aadhaar Enabled Verification
12.3 Online Customer On-boarding Modalities
12.4 Functions of Central KYC Registry (CKYCR)
12.5 Regulatory Co-Ordination for AML/CFT/KYC
12.6 Maintaining Records
12.7 Let us Sum up
12.8 Check Your Progress
12.9 Answer to 'Check Your Progress'

OBJECTIVES

Knowing about electronic modes of KYC/ on-boarding of customers. Knowing about the procedure related to Centralised KYC Registry (CKYCR). Knowing about legal and regulatory requirements for maintain records pertaining to customers and transactions.

12.1 NON-FACE-TO-FACE CUSTOMERS

RBI KYC Directions define non-face-to-face customers as follows:
"Non-face-to-face customers" means customers who open accounts without visiting the branch/offices of the REs or meeting the officials of REs."

Wherever accounts are opened for customers without their need to visit the bank branch certain specific measures need to be taken in order to mitigate higher risk. These would include the following:

(i) Certification of all the documents to be insisted
(ii) Additional documents, if necessary to be obtained
(iii) First payment, if considered necessary, to be through the customer's account with another bank (adhering to similar KYC standards)
(iv) For cross-border customers, certification of documents/introduction by a third party, which is regulated and supervised entity with adequate KYC systems in place.

12.2 e-KYC–AADHAAR ENABLED VERIFICATION

In addition to the abovementioned documents e-KYC service of Unique Identification Authority of India (UIDAI) is also acceptable.

- *Acceptability*: Under PML Rule 9, e-KYC service of Unique Identification Authority of India (UIDAI) is a valid process for KYC verification, and the customer information and photographs made available from this, is treated as an 'Officially Valid Document'.
- *Information Available*: The UIDAI transfers electronically to the bank/business correspondents'/ business facilitators, following data of the individual:
  - Name
  - Age
  - Gender
  - Photograph
- *Requirement*: Through biometric authentication, the individual user has to authorize UIDAI to release her/his information to the banks/business correspondents'/business facilitators.
- *Alternative Modes*: Following two alternatives are also available for verification through UIDAI portal.
  - Confirming the identity and address through the authentication service of UIDAI (where a copy of e-Aadhaar Letter downloaded earlier is provided by the customer)
  - Printing the e-Aadhaar letter directly from the UIDAI portal (possible even if only Aadhaar number is available).

12.2.1 e-KYC: Salient Procedural Points

Some important points to be followed while adopting e-KYC process in respect of the customer who submits Aadhaar Card or Proof of possession of Aadhaar for on-boarding are as follows:

a) On receipt of the Aadhaar number with the explicit consent of the customer, e-KYC authentication (biometric or OTP based) or Yes/No authentication will be done,

b) One Time Pin (OTP) option may also be provided for on-boarding of customers, subject to:

   i. Specific consent from the customer for authentication through OTP,

   ii. Yes/No authentication shall not be carried out while establishing an account based relationship,

   iii. In case of existing accounts where Yes/No authentication is carried out, Branch shall ensure to carry out biometric or OTP based e-KYC authentication within a period of **six months** after carrying out yes/no authentication,

   iv. Yes/No authentication in respect of beneficial owners of a legal entity shall suffice in respect of existing accounts or while establishing an account based relationship,

   v. Biometric based e-KYC authentication is permitted by bank official/business correspondents/business facilitators,

   vi. Branches will inform the customer about the above provisions while opening the account.

12.2.2 Accounts Opened Using OTP based e-KYC

Accounts opened for non-face-to-face customers using this mode are subject to the following conditions:

(i) *Customer Consent*: Specific consent from the customer is required for authentication through OTP.

(ii) *Balance Ceiling*: For all the deposit accounts total balance should not exceed ₹1lakh. On crossing the limit, the operations to be stopped till CDD is completed.

(iii) *Credits Ceiling*: Total credits in a financial year in all the deposit accounts together, should not exceed Rs.2 lakh.

(iv) *Loans:* Only term loans can be sanctioned, up to an aggregate amount of ₹60,000 in a year.

(v) *Tenor*: Such accounts (deposit or borrowal) are allowed up to one year only, unless identification as per laid down norms is carried out. If Aadhaar details are used for this purpose, the entire process including fresh OTP authentication is to be followed

(vi) *No CDD*: If the CDD procedure is not completed the deposit accounts shall be closed immediately. For borrowal accounts no further debits should be allowed.

(vii) *Declaration*: A declaration shall be obtained that no other account has been opened nor will be opened using OTP based KYC in non-face-to-face mode with any other RE.

(viii) *CKYCR Intimation*: While uploading KYC information to CKYCR, REs shall clearly indicate that such accounts are opened using OTP based e-KYC and other

REEs shall not open accounts based on the KYC information of such accounts.

(ix) *Monitoring System*: REs shall have strict monitoring procedures including systems to generate alerts in case of any non-compliance/violation, to ensure compliance with the above mentioned conditions.

12.2.3 Masking of Aadhaar Number

If the proof of possession of Aadhaar is collected as an OVD and the customer is not seeking Government benefits, Banks should ensure that such customer redacts or blacks out his Aadhaar number through appropriate means where the authentication of Aadhaar number is not required or undertaken.

12.3 ONLINE CUSTOMER ONBOARDING MODALITIES

To facilitate customer onboarding using internet facility two modalities have been framed – one, under PMLR viz. Digital KYC, and the other under KYC Master Directions, viz. Video-CIP. Let us look at the salient features of both these processes.

12.3.1 Digital KYC Process

The highlights of the Digital KYC Process are summarised as below:

(i) The reporting entities shall make available at customer touch points an application for digital KYC process.

(ii) The access to the application will be through a login-id and password or Live OTP or Time OTP.

(iii) The customer will visit the RE's touch point or an official of RE will visit the customer's location.

(iv) Live photograph of the customer is taken by the authorized officer and it is embedded in the Customer Application Form.

(v) The photograph will be water marked and stamped with CAF number, GPS coordinates, authorized official's name, unique employee Code (assigned by Reporting Entities) and Date (DD:MM:YYYY) and time stamp (HH:MM:SS).

(vi) Live photograph of the original officially valid document or proof of possession of Aadhaar where offline verification cannot be carried out (placed horizontally), shall be captured and watermarked.

(vii) All the entries in the Customer Application Form (CAF) shall be filled as per the documents and information furnished by the client.

(viii) This information is authenticated by the customer through an OTP for confirming message that is treated as a signature on the CAF.

For detailed procedure please refer to RBI Master Direction - Know Your Customer (KYC) Direction, 2016.

12.3.2 Video-Customer Identification Process (V-CIP)

KYC Directions contain procedure for Video-Customer Identification Process that is defined as follows:

"Video based Customer Identification Process (V-CIP)": an alternate method of customer identification with facial recognition and customer due diligence by an

authorised official of the RE by undertaking seamless, secure, live, informed-consent based audio-visual interaction with the customer to obtain identification information required for CDD purpose, and to ascertain the veracity of the information furnished by the customer through independent verification and maintaining audit trail of the process. Such processes complying with prescribed standards and procedures shall be treated on par with face-to-face CIP for the purpose of this Master Direction."

12.3.2.1 Permitted Situations

V-CIP can be adopted for the following situations:

i. *CDD of New Customer*: For on-boarding for individual customers, proprietor in case of proprietorship firm, authorised signatories and Beneficial Owners (BOs) in case of Legal Entity (LE) customers. For a proprietorship firm, the equivalent e-document of the activity proofs with respect to the proprietorship firm should also be obtained, besides undertaking CDD of the proprietor.

ii. *Conversion of Existing Accounts*: Accounts opened in non-face to face mode using Aadhaar OTP based e-KYC authentication may be converted to normal face-to-face account through this procedure.

iii. *Updation/ Periodic Updation of KYC*: For eligible customers periodic updation can be done through this mode.

12.3.2.2 V-CIP Procedure

The highlights of the V-CIP procedure are as follows:

(i) V-CIP process shall be operated only by officials of the RE specially trained for this purpose.

(ii) The sequence and/or type of questions, during video interactions shall be varied in order to establish that the interactions are real-time.

(iii) The authorised official of the RE performing the V-CIP shall record audio & video as well as capture photograph of the customer present for identification and obtain the identification information using any one of the following:

(iv) OTP based Aadhaar e-KYC authentication

(v) Offline Verification of Aadhaar for identification

(vi) KYC records downloaded from CKYCR using the KYC identifier of the customer

(vii) Equivalent e-document of Officially Valid Documents (OVDs) including documents issued through Digilocker

(viii) RE shall ensure to redact or blackout the Aadhaar number.

(ix) Offline verification of Aadhaar using XML file or Aadhaar Secure QR Code, should be carried out within 3 days of their generation.

(x) The economic and financial profile/information submitted by the customer should be confirmed from The customer undertaking the V-CIP in a suitable manner.

(xi) A clear image of PAN card is captured during the process, except in cases where e-PAN is provided

(xii) Use of printed copy of equivalent e-document including e-PAN is not valid for the V-CIP.

(xiii) RE shall ensure that photograph of the customer in the Aadhaar/OVD and PAN/e-PAN matches with the customer undertaking the V-CIP.

(xiv) Assisted V-CIP shall be permissible when banks take help of Banking Correspondents (BCs) facilitating the process only at the customer end.

(xv) All accounts opened through V-CIP shall be made operational only after being subject to concurrent audit.

(xvi) The entire data and recordings of V-CIP shall be stored in a system / systems located in India.

For details regarding V-CIP procedure please refer to RBI Mater Direction – Know Your Customer Direction 2016.

12.4 FUNCTIONS OF CENTRAL KYC REGISTRY (CKYCR)

Its main functions are to receive, store, safeguard and retrieve electronic copies of KYC records obtained by the reporting entities from their clients, in accordance with PML Rules. It is responsible to make such records available online to the reporting entities registered with it or the FIU.

12.4.1 Key Operational Aspects

The basic operational aspects of furnishing records to CKYCR and obtain records from it are as follows:

i. Reporting entity (RE) will file the electronic copy of the client's KYC records with the CKYCR within ten days after the commencement of an account-based relationship.

ii. RE shall maintain the physical copy of the records of identity of its clients.

iii. CKYCR will de-duplicate the data received and issue a KYC Identifier for each client to the RE.

iv. RE shall communicate the KYC Identifier in writing to their client.

v. Know Your Client (KYC) Identifier will be the unique number or code assigned to a client by the CKYCR.

vi. Where for the purpose of KYC a client submits a KYC Identifier to a RE, it will retrieve the KYC records online from the CKYCR. It will not ask a client to submit the same KYC records or information or any other additional identification documents or details.

vii. In following situations, the RE may ask for further information:

(a) There is a change in the information of the client as existing in the records of Central KYC Records Registry;

(b) The current address of the client is required to be verified;

(c) The RE considers it necessary in order to verify the identity or address of the client, or to perform enhanced due diligence or to build an appropriate risk profile of the client.

viii. RE shall furnish to CKYCR additional or updated information obtained from a client; and CKYCR will inform the same electronically to all REs who have dealt with the concerned client.

ix. The RE which performed the last KYC verification or sent updated information in respect of a client shall be responsible for verifying the authenticity of the identity or address of the client.

x. RE cannot use the KYC records received from CKYCR for any purpose other than verifying the identity or address of the client, nor transfer the records/information to any third party; unless authorised to do so by the client, the regulator or the FIU.

For further details on the CDD procedure and sharing of information with CKYCR please refer to RBI Mater Direction – Know Your Customer Direction 2016.

12.4.2 *Benefits of CKYCR System*

The major benefits of CKYCR system are as follows:

i. Customers will not be required to provide KYC documents and other KYC related data to various financial sector entities repeatedly.
ii. This will also help in updation of KYC only once.
iii. It will save the efforts and resources currently deployed separately by the individual players for the KYC of the same customer, due to sharing of the information among all the players.
iv. The information of an individual or entity will be uniform across the entire financial sector, thereby mitigating to certain extent the risk of misrepresentation.
v. Central deduping of the information for every client can also help in detecting cases of multiple entities set up by same set of individuals, and with appropriate due diligence in weeding out such clients from the financial sector.

12.5 REGULATORY CO-ORDINATION FOR AML/ CFT/ KYC

The provisions of PML Act and PML Rules are applicable to all the financial sector players. The regulatory guidelines in different sectors, however, differ partly due to the nature of activities, and partly because of different approaches of the regulators. For better effectiveness of AML/CFT measures some co-ordination among various regulators is called for.

With operationalization of common KYC Registry there will be uniformity in KYC standards for the financial sector. It can also serve as a UCIC for a person across the financial sector and help in more effective linkage of the transactions carried out by a person in different banks, as also other financial institutions.

In case of Foreign Institutional Investors (FII), RBI and SEBI have jointly worked out a modality for sharing of KYC documents by the custodian that does the KYC and due diligence on the FII, with the banks with which they open their accounts. There is no need for the FII to provide its particulars to multiple entities. This is convenient for the customers; also it ensures uniformity of approach.

Another area that calls for better co-ordination among various sectors is sharing of red flag indicators among them. Linking of indicators for transactions in bank accounts with those in other sector say insurance or mutual funds could help in better detection of suspicious transaction.

12.6 MAINTAINING RECORDS

12.6.1 Types of Records

Sec. 12 of the PMLA prescribes that banks are required to maintain the records of transactions and other information connected with the customers. These records in fact serve as an evidence where money laundering case is filed against any person. Rules 3 and 4 of PML Rules specify the records that need to be maintained. The records to be maintained under these provisions are of the following types:

(i) Records of transactions: The records of all transactions are required to be maintained so that the individual transactions can be reconstructed. These should also include the records of those trans- actions that are reported to FIU-Ind viz. Cash transactions, Cross-border transactions, Counterfeit Currency transactions, Receipts of Non-profit entities, and Suspicious transactions. RBI has further amplified that the background including all documents/office records/memorandums pertaining to suspicious transactions and purpose thereof should be examined, and the findings at branch as well as Principal Officer level should be properly recorded. All transaction records must contain the information as laid down by the regulator, including the following elements –
  - Nature of transaction
  - Amount and currency of the transaction
  - Date on which transaction was conducted
  - Parties to the transaction

(ii) Identity Documents: PMLA prescribes that the records of documents that evidence identity of the customers and the beneficial owners of the customers must be maintained by banks. RBI has also advised that address proofs must also be retained.

  Other Documents: PMLA also prescribes that records of other documents pertaining to the customers viz. Business Correspondence, and Account files should also be maintained by banks.

Hence, banks need to be particular in maintaining all pertinent records pertaining to any customer, irrespective of the value of the transaction; or the risk category of the customer or the transaction. It may be noted that the business correspondence would also include the emails exchanged with clients for any transaction. Besides, it will also include the correspondence, if any, with any of the law enforcing agencies pertaining to a customer. The reports filed with the FIU are also covered in the record retention requirement.

12.6.2 Period of Retention

The period prescribed for holding the record under PMLA is five years. However, the date from which is reckoned depends on the type of record:

(i) Transaction records: To be retained for 5 years from the date of transaction.

(ii) Identity and other KYC documents: To be retained for 5 years from the date of cessation of relationship or closure of the account, whichever is later.

(iii) Other Documents/Information: To be retained for 5 years from the date of cessation of relationship or closure of the account, whichever is later.

It is important to determine the date from which the retention period commences, based on the stipulations indicated above. In those cases, where any legal/regulatory process is likely to take place or has already commenced, the records need to be held till such time as these proceedings do not reach a final conclusion. Typically, where court cases have been filed the period would commence from the date of judgment.

12.6.3 Manner of Maintaining Information

Rule 5 of PML Rules specifies that the manner of maintaining information will be as prescribed by the Regulator this will include the form, the manner and the intervals of maintaining the information. RBI has advised banks to maintain the records in a manner that permits their easy and quick retrieval. RBI has permitted retaining the records in hard or soft format.

12.7 LET US SUM UP

This chapter deals with online facilities for customer on-boarding, its modalities for verification of OVDs, obtention of Aadhaar and compliances with UIDAI Act, Digital KYC, Video based a/c opening, accounts of non-face-to-face customers. The processes and procedures involved in these products while servicing to the customers. The provisions of maintaining records have also been discussed.

12.8 CHECK YOUR PROGRESS

1. Which OVD is mandatory for e-KYC procedure?
   (a) PAN – which can be verified online from Income Tax website
   (b) Driving Licence – which can be verified from website
   (c) Voter ID – which can be verified from Election Commission website
   (d) Aadhaar Card – which can be verified from UIDAI site

2. Which one of the following is true in respect of CKYCR?
   (a) Customer will not be required to submit document to other FIs repeatedly.
   (b) KYC updation will not be required periodically.
   (c) KYC document will be submitted to each FI only once.
   (d) Customer can change his address with other FIs as per his current location.

12.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (d); **2.** (a)

CHAPTER 13

ORGANISATIONAL ROLES AND RESPONSIBILTIES

STRUCTURE

OBJECTIVES

Knowing about the roles and responsibilities of various functionaries/functional units for implementation of KYC/AML regulations in the Bank. To know about the set-up required for handling specifically KYC/ AML related functions.

13.1 ROLES & RESPONSIBILITIES

13.1.1 Role of the Board and Senior Management

The Board of Directors and the senior management of the Bank have the responsibility to ensure that the Bank's control processes and procedures are appropriately designed and implemented and are effectively operated upon to reduce the risk of the Bank being used in connection with money laundering or terrorist financing.

The Board of Directors should ensure that an effective AML / CFT programme at a group level is in place by establishing procedures and ensuring their effective implementation. It should cover proper management oversight, systems and controls, segregation of duties and other related matters.

The responsibilities of the Board of Directors in respect of the Bank's obligations under PMLA and related regulatory guidelines are mainly as follows:

- The bank has a KYC Policy that is aligned with the legal and regulatory stipulations and is periodically reviewed (minimum annually).
- There is a Customer Acceptance Policy being part of KYC Policy in line with the regulatory requirements.
- There is an effective AML/CFT process and set-up in the bank covering various aspects along with allocation of responsibilities
- The bank has appropriate policy for risk categorization of customer being part of KYC Policy using risk based approach to address management and mitigation of various AML/CFT risks.
- Independent evaluation by the compliance function of Bank/FI's policies and procedures, including legal and regulatory requirements.
- Concurrent audit to verify the compliance with KYC / AML policies and procedures.
- Putting up consolidated note on such audits and compliance to the Audit Committee at quarterly intervals.
- To appoint the Designated Director and Principal Officer in terms of PMLA.

13.1.2 Responsibilities of the Senior Management

While under PML Rules, the responsibility 'to ensure overall compliance with the obligations' is vested with the 'Designated Director', the other members of the Senior Management also carry the responsibility for effective compliance with the KYC/AML regulations/legal requirements.

13.2 RESPONSIBILITIES OF THE DESIGNATED DIRECTOR

Rule 2(ba) of PML Rules defines 'Designated Director' as the person vested with the responsibility 'to ensure overall compliance with the obligations' under PMLA and PML Rules. The criteria for a person to be nominated as 'Designated Director' of various types of entities are given in the Table below.

Table 13.1 Designated Director Criteria

Constitution of the Entity	Criteria
Company	Managing Director or a whole-time Director (authorized by the Board)
Partnership Firm	Managing Partner
Proprietorship Firm	Proprietor
Trust	Managing Trustee
An Association or body of individuals	An individual who manages the affairs of the entity

The Designated Director has the responsibility to see that the bank fulfils the obligations as specified in the PMLA. In view of this the responsibilities of the Designated Director would cover the following aspects:

- The bank has a KYC Policy that is regularly updated, and the responsibility for this is clearly assigned to a designated functionary (usually the Principal Officer).
- The products and processes of the bank are KYC compliant, and the business plans of the bank are based on the potential for legally acceptable business.
- The Bank has a Principal Officer.
- There is appropriate set-up for generation and submission of reports to FIU-India, and these reports cover all transactions including those occurring outside the core banking system.
- The Bank's sales/marketing units and operations units follow the KYC and customer due diligence requirements.
- There are control and monitoring units to ensure that the KYC/AML requirements are being followed.
- The bank follows the risk based approach, and has an appropriate system for risk categorization of its customer, products and processes.
- The Compliance and Audit functions of the bank monitor compliance with the KYC/AML aspects.
- The bank is geared up to operationalize any changes in the regulatory/legal stipulations.
- The bank has adequate arrangements for maintaining records of the transaction data and documents related to KYC/AML for the stipulated period.
- There are adequate arrangements for training and sensitizing of various functionaries for their respective responsibilities for KYC/AML aspects.

13.3 RESPONSIBILITIES OF THE PRINCIPAL OFFICER

Rule 7(2) of the PML Rules specifies that the Principal Officer is responsible for submission of the prescribed reports to the FIU-IND within the specified timelines. Besides, RBI expects that the Principal Officer is the nodal point in the Bank for overseeing that the regulatory guidelines are operationalised in the bank. In view of this the responsibilities of the Principal Officer will cover the following aspects:

- To formulate the KYC Policy for the bank and to keep it updated.
- To co-ordinate with various verticals/functional units for the following:
  - They have KYC/AML operations Manual that cover their respective processes.
  - The Product papers contain ML risk assessment of the product.
  - The SOPs (Standard Operating Procedures) contain the modality and ownership for transaction monitoring for ML reporting purposes.
  - Appropriate due diligence processes are adopted in various business lines.
  - Proper customer risk categorisation models are adopted in various business lines.
- To put in place proper arrangements (covering organization set-up, software applications, etc.) for submission of various reports to FIU-Ind.
- To ensure that all transactions get covered for FIU reports, irrespective of the applications in which they are recorded.
- To ensure appropriate arrangements for detection of suspicious transactions, and adopting various red flag indicators recommended by IBA Working Group and those determined based on own experience.
- To take various initiatives for training and sensitizing of staff in KYC/AML aspects.
- To keep the Designated Director apprised of the significant matters pertaining to implementation of various legal/regulatory aspects, gaps if any, measures being taken for covering these.
- To put up periodical reports to the Board/Audit Committee of the Board.
- The reporting formats and comprehensive reporting format guide, prescribed/ released by FIU-IND and Report Generation Utility and Report Validation Utility developed to assist reporting entities in the preparation of prescribed reports shall be taken note of.
- The editable electronic utilities to file electronic Cash Transaction Reports (CTR) / Suspicious Transaction Reports (STR) which FIU-IND has placed on its website shall be made use of by REs which are yet to install/adopt suitable technological tools for extracting CTR/STR from their live transaction data. The Principal Officers of those REs, whose all branches are not fully computerized, shall have suitable arrangement to cull out the transaction details from branches which are not yet computerized and to feed the data into an electronic file with the help of the editable electronic utilities of CTR/STR as have been made available by FIU-IND on its website http://fiuindia.gov.in.
- REs shall not put any restriction on operations in the accounts where an STR has been filed. REs shall keep the fact of furnishing of STR strictly confidential. It shall be ensured that there is no tipping off to the customer at any level.

- REs must ensure to use Robust software, throwing alerts when the transactions are inconsistent with risk categorization and updated profile of the customers shall be put in to use as a part of effective identification and reporting of suspicious transactions.

13.4 RESPONSIBILITIES OF THE AML MONITORING UNITS

For submission of various reports to FIU-IND, banks need to put in place proper organization set-up for transaction monitoring and processing. The structure and size of the set-up for this purpose will depend on various factors. Following are some of the major factors:

- Range of business lines, and product lines
- Size of total business, and composition of business-mix
- Size and geographical spread of branch net-work, like
- Overall organisation structure
- Business arrangements with other financial sector organisations (like Mutual funds, insurance companies, stock brokers, etc.)
- Business agency arrangements (like direct sales agents, recovery agents arrangements, business correspondents, etc.)

There can be various options for this purpose ranging from one single AML Monitoring Unit handling the functions for the entire bank to having a separate AML Monitoring Unit for each of the business lines, especially for the purposes of handling STR related activities. Where the bank's organization structure is so designed that there is segregation of the operations and business responsibilities, the AML units, must be in the operations verticals and not the business verticals. These AML units, even though they are located in different verticals, should have functional reporting to the Principal Officer.

13.4.1 Reports Other Than STRs

The reports other than STRs (i.e. CTR, CCR, CBWTR, and NTR) are to be submitted on monthly basis, including all transactions to be reported in a single report. Hence, these reports will be compiled and submitted to FIU-IND by one of the AML Units. Typically, CTR and NTR could be handled by the AML Unit i.e. handling monitoring of the account based transactions. CCR compilation and submission could also be the responsibility of this AML Unit. Alternatively, CCR compilation and submission could be handled by the Forged Notes Vigilance Cell set up at the Head Office. As regards, CBWTR, this could be the responsibility of the AML Unit monitoring the cross-border remittances.

13.4.2 STRs Submission

a) Alert Based STRs

The process of submission of STRs is intricate, comprises several stages, and requires involvement of several functional units. Typical stages involved in examination of potential suspicious transactions based on alert generation and the units responsible for same are shown in Fig. 5.1 below.

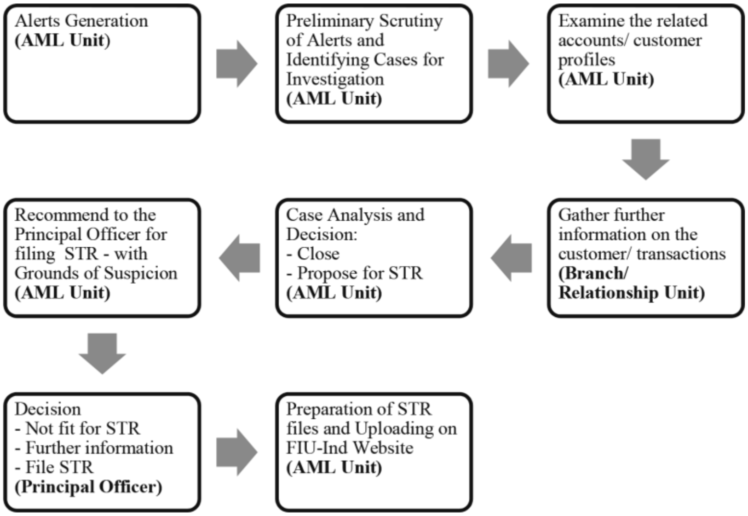


Fig. 13.1 Alert Based STR: Stages for filing of STR

As discussed earlier, for generation of alerts based on red flag indicators is done through a software application. The red flag indicators for various types of transactions or products will be different. Hence, the processing STRs for different types of transactions would be handled by respective AML Units. Irrespective of which AML Unit examines the STR case, it is important to examine all the products/ services availed by the customer, the transactions done by/for the customer and include information on all these in the STR.

b) Review of Red Flag Indicators

Based on the experience gathered in examination of alerts, the red flag indicators in the alert generation software need to be modified regularly by the AML Units. This helps in reducing the proportion of false positives in the alerts.

c) White listing of Accounts

As we have seen, for effective handling of alerts, white listing of accounts is adopted. This is part of the functions of the AML Units.

d) Branch/Functional Unit Initiated STRs

There are several red flag indicators, especially those related to customer behavior, or documents related that are noticed by the branches, or other functional units like customer relationship unit or processing centres. In such cases, these units will be raising the case to the AML units with the information they have about the customer and the transaction, including the grounds arousing their suspicion. The AML units will examine the case for filing of STR.

13.5 RESPONSIBILITIES OF THE TRANSACTIONS PROCESSING UNITS

Most medium and large sized banks have centralized bulk of the operations activities, for example opening of a savings bank account; issue of LCs, etc. These units while executing the transactions or other tasks need to take care of the following aspects:

- Check that KYC related documents and information as required are accompanying.
- For transactions especially cross-border transactions, check that other required documents are accompanying.
- Verify documents carefully, for any features that could be unusual or would reveal any discrepancy.
- Communicate the details of the transactions and the customer to the AML Units for those cases where any suspicions arise.
- Account opening processing centres apart from checking KYC documents, will also ensure customer risk categorization.
- Similarly, operations processing units will need to undertake review of customer risk categorization, and updation of KYC.

13.6 RESPONSIBILITIES OF THE BRANCHES/ FIELD UNITS

The branches and/or other units sourcing customers, and maintaining customer relations have the following responsibilities:

- To carry out appropriate customer due diligence and collect required KYC documents/information.
- To maintain a watch on the account operations and transactions conducted through the branch.
- To be alert of the customer behavior
- To watch out for any market report on the customers
- To report to the AML Unit particulars of any suspicious transaction
- To report to the AML Unit any attempted transaction instance, including cases of mere inquiries regarding handling of large cash transactions with the purpose of infusing them in the formal financial sector.
- To investigate diligently the alerts received from AML Unit in connection with likely suspicious transactions, and provide the information gathered on these along with own judgment about the genuineness of the transaction to the AML Unit.

13.7 RESPONSIBILITIES OF THE COMPLIANCE & AUDIT FUNCTIONS

Compliance and Audit functions in a bank play important roles in ensuring that the bank carries on with its business within the regulatory and statutory framework. They help in detection of any gaps or deviations so as to mitigate compliance risk. KYC/AML obligations encompass all the activities of a bank; hence the KYC/AML compliance requirements should engage considerable attention of both these functions.

13.7.1 Compliance Function

Compliance function should keep a watch that the bank has a KYC Policy and it is kept regularly updated. IT should also monitor that for all business lines and processes have guidance documents in the form of KYC/AML process manuals/SOPs or the respective

SOPs covering the KYC/AML requirements appropriately. Compliance function typically vets the new product papers. In the process it should be ensured that KYC/AML requirements are taken care of. Compliance Department functions as a part of its monitoring function.

13.7.2 Audit Function

Audit should check in its audit of various processes specifically for KYC/AML requirements. Besides, it should carry out audit of various functional units handling specifically KYC/AML related functions regularly say once a year.

13.7.3 Guidance against "Tipping off"

Senior management should provide sufficient guidance to staff to ensure that the customer or any other third party, under any circumstances, is not informed (i.e. tipped off) that his/her accounts are under monitoring for suspicious activities and / or that a disclosure has been made to the FIU-IND.

No restriction shall be put on operation of the account in which STR has been filed. The fact of furnishing of STR shall be kept strictly confidential.

13.8 THREE LINES OF DEFENCE

The roles and responsibilities enumerated above for various functionaries conceptualize **Three Lines of Defence** on the subject to move forward and these are part of guidance note (Paper from BCBS year 2014), are replicated hereunder with details, as it helps in having proper vigil and ensuring overall KYC AML CFT compliances.

Table 13.2 Three Lines of Defence

1st line of defence	**2nd line of defence**	**3rd line of defence**
Frontline staff	Supervisory staff	Audit (Internal), Concurrent audit
Instil by persistent guidance, instructions	Attitude towards execution of control measures in its spirit	Carrying out granular checking as per laid down frequency, Oversight

13.8.1 First Line of Defence

- The frontline staff dealing with the customer, must be well abreast with the regulatory guidelines and directions on KYC AML norms,
- Their knowledge updation should be on-going and necessary training must be ensured,
- Adequate resources for the purpose must be ensured by the management,
- Policies and Procedures must be clearly advised in writing,
- Internal procedures must be put in place for reporting towards suspicious transactions

13.8.2 Second Line of Defence

- It covers Back office operations at branch and administrative office level
- Office in charge in these segments must be assigned with clear roles and responsibilities
- Implementation of KYC guidelines at branch through regular checking and monitoring must be ensured,
- Test checking from administrative offices must be ensured as per stipulated frequency,
- Officer in charge at central location/ office should be contact point for FI
- Reporting under PML Act i.e. CTR, NPOTR, CBWTR, CCR & STR must be ensured as per guidelines,

13.8.3 Third Line of Defence

- It is internal audit function and REs must ensure that all branches must be covered as per business and resources,
- Frequency of internal audits must be defined vide Board approved policy,
- Proper checking of KYC (OVD) documents, maintenance of Customer profiles, Risk assessment / categorisation and Re-KYC aspect must be checked by auditors
- Senior Management must ensure that audit functions are assigned to staff who are well versed with the subject,
- External auditors (Concurrent Auditors) also must be assigned the KYC AML audit to cover new accounts, Re-KYC and especially current accounts which are important towards compliance risks,

13.9 LET US SUM UP

This chapter deals with roles and responsibilities of different functionaries and functional units in the organisation. It also elaborates the roles of the Designated Director and the Principal Officer. .

13.10 CHECK YOUR PROGRESS

1) Every RE specifies a 'Designated Director' (DD) as per legal requirement. Which one of the following statements is correct?
   (a) DD is responsible for overall compliances with the obligations under PML act.
   (b) DD is posted for monitoring AML activities.
   (c) DD's role is to file STR in a time bound manner.
   (d) DD is selected from outside the bank for AML monitoring to avoid conflict of interest.

2) Which one of the following functional unit is unlikely to notice a likely suspicious transaction for reporting as STR?
   (a) Central processing unit for account opening,
   (b) A branch
   (c) Internal Audit function.
   (d) Regulatory returns function

13.11 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a) **2.** (d)

CHAPTER 14

TRAINING AND AWARENESS

STRUCTURE

OBJECTIVES

To understand the significance of sensitising both the staff and the customers regarding the AML/CFT measures for effectiveness. Knowing the modalities that can be adopted for this purpose.

14.1 STAFF TRAINING/ AWARENESS

14.1.1 Need to Sensitise Staff

As we have discussed earlier an effective KYC/AML program must essentially cover the entire organisation, and every person in the bank has a role in ensuring that the organisation fulfils its obligations under the PMLA. Hence a well informed and skilled staff will be an essential requirement for successful implementation of KYC/AML program. Banks therefore need to take appropriate measures to ensure that its human resources are adequately groomed for discharging their responsibilities in this regard. It is important that the Bank's senior management and the Board of Directors appreciate that under the PMLA both the bank and the individual employees are subject to penal measures for any violation of the obligations prescribed under it.

14.1.2 Staff Awareness

Given all-pervading nature of KYC/AML regime it is important that various obligations and guidelines in this area are disseminated among the employees. Also, due to continuing developments taking place this has to be an ongoing activity. Various modalities useful for enhancing awareness among staff are given in Table 6.1 below.

Table 14.1 Modes of Communications for Staff Awareness

Mode	**Features**
Policy	• Formal document (duly approved by Board) • A regulatory requirement • Contains the bank's internal norms on all aspects of KYC/AML • To be a mandatory reading for all employees
Manuals/SOPs	• Formal document of the bank's policies and instructions • Prepared for various activities. • Ensure uniformity in compliance and execution. • To include distinct KYC/AML requirements applicable to the specific product/ process. • To include also the ML risk category of the product/process. • Need to be updated periodically. • Useful to the functional staff as ready reference document. • Evidences to the regulatory/legal authorities' appropriateness and completeness of the bank's approach.

Regular Circulars	• Formal documents evidencing the bank's instructions. • Prevalent in all banks, because banking is highly regulated activity. • Convenient for quick and prompt dissemination of any developments. • Employees need to keep track of new circulars issued. • Difficult for users to refer to old instructions, it facilitates to some extent through cross referencing and robust search facilities.
Guidance Notes/ Frequently Asked Questions (FAQs)	• Informal mode of communication • Useful for conveying rationale/purpose of various requirements • Help in recapitulating salient aspects briefly • Being brief more likely to be read by wider audience • Can be used to enunciate approach for peculiar situations
Flyers/EDMs	• Informal mode of communication • Brief cryptic message on one or two points at time • Useful for focusing on critical aspects • Serves to remind about other related aspects • Likely to catch attention of all employees – if appropriately placed on intranet, or at strategic points in branches.

14.1.3 Staff Training

Need and Coverage of Staff Training

a. *Need for Skill Development*: Given the nature of KYC/AML procedures the bank employees need to develop requisite skills in order to meet their respective obligations. It is therefore necessary to train bank staff in KYC/AML concepts and processes.

b. *Programmes for all Levels*: Banks need to have a well-designed training framework of programmes for the personnel at different levels, viz. sales personnel, operating staff, controllers, monitoring staff, business/product heads, compliance and audit functions.

c. *For Board and Senior Management*: Even the Board of Directors and Senior Management of banks need to be covered in training framework because they carry the responsibility for the bank having an appropriate KYC Policy and adequate organisational set-up; with the Designated Director being responsible for the bank fulfilling the obligations under PMLA.

d. *Differentiated Programmes*: It is also essential that every employee of a bank is imparted with training in KYC/AML in view of applicability of these provisions to all the activities of a bank. The perspectives and skills required differ widely depending on the roles and responsibilities of the concerned functionaries. Hence, the focus of the training should be different for frontline staff, compliance staff, and staff dealing with new customers.

e. *At Different Stages*: Due to continuous changes in the modalities of ML/TF and consequently the measures required for AML/CFT purposes, it is essential that banks' staff are regularly updated. Hence, training programmes for them are required at various stages. Induction programmes at the time of onboarding must be mandatory for all employees. Also, role specific training programme should be imparted to a staff on entering a new role. Functionaries directly dealing with AML/CFT related aspects, and the executives handling sales and operations activities directly need to be imparted refresher training periodically, say once in two/three years.

14.1.3.1 Scope of Training Programmes

Let us reflect on the salient aspects to be covered in these Training Programmes, and differentiation for various groups of functionaries.

(i) *General Areas*: Following topics should be discussed in the training programmes for all levels though the focus and extent will be varied according to the target group:
- Global concerns about ML/FT
- Vulnerability of banks, and their crucial role
- Initiatives of international bodies for AML/CFT, and Expectations from member nations
- FATF Recommendations, and Guidelines of other bodies like BCBS, APG, EAG, Wolfsberg Group
- Obligations of banks under PMLA, and Penal Provisions
- RBI and IBA Guidelines
- Risk Based Approach for ML/FT

(ii) *Differential Areas*: Given below in Table 6.2 are some topics for specific target groups.

Table 14.2 Topics for Specific Target Groups

Target Group	**Salient Aspects**
Board & Senior Management	
Board of Directors	• Responsibilities of the Board under PMLA/RBI Guidelines • Need for KYC Policy and its Key elements • Major high risk business lines/customer categories for the bank
Designated Director & Senior Management	• Responsibilities of Designated Director/Senior Management • Factors affecting ML/FT Risk • Formulating AML/CFT strategy for the bank • Need for KYC Policy and its Key elements • Organisation set-up and IT Systems Requirements • Factoring ML/TF risks in business plans and policies • Defining the principles for effective implementation of AML/CFT measures • Online & Offline RFIs- ensuring implementation and review periodically

Target Group	Salient Aspects
Head/Corporate Office	
Common Areas for Corporate Office Level	• Salient Aspects of KYC Policy • Organisation set-up in the Bank for KYC/AML • Factors affecting ML/FT Risk • Customer Due Diligence requirements • Customer Risk Categorisation and High Risk Customers • Products/Channels/Locations Risk Categorisation • STR Typologies and Indicators of Suspicious Transactions • Vigilant towards Offline RFIs & its reporting
Principal Officer, and Heads/Staff of KYC/AML Functional Units	• Responsibilities of Principal Officer for FIU, AML/CFT Units • Formulating KYC Policy of the Bank • Designing Organisation set-up for ensuring KYC/AML requirements • Determining IT Systems requirements • Determining ML/TF Risks in Products/Channels/Locations • Customer Risk Categorisation • Designing processes for compilation of CTRs/NTR/CBTR/CCR • Mechanism for STRs generation and reporting • STR Typologies and Indicators of Suspicious Transactions • Handling of AML alerts Online as well as Offline, and analysis of cases of suspicious transactions • Media research for identifying doubtful customers, and cases for STRs
Heads/Staff of Business/ Product Units	• Responsibilities of Business/Product Units • AML/CFT aspects to be included in Product papers/SOPs • High risk business lines/customer groups • Training / learning about alert reporting to Central Office in terms of PMLA
Heads/Staff of Processing/ Operations Units at the Corporate/Nodal Offices	• Customer Due Diligence Requirements for various types of Customers • Specific care for high risk Products/Channels/Locations • Identifying any doubtful/suspicious case & its reporting mechanism
Zonal/Regional Controllers/Offices	

Target Group	Salient Aspects
Common Areas for Zonal/Regional Level	• Salient Aspects of KYC Policy • Factors affecting ML/FT Risk • Customer Due Diligence Requirements for various types of Customers • Customer Risk Categorisation and High Risk Customers • Products/Channels/Locations Risk Categorisation • Organisation set-up in the Bank for KYC/AML • Sensitising the Staff under their control about RFIs • STR Typologies • Suspicious Transactions Patterns/Indicators; High Risk Transactions • Responsibilities of Processing Units • Checks and scrutiny to be carried out and identifying deviant transactions • Escalating cases of suspicious nature – doubtful customer, suspicious transaction • Identifying branches/individuals with repetitive suspicious cases
Heads of Zonal/ Regional Office/ Functional Units	• Responsibilities of Heads of Zonal/Nodal Units • High risk business lines or customer groups • Identifying branches/individuals with recurring doubtful/suspicious cases
Functionaries at the Zonal/Nodal Control Units	• Responsibilities of these functionaries • Checks for various types of Customers • Scrutiny of transactions and identifying deficiencies in them • Additional checks for High Risk Customers • Additional care for High Risk Products/Channels/Locations
Branch Level	
Common Areas for Branch Level	• Salient Aspects of KYC Policy • Factors affecting ML/FT Risk • Customer Due Diligence Requirements for various types of Customers • Modalities of Customer Due Diligence and Additional checks for High Risk Customers • Organisation set-up in the Bank for KYC/AML • STR Typologies • Suspicious Transactions Patterns/Indicators; High Risk Transactions • Responsibilities of Branch Heads/Branch Operations Heads/Branch level Functionaries

Target Group	Salient Aspects
	• Precautions in interacting with walk-in/potential customers • Identifying suspicious transaction or doubtful customer • Reporting cases/events of suspicious/doubtful nature
Branch Heads and Heads of Operations at branches	• Monitoring and control for AML/CFT related aspects • Vigil on branch functionaries • Reporting any suspected employee case
Branch Operations Staff	• Care in handling regular customer transactions • Precautions in interacting with walk-in/potential customers • Identifying suspicious transaction or doubtful customer • Reporting cases/events of suspicious/doubtful nature • Reporting any suspected employee and Whistle-blowing
Sales Staff at branches	• Modalities of customer Due Diligence • Modalities of enhanced Due Diligence for High Risk Customers • Care in handling regular customer transactions • Precautions in interacting with walk-in/potential customers – reporting of suspicious instances

14.1.4 Awareness/Training – Regulatory Obligation

Creating awareness among and training of staff in AML/CFT aspects are regulatory and legal requirements also. In any KYC/AML related investigation, RBI or other authorities examine what measures were taken by banks for creating awareness and training their staff. It is therefore important that records and evidences of all measures taken in this regard should be maintained.

14.2 CUSTOMER AWARENESS

14.2.1 Need for Customer Awareness

KYC/AML measures can be effective only if the genuine customers of banks are co-operative and share their correct and full information with the banks as per their requirements. However, as the information sought is of very personal and sensitive nature, there is obviously high degree of reluctance among customers to respond to these requests as the customers are not generally aware of the risks of money laundering and relevance of their information in mitigating this risk. Another fall out is, when they provide the information sought it is done casually by them for completing form filling exercise, thus eroding its utility. Hence, it is important to sensitise the customers about the following aspects:

- Negative impact of money laundering and Terrorism financing
- Risks of banks being used for Money Laundering and Terrorism Financing
- Measures that can help in mitigating these risks
- Importance of customer information for banks in mitigating these risks

14.2.2 *Modes for Customer Awareness*

Creation of customer awareness is a very huge task and hence requires using available modalities for various levels viz. individually, existing customers of the bank, and mass public awareness. Similarly, using various channels is important for covering larger proportion of people. Some of the suggested modalities are the following:

- *Individual Customers*: The most obvious point for creating awareness is when a customer is contacted for opening an account or availing any other product. The sales staff of the bank therefore should be made aware of the need to do so. Further, the branch staff may be made aware of the need to sensitise the customers. They can therefore explain to the customers these aspects whenever the customers visit the branch for inquiries/carrying out any transaction.
- *Existing Customers*: Flyers on KYC/AML can be sent to the existing customers through mail/ email along with their bank account statements/any other communication. There can also be pop- up messages on the ATM screens, internet banking pages, etc. SMS messages sent to the existing customers will be effective way of reaching out to a large number of customers quickly. KYC/ AML aspects can also be discussed in the meetings of the customer service committees at branch level. These could also be discussed at any customer relations event held. Salient aspects of KYC policy related to customers must be explained well during interactions.
- *Public Awareness*: Banks can include KYC/AML related messages in their public communications, like advertisements in newspapers, TV/radio channels commercials, advertisements in movies, ATMs, official websites, official social media platforms etc.

14.3 LET US SUM UP

This chapter deals with the need for training and awareness about KYC AML norms, measure and regulations, the training needs of staff at all level from branch (frontline) to senior management, and creating customer awareness about these norms.

14.4 CHECK YOUR PROGRESS

1. Which one of the following statements is not correct in respect of training on AML/CFT?
   - (a) AML training should be organised for the Board of Directors.
   - (b) Staff in AML Units need to be trained only at the time of joining.
   - (c) Business vertical heads should be periodically imparted training.
   - (d) Principal Officer of the bank should attend annually a programme on AML.

14.5 ANSWERS TO CHECK YOUR PROGRESS

1. (b)

ANNEXURE I

CASE STUDIES

Case no. 1

1. Mr 'D', a drug trafficker targeted by Her Majesty's Customs and Excise Department, UK, had, unknown to them, built up a very sizeable portfolio of investments with his ill-gotten gains. They were managed on his behalf by a broker institution. Mr 'Tom', his portfolio manager knew him as a successful importer/exporter. Tom had moved from one institution to another, taking the majority of his clients with him, with the new institution making no attempts to identify these new clients.
2. The Customs department eventually tracked Mr 'D' and seized a delivery of drugs from the Scottish coast. Their target was not on board. He had slipped abroad. The department continued its search for him.
3. 'D', realising that his assets were at considerable risk, quietly returned to the UK and met with Tom. 'D' sold the latter a story that it was his partner who was under investigation, while he was innocent. He was concerned that the authorities might restrain his portfolio mistakenly. Was there anything that his long-standing portfolio manager could do to help?
4. Tom suggested that the portfolio be quietly transferred to a new trust fund set-up in the Channel Islands, and he arranged a meeting with a new trust manager. The latter was advised that the trust was required to assist tax management - there was no mention of the associated drug investigation. The portfolio was then shifted to the new venue.

   The Customs officials had, in fact, contacted Mr Tom before the new trust was established. Not knowing the details of his meeting with Mr 'D' or the new trust manager, they accepted his statement of not knowing about drug trafficking or what happened to the funds. He was instructed by the customs authority to not transfer the funds, as a restraint order was to be issued. He had been told that if the client did contact him, he was to advise the Customs authority immediately, without disclosing to the client that they were investigating his business.
5. When the restraint order was presented, Tom confessed that he had been in contact with his client and that he had not advised the Customs, despite their previous instructions to him.
6. The Customs obtained an order on Tom's institution to produce of all records relating to 'D'. They discovered Tom's handwritten note to 'D' advising him of the Customs investigation and the new trust manager for Channel Islands.
7. Tom's initial defence was that he was not aware of the law of money laundering, that the institution had no procedures, and that he had no training.

The Result

Tom was prosecuted under Section 31 of the Drug Trafficking Offences Act 1987 UK for tipping off. He was also prosecuted under Section 24 for assisting a drug trafficker to launder the proceeds. The portfolio manager also lost his job.

Important Points to Note

1. No institution should associate itself with money laundering activity.
2. All institutions dealing with funds management should have clear policies and procedures covering all activities including anti-money laundering, and should train all staff, however senior or junior they may be.
3. Clients of other firms should be accepted only after a fresh KYC on them, at the time of transferring accounts.
4. Institutions should be vigilant about their employees. In this case, Tom was moving from one firm to another, along with his clients.
5. There should be no effort to conceal facts from regulatory authorities; the staff should cooperate with them.

<u>Case no. 2</u>

EUROPEAN BANK PLEADS GUILTY TO LAUNDERING IN USA: STAFF FAILURE

1. Two South American nationals opened an account in a bank in Europe. During the next one year an aggregate amount of approximately US $ 2.3 million was deposited in the account, in the form of US cashiers cheques.
2. The cheques were actually part of a smurfing operation in which money made from drug trafficking in California was used to purchase the cheques from various US banks at different locations. All these cheques were for less than US $ 10,000, the threshold limit for the filing of currency transaction reports.
3. After the purchase, the cheques were sent to South America where they were aggregated and sent (in bulk) to the European bank for deposit. After the money had been deposited, approximately US $ 1.6 million was withdrawn and transferred back to the USA.

The Result

1. After about 4 years, the European bank has pleaded guilty to money laundering, when their internal audits showed suspicious transactions.
2. The bank admitted that the account officer who handled the account, either knew or was wilfully blind to the fact that the account was being used to launder the proceeds of crime.
3. Under the plea bargain the bank agreed to – forfeit US $ 2.3 million to the government; to pay a fine of US $ 60,000, submit special audit reports for the following 3 years; and publish a document of money laundering for distribution to other European banks.

   In Los Angeles, one of the two South Americans pleaded guilty to money laundering. The US government confiscated a further US $ 1.75 million in real estate and cash, which were traced to the trafficking operation. The European government also confiscated US $ 1 million from the South Americans' accounts.

Important Points to Note

1. The case contains a salutary message for all institutions with interests in the US. The US approach to extraterritoriality – whereby they attempt to impose their will over any country/institution using their financial system – is a reality.
2. While the institution in this case took responsibility for the actions of its account officer, it is hoped that all bank employees, if trained, would not knowingly assist a money launderer, or deliberately exercise wilful blindness (i.e. ignoring or pretending not to see that, which is patently obvious to any reasonable person).
3. It is important to train staff to recognise suspicious transactions and risk transaction patterns (e.g. the bulk deposit of US bank cheques each under US $ 10,000 – the CTR threshold – followed by transfer back to the US) that make no banking sense.
4. In the UK, the bank employee might well have been prosecuted under the Drug Trafficking Act, and then he/she might have found difficulty in proving that he/she had no suspicion about the source of funds.
5. International banks should develop their AML policies and procedures, taking note of legislations in both their home country and others where they have operations. The European bank should have considered the US approach to money laundering when they structured their policies and procedures.
6. The pattern of transactions in this case fell within a very obvious money laundering template.

Case no. 3

EUROPEAN BANK HELPS GOVT. IN ANTIDRUG TRAFFIC EFFORTS

1. An accounts manager in an international private bank in one of the financial centres located in the English Channel noticed that one of his customers had started effecting cash deposits. The deposits were being made, in batches, through various bank branches in Birmingham. The customer's account had never received cash deposits in the past; and the manager knew Birmingham sufficiently of well enough to realise that all these bank branches in the city centre were within easy walking distance of each other. The customer was a South African national living in the UK.
2. While the deposits were noticed by the manager, he did not feel suspicious. The valued customer had held the account for several years and had not given his business legitimacy and respectability any cause for concern. The manager, therefore, wrote a 'customer care letter' indicating he had noticed the new cash deposits, and enquired if the customer had started a new business venture; if so, could the bank assist him to process the cash deposits more efficiently and securely.
3. In his response, the customer advised the bank that he was starting a new venture importing second- hand electrical goods by air to the UK from his native country South Africa; often the goods had to be paid for in cash, and also they were sold to small shops in cash, but he did not require any further services from his bank. The customer was more obliging than he realised, for he enclosed with his response a copy of one of the airway bills.
4. The manager could not understand the commercial rationale for the import, as surely the UK did not require second-hand electrical goods from South Africa, and

even if it did, there was no sense in using expensive air freight. Therefore, a disclosure was made to the government.

The Result

Investigations by the Customs Department, UK, discovered that drugs were packed inside the electrical goods and imported to the UK.

Important Points to Note

1. Unexpected changes in the pattern of transaction within long established accounts may reveal valuable information. Ongoing monitoring of bank accounts is necessary both for fraud prevention and for money laundering.
2. Further enquiries of the customer might be made, in case more information is needed to verify a suspicion, through a routine correspondence from the account executive responsible for the relationship. Such enquiries are not at risk from the tipping off offence, as they are made before any decision is taken to make a disclosure. They must not, however, refer in any way the suspicion or to the disclosure process, as this might tip off the customer. Such enquiries, when justified, do help to avoid unnecessary disclosures.
3. In this case study, the account executive had made the following intelligent moves and deductions:
   - Noticing the new pattern of cash deposit.
   - Noticing the use of several proximate branches.
   - Understanding that import of second-hand electrical goods from South Africa to the UK looked a bit incongruous.
   - Enquiry through a polite customer service offer.
   - Reporting the transaction when he had a doubt.

<u>Case no. 4</u>

NEW BUSINESS VENTURE OF A RESPECTED CUSTOMER OF AN OFFSHORE BANK: CASH DEPOSITS

1. Mr H was a well-known, pleasant mannered 63 year-old, who owned two chemist shops in the local town centre. He was the owner of a cottage situated in a small village.
2. He held a well operated business account with the bank for a number of years. He also held a second account used for a small sideline business – involving the sale and supply of pigeon food. This sideline had a monthly turnover of around £ 1,000.
3. In January 1993, he arrived at the bank with a bag containing £ 5,000 in cash and requested that he be issued a bank draft favouring a chemical company in Italy. Four similar transactions were made during a six-week period and on each occasion the amount of cash involved increased.
4. The branch then insisted that the cash be first deposited into his account. Thereafter, the bank charged the customer for the counting of cash and the issue of the bank draft. He agreed to this procedure, using his second account, and asked for a letter showing the amount of bank charges, so that he could show it to his business

associate. He never challenged or checked the amount that the bank charged him for counting cash and issuing drafts. He was enquired about the nature of the business operation and he told the branch that it involved ‘import/export of chemicals’.

5. From April 1993, the drafts were made payable to a company in Germany and the amounts of cash involved increased in some occasions to as much as £ 17,000.
6. Such pattern of depositing cash and withdrawing it in a draft form, in favour of the German company continued, sometimes on a weekly basis, for over 3 years.
7. During that two-year period, a total of 42 bank drafts were issued to a total value in excess of £ 3,40,000.
   During this period the bank became suspicious and made a disclosure (i.e. reported a suspicious transaction).

The Result

Initial financial enquiries by the police, following the disclosure, aroused their interest, but nothing was known of the chemist. Being short of a ‘full frontal’ interview and questioning, it was not possible to determine criminality. The disclosure remained in the police as a ‘very interesting’ file.

Sometime later, another police force arrested a suspect importer of anabolic steroids, amphetamines, etc. (2.7 metric tonnes over three years). This disclosure remounted the ‘very interesting’ file, i.e. a link between the two was established. The chemist was receiving drugs from the trafficker, sold them for cash, converted cash to drafts, and even got a letter confirming the issue of drafts by the bank.

The drug trafficker was prosecuted and sent to prison for five-and-half years, and a confiscation order was made for £ 2,00,000.

The chemist was also prosecuted and found guilty. In view of his age (above 60), he was sentenced to community service.

Important Points to Note

1. It is essential to continue knowing your long-standing banking customers, and monitor transactions against the routine pattern of transactions. A significant change, seen as in this case, should put an institution on enquiry.
2. In this case, the change of pattern was coupled with a change of attitude. A pleasant small business customer became reluctant to discuss his new business that was generating so much income, and he also stopped challenging his bank charges, etc.
3. The pattern involved cash withdrawals and deposits; converting cash into drafts is a typical ML technique. A businessman buying and selling in cash is, likewise, an abnormality indicating possible money laundering.

Case no. 5

SUDDEN ACTIVITY IN DORMANT ACCOUNT

The Case

A financial disclosure from a bank directly resulted in a good ‘bread and butter job’ for the police.

A dormant joint account held by a married couple suddenly came back to life. An initial credit of £ 1,500 was deposited through a distant branch, closely followed by a second deposit of £ 4,000 in cash at another distant branch. The bank's records showed the husband as unemployed and his wife to be a home as maker. The bank reported a suspicious transaction as the deposits were made in a dormant account and the amount was not related to the customer's occupation/unemployment.

The Result

Police enquiries linked the disclosure to a London drug dealer, who turned out to be the wife's brother. There was a successful prosecution, and over £ 13,000 were seized.

Important Points to Note

1. All changes in an account transaction pattern are worth examining for both money laundering and fraud – particularly, fresh operations in a long-dormant account.
2. It is important to consider all deposits, those that come through other branches, in addition to those across the counter.
3. The knowledge of the customer is the key for retail banks. The customer's unemployment, coupled with the long absence of account activity, made the sudden inflow of wealth, unusual enough to warrant enquiry.

Case no. 6

CASH DEPOSIT AND IMMEDIATE WITHDRAWAL

The Case

1. Three partners opened a business account with a branch of a US bank in the UK. The partners were all American citizens; one was a resident of London. The bank followed rigorous 'know your customer' routines and, in line with its policy, also prepared a customer profile/template showing the pattern of transactions predicted from the information provided by the customers.
2. The partners explained that they were property developers, planning enhanced business in the UK market, hence, the need for a local account. Therefore, the customer profile/template predicted funds flowing to and from the US, and disbursements within the UK. In reality, more than US $ 1 million was transferred into the account within a short period of time, all with instructions for immediate transfer to various accounts in Europe. There were little, if any, local UK disbursements.
3. A disclosure report was made, as this pattern was alien to the customer profile.

The Result

The police were interested and quickly contacted the bank. At their request, the bank called in the customers for clarifications. The police maintained vigilance and eventually arrested the customers. Their real business was not real estate, but smuggling.

Important Points to Note

1. It is not sufficient to merely verify identity. Banks also need to know their customer's transaction profile; they should be capable of predicting (however

informal the prediction process may be) the customer's requirements and the expected pattern of transactions.

2. A number of banks, especially US banks, are now preparing a new customer profile as an integral part of the new customer procedures for their banking business. The profile is considered valuable from both the marketing and risk points of view. A predictable pattern of transactions would certainly help to identify unusual/suspicious transactions, as it did in this case.

   (*Source*: Guidance Notes for the Financial Sector, published by the Joint Money Laundering Steering Group, London)

<u>Case no. 7</u>

The Case

GI was issued a credit card with credit limit INR 30,000. Some small transactions and payment through third party cheque drawn in favour of the card holder were observed. Further, payments were through demand drafts issued from Africa and other countries including domestic drawn in favour of various persons with endorsements authorizing payment to GI's credit card account. Number of withdrawals in cash through ATMs and branches, high value purchases from jewellers, electronic shops, etc. Account continuously remained in credit. Fraud Control got alert due to high value transactions. Verified with customer who confirmed the transactions. Complaint from one of the beneficiaries of the draft led to the discovery that about 30 drafts for approx. INR 950,000 were fraudulently collected through the credit card account. Subsequent investigation revealed airline staff pilfered drafts from mail bags. The drafts should not have been credited in the account, as the endorsements were not valid. Authorisation while making the verification should have gone through the pattern of transactions in the account. There were indications such as large purchases from Jewellers, electronic goods shop and cash withdrawals that would have given suspicion about the transactions. The large credit balance and the odd figures of deposit should also have given doubt about the transactions.

Key Message

While investigating an unusual or suspicious activity, go into all aspects and get satisfied before giving a go ahead. Do not simply rely on explanations / clarifications unless there are grounds to believe them.

Such scenarios are part of the matrix put in Transaction Monitoring software, so alerts should be studied / analyzed that it is a fit case for filing STR at an early stage.

<u>Case no. 8</u>

The Case - Charity used to Finance Terrorism

One UK investigation arose as a consequence of a suspicious transaction report. A bank disclosed that an individual who allegedly was earning a salary of £12,000 per annum had a turnover in the account of £250,000. A financial investigation revealed that the individual did not exist and that the account, fraudulently obtained, was linked to a Middle East charity. A fraud was being perpetrated for the purpose of raising funds for a terrorist organisation. Donations were paid into an account and the additional charitable payment was being claimed back from the government. The donation was then returned to the donor. This fraud resulted in over £800,000 being fraudulently obtained.

Key Message
Even charities can be used to raise funds for terrorist purposes.

Case no. 9

The Case
A bank observes large value cash transactions executed through its accounts almost on a daily basis by a trading concern, X Enterprises. The deposits are always below the reporting threshold of Rs.10 lakh. These deposits are done using multiple tellers at the same branch. The value of each cash transaction hovers between Rs.8 to 9.5 lakhs. The customer is in the business of garments. The pattern observed is deposit of cash followed by simultaneous transfer to other accounts within the bank or issue of cheques.

On investigation into the profile of other accounts it is observed that these accounts are of entities of varied industries like chemicals, plastic, metals, food grains & packaging. The turnover in each of these accounts amounts to crores of Rupees. On scrutiny it is observed that many of these entities are related by virtue of same partners, same address, same telephone. They have different PAN numbers. Most of these entities are in near vicinity of each other. These entities have availed no credit facilities from the banks.

The Branch manager decides to visit some of these entities and discretely finds that none of these entities have infrastructure to support the activities as per their profile. Many are not open during business hours. It is found that these entities are into business of converting cash into cheques and vice versa for persons across a spectrum of businesses. This type of business is colloquially called ‘entry business’. An STR is raised for these accounts.

Key Message
This is a classic example of money laundering in Indian Context. Enhanced Due diligence helped reveal that transactions are not in line with the profile of the customer and indeed suspicious.

Case no. 10

An NRI customer from Europe receives remittances worth crores of Rupees into his account. The proceeds are invested into various capital market instruments covering mutual funds, shares and securities. On checking the remitter details it is observed that funds are being received from his account in Europe. The bank officer checks the remittances received from this remitter across the Bank and finds that similar large value amounts are transferred into accounts of unrelated persons over last six months whose accounts have since gone dormant. The amount has been withdrawn in cash and currently there is no balance in these accounts. These accounts are reported as an STR.

Key Message

While an instant unusual transaction may not appear to be suspicious, related accounts may throw up suspicion. Therefore, it is necessary to look at the totality of the customer transactions.

<u>Case no. 11</u>

The account of a resident Y is receiving a number transfers from a non-resident X stationed in gulf through internet transfers. The account of X in turn is receiving remittances from another non-resident Z working in same oil refinery as X. Z receives money through large value clearing cheques from another non-resident W. In spite of enhanced due diligence (EDD) it is not possible to establish any relation between these persons. The manager files the STR and two months later finds the name of the Y as being involved in a terrorist act in a foreign country. Further, STRs filed in the case.

Key Message

Look out for transactions that do not make economic sense. High Risk customers must be under constant Transaction Monitoring & timely Re-KYC exercise.

<u>Case no. 12</u>

The Branch manager during his analysis of AML exception reports for May finds some accounts where cash is being deposited through multiple branches and withdrawn on same day. One such account holder is Mr. Y. who ensures that he does not maintain balance over a period of one or two days. Deposits are in form of third party walk ins. The amounts deposited are between Rs. 2500 to 3000. The manager directs the teller to inform him the next time any person other than the account holder approaches to deposit cash in the account. Five days later the manager is alerted by teller and immediately asks the depositor reason for depositing cash in this account who informs him that he has been instructed to do so by one Mr. T who has promised him a lottery winning of Rs. 10 lakhs provided he deposits Rs. 3000 as processing fee. Manager immediately files an STR for same.

Manager comes across another such account in name of Mr. O. Unlike Mr. T the amounts are received by him though ATM cash deposits. No person physically visits branch to deposit the amount. The transaction pattern is similar to that of account of Mr. Y. An STR is filed by the manager. One month later the manager receives a letter from the Narcotic Control Bureau asking him further information in relation to Mr. O. It has now come to light that O was a drug peddler was using bank’s channels to receive cash from his customers who were couriered drugs.

Key Message

Compare the activity in the account to the profile of the customer / behavior of such segment of customers. This may reveal unusual behavior.

Case no. 13

The Case

A Bank officer processing foreign currency cheques observes that an Non Resident customer receives three to four foreign currency cheques in a day for clearing. There are also credits from on line site aggregators. Each credit is between 3000 to 4000 USD. These credits come from different countries. On checking with the customer's mandate holder, he states that these are payments received by way of commission in the business of internet marketing. On conducting a search over the internet it is also revealed that the customer is running a site which invites people to subscribe to his services. The content of the site is perfectly educational and legal. However, this conflicts with the version of the mandate holder. The customer has not made a single withdrawal from the account over a period of one year that he has an account with the bank and the total balance in the account is very high. An STR is filed for the customer.

Key Message

In respect of certain customers, a desktop due diligence in form of Internet searches may reveal details of the customer activity and help gather evidence for reporting a suspicious transaction.

Case no. 14

The Case - Alternative Remittance Systems – Supported by Import / Export Activity

A national from Country S was arrested in Country M on suspicion of unlicensed banking. The investigation revealed that this subject had been running an informal fund transfer system (hawala) for almost four years. Three other individuals who had already left country M were also identified as associates.

Balances were settled between countries M and S through import / export transactions relating to car parts. A company exported car parts from Country M to an importer in Country S with a specific charge. The importer from country S paid 50% of the specific charge directly to the exporter in country M and the hawala operators paid the other half. In return, the importer in Country S paid 50% of the price to the groups account in country S to settle the balance. The payment was made in local currency and at a rate advantageous to the receivers, so that the group was certain to make a given profit from the transaction.

Key Message

Had the exporter's bank been alert to the source of funds for payment of the exported goods, suspicions would have been raised that payment was being made from two different sources in respect of one transaction.

ANNEXURE II

SITUATION ANALYSIS
Situation 1

Know Your Customer or Lose Your Customer
A Report
After attending a seminar on KYC at the Zonal Office, Srivastava, a young branch manager, vigorously commences applying KYC procedures at his branch.

He had a meeting with his officers as also those manning the desks, and explained the KYC rationale, the bank's policy and processes. He also sensitised them to the datelines fixed by his controllers, for implementing KYC, both in existing accounts and new ones.

The participants became enthusiastic. After a week, Ashok, the manager of his personal banking division, had a confidential discussion with him. He reported that while he was able to manage the ruffled tempers of most of his existing customers, who were being put through KYC screening, a few of his high net worth customers were proving to be difficult, particularly, two NRI customers and a local businessman, both with substantial deposits in the bank for more than 5 to 6 years.

'I am afraid we may have to relax our norms a bit, sir,' said the official. 'These customers are saying that we are asking too many questions, calling for too many documents. The NRI customers and the businessman who are from high risk countriesreminded me that for confidentiality, they had even asked, in the past, not to record their mailing addresses openly in the bank's ledgers, nor send letters.'

The local businessman, who was also politically influential, said, 'You know me for years. We have been put through high value transactions all these years. You are now refusing to accept large cash deposits. I see no reason as to why I should advise you of my turnover, or give my balance sheet or profit and loss statement or IT returns. I am not a borrower.'

Ashok said, 'they threatened to leave the bank and shift to the new bank across the road. I think we should leave things as they are. After all, we never had any problems with their accounts all these years, and they are all very pleasant people.'

Solution
1. As the three customers hold good deposits, Mr Srivastava may also personally discuss the issue with them, and try to obtain data required to fulfil KYC needs.
2. If the customers refuse, it would be prudent to let them close their accounts. The data, as available in the situation is not comforting. Following are the probabilities:
   (a) The NRIs and the businessman are from high risk countries. Their past 'instructions' are also not satisfactory under the present ML regime.
   (b) Non-availability of such data will prevent the branch from creating a proper

customer and transaction profile, and also a threshold for normal transactions.

(c) As non-submission of adequate information or reluctance to furnish them, places again, under the 'suspicious transactions' category, of the customer, the branch should close their accounts.

(d) Mr Srivastava should ensure that the time schedules are kept, and the task is completed within the controller's datelines. To do this, he should keep a close watch on the tasks getting completed, work along with the staff to keep them motivated, advise them when they are in doubt, get first-hand information on customer response and difficulties, and talk to customers who are reluctant and convince them for submission.

(e) We should ensure that there is no customer harassment; one has to remember that quite a few customers do not furnish data, more out of apathy than any other reason, and we need to have a warm customer relationship. It would, hence, be necessary to gently persuade customers to submit data in genuine cases.

(f) In the case of accounts where KYC screening is not possible due to non-availability of necessary data, despite repeated attempts, it is better to close them, advise the controller treating them as 'suspicious transactions' and create record retention systems as required.

(g) Mr Srivastava would also need to counsel Mr Ashok appropriately; he needs to move away from the 'past' and ensure that the bank's KYC policy is clearly understood by him, and he follows them, in letter and spirit.

Situation 2

ABC Enterprises has a current account with you. ABC Enterprises is a dealer of house hold appliances. Normal transactions in the account are daily cash deposits of about INR 100,000 and deposit of cheque and credit card charge slips for about 100,000. Payments to various distributors are through cheques. There are some cash withdrawals especially in the beginning of the month for salary payments. During the last 15 days, you have noticed that the cash deposits are in the range of INR 150,000 to INR 200,000 and there have been some increase in the deposits by cheques and charge slips as well.

Solution

Mere increase in the cash deposit does not necessarily mean a suspicious activity. Here in this case, there has been an increase in the cheque / charge slips deposit as well. There could be some reason for the increase in sale, like a festival season. Make enquiry about a reason for the increased sale and also check the payment part to see whether the money is going anywhere other than the usual suppliers. File a STR only if you are not convinced about the reason for the increase in cash deposit.

Situation 3

DEF Traders maintains a current account with you for the last three months. The account was opened with a deposit of INR 25,000. While opening the account, the business declared is Commission agents and he mentioned that he is getting distribution agency for some well-known cosmetic and detergent products. The expected transaction volume declared was monthly credit of INR 1 million and an average balance of INR 50,000. There were no transactions in the account for 2 months. For the last one month, the volume of transactions suddenly increased and at present there is a daily deposit of approximately INR 200K and the average balance is around 25,000. The withdrawals are through pay orders and most of the time favouring different firms and the pay orders are paid in clearing through banks in various cities. You met the customer and enquired about the business and he mentioned that he did not take the distributorship of the cosmetic and detergent products as he did not want to restrict his product range and he is now purchasing from various distributors and supplying to small businesses in the area and the business was very good. Your enquiry revealed that the customer did not have any separate office or godown and the business address given in the AOF is his residence address.

Solution

Though the explanation of the customer could account for the large cash deposits (sale to small traders) and payments to different firms, absence of any godown or distribution set up give sufficient reasons to suspect the bonafides of the customer. An STR should be filed.

Situation 4

ABC Corporation is a partnership firm with AB and CD and their wives as partners. About six months ago, ABC Corporation opened a current account with your branch. While opening the account, the firm has shown its business as multi-layer marketing and the expected volume of transactions in the account was shown as deposits of INR 2,000.000 and withdrawals of INR 2,000,000. For the first two months of operation, there were very few transactions in the account. Now, there are daily cash deposits of about INR 400,000 through different branches. You have noticed that different people come to the branch for depositing amounts ranging from INR 10,000 to INR 30,000. The withdrawals are by way of clearing cheques or by purchase of demand drafts or pay orders.

Solution

Definitely, the transactions are unusual and need to be investigated. There should be a discreet talk with the customer to clarify as to who are the people who were making deposits to the account and what is the source of these funds. It may also be ascertained as to who are the beneficiaries of the payments from the account. From the explanation, if you get satisfied that the money is from a genuine business and the payments are going for meeting the business related expenses, no STR be raised. If the customer is evasive or refuses to answer your queries or the explanation does not satisfy you, you have to raise a STR.

Customer should be asked to submit financials in support of the transactions in the account.

Situation 5

NM has taken a loan of INR 5 million against mortgage of a commercial property valued at INR 20 million. The KYC and credit information collected during the opening of the account showed that NM was a real estate developer and also a trader in commodities. He has declared an average income of INR 3 million during the last three years. He has also been maintaining a current account with you. After six months of taking the loan, NM came with a request to pre-close the loan account. You calculate the amount to be repaid and add the pre-closure penalty and as per the instructions of the customer, transfer the amount from his current account. After about two months, the customer again comes to you and request for a loan of INR 10 million against mortgage of the same property.

Solution

The situation definitely needs further probe. First of all, it has to be seen how the current account was funded for the earlier pre-closure. If these were through cash deposits or other deposits that cannot be connected to his business or personal finance, then you have to file an STR. If the funding is through genuine business receipts or transparent personal financial transactions, you may seek further clarifications from the customer through normal queries like the purpose of taking the loan, how he intends to repay, etc. and if you are satisfied with the responses, go ahead with the transaction in the usual course of business.

ABBREVIATIONS USED

AML	Anti-Money Laundering
ATM	Automated Teller Machine
BCBS	Basel Committee on Banking Supervision
BO	Beneficial Owner
CAP	Customer Acceptance Policy
CBWTR	Cross Border Wire Transfer Report
CCR	Counterfeit Currency Report
CDD	Customer Due Diligence
CFT	Combating Financing of Terrorism
CIP	Customer Identification Procedure
CTR	Cash Transaction Report
EDD	Enhanced Due Diligence
FATCA	Foreign Accounts Tax Compliance Act
FATF	Financial Action Task Force
FIU-IND	Financial Intelligence Unit, India
FT	Financing of Terrorism
ICAI	Institute of Chartered Accountants of India
IBA	Indian Banks' Association
ISIC	International Standard Industrial Classification
KYC	Know Your Customer
LEA	Law Enforcement Agency
ML	Money Laundering
MT	Monitoring of Transaction
NGO	Non-Governmental Organisation
NIA	National Investigation Agency
NPO	Non-Profit Organisation
PAN	Permanent Account Number
PEP	Politically Exposed Person
PMLA	Prevention of Money Laundering Act
PO	Principal Officer
RBI	Reserve Bank of India
STR	Suspicious Transaction Report
SFIO	Serious Fraud Investigation Office
TF	Terrorist Financing
UAPA	Unlawful Activities (Prevention) Act

MODULE III

REGULATION AND COMPLIANCE

CHAPTERS

CHAPTER 15

REGULATION IN BANKS

STRUCTURE

15.1 Importance of Banks in the Economy
15.2 Role of Banks
15.3 General Principles of Bank Regulation
15.4 Role of Regulator
15.5 Universal Functions for Financial Regulators
15.6 Regulatory Authorities
15.7 Other Bodies Issuing Guidelines
15.8 Important Acts Applicable in India
15.9 Let us Sum up
15.10 Key Words
15.11 Check Your Progress
15.12 Answers to 'Check your Progress'

OBJECTIVES

In this Chapter the learner will –

- Know the importance of banks
- Understand the role of banks
- Understand the principles of regulation and the role of regulator
- Know about other sources of guidelines

15.1 IMPORTANCE OF BANKS IN THE ECONOMY

A bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets. A bank is the connection between customers that have capital needs and customers with capital surpluses.

Due to their influence within a financial system and an economy, banks are highly regulated. Banks operate under fractional reserve banking where they hold a small reserve of the funds deposited and lend out the rest. They are subject to minimum capital requirements based on an international set of capital standards, known as the Basel Accords.

Under English common law, a banker is defined as a person who carries on the business of banking, which is specified as

- Conducting current accounts for his customers,
- Paying cheques drawn on him/her, and
- Collecting cheques for his/her customers.

15.1.1 Banking Set-up in India

The banking structure in India comprises commercial and cooperative banks. Banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934 are known as Scheduled Commercial Banks and Scheduled Cooperative Banks. Most of the banks are Scheduled banks.

15.1.2 Commercial Banks

- Public Sector Banks: where majority stake is held by the Government of India. Examples: SBI, Bank of India, Canara Bank, etc.
- Private Sector Banks: where majority of the share capital of the bank is held by private individuals or by institutions which promote them. These banks are registered as companies with limited liability. Examples: ICICI Bank, Axis Bank, HDFC, etc.
- Foreign Banks: are registered and have their headquarters abroad but operate some branches in India. Examples: HSBC, Citibank, Standard Chartered Bank, etc.
- Regional Rural Banks: were set up with a view to developing the rural economy by providing banking facilities.
- Local Area Banks: were conceived as low cost structures which would provide efficient and competitive financial intermediation services in a limited area of operation.

- Small Finance Banks: were set up with the objectives of furthering financial inclusion through high technology and low cost of operations.
- Payments Banks: were set up with the objectives of furthering financial inclusion by providing (i) small savings accounts and (ii) payments/remittance services to unorganised sector.

15.1.3 Cooperative Banks

These are financial entities which belong to its members, who are at the same time the owners and the customers of their bank. Co-operative banks are often created by persons belonging to the same local or professional community or sharing a common interest.

15.2 ROLE OF BANKS

15.2.1 Standard activities

Banks act as payment agents by maintaining deposit accounts, paying cheques, and collecting cheques, and remittances through other modes. Banks borrow money by accepting funds as deposits and by issuing debt securities. Banks lend money by making advances, instalments loans, and investing in debt securities. Banks create new money when they make a loan, thereby increasing the money supply. This is called multiplier effect.

15.2.2 Risks and Capital

Banks face a number of risks in conducting their business, for instance:

- Credit risk: risk of loss arising due to non-recovery of loans.
- Liquidity risk: risk that a given security or asset cannot be realised to meet the cash requirement.
- Market risk: risk that the value of an asset portfolio will decrease due to fall in market prices.
- Operational risk: risk arising from business operations.
- Reputational risk: risk related to the trustworthiness of the organisation.
- Macroeconomic risk: risks related to the economy the bank is operating in.

The capital requirement is a primary bank regulation prescription, to enable banks to withstand the risks and sustain. The categorization of assets and capital is standardized with regulatory prescriptions so that it can be adequately risk weighted.

15.2.3 Economic functions

i. Issue of money, in the form of cheques, demand drafts, etc. These claims on banks act as money.
ii. Netting and settlement of payments – as collecting and paying agents for customers through interbank clearing and settlement systems and reduce the cost of settlement for customers.
iii. Credit intermediation – banks borrow and lend back-to-back on their own account.

Role of banks primarily comprises:

(1) Intermediation
(2) Payment systems
(3) Financial services
(4) Life line of economy

15.3 GENERAL PRINCIPLES OF BANK REGULATION

The common objectives of regulating banks are:

a) Prudential - to reduce the level of risk to which bank creditors, mainly depositors, are exposed
b) Systemic risk reduction - to reduce the risk of disruption from adverse trading conditions
c) Avoid misuse of banks - to reduce the risk of banks being used for criminal purposes
d) To protect confidentiality of customer information
e) Credit allocation - to direct credit to favoured sectors
f) Customer service and Corporate Social Responsibility (CSR) by banks to be maintained

The general principles of banking regulations are described below.

i. Minimum requirements
Certain requirements for financial management are imposed to promote the objectives of the regulator. These are like maintaining prescribed capital ratios, statutory liquidity ratio, etc.

ii. Supervisory review
Banks need to obtain a license to carry on business as a bank, and the regulator supervises the banks for compliance with requirements towards regulatory directions and guidelines.

iii. Market discipline
Banks are required to publicly disclose financial and other information, so that depositors and other creditors are able to assess the level of risk.

15.4 ROLE OF REGULATOR

The role of the regulator is to

i. Set standards for the constituents of the system and review them continually.
ii. Enforce the standards through legislation, policies, rules, and regulations.
iii. Supervise the system which it controls.
iv. Develop markets by encouraging organic growth and facilitating inorganic growth.

15.5 UNIVERSAL FUNCTIONS FOR FINANCIAL REGULATORS

The regulators of financial sector have following specific functions:

i. Prudential regulation for safety and soundness of financial institutions;
ii. Maintaining stability and integrity of the payments system;
iii. Prudential supervision of financial institutions;

iv. Set norms for business regulation (i.e. rules about how firms conduct business with their customers);
v. Conduct of business supervision;
vi. Make safety net arrangements such as deposit insurance and the lender-of-last-resort role;
vii. Provide liquidity assistance for systemic stability;
viii. Handling of insolvent institutions;
ix. Crisis resolution; and
x. Handling issues related to market integrity.

15.6 REGULATORY AUTHORITIES

The main regulatory authorities that govern Indian financial system are given below

15.6.1 Reserve Bank of India (RBI)

i. Financial Supervision: The RBI performs this function under the guidance of the Board for Financial Supervision (BFS), committee of the Central Board of Directors of the RBI. Primary objective of BFS is to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions and non-banking finance companies.

Some of the initiatives taken by BFS include:

a. restructuring of the system of bank inspections,
b. introduction of off-site surveillance,
c. strengthening of the role of statutory auditors, and
d. strengthening of the internal defences of supervised institutions.

The Audit Sub-committee of BFS reviews the system and issue observations pertaining to concurrent audit, norms of empanelment and appointment of statutory auditors, the quality and coverage of statutory audit reports, and the important issue of greater transparency and disclosure in the published accounts of supervised institutions.

ii. Objectives of Regulation:

These are mainly-

a) Prudential i.e. to reduce the level of risk to protect depositors,
b) Systemic i.e. to reduce risk of disruption,
c) Control Misusing of banks for Criminal Purposes i.e. Money laundering & proceeds of Crime,
d) Protection of Confidentiality towards its Customers,
e) Needful Credit allocation to favoured sectors (priority sector),
f) Fair treatment to customers

iii. Risk Based Supervision

The process / programme is conducted through SPARC - Supervisory Program for Assessment of Risk & Capital. There are TWO major areas of assessment under SPARC - Risk and Capital,

It is carried out through Off-site analysis of the data & information furnished by Bank as well as finding of the On-site Inspection for Supervisory Evaluation (ISE). The Risk assessment covers

- inherent risks,
- risk due to gaps in controls for the inherent risks,
- risks due to gaps in the Governance & Oversight & degree of compliance
- to regulatory requirements.

The observations in RAR report broadly cover:

A. Supervisory Evaluation of Risks & Control Gaps

i) GOVERNANCE & OVERSIGHT which includes
   (1) Board
   (2) Senior Management
   (3) Risk Governance
   (4) Internal Audit
   (5) Risk Culture

ii) Business Risk
   1) Credit
   2) Market
   3) Liquidity
   4) Operational
   5) Other Pillar II

Further observations include Inherent Risk, Policy Environment, Risk identification, Control Gaps, Monitoring & Review, ICAAP & Stress Testing.

B. Banks are required to submit data / information (data points) towards ISE (RBS) on quarterly / annually vide Tranche submission:

Data / information	**No of Data points**	**Frequency**	**Details of data points**
Tranche 1 & 1 A to 1 F	784	Quarterly	For Data pertaining to Risk and Financial parameters
Tranche 2	386	Annually	Consists of 12 Risk related Parameters and Governance assessment

Tranche III	385	Annually	Subjective / Control Gap Parameters
TOTAL	1555		

iv. **Monetary Authority**: It formulates, implements and monitors the monetary policy. The objective is maintaining price stability and ensuring adequate flow of credit to productive sectors.

v. **Regulator and supervisor of the financial system:** It prescribes broad parameters of banking operations within which the country's banking and financial system function. The objective is to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public. For effective monitoring of the functioning of banks RBI obtains various periodical returns/ statements from banks and seek distinct data point information by way TRANCHE under Risk Based Supervision. Banks are directed to ensure to maintain quality and integrity while submitting these data point information.

vi. **Manager of Foreign Exchange**: It oversees the implementation of Foreign Exchange Management Act, 1999. The objective is to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

vii. **Issuer of currency:** It issues and exchanges currency and coins, and destroys those not fit for circulation. The objective is to give the public adequate quantity of quality currency notes and coins.

viii. **Developmental role:** It performs a wide range of promotional functions to support national objectives like financial inclusion, development of MSMEs, etc..

ix. **Related Functions:** It functions as the banker to the Government and performs merchant banking function for the Central and the State Governments. It also acts as the banker to banks and maintains banking accounts of all scheduled banks.

15.6.2 The Securities and Exchange Board of India (SEBI)

The SEBI was established on April 12, 1992 to protect the interests of investors in securities and to promote the development of, and to regulate the securities market. It undertakes mainly the following functions:

i. Registration, supervision, compliance monitoring and inspection of all market intermediaries in respect of all segments of the markets viz. equity, equity derivatives, debt and debt related derivatives.

ii. Supervising the functioning and operations (except relating to derivatives) of securities exchanges, their subsidiaries, and market institutions such as Clearing and settlement organizations and Depositories.

iii. Regulating (a) Issuance and listing of securities, (b) corporate governance and accounting/auditing standards (c) corporate restructuring through takeovers/buy backs (d) Delisting, etc.
iv. Registering and regulating mutual funds, venture capital funds, foreign venture capital investors, and collective investment schemes, including plantation schemes, Foreign Institutional Investors, Portfolio Managers and Custodians.
v. Monitoring market activity through market systems, data from other departments and analytical software.

15.6.3 Insurance Regulatory and Development Authority of India (IRDAI)

The IRDA was constituted to regulate and develop insurance business in India. It is responsible to protect the rights of policyholders. Its role includes the following aspects:

i. Registration of a life insurance company.
ii. Framing regulations on protection of policyholders' interests.
iii. Specifying the requisite qualifications, code of conduct and practical training for intermediaries or insurance intermediaries and agents.
iv. Regulating the investment of funds by insurance companies.
v. Regulating the maintenance of margins of solvency.
vi. Specifying the percentage of premium income of the insurer to finance schemes for the promotion and regulation of certain specified professional organisations;
vii. Specifying the percentage of life insurance business to be undertaken by an insurer in the rural or social sector.

15.6.4 Pension Fund Regulatory and Development Authority (PFRDA)

The PFRDA was established in 2014 for regulating National Pension Scheme (NPS) open to employees of Govt. of India, State Governments, private institutions/organizations and unorganized sectors. Its basic functions are:

i. Regulating the NPS and other pension schemes under its perview.
ii. Approving the schemes, and investment guidelines under these.
iii. Registering and regulating intermediaries.
iv. Protecting the interests of subscribers by appropriate regulations.
v. National Bank for Agriculture and Rural Development (NABARD)

15.6.5 National Bank for Agriculture and Rural development (NABARD)

NABARD was set up by the Government of India as a development bank for promotion and development of agriculture and integrated rural development. It is an apex institution handling matters concerning policy, planning and operations in the field of credit for agriculture and for other economic and developmental activities in rural areas. It is a refinancing agency for financial institutions offering production credit and investment credit for promoting agriculture and developmental activities in rural areas.

It has been vested with the powers of inspection of the RRBs, the District Central Co-operative Banks (Dt.CCB) and the State Co-operative Banks (St.CB) on behalf of the RBI.

15.7 OTHER BODIES ISSUING GUIDELINES

15.7.1 Indian Banks Association (IBA)

The IBA is a body of banks comprising banks of all types as its members. Its main objectives are:

i. To promote and develop in India sound and progressive banking principles, practices and conventions and to contribute to the developments of creative banking.
ii. To develop and implement new ideas and innovations in banking services, operations and procedures.
iii. To organize co-ordination and co-operation on procedural, legal, technical, administrative or professional problems and practices of banks and the banking industry.
iv. To initiate advance planning for introduction of new systems or services in the banking industry.
v. To collect, classify and circulate statistical and other information on the structure and working of the banking system.

15.7.2 Fixed Income Money Market and Derivatives Association of India (FIMMDA)

FIMMDA is association of Market Players and aids the development of the bond, money and derivatives markets. Its main objectives are:

i. Being the principal interface with the regulators on various issues that impact the functioning of these markets.
ii. Undertaking developmental activities, such as, introduction of benchmark rates and new derivatives instruments, etc.
iii. Providing training and development support to dealers and support personnel at member institutions.
iv. Adopting/ developing international standard practices and a code of conduct.
v. Devising standardized best market practices.
vi. Developing standardized sets of documentation.

15.7.3 Foreign Exchange Dealer's Association of India (FEDAI)

The FEDAI is an association of Authorised Dealer banks. It is has framed the rules governing the conduct of inter-bank foreign exchange business among banks vis-à-vis public and liaison with RBI for reforms and development of forex market. Its other main functions are:

i. Training of Bank Personnel in the areas of Foreign Exchange Business.
ii. Accreditation of Forex Brokers
iii. Announcement of daily and periodical rates to member banks.

15.7.4 The Association of Mutual Funds in India (AMFI)

AMFI is dedicated to developing the Indian Mutual Fund Industry. Its main activities are:

i. To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management including agencies connected or involved in the field of capital markets and financial services.
ii. To interact with the SEBI on matters concerning the mutual fund industry.

iii. To represent to the Government, RBI and other bodies on matters relating to the Mutual Fund Industry.

iv. To develop a cadre of well-trained Agent distributors and to implement a programme of training and certification for them and other intermediaries.

v. To undertake investor awareness programme on the concept and working of

vi. mutual funds.

15.8 IMPORTANT ACTS APPLICABLE IN INDIA

Banking activity requires handling various finance related matters pertaining to customers of different constitutions. Banking itself is regulated business. It is important to be aware of certain important acts.

1) **The RBI Act, 1934**: It is an Act that constituted Reserve Bank of India. It lays down the functions of RBI, provisions for its capital, management, provisions relating to acceptance of deposits from public, prohibition on acceptance of deposits by unincorporated bodies. Regulation of transactions in derivatives, money market instruments, securities, etc. and provisions related to monetary policy.

2) **The Banking Regulation Act, 1949**: It was enacted to consolidate the law relating to banking. It includes various provisions pertaining to functioning of banks. It defines the business of banking companies. It contains the provisions related to prohibition on trading, disposal of non-banking assets, management of banks, certain operations of banking companies, acquisition of banking undertakings, suspension of business, winding up of banking companies.

3) **The Negotiable Instruments Act, 1881**: It is an Act that defines the law relating to Promissory Notes, Bills of Exchange and Cheques. It covers various provisions related to dealing with such instruments, the liabilities of various parties, dishonor of instruments, crossing of cheques, negotiation of instruments, payment of cheques, dishonor of cheques.

4) **Foreign Exchange Management Act, 1999**: It is a law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India. It covers the aspects connected with regulation and management of foreign exchange, authorised persons to deal in foreign exchange, penalties for contravention of the provisions, and the Directorate of Enforcement vested with authority for investigations of contraventions.

5) **Information Technology Act, 2000**: An Act to provide legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication (i.e. electronic commerce). The law also amended the Indian Penal Code, the Indian Evidence Act, 1872, the Bankers' Books Evidence Act, 1891 and the Reserve Bank of India Act, 1934 in the context of recognizing the use of alternatives to paper-based methods. It contains provisions related to Digital Signature

and Electronic Signature; Electronic Governance; Attribution, Acknowledgement and Despatch of Electronic Records; Secure Electronic Records and Secure Electronic Signature; Regulation of Certifying Authorities; and Electronic Signature Certificates.

6) **The Income Tax Act, 1961**: This is law related to the income-tax. It covers various provisions based on which the income tax liability is arrived at; treatment of different types of income, various permitted deductions for different types of assesses, treatment of loss, avoidance of income-tax, transactions for avoidance of income tax, filing of return of income-tax, permanent account number, quoting Aadhaar number, undisclosed income, advance tax payment, tax deduction at source, tax collection at source, wilful attempt to evade tax, and assessment and appeals.

7) **The Companies Act, 2013**: This Act replaced the erstwhile The Companies Act, 1956, and covers various provisions related to the incorporated companies viz, different types of companies, registration, raising capital, borrowings, acceptance of deposits, registration of charges, dividends, accounts, audit, directors, Board responsibilities, Board meetings, revival and rehabilitation, winding up, producer companies, government companies, companies registered outside India, National Company Law Tribunal and the Appellate Tribunal.

8) **The Indian Partnership Act, 1932**: It is the law related to partnership firms. It contains provisions pertaining to nature of partnership, relations of partners to each other and to third parties, incoming and outgoing partners, and registration of firms.

9) **The Limited Liability Partnership Act, 2008**: This law pertains to the formation and regulation of limited liability partnerships. It contains provisions related to Nature of Limited Liability Partnership; Incorporation; Relations of partners; Extent and Limitation of Liability of Limited Liability Partnership and Partners; Assignment and Transfer of Partnership Rights; Conversion into Limited Liability Partnership; Foreign Limited Liability Partnerships; Compromise, Arrangement or Reconstruction of Limited Liability Partnerships; and Winding Up and Dissolution.

10) **Prevention of Money Laundering Act, 2002**: It is an Act to prevent money-laundering and to provide for confiscation of property derived from, or involved in, money-laundering. It contains provisions related to definition of money laundering offence, punishment for money laundering offence, procedures for investigation and prosecution, authority for it, obligations of finance sector and certain other businesses for preventing their abuse for money laundering, establishment of Financial Intelligence Unit and its role.

11) **The Unlawful Activities (Prevention) Act, 1967**: It is an Act to provide for more effective prevention of certain unlawful activities of individuals and associations, and for dealing with terrorist activities. It contains provisions related to Unlawful

Associations; Punishment for Terrorist Activities; Forfeiture of Proceeds of Terrorism or any Property Intended to be Used for Terrorism; and Terrorist Organisations.

12) **Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016**: This Act provides for targeted delivery of subsidies, benefits and services rendered through the Consolidated Fund of India, or the Consolidated Fund of the State through assigning of unique identity numbers to the beneficiaries. It contains provisions for establishing the Unique Identification Authority of India, enrolment of individuals, and authentication of the enrolled individuals.

13) **The Recovery of Debts and Bankruptcy Act, 1993**: It is an Act for the establishment of Tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions, insolvency resolution and bankruptcy of individuals and partnership firms. It contains provisions for Procedure of Tribunals; Recovery of Debt Determined by Tribunal; and Jurisdiction, Powers and Authority of Tribunals.

14) **The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002**: It is an Act to regulate securitisation and reconstruction of financial assets and enforcement of security interest and to provide for a Central database of security interests created on property rights. It contains provisions for regulation of Securitisation and Reconstruction of Financial Assets of Banks and Financial Institutions; Enforcement of Security Interest; Central Registry; and Registration by Secured Creditors and other Creditors.

15) **The Insolvency and Bankruptcy Code, 2016**: It is an Act pertaining to laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India (IBBI). It contains provisions for Insolvency Resolution and Liquidation for Corporate Persons; Insolvency Resolution and Bankruptcy for Individuals and Partnership Firms; and Regulation of Insolvency Professionals, Agencies and Information Utilities.

15.9 LET US SUM UP

A bank is the connection between customers that have capital needs and customers with capital surpluses. Banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934 are known as Scheduled Commercial Banks and Scheduled Cooperative Banks.

Banks face a number of risks in conducting their business. The capital requirement is a primary regulatory prescription, to enable banks to withstand the risks and sustain.

The role of the regulator is to set standards, enforce them, supervise the system, and develop markets. The regulators of financial sector have specific functions. The main financial sector regulators are - RBI, SEBI, IRDA, PFRDA. NABARD also has regulatory role. Other bodies that issue guidelines related to banking activities are IBA, FIMMDA, FEDAI and AMFI.
It is important that a banker is familiar with the provisions of certain laws. For instance - the RBI Act, 1934; The Banking Regulation Act, 1949; The Negotiable Instruments Act, 1881; Foreign Exchange Management Act, 1999; Information Technology Act, 2000; The Income Tax Act, 1961; etc.

15.10 KEY WORDS

financial intermediary; Public Sector Banks; Private Sector Banks; Regional Rural Banks; Local Area Banks; Small Finance Banks; Payments Banks; Cooperative Banks; Credit risk; Liquidity risk; Market risk; Operational risk; Reputational risk; Macroeconomic risk; settlement of payments; Intermediation; Prudential; Systemic risk; Credit allocation; Corporate Social Responsibility; safety net arrangements; Board for Financial Supervision; Monetary Authority; supervisor

15.11 CHECK YOUR PROGRESS

1) Which of the following is not one of the major functions of the National Bank for Agricultural and Rural Development (NABARD)?
   a) Conducting inspections of co-operative banks and RRBs
   b) Extending assistance to the government and others in matters related to rural development
   c) Providing refinance to lending institutions in rural areas
   d) Review of monetary and credit policy

2) Which of the following is not a function of a commercial bank?
   a) Registration of charges and mortgages
   b) Transactions services
   c) Asset transaction
   d) Real-time Gross Settlement

15.12 KEY TO 'CHECK YOUR PROGRESS'

1 (d); 2 (a).

References:

(1) Websites of RBI, SEBI, IRDA, PFRDA, NABARD, IBA, AMFI, FIMMDA, FEDAI

CHAPTER 16

Compliance Function in Banks

STRUCTURE

16.1 Compliance Risk and Significance of Compliance Function
16.2 Compliance Policy
16.3 Compliance Principles, Process and Procedures
16.4 Compliance Programme and Scope of Compliance Function
16.5 Role and Responsibilities of Chief Compliance Officer
16.6 Let us Sum up
16.7 Key Words
16.8 Check Your Progress
16.9 Key to 'Check your Progress'

OBJECTIVES

In this Chapter the learner will –

- Learn about Compliance Risk and Significance of Compliance Function
- Know about Compliance Policy
- Understand the scope of Compliance Function
- Know about the Role of Chief Compliance Officer

16.1 COMPLIANCE RISK AND SIGNIFICANCE OF COMPLIANCE FUNCTION

The BCBS paper on Compliance and the Compliance Function in Banks (April 2005) defines Compliance risk as "the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities" (together, "compliance laws, rules and standards").

BCBS paper devised basic principles for Compliance function and all Regulators globally have adopted the same while formulating Compliance function in Banks and issuing directions for effective implementation. These principles are:

Principle 1:
The Bank's Board of Directors (BOD) are responsible for overseeing and management of the bank's compliance risk. The Board should approve the bank's compliance policy which must include a formal document establishing a permanent and effective compliance function. At least once a year, Board or a committee of the Board should assess the extent to which the banks are managing its compliance risk effectively.

Principle 2:
The bank's senior management is responsible for effective management of the bank's compliance risk.

Principle 3:
The bank's senior management is responsible for establishing and communicating a compliance policy and for reporting to the BOD on the management of the bank's compliance risk.

Principle 4:
The bank's senior management is responsible for establishing a permanent and effective compliance function within the bank as part of the bank's compliance policy.

Principle 5:
The bank's compliance function should be independent.

Principle 6:
The bank's compliance function should have the resources to carry out its responsibilities effectively.

Principle 7:
The responsibilities of compliance function are carried out by staff in different departments, the allocation of responsibilities to each department should be clear.

Principle 8:
The scope and breadth of the activities of the compliance function should be subject to periodic review by the internal audit function.

Principle 9:
Banks should comply with applicable laws and regulations in all jurisdictions in which they conduct business.

Principle 10:
Specific tasks of the compliance function may be outsourced, but those must be subject to appropriate oversight by the head of compliance on continuous basis (periodic review).

The Compliance Risk is closely interrelated with other risks faced by a bank such as:

a) Regulatory Risk: Regulatory Risk refers to the potential consequences to the general public and the bank on account of non-compliance with the regulation.
b) Operational Risk: Risk arising due to operational activities. It may manifest due to non-compliance with regulations.
c) Legal Risk: Legal Risk is "the possibility that lawsuits, adverse judgments or contracts that turn out to be unenforceable". Compliance failures can lead to litigation and associated damages.
d) Reputational Risk: Reputation risk is of negative publicity for the bank's business practices, health, soundness of operations, etc. Compliance failures can damage reputation.
e) Annihilation Risk: Arises from possibility of regulatory action of closing down business. This could also occur due to major non-compliances.

Given the significance of these risks, a strong group/ enterprise-wide compliance programme is a necessity for banks. A group/ enterprise- wide compliance programme helps the bank to look at and across business lines and activities of the organization as a whole and to consider how activities in one area of the firm may affect the legal and reputational risks of other business lines and the entire group/enterprise. It also helps in understanding where the legal and reputational risks in the organization are concentrated, provide comparisons of the level and changing nature of risks, and identify those control processes that most need enhancement. The compliance function must ensure that controls and procedures capture the appropriate information to allow senior management and the board to better perform their risk management functions on a group-wide basis.

16.2 COMPLIANCE POLICY

Compliance function is one of the key elements in Banks' corporate governance structure. The compliance function in the bank has to be adequately enabled and made sufficiently independent in accordance with the perception of the Basel Committee on Banking Supervision (BCBS), April 2005.

The compliance policy must speak of certain principles, standards and procedures relating to compliance function consistent with the RBI directions. The policy also must intend to articulate that the compliance function is an integral part of governance along with the internal control and risk management process.

A policy document in the Bank in respect of Compliance guidelines should be formulated / prepared considering and adopting ingredients contained in various RBI Circulars/ Directions on compliance to keep pace with the increasing complexities and sophistication in Bank's business. Compliance function needs to be fully cognizant of the "compliance risk" and the reputational risk arising out of compliance failures causing huge economic costs.

Reserve Bank of India had vide their Circular No RBI/2006-2007/335 REF. DBS.CO.PP.BC 6/11.01.005/2006-07 dated 20.04.2007 advised all banks to formulate and implement Compliance Function Policy for the Bank within 6 months from the date of the circular on the basis of the framework evolved by them. It was also advised that they would subject the implementation of compliance function in the bank to a comprehensive review during the Annual Financial Inspection.

The Compliance policy was required to include the following key elements:

I. Compliance Objective,
II. Scope of Compliance Function,
III. Compliance Function at Corporate Office / Zonal Office / Branches/ Subsidiaries / Foreign Centers,
IV. Role & Responsibilities of Chief Compliance Officer

RBI reviewed the Banks responses and preparedness annually and observed that uniformity in approach for effective compliance function is needed to align with supervisory expectations on CCOs with best practices. Accordingly, RBI issued communication on 11th September' 2020 about Compliance Functions in Banks and Role of CCO inter-alia advised following guidelines for formulation of Compliance Policy:

1) A bank must have a board approved Compliance Policy. The Policy should clearly spell out - its Compliance Philosophy, Expectations on Compliance Culture (covering Tone from the Top, Accountability, Incentive Structure and Effective Communication and Challenges thereof), Structure and Role of the Compliance Function, Role of CCO, and Processes for identifying, assessing, monitoring, managing and reporting on Compliance Risk throughout the bank.
2) The Policy shall adequately reflect the size, complexity and compliance risk profile of the bank, expectations on ensuring compliance to all applicable statutory provisions,

rules and regulations, various codes of conducts (including the voluntary ones) and the bank's own internal rules, policies and procedures, and creating a disincentive structure for compliance breaches.

3) The bank shall also develop and maintain a quality assurance and improvement program covering all aspects of the compliance function. The quality assurance and improvement program shall be subject to independent external review periodically (at least once in three years).
4) The policy should lay special thrust on building up compliance culture; vetting of the quality of supervisory / regulatory compliance reports to RBI by the top executives, non-executive Chairman / Chairman and ACB of the bank.
5) The policy should be reviewed at least once a year.

16.3 COMPLIANCE PRINCIPLES, PROCESS AND PROCEDURES

i. The Compliance Department at the Head Office has the central role in identifying the level of compliance risk in each business line, products and processes and formulate proposals for mitigation of such risk. It should circulate the instances of compliance failures among staff along with preventive instructions.
ii. Inspection/audit findings serve as a feedback mechanism for assessing the areas of compliance breaches/failures.
iii. The compliance function should ensure that regulatory guidelines/ instructions are promptly issued/disseminated within the organization, and monitor compliance with these. Compliance function should vet the guidelines/circulars before these are disseminated amongst the operational units.
iv. The Compliance Department should serve as a reference point for clarifications/ interpretations of various regulatory and statutory guidelines.
v. The Compliance function should identify, document, assess the compliance risks associated with banks' business activities and products, including in all new products and processes. Appropriate risk mitigants should be put in place before launching. All new products should be subjected to intensive monitoring for the first six months for indicative compliance parameters.
vi. Bank should develop function-wise Compliance Manuals, if operating manuals do not contain specific sections or chapters on compliance.
vii. Compliance officers should have access to all information they require and have the right to conduct investigation and report the findings to the Chief Compliance Officer (CCO).
viii. There should be close co-ordination and partnership between Compliance and Business Operations functions. The interaction may be formalized by making the CCO a member of the various interdepartmental committees in the bank.
ix. The compliance function should monitor and test compliance by representative compliance testing and the results should be reported to the senior management.
x. It should consider ways to measure compliance risk (e.g. by using performance indicators) and to enhance compliance risk assessment.
xi. Compliance staff can conduct compliance reviews/ investigations, whenever required.

xii. The code of conduct for employees should envisage dealing with customers in a fair manner and conducting business operations consistent with rules and regulations. Due weightage could be given to record of compliance during performance appraisal of staff at various levels. Staff accountability should be examined for all compliance failures.

16.4 COMPLIANCE PROGRAMME AND SCOPE OF COMPLIANCE FUNCTION

16.4.1 Compliance Programme

i. The compliance programme should be risk-based and ensure appropriate coverage across businesses and co-ordination among risk management functions. A comprehensive compliance plans replete with compliance testing and review structures needs to be implemented.

ii. Banks should carry out an annual compliance risk assessment in order to identify and assess major compliance risks faced by them and prepare a plan to manage the risks. The Annual review should broadly cover the following aspects.
   a. Compliance failures, consequential losses, regulatory action, and steps taken to avoid recurrence.
   b. Major regulatory guidelines issued during the year and steps taken for compliance.
   c. System of internal control to minimize compliance risk.
   d. Compliance with fair practices codes and standards of self-regulatory bodies and accounting standards.
   e. Progress in rectification of significant deficiencies pointed out in the internal audit, statutory audit and RBI inspection reports.
   f. Strategy for the next year.

iii. An Annual Report on compliance failures/ breaches should be compiled and placed before the Board/ACB/Board Committee and circulated to all the functional heads.

iv. A monthly report on the position of compliance risk may be put up to the senior management/ CEO by the CCO. A brief report on the compliance position may also be placed before the Board/ACB/Board Committee, on a quarterly basis.

v. Instances of all material compliance failures which may attract significant risk of legal or regulatory sanctions, financial loss or loss of reputation should be reported to the Board/ACB/Board Committee promptly.

vi. Adherence and compliance with MAP/RMP prescribed pursuant to the Risk Assessment Report under Risk Based Supervision processes is very important.

vii. The activities of the compliance function should be subject to annual review by the internal audit.

16.4.2 Scope of Compliance Function:

The scope of compliance function covers the following:

i. Statutory Compliance: A bank is required to comply with statutory provisions contained in various legislations especially Banking Regulation Act, Reserve Bank of India Act, Foreign Exchange Management Act and Prevention of Money Laundering Act etc.

ii. Regulatory Compliance: A bank is required to comply with regulatory guidelines issued from time to time by the Regulators such as RBI, SEBI, IRDA, etc.
iii. Code of Conduct: A bank has to frame Code of Conduct based on guidelines issued by organizations like IBA, , FEDAI/FIMDDA, etc. and abide by these.
iv. Accounting Standards: A bank has to abide by those Accounting Standards of ICAI that are applicable to banks.
v. Listing Agreement: A bank with its shares listed on NSE/BSE has to comply with the requirements of Listing Agreement with stock exchanges.
vi. Internal Compliances (Process /Policy Compliances): A bank is required to comply with the internal guidelines, policies, processes related compliances.

16.5 ROLE AND RESPONSIBILITIES OF CHIEF COMPLIANCE OFFICER (CCO)

The CCO is primarily responsible for overseeing and managing compliance issues within the bank. Recent RBI guidelines speak few specific directions in regard to appointment and Role of CCOs. Accordingly, the designated CCO should be selected through a suitable process with an appropriate "Fit & Proper" evaluation / selection criterion to manage compliance risk.

Those directions are given as under:

a. Tenor for appointment of CCO - The CCO shall be appointed for a minimum fixed tenure of not less than 3 years. The Audit Committee of the Board (ACB) / Managing Director (MD) & CEO should factor this requirement while appointing CCO;
b. Transfer / Removal of CCO - The CCO may be transferred / removed before completion of the tenure only in exceptional circumstances with the explicit prior approval of the Board after following a well-defined and transparent internal administrative procedure;
c. Eligibility Criteria for appointment as CCO - Rank - The CCO shall be a senior executive of the bank, preferably in the rank of a General Manager or an equivalent position (not below two levels from the CEO). The CCO could also be recruited from market;
d. Age - Not more than 55 years;
e. Experience - The CCO shall have an overall experience of at least 15 years in the banking or financial services, out of which minimum 5 years shall be in the Audit / Finance / Compliance / Legal / Risk Management functions;
f. Skills - The CCO shall have good understanding of industry and risk management, knowledge of regulations, legal framework and sensitivity to supervisors' expectations;
g. Stature - The CCO shall have the ability to independently exercise judgement. He should have the freedom and sufficient authority to interact with regulators/supervisors directly and ensure compliance;
h. Others - No vigilance case or adverse observation from RBI, shall be pending against the candidate identified for appointment as the CCO.
i. Selection Process - Selection of the candidate for the post of the CCO shall be done on the basis of a well-defined selection process and recommendations made by the senior executive level selection committee constituted by the Board for the purpose. The selection committee shall recommend the names of candidates suitable for the post of the CCO as per the rank in order of merit and Board shall take final decision in the appointment of CCO;

j. Reporting Requirements - A prior intimation to the Department of Supervision, Reserve Bank of India, Central Office, Mumbai, shall be provided before appointment, premature transfer/removal of the CCO. Such information should be supported by a detailed profile of the candidate along with the fit and proper certification by the MD & CEO of the bank, confirming that the person meets the above supervisory requirements, and detailed rationale for changes, if any;
k. Reporting Line - The CCO shall have direct reporting lines to the MD & CEO and/or Board/Board Committee (ACB) of the bank. In case the CCO reports to the MD & CEO, the Audit Committee of the Board shall meet the CCO quarterly on one-to-one basis, without the presence of the senior management including MD & CEO. The CCO shall not have any reporting relationship with the business verticals of the bank and shall not be given any business targets. Further, the performance appraisal of the CCO shall be reviewed by the Board/ACB;
l. Authority - The CCO and compliance function shall have the authority to communicate with any staff member and have access to all records or files that are necessary to enable him/her to carry out entrusted responsibilities in respect of compliance issues. This authority should flow from the compliance policy of the bank;

16.5.1 Duties and Responsibilities of CCO

The duties and responsibilities of the compliance function and role of CCO includes the following aspects:

i. To apprise the Board and senior management on regulations, rules and standards and any further developments.
ii. The CCO should be an invitee to the meetings of the ACB.
iii. To provide clarification on any compliance related issues.
iv. To conduct assessment of the compliance risk (at least once a year) and to develop a risk-oriented activity plan for compliance assessment. The activity plan should be submitted to the ACB for approval and be made available to the internal audit.
v. To report promptly to the Board / ACB / MD & CEO about any major changes / observations relating to the compliance risk.
vi. To periodically report on compliance failures/breaches to the Board/ACB and circulating to the concerned functional heads. The CCO can use external experts for the purpose of investigation.
vii. To monitor and periodically test compliance by performing sufficient and representative compliance testing. The results of the compliance testing should be placed to Board/ACB/MD & CEO.
viii. The CCO should have the right of direct access to the Board or ACB or a committee of the Board, by passing normal reporting lines. The Board or the ACB or a Committee of the Board should meet with the CCO at least annually.
ix. To examine sustenance of compliance as an integral part of compliance testing and annual compliance assessment exercise.
x. The Chief Compliance Officer should be a member of the 'new product' committee/s to ensure that the new products / processes have clearance from all perspectives including compliance. All new products should be subjected to intensive monitoring

for the first six months of introduction to ensure that the indicative parameters of compliance risk are adequately monitored.

xi. At frequent intervals, interact with Legal Department, Risk Management Department, Finance & Taxation Department and Inspection & Audit Department to take stock of the latest changes in compliances and new areas of compliances.

xii. To ensure compliance of Supervisory observations made by RBI and/or any other directions in both letter and spirit in a time bound and sustainable manner.

xiii. To be the nodal point of contact between the bank and the RBI, and other Regulators.

xiv. Non-compliance with any regulatory guidelines and administrative actions initiated against the bank and/ or corrective steps taken to avoid recurrence of the lapses should be disclosed in the annual report of the banks.

16.5.2 Other aspects of the Role of CCO

i. Dual Hatting: There shall not be any ‘dual hatting’ i.e. the CCO shall not be given any responsibility which brings elements of conflict of interest, especially the role relating to business. Roles which do not attract direct conflict of interest like role of anti-money laundering officer, etc. can be performed by the CCO in those banks where principle of proportionality in terms of bank’s size, complexity, risk management strategy and structures justify that;

ii. The CCO shall not be member of any committee which brings his/her role in conflict with responsibility as member of the committee, including any committee dealing with purchases / sanctions. In case the CCO is member of a committee, he/she may have only advisory role;

iii. Typical core elements of the mandate of CCO must include the design and maintenance of compliance framework, training on the regulatory and conduct risks, and effective communication of compliance expectations, etc.;

iv. CCO should coordinate with Senior Supervisory Manager (RBI team head for conducting RBS) comprehensively for providing necessary Banks’ information /data to SSM and team members for smooth and meaningful conduct of RBS.

v. All the disclosure requirements in terms of Regulatory Guidelines i.e. RBI, SEBI or other, shall be ensured by CCO within the timelines prescribed for the regulation.

16.5.3 Disclosure requirement in respect of divergence in the asset classification and provisioning beyond specified threshold under Risk Assessment Report (RAR)

Compliance function should ensure that the concerned department makes necessary disclosures in a prescribed format in respect of divergence, if any, in the asset classification and provisioning beyond specified threshold under Risk Assessment Report (RAR) of the Bank

- Not later than 24 hours upon receipt of Final RAR in compliance with the SEBI Circular No. CIR/CFD/CMD1/120/2019 October 31, 2019
- In the Notes to Accounts in the ensuing Annual Financial Statements published immediately following communication of such divergence in compliance with RBI Notification No. RBI/2016-17/ 283; DBR.BP.BC.No.63/ 21.04.018/ 2016-17 dated April 18, 2017.

16.5.4 Compliance in respect of reporting of Strictures / Show Cause Notices (SCNs) / Cautionary Advice issued / Imposition of penalty on Bank / Subsidiary

- Any adverse action against Bank exposes towards reputational risk, therefore, the Compliance Function should ensure that such Strictures / Show Cause Notices (SCNs) / Cautionary Advice / Imposition of penalty must be attended to by the concerned functional department in a time bound manner. .
- The concerned functional department should undertake the root cause analysis for the reasons resulted in Strictures / Show Cause Notices (SCNs) / Cautionary Advice issued / Imposition of penalty against the Bank and appraise the Board about the reasons and corrective actions.

Compliance Department at Corporate / Central Office level must be single point of contact for RBI and other regulators with CCO as its helm.

16.6 LET US SUM UP

Compliance risk as "the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, etc. A strong group/ enterprise-wide compliance programme is a necessity for banks. A bank must have a board approved Compliance Policy that is reviewed at least once a year. The policy should lay special thrust on building up compliance culture.

The Compliance Department at the Head Office has the central role in identifying the level of compliance risk in each business line, products and processes and formulate proposals for mitigation of such risk. There should be close co-ordination and partnership between Compliance and Business Operations functions.

The compliance programme should be risk-based and ensure appropriate coverage across businesses and co-ordination among risk management functions. The scope of compliance function covers both external and internal compliances. The CCO is primarily responsible for overseeing and managing compliance issues within the bank.

16.7 KEY WORDS

Compliance Function; Compliance Risk; Regulatory Risk; Operational Risk; Legal Risk; Reputational Risk; Annihilation Risk; Compliance Policy; compliance culture; Compliance Programme; Accounting Standards; Code of Conduct; Listing Agreement; Chief Compliance Officer.

16.8 CHECK YOUR PROGRESS

1) Possibility of regulatory action of closing down business is _____risk
   a) Annihilation
   b) Legal
   c) Operational
   d) Regulatory

2) Which of the following is a statutory regulation?
   a) Guidelines from SEBI
   b) Guidelines from RBI
   c) Legislation under RBI act
   d) Guidelines from IRDA

16.9 KEY TO 'CHECK YOUR PROGRESS'

1 (a); 2 (c)

References:

1) RBI Circular DBS. CO.PP.BC 6/11.01.005/2006-07 dated April 20, 2007 - Compliance function in banks (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=3433)
2) RBI Circular DBS.CO.PPD.10946/11.01.005/2014-15 dated March 04, 2015 - Compliance function in banks (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=9598)
3) RBI Circular DoS.CO.PPG./SEC.02/11.01.005/2020-21 dated September 11, 2020 - Compliance functions in banks and Role of Chief Compliance Officer (CCO) (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11962)
4) BCBS Guidelines, 29th April 2005, 'Compliance and the compliance function in banks' (https://www.bis.org/publ/bcbs113.htm)

CHAPTER 17

COMPLIANCE GOVERNANCE STRUCTURE

STRUCTURE

17.1 Organizational Structure – GRC Framework
17.2 Responsibility of the Board and Senior Management
17.3 Compliance Structure at the Corporate Office and Functional Departments
17.4 Compliance Structure at Field Levels
17.5 Internal Controls/ Measures and its Importance
17.6 Whistle Blower Mechanism
17.7 Let us Sum up
17.8 Key Words
17.9 Check Your Progress
17.10 Key to ‘Check your Progress’

OBJECTIVES

In this Chapter the learner will –

- Understand the GRC framework in an organization
- Know about the responsibility of the Board and Senior Management
- Learn about the compliance structure in an organsiation
- Understand the importance of internal controls/ measures

17.1 ORGANIZATIONAL STRUCTURE – GRC FRAMEWORK

17.1.1 GRC - Framework

Growing regulatory environment, higher business complexity and increased focus on accountability have led enterprises to pursue a broad range of governance, risk and compliance initiatives across the organization. These initiatives get planned and managed in silos, which potentially increases the overall business risk for the organization, apart from duplication of efforts and spiralling of costs. Governance, Risk, and Compliance process through control, definition, enforcement, and monitoring aims to coordinate and integrate these initiatives.

The Governance, Risk and Compliance (GRC) framework includes three elements.

i. **Governance**: This is the oversight role and the process by which companies manage and mitigate business risks. The governance process within an organization includes elements such as definition and communication of corporate control, key policies, enterprise risk management, regulatory and compliance management and oversight (e.g., compliance with ethics and options compliance as well as overall oversight of regulatory issues). It requires evaluating business performance through balanced scorecards, risk scorecards and operational dashboards.

ii. **Risk Management**: It enables an organization to evaluate all relevant business and regulatory risks and controls, and monitor mitigation actions in a structured manner. With the recent jump in regulatory mandates and increasingly activist shareholders, many organizations have become sensitized to identifying and managing areas of risk in their business: whether it is financial, operational, IT, brand or reputation related risk. Companies are looking to systemically identify measure, prioritize and respond to all types of risk in the business, and then manage any exposure accordingly.

iii. **Compliance**: This ensures that an organization has the processes and internal controls to meet the requirements imposed by governmental bodies, regulators, industry mandates or internal policies. An initiative to comply with a regulation typically begins as a project as companies race to meet deadlines to comply with that regulation. However, compliance is not a one-time event - organizations realize that they need to make it into a repeatable process. When an organization is dealing with multiple regulations at the same time, a streamlined process of managing compliance with each of these initiatives is critical, or else, costs can spiral out of control and the risk of non-compliance increases.

17.1.2 Integrated GRC Approach

Even though, each initiative of an entity individually follows the governance, risk and compliance process, the software solutions deployed to enable these processes, were selected in a very tactical manner. As a result, organizations ended up with numerous systems to manage individual governance, risk and compliance initiatives, each operating in its own silo.

By taking an integrated GRC process approach and deploying a single system to manage the multiple governance, risk and compliance initiatives across the organization, several benefits, indicated below can result.

i. Positive impact on organizational effectiveness providing a clear process and a single point of reference.
ii. Eliminating redundant work.
iii. Providing a "single version of the truth" to employees, management, auditors and regulatory bodies
iv. Significantly reducing the cost of compliance.

17.1.3 Organisational Structure

A bank should have a structure that ensures proper corporate governance, risk management and compliance in its functioning. For this purpose, the broad structure followed is based on the concept of 'Three Lines of Defence'. Broad organisation structure of a bank structured on this basis is as shown below.

Fig. 17.1 Organisational Structure

The responsibility of compliance rests with every individual in the bank – from the Directors to the frontline executives.

i. The Board of Directors has the ultimate responsibility to ensure that the bank's business and activities are conducted in compliance with all applicable laws/

regulations/ codes and internal policies. (ii) The Senior Management is responsible for ensuring compliance in day to day activities.

ii. The first line of defence (i.e. various business/ operations/ support functions) implement the compliance requirements in carrying out the business activities.
iii. The second line of defence (i.e. Compliance and Risk functions) monitor on ongoing basis the compliance by the first line and provide required guidance.
iv. The third line of defence viz. Audit function provides the assurance to the Board and Senior Management on the status of compliance based on periodical audit exercises.

The structure of compliance function depends on the branch network, size and complexity of the business operations, sophistication of products and services offered etc,

The Organizational structure of Compliance function could be as under:

Independent Compliance Department headed by Chief Compliance Officer
Compliance Function at Verticals at Corporate Office.
Compliance Function at Field Offices - Zonal Offices - Regional Offices - Branches

17.2 RESPONSIBILITY OF THE BOARD AND SENIOR MANAGEMENT

Compliance starts at the top. It will be most effective in a corporate culture that emphasizes standards of honesty and integrity and one in which the board of directors and senior management lead by example.

17.2.1 Responsibility of the Board of Directors

i. Ensure an appropriate compliance policy is in place, and oversee its implementation.
ii. Ensure compliance issues are resolved effectively and expeditiously by Senior Management.
iii. Ensure there is no potential for any conflict of interest, the compliance function is subject to independent review, and the compliance and the audit functions are being kept separately.
iv. Review compliance functions on a quarterly basis and an annual review of compliance status is carried out.
v. Compliance failures may be reviewed by Boards/Management Committees and appropriate remedial measures may be taken.
vi. The Board may delegate these tasks to the Audit Committee of the Board (ACB).

The Companies Act, 2013 casts the responsibility on the Directors to devise proper systems to ensure compliance with the provisions of all applicable laws. This is to be confirmed in the

Directors' Responsibility Statement to be included in the Directors' report to the Shareholders.

17.2.2 Responsibility of Senior Management

i. Establish a written compliance policy containing the basic principles for compliance, the main process for identifying and managing compliance risk.
ii. Ensure that all regulatory directions, instructions and guidelines are duly incorporated and formulated as per the size, volume and spread of business.
iii. ensure that policy address the proper reporting mechanism at various levels of controls.
iv. Ensure that appropriate remedial or disciplinary action is taken if breaches are identified.
v. At least once a year, identify and assess the main compliance risk and formulate plans to manage them.
vi. Submit to the Board/ACB, quarterly and annual reviews, to enable them to make an informed judgment on management of compliance risk, and report promptly to the Board or the ACB any material compliance failure.

17.3 COMPLIANCE STRUCTURE AT THE CORPORATE OFFICE AND FUNCTIONAL DEPARTMENTS

17.3.1 Compliance Department at Corporate Office

At the Corporate Office, an independent Compliance Department is set up, headed by a senior executive as Chief Compliance Officer/ Head Compliance. It has the overall responsibility for coordinating identification of Compliance issues and management of the bank's compliance risk. It shall frame an appropriate mechanism for coordination among various functional departments/ field offices/ branches of the bank to enable the CCO to perform effectively. The Compliance Department shall be staffed adequately with well-qualified persons. Compliance staff shall preferably have fair knowledge of Law, Accountancy and Information Technology and adequate practical experience in various business lines and audit/inspection functions. Compliance Department should have close co-ordination with the operations risk function on compliance matters.

Within the scope set for the compliance function, the Compliance Department at Corporate Office should coordinate with all functions at group level including subsidiaries and overseas establishments and undertake the duties and responsibilities for achieving the objective of the compliance function, specifically:

i. To identify the business functions of the bank that fall under each statutory and regulatory guideline.
ii. To assess the level of compliance risk in each business line, product and process into High, Medium and Low Risk and accordingly formulate proposals for mitigation of the risk.
iii. To ensure prompt dissemination of statutory and regulatory guidelines and instructions for compliance to Functional departments / Verticals for onward circulation to all controlling

offices down the line and also ascertain effecting system level modifications, if needed, so as to submit compliance of each RBI direction to ACB on prescribed frequency.

iv. To evolve strategies and develop systems for communication and transfer of information on compliance matters between branches to Zonal Compliance Departments and from Zonal Compliance Departments / Overseas Compliance Departments/ Corporate Office functional departments to itself and vice versa.

v. To ensure that the functional departments have their policies with function wise compliance parameters for information of the staff associated with the functions and also list out various returns to be submitted by the bank to the statutory and regulatory authorities.

vi. To circulate periodically the instances of compliance failures to H.O. departments and Branches/Offices along with preventive instructions.

vii. To monitor all new products and process intensively for 6 months from introduction thereof, to ensure that the indicative parameters of compliance risk are adequately met. The convenor of the Product Group Committee, should monitor and advise gaps on operational & compliance front, if any, in coordination with I&A Department.

viii. To provide a checklist on the compliance aspects to the inspectors/concurrent auditors to verify the level of compliance in domestic branches. The Inspection/Audit findings related to compliance should be scrutinized and appropriate corrective measures are to be taken in case of any compliance breaches/failures.

ix. To co-ordinate with the SSM Team of RBI in conducting Risk Based Supervision (RBS). The department should co-ordinate with all the departments for periodic submission of the Data under Tranche pertaining to the RBS. The department should review / interact with the concerned functional department for correctness of the data for Tranche and shall ensure vetting by a committee of senior officials before its submission to RBI.

x. To provide guidance in respect of cross border business undertaken by the bank, to the operational departments (in consultation with the Head of the International Division) so that they ensure compliance of such business activity with the legal and regulatory guidelines prevalent in the respective jurisdiction.

xi. To scrutinise the RBS report and ensure time bound submission of compliance / replies to the observations of Risk Assessment Report / Major Area of Financial Divergence / Major Area of Non-Compliance/ Risk Mitigation Plan to RBI and also devise a time bound strategy to ensure that the compliance on all Action points of the Risk Mitigation Plan (RMP) is achieved within the given time line.

xii. To ensure sustainability of compliance to RBI observations, the compliance department should ensure that I&A Department conducts audit in respect of execution of different action points / compliances by Branches / functional departments at Corporate Office in respect of Risk Mitigation Plans (RMPs) and observations vide Risk Assessment Report (RAR) of RBI.

xiii. To ensure formulation / updation of compliance rules (CRs) in co-ordination with principal functional departments for all banking functions and their operational implementation in terms of statutory guidelines covering especially pertaining to KYC-AML-CFT guidelines, Deposits and Services, Advances and FEMA Guidelines. The department shall also ensure submission of CRs by the Branches / Zones on monthly / quarterly basis and onward reporting to ACB.

xiv. The Banks having overseas establishments should have an overseas compliance set up and undertake the following compliance functions for overseas establishments: -

a) to ensure that the overseas branches are using updated and reviewed policies, not more than a year, specifically in respect of KYC- AML policy as well as compliance policy.

b) to obtain periodic certifications/confirmation from overseas establishments and strengthen the monitoring process from corporate office with measures as under-.

i. Obtention of Compliance Sustainability Tracker covering various compliance matters of overseas branches and report the status to the Top Management periodically as prescribed vide policy,

ii. Obtention of monthly certificates / confirmations on position of Regulatory Violations / Enforcement Actions / Imposition of Penalties, if any, for non-compliance issues at overseas centers.

c) To ensure that the compliance officers at overseas branches are conducting an independent compliance testing and submit the report periodically, currently at quarterly intervals.

d) To ensure that overseas branches are submitting the reports of compliances to the regulators' observations/ issues raised in regulatory examinations to their regulators on time.

e) To report compliance status/emerging compliance issues at overseas centers to the Top Management & ACB / Board and co-ordinate with the overseas branches/ International Division for timely compliance of directions thereof.

xv. To prepare an Annual Report on compliance failures/breaches and place before the Board/ACB and also circulate to amongst the concerned departments.

17.3.2 Compliance Structure at Functional Departments

The Functional Departments at Corporate Office shall have a senior functionary to act as Compliance Officers for managing compliance risk pertaining to their functional area. They shall report to the Compliance Department, and coordinate with it. The key functions of this functionary are:

i. To identify compliance requirements/ issues pertaining to their Functional Department based on regulatory/statutory guidelines.

ii. To act on compliance issues identified by Compliance Department.

iii. To monitor compliance of all regulatory and statutory guidelines as well as internal policy guidelines and report to CCO any breaches/non-compliances observed.

iv. To ensure timely submission of regulatory returns as per the calendar of returns.

v. To interact with Compliance Department for any clarification.

vi. To extend necessary cooperation in the process of compliance testing.

vii. To share their views/ suggestions arising out of their experience and knowledge of Compliance in their functional area.

viii. To associate with the training programmes/ workshops arranged by Compliance Department.

ix. To ensure implementation of all regulatory/statutory guidelines by the Functional Department.

17.4 COMPLIANCE STRUCTURE AT FIELD LEVELS

17.4.1 At Branches

The Branch Manager and the branch staff play a crucial role in compliance as branches are the delivery and service points. Conflict of interest between managing the compliance risk and business development cannot be avoided at this level. It must be ensured that this potential conflict is not allowed to come in the way of compliance as well as delivery of services and business, Appropriate mechanism with written SOP must be put in place. The Branch Manager, Service Managers and other officers are primarily responsible for compliance of rules and regulations. The Branch Manager will be the Compliance Officer for his branch.

17.4.2 At Zonal/ Regional Offices

Zonal/Regional Heads will perform the role of Compliance Officers in their respective jurisdictions. The departmental heads in a ZO/RO are equally responsible for managing the compliance pertaining to their functional area. They are required to apprise the Zonal/Regional Head about the level of compliance and breaches observed, if any, so that prompt corrective action is taken. These incidents should be reported to the Compliance Department. They shall be responsible for compliance to lay down systems, procedures, rules and guidelines for Regional Office as well as for all the branches reporting to Regional Office. They shall also be responsible for submission of compliance reports to the Compliance Department for the ZO/RO and to monitor submission of these reports by the branches. They also have a role of handholding, trouble shooting and monitoring for compliance matters at branches.

17.5 INTERNAL CONTROLS/ MEASURES AND ITS IMPORTANCE

An area that plays a crucial role in the control of a compliance risk is its system of internal controls. Effective internal controls enhance the safeguards against system malfunctions, errors in judgment and fraud. Without proper controls in place, management will not be able to identify and track its exposure to risk.

Six aspects of internal controls need attention:

i. Information Systems: Effective controls are essential to ensure the integrity, security, and privacy of information contained on the bank's computer systems. There should also be a tested contingency plan for any failure of the computer systems.

ii. Segregation of Duties: There should be adequate segregation of duties in every area of operation for dual or multiple controls.

iii. Audit Programme: An effective audit function and process should be independent, reporting to the board without conflict or interference with management. An annual audit plan is necessary to ensure that all risk areas are examined, and that those areas of greatest risk receive priority. Follow-up of any unresolved issues is essential, e.g., examination of exceptions should be covered in subsequent reports.

iv. Record Keeping: A bank must maintain records of required information/ documents not only for compliance with legal requirements but also for the control purposes. The records and accounts should reflect its actual financial condition and accurate results of operations.

v. Protection of Physical Assets: A principal method of safeguarding assets is to limit access by authorized personnel. Protection of assets can be accomplished by developing operating policies and procedures for cash control, joint custody (dual control), teller operation, and physical security of the computer.

vi. Education of Staff: Bank staff should be thoroughly trained in specific daily operations. A training programme tailored to meet management's needs should be in place and cross-training programmes for office staff should be present. Risk is controlled when the bank is able to maintain continuity of operations and service to members.

Actionable towards the objective of compliance framework and monitoring, may be enumerated as under:

Theme	Key components for assessment
Effective governance	❖ Board-approved Compliance policy formulating compliance-related responsibilities of governance committees and framing THREE lines of defence (namely, business, operations & finance; compliance & risk; and internal audit) ❖ Reporting procedure with defined SOPs to the Board (or committee thereof), including results of compliance program, regulatory reporting such as RBS, etc.
Strengthening the first line of defence	❖ Role of business and operations in compliance management – role, enablement infrastructure, including documentation of processes, risks and controls ❖ Scope and coverage of concurrent audit
Compliance processes and systems (second line of defence)	Compliance function in line with the RBI directions ❖ Risk-based Compliance monitoring and testing program, and its convergence with the Bank's other control and assurance programs such as concurrent audits, internal audits, operational/enterprise risk and control assessments, etc. ❖ IT systems for compliance management, automation of key compliance controls and indicators/alerts
Role of internal audit (third line of defence)	❖ Scope and coverage of internal audit function, as the third line of defence and source of objective feedback on the compliance health in the organization

Theme	Key components for assessment
Thematic compliances	❖ Implementation of KYC AML CFT policy updated in terms of Master Direction of RBI along with AML/CFT program addressing other leading industry standards across the three lines of defence with appropriate structural MIS in place ❖ Implementation of other compliance changes i.e. proactive fraud risk management, early warning signals for credit risk, information and cyber security measures, etc., as considered relevant by the bank

17.6 WHISTLE BLOWER MECHANISM

Regulation 4(2)(d)(iv) of SEBI (LODR), 2015 provides for the listed entity to devise an effective Whistle Blower mechanism viz. Whistle Blower Policy enabling stakeholders, including individual employees and their representative bodies, to freely communicate their concerns about illegal or unethical practices. The vigil mechanism shall provide for adequate safeguards against victimization of director(s) or employee(s) or any other person who avail the mechanism and also provide for direct access to the chairperson of the audit committee in appropriate or exceptional cases. These Regulations also require that the details should be displayed on the website. The ACB is required to review the functioning of this mechanism and the Annual Report should contain its details with an affirmation that no personnel have been denied access to the audit committee.

RBI in its guidelines on Fraud Classification and Reporting has stipulated that Employees should be encouraged to report fraudulent activity in an account, along with the reasons in support of their views, to the appropriately constituted authority, under the Whistle Blower Policy of the bank. Protection should be available to such employees under the Whistle Blower policy of the bank so that the fear of victimisation does not act as a deterrent. (RBI Circular No. DBS.CO.CFMC.BC.No.1/23.04.001/2015-16 dated July 01, 2015).

Apart from the legal and regulatory requirement, a whistle blower mechanism, if appropriately administered, is a useful tool in bringing about healthy compliance culture. The thought that one’s conduct is under watch, encourages persons to act in a manner as expected by the norms and deregulations.

17.6.1 Components of Whistle-Blower Policy

There are four broad components of whistle-blower policy:

i. **A Whistle Blower:** A Whistle Blower is a person who raises a concern about wrong-doing occurring in an organisation or body of people. This person may be an employee, a customer or even from general public. The revealed misconduct may be classified in many ways; for example, a violation of a law, rule, regulation and/or a direct threat to public interest, such as fraud, health/safety violations, and corruption. Sometimes a Whistle Blower may raise the issue with the regulatory or legal authority.

ii. **A wrongful or unethical practice**: The wrongful practice or unethical conduct that is sought to be covered under the Whistle-Blower policy is expected to be grave and serious in nature, and may involve several parties. It is not intended to be alternative to consumer grievance redressal mechanism. These practices may concern serious disregard to the law of the land (e.g., dealing in narcotics), a crime against human rights (e.g., child trafficking, dealing in human organs), corruption of a high order (e.g., supply/use of substandard or expired medicines in a hospital), compromise of the organisational values (e.g., bribery, unfair trade practices) and similar serious acts.

iii. **An authority**: The policy defines a specific process to be followed for escalation of information regarding the wrongful or unethical practice. The person/ authority to which the communication may be sent, the manner of sending communication and the manner in which the information received would be dealt with is clearly defined in the policy. The authority which deals with the information provided by a Whistle-Blower must be independent, senior and responsible - and the policy must provide for confidentiality of the information as well as the identity of the informer.

iv. **A policy**: A Whistle-Blower policy is thus an internal policy on access to the appropriate designated authority, by persons who wish to report on unethical or improper practices. The policy is intended to create a platform for alerting the management of the company or those charged with the Governance of the company about potential issues of serious concern, by ensuring confidentiality, protection and expedient action. The Whistle-Blower must have a direct access to the Chairman of the Audit Committee for reporting on wrong doings by the senior management.

The success of the Whistle-Blower Policy largely depends upon various factors viz. the level of tone at the top and the signals that it sends down the level, organisational philosophy and code of conduct; whistle-blower policy campaigning, orientation and awareness in the organisation.

The Whistle-Blower Policy should clearly state that:

i. Anonymity of the informant will be maintained.
ii. The authenticity of the information will be confirmed and there will be no reprisal for reporting the information.
iii. Appropriate and disciplinary action will be taken after investigation and on confirmation of the information.

17.7 LET US SUM UP

Enterprises to pursue a broad range of governance, risk and compliance initiatives across the organization. Taking an integrated GRC process approach and deploying a single system to manage the multiple governance, risk and compliance initiatives across the organization, yields several benefits. The broad structure followed for GRC is based on the concept of ‘Three Lines of Defence’. Compliance function may be structured in different ways depending on the organization’s size volume of business, etc.

Compliance starts at the top. The Board of Directors and the Senior Management have the ultimate responsibility for compliance.

The Compliance Department at the Corporate Office has the overall responsibility for coordinating identification of Compliance issues and management of the bank's compliance risk. The Functional Departments at Corporate Office shall have a senior functionary to act as Compliance Officers for managing compliance risk. His role is to ensure implementation of all regulatory/statutory guidelines by the Functional Department. Compliance responsibility is to be assigned to functionaries at each branch, and each zonal/ regional office. Effective internal controls enhance the safeguards against system malfunctions, errors in judgment and fraud. Whistle blower mechanism is required in each company. It can be an important measure for early detection of deviant behavior.

17.8 KEY WORDS

Governance; Risk management; Integrated GRC; Three Lines of Defence; First Line of Defence, Second Line of Defence, Third Line of Defence, Compliance failures; Internal controls; Information Systems; Whistle Blower Policy; unethical.

17.9 CHECK YOUR PROGRESS:

(1) In the compliance hierarchy the audit committee is placed
- (a) Before the CMD
- (b) After the CMD and before the board
- (c) After the board
- (d) Not important to be rigid

(2) At the branch level the most important hurdle in being compliant is
- (a) Conflict of interest.
- (b) Lack of awareness of regulations.
- (c) Laid back attitude.
- (d) Lack of coordination amongst staff.

17.10 KEY TO 'CHECK YOUR PROGRESS'

1 (b); 2 (a)

References:

1. RBI Circular DBS. CO.PP.BC 6/11.01.005/2006-07 dated April 20, 2007 - Compliance function in banks (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=3433)
2. RBI Circular DBS.CO.PPD.10946/11.01.005/2014-15 dated March 04, 2015 - Compliance function in banks (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=9598)
3. RBI Circular DoS.CO.PPG./SEC.02/11.01.005/2020-21 dated September 11, 2020 - Compliance functions in banks and Role of Chief Compliance Officer (CCO) (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11962)
4. BCBS Guidelines, 29th April 2005, 'Compliance and the compliance function in banks' (https://www.bis.org/publ/bcbs113.htm)

CHAPTER 18

FRAMEWORK FOR IDENTIFICATION OF COMPLIANCE ISSUES AND COMPLIANCE RISKS

STRUCTURE

Appendix

10. Indicative list of Compliance Rules (CRs) for Advances

OBJECTIVES

In this Chapter the learner will –

- Understand compliance culture
- Learn about compliance issues
- Understand the compliance risk
- Know the reasons for compliance failures

18.1 COMPLIANCE CULTURE

Global Financial Crisis 2008 – Observation

"Serious deficiencies in prudential oversight and financial regulation in the period before the crisis were accompanied by major governance failure within Banks"

The Corporate culture evolves and settles within working environment. The compliance function, a paramount for any financial institution, is needed to be engrafted with corporate culture effectively. Such macro and micro level implementation in Banks must pave way for evolution of compliance culture to deliver regulatory objectives suitably and sustainably.

Culture can be understood explicitly as culmination of –

- Ethics and Values which define character, scale of ownership, a system of principles governing morality and conduct thereon,
- Attitudes, Habits & Mind-sets etc. of the staff at all levels which are imbibed over a period involving beliefs and feelings towards disposition,
- Assumptions & heritage in respect various business products & models,
- Expectations and Aspirations in terms of regulatory standards

All these above said parameters shape day to day functioning of banks while dealing with different kind of clients.

18.1.1 General Drivers of the culture

1) **From the top**:
   Creating a culture where each one realises the ownership and perform with due responsibility, such values should be set in normal working. These standards should be demonstrated by the top management vide their actions and provide directions to the employees down the line.
2) **Adopting Best Practices and mend behaviour:**
   These translates into business practices i.e. how delegations are used at different levels, how schemes are implemented and customers are responded to their needs. Therefore, translating culture into practices is essential.
3) **Skill Development, Trainings and Motivation through Reward:**
   The compliance department must be duty bound to develop needed skills among their employees through trainings and reward and these should be on-going tools and methods to ensure needful performance and influence at appropriate level.

The leadership with adequate oversight, strategy at various levels in the Institution as per hierarchy, delegations duly defined with approved policies, embedding of control measures, skill development through trainings and rewards are the key ingredients.

The evolution of compliance culture in PSBs is essential with increasing concerns about Governance, Risk & Compliance (GRC) pertaining to various regulations from Banking and Market regulators as well as Investigating Agencies. The pace in the path of needful compliance should be effective and in tune with regulatory aspirations. RBI in the matter have given concrete prescriptions in the recent past clearly and substantially stating about-

- Need for Effective Compliance culture
- Independent Corporate Compliance Function
- Strong Compliance Risk Management Programme

Over and above, RBI has issued the detailed directions with serious outset tone i.e. "Robust Compliance System along with prescription based ingredients."

The PSBs' endeavours need more attention, skill and regular oversight by their senior management. The information dissemination pertaining to regulatory directions / concerns at various level from Top management to functionaries in field is extremely helpful in evolving Compliance Culture.

A culture of compliance in an organization, especially a bank, is crucial. Compliance must be visibly embraced by senior management and built into the hiring and training process. Right metrics can make the culture of compliance concrete. It is important to address such questions as: Who delivers the compliance message - line or staff? How senior are the messengers? How often do they address compliance issues? Culture, like other aspects of compliance processes, can be managed and measured over time. This report shows how banks around the world are building more effective compliance programmes. It describes the current state of compliance and how banks are struggling to understand and improve the effectiveness of their programmes in order to meet the challenges which may come in the way or in future. The Indian financial regulators always emphasize the importance of an organization's "culture of compliance,". Having a "robust" culture of compliance can help firms avoid severe financial consequences.

18.1.2 What is a "robust culture of compliance?"

It is an overall environment that fosters ethical behaviour and decision-making. Even the most clearly written, comprehensive compliance program is destined for failure without such an environment. Here are 10 typical attributes that regulators look for to gauge 'compliance culture'.

i. Tone at the top: This is the most important hallmark of a culture of compliance. Regulators are increasingly meeting with senior management during examinations to get a sense of their engagement in compliance. Tone at the top is often evidenced by the processes for making critical decisions.

ii. Integration across the enterprise is key: Risks in banking are both complex and often inter-related. To ensure that risk is managed thoughtfully across the enterprise, compliance must work closely and communicate well with all risk areas and businesses.
iii. Silos: The compliance department should not be walled off from the rest of the organisation. Is compliance staff present when business decisions are made? Does the firm seek their input? Firms with a strong culture of compliance would answer "yes" to both.
iv. Power: Regulators also look at who holds power in the firm. Is the chief compliance officer (CCO) part of senior management? Is the compliance department independent? Is it respected? Or does the CCO sit in a back office, neither seen nor heard? When discussing an issue, who wins - business or compliance?
v. Cowboys: Does the organisation reward risk-taking without limits? Are rewards based solely on financial performance? In a strong culture of compliance, risks are taken within the organization's tolerance for risk.
vi. Resources: Compliance costs money. Is the compliance program appropriately structured and sufficiently funded?
vii. Employee Buy-In: Once the compliance infrastructure is established, it is the employees who carry out the mandate. The firm's culture of compliance must be embedded in the culture of the employees. To facilitate employee buy-in, organisations should have a zero tolerance policy for employee misconduct.
viii. Living Compliance Program: The compliance program must be tailored to the organisation's business and risks; it must be tested and modified; and it must be enforced.
ix. Technology: Does the organisation look for ways to automate compliance and limit human error, as it does with portfolio and risk management? How are workflows and documents managed?
x. Documentation: Regulators love documentation and so should organisations to establish their commitment to compliance. Good record keeping reflects a strong compliance culture.

18.2 COMPLIANCE ISSUES

The responsibilities are carried out under a Compliance Programme that sets out its planned activities such as the review of compliance risk assessment in specific products/processes to which the Regulator attaches importance, compliance testing, and educating staff on compliance matters/ activities.

The Compliance Programme should cover the following:

a) Identify major compliance issues to be addressed on priority basis
b) Coordinate with Internal Audit department for simultaneous identification of key compliance issues based on their findings.
c) Develop testing and monitoring procedures for assessing extent of compliance in various activities.

d) Review policies by the functional departments based on the experience gained during implementation of the policy.
e) Create awareness and educate staff on Compliance function.
f) The Bank shall carry out at least annual compliance risk assessment in order to identify and assess major compliance risks faced by the bank and prepare a plan to manage the same.

The compliance function should consider ways to measure compliance risk (e.g. by using performance indicators) and use such measurements to enhance compliance risk assessment. The basis for identification of compliances in any product/process is:

(i) Regulatory guidelines
(ii) Laws and statutes
(iii) System and information security
(iv) Internal controls

Based on RBS cycles in all Banks, RBI has analysed the position / status of compliance and identified following areas which require greater oversight by the Board /Top / Senior Management in Banks:

a) Risk Based Supervision (RBS) – Specific template – CCO is responsible for ensuring total compliance with all guidelines specified;
b) Compliance Function & Audit should necessarily be kept separate;
c) Board/ACB/Board level committees/ Internal Audits should regularly review compliance functions;
d) Staffing of Compliance Department and succession planning is a matter of concern and recent guidelines should be adhered
e) Compliance with RAR observations, Monitorable Action Plans / RMPs
f) Evaluate the compliance risk in each business line at periodic intervals
g) Copies of compliance furnished to RBI Inspection Reports to be sent to CCO
h) Staff accountability and policies for non-compliance
i) Compliance should not be seen as an activity of the compliance department alone but as a culture that should pervade across the banks.

18.2.1 Un-authorized Operation of Internal / Office accounts

The RBI observations in the matter are as under:

a) Banks in general, do not have policy for opening, operating, reviewing, monitoring, reconciliation and provisioning of internal / office accounts. SOP document remains missing in this regard. Common mapping to link GL/PL heads remain missing.
b) Entry is Sundry / Suspense accounts are not made on POINTING basis.
c) Large cash deposits of customer accounts are routed through internal / office accounts to bypass CTR / STR rules.
d) System level changes are effected for operation in the accounts without SOP / authority.

The compliance function must identify the risk factors and embed necessary changes to control these gaps.

18.3 COMPLIANCE RISK

The Basel Committee on Compliance Function defines Compliance risk as "the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self- regulatory organization standards, and codes of conduct applicable to its banking activities" (together, "compliance laws, rules and standards").

Another aspect of compliance is the area of operational risk control. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk. Operational risk can arise from a wide range of external events like power failures, floods or earthquakes, or terrorist attacks. Operational risk can arise also from internal events such as the potential for failures or inadequacies in any of the Bank's processes and systems or those of its outsourced service providers.

Historically the compliance function did not understand and model processes for risk management. Compliance documented and met requirements, and found and resolved issues. Most often compliance was reactive, putting out fires instead of actively interpreting and predicting compliance and ethics risk issues, and developing plans to mitigate or avoid damage to the organization. The present day approach is risk based.

The level of Compliance Risk in each business line, products and processes may be identified based on following factors:

- Regulatory Focus: Customer Service aspect; Control aspects
- Nature of activity: Whether of high inherent risk in nature
- Bank's exposure to it: Materiality
- Any major breaches reported in the past: History
- Penalty implications

18.4 INHERENT RISK, CONTROL RISK AND RESIDUAL RISK

Organisations take several measures to mitigate risks so that the occurrence of an event of risk can be avoided to the extent possible, and the damage on occurrence of the risk event is minimized, if not avoided totally. Thus, from the perspective of assessing the risk level one has to consider – Inherent Risk, Residual Risk and Control Risk.

Inherent risk refers to the risk in the absence of any controls or actions to alter, mitigate, or reduce either the likelihood or impact of the risk event. In other words, the inherent risk of a system is the level of risk in any activity in the absence of any control measures. It is a function of threats and vulnerability.

Presence and operation of control measures have the effect of reducing either or both - the likelihood and the impact of the risk event thereby decreasing the potential impact of the risk event. However, there is also a risk associated with the effect of the controls. This is known as the Controls Risk. The controls risk includes both the risk of the controls failing to function as also its effect on the impact of a risk event.

Residual risk therefore is a function of inherent and control risk and refers to the risk that can still occur due to certain risk event after the control measures have been put in place. .

A simple example to illustrate the difference between inherent risk and residual risk is walking across the street. One of the inherent risks with high probability and severe impact is getting hit by a vehicle. The control measure to mitigate this risk is the practice of "looking left and right to check for oncoming traffic before crossing." But this does not eliminate altogether the possibility of being hit by a vehicle, though it certainly reduces the probability of this to a large extent. Thus the residual risk is reduced significantly.

18.5 COMPLIANCE TESTING

Compliance units in banks may evaluate the compliance risk in each business line at periodical intervals and put up the results to the Board/Management Committee. For this purpose, the Compliance Department must have a Compliance Testing Programme covering all the activities of the bank.

The components of an effective testing programme are:

i. To have proper scoping including all business activities and products
ii. To cover all applicable regulations and guidance
iii. To conduct adequate sample size for transaction testing
iv. To design a well-organized testing process including its documentation
v. To establish clear document trails
vi. To identify violations
vii. To recommend appropriate mitigation measures
viii. To track for action taken on recommendations
ix. To communicate the results to the Board /Audit Committee and senior management

Compliance Testing is not a one-time exercise. It should be a regular activity and for every business activity it needs to be repeated periodically. This is important because the compliance risk is dynamic and it changes on account of changes occurring in the business of a bank due to following factors –

i. Changes in the customer base and its composition
ii. Changes in the product suite
iii. Changes in the transaction volumes
iv. Changes in the business lines
v. Changes in the systems, processes and procedures
vi. Changes in the regulatory norms, directions and guidelines
vii. Changes in the applicable legal provisions

The compliance testing across the business units should be divided in two parts.

The first part relates to regulatory prescriptions i.e. all the regulations, directions and guidelines for each product should be tested on suitable frequency to provide an oversight to the senior and top management. The Compliance Rules (CR) for all products and services undertaken by the Bank be prepared in coordination with functional departments at Corporate office level keeping the regulatory guidelines and prescriptions in view. These CRs should be framed / grouped for the products as under:

Compliance Rules (CR) for

- Adherence to
  - A Set of Laws
  - Regulation
  - Rules
  - Practices
  - Self-Regulatory Organisation Standards
  - Code of Conduct
- CRs should be Grouped into
  - Internal Compliance
  - Regulatory Compliance
  - Legal Compliance
- CRs should Promote
  - Orderly Behaviour
  - Systemic Strength

These CRs are for compliance and reporting purpose and the same must be covered for the testing with a suitable sample size i.e. number and type of branches on a quarterly basis,

Indicative Banking business activities within those the related product and services should be covered. The frequency for testing should be decided by Bank's Senior Management and should be incorporated in Compliance Policy. Major heads for all Banking Products & Services are indicated hereunder, for meaningful monitoring and controls.

(a)	Deposit related products & services	(frequency: Half Yearly/ Quarterly)
(b)	Advance related products & services	(-----------------do--------------------)
(c)	Administration & Miscellaneous services	(------------------------do--------------)
(d)	Forex related products & services	(------------------------do--------------)
(e)	KYC AML Compliance	(frequency: Quarterly / Monthly)*

*This is an area which needs more stringent controls

(Note: Indicative list of Compliance Rules (CRs) for Advances is given vide Appendix 10 to this chapter. The list of CRs in meant for functionaries at field level (branches) and may be submitted by the branches on a frequency as decided by the Bank. CRs need to be reviewed from time to time. CRs may be prepared for other segments on similar lines.)

The Second part should cover the regulatory observations vide RARs (Risk Assessment Report) and Risk Mitigation Plans as per previous RBS cycles. The Banks are mandated to submit conclusive compliance to these points to RBI within given timelines after the approval of the ACB. Therefore, compliance testing for these points at defined frequency ensures the sustainability of those compliances. Compliance policy should address and formulate this aspect and compliance function should put a framework across business lines to ensure effective implementation.

Banks should select a sample size for the testing and follow the frequency for the above testing. The reports of these compliance testing should be examined by Compliance Department at Corporate Office level and Chief Compliance Officer presents the consolidated position to ACB for their observation, noting and requisite comments.

18.6 REASONS FOR COMPLIANCE FAILURES

The major factors causing non-compliance are as discussed below.

i. Lack of understanding of law: This could occur due to lack of requisite skills in the employees or the legal provisions being too complex or ambiguous. People cannot comply with regulations if they do not understand what specifically is required.
ii. Collapse of belief in law: Compliance is costly. Voluntary compliance is likely to be low when costs (in terms of time, money, or effort) of complying with a rule are considered to be high. If a rule seems unreasonable, instead of complying, businesses may spend more time and money in lobbying with the regulators to change it or asking for special treatment rather than on compliance efforts.
iii. Overly legalistic regulation: People lose confidence in regulators and governments if they are required to comply with technical rules that do not appear to relate to any substantive purpose.
iv. Regulation is at odds with market or cultural practices: Degree of compliance is lower when regulation does not fit well with existing market practices or is not in consonance with cultural norms. Sometimes the basic purpose of a rule is to counter an existing market or cultural practice. For example, consumer protection provisions were necessary to outlaw over- selling in insurance industry precisely because it became common practice.
v. Failure to monitor: A rule that is on the books, but not monitored is unlikely to elicit compliance. Random inspections among the target group have the effect of making people and enterprises that are normally law-abiding constantly aware of the existence of enforcement activities and tend to reduce the likelihood of future non-compliance.
vi. Procedural injustice: Researchers have found that if people feel they are treated unfairly by the government or a regulatory agency, then they will often respond by refusing to comply with regulatory requirements.
vii. Deterrence failure: Regulators can face a failure of deterrence when business rule breaking may have high reward and low probability of detection.
viii. Failures of administrative capacity: Voluntary compliance levels are compromised if the organisations do not have necessary information and other support or mechanism for compliance with multitude of requirements.

18.7 LET US SUM UP

A culture of compliance in an organization, especially a bank, is crucial. Tone at the top is the most important hallmark of a culture of compliance. Compliance Programme should identify major compliance issues. The Bank shall carry out at least annual compliance risk assessment. Another aspect of compliance is the area of operational risk control. Organisations take several measures to mitigate risks. Thus, from the perspective of assessing the risk level one has to consider – Inherent Risk, Residual Risk and Control Risk. Compliance units in banks may evaluate the compliance risk in each business line at periodical intervals. Non-compliance occurs due to several reasons like lack of understanding of law, failure to monitor, deterrence failure, etc.

18.8 KEY WORDS

Compliance culture; Tone at the Top; Silos; Cowboys; Compliance testing; Inherent risk; Residual risk; Controls Risk; Deterrence failure; Procedural injustice, RAR – Risk Assessment Report, RMP – Risk Mitigation Plan, Risk Based – Risk Based Supervision; SPARC- Supervisory Programme for Assessment of Risk and Capital. ISE- Inspection for Supervisory Evaluation

18.9 CHECK YOUR PROGRESS

1) Which one of the following is not compliance risk?
   a) Violation of regulatory guidelines
   b) Non-compliance of a legal provision
   c) Overdues in credit portfolio
   d) Non-adherence to the bank's internal policy

2) 'The probability of loss that remains to systems that store, process, or transmit information after security measures or controls have been implemented is called __risk.
   a) Residual
   b) Control
   c) Inherent
   d) Operational

18.10 KEY TO 'CHECK YOUR PROGRESS'

1 (c), 2 (a)

References:

1) RBI Circular DBS. CO.PP.BC 6/11.01.005/2006-07 dated April 20, 2007 - Compliance function in banks (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=3433)
2) RBI Circular DBS.CO.PPD.10946/11.01.005/2014-15 dated March 04, 2015 - Compliance function in banks (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=9598)

3) RBI Circular DoS.CO.PPG./SEC.02/11.01.005/2020-21 dated September 11, 2020 - Compliance functions in banks and Role of Chief Compliance Officer (CCO) (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11962)
4) BCBS Guidelines, 29th April 2005, ‘Compliance and the compliance function in banks’ (https://www.bis.org/publ/bcbs113.htm)

Appendix 10

Indicative list of Compliance Rules (CRs) for Advances

No.	Compliance Rules	Risk	Complied		
			Yes	No	Business Nil
ADVANCES					
Status Report/Credit Report/Defaulters List					
1	RBI Wilful Defaulters list and RBI defaulters list are verified in all accounts sanctioned during the period.	H			
2	Special Approval List (SAL) of ECGC is verified in all Export Accounts sanctioned during the period and prior approval from ECGC is obtained in case of exporters appearing in the SAL.	H			
3	The Credit Information Report from CIBIL is obtained in all retail loans sanctioned during the period.	H			
Credit Exposure					
4	Credit exposure to a single borrower is within the limit stipulated by the bank from time to time.	H			
5	Credit exposure to borrowers belonging to a group is within the limit stipulated by the bank from time to time.	H			
6	No finance is extended for setting-up of new units consuming / producing Ozone Depleting Substances to the identified sectors i.e. (i) foam products (ii) refrigerators & air-conditioners (iii) aerosol products (iv) fire extinguishers (v) solvents in cleaning applications.	H			
7	Wherever loans or advances for commodities under Selective Credit Controls are granted, norms regarding minimum margin, interest rate and valuation are followed.	H			
Advances to Directors, their Relatives, Officers and their Relatives					
8	No loan and advance (other than the exemptions permitted) including purchase of or discount of bills is granted to any of the Bank's directors or to any	H			

No.	Compliance Rules	Risk	Complied		
			Yes	No	Business Nil
	firm or company with which any director is associated in any capacity or having interest or to any individual, firm or company wherein any director is a guarantor.				
9	No loan or advance aggregating to or above the specified limit (Rs.25 lakhs) is granted to Directors of other banks or any firm/company in which any of the directors of other banks is interested as a partner/ director/guarantor, without HO approval.	H			
10	No loan or advance aggregating to or above the specified limit (Rs.25 lakhs) is granted without HO approval to: i) Relatives (in any capacity) of the Bank's Directors. ii) Relatives (in any capacity) of Directors of other banks.	H			
11	A declaration from every borrower (in any capacity), to the bank, that he/she/any partner/director is not a specified near relative of a senior officer/director of the bank is obtained.	M			
12	No credit facility is sanctioned by any officer to his/her relative or to any firm/company in which such relative holds substantial interest or is interested as partner, director or a guarantor.	H			
Advances against Shares					
13	No loan/advance is granted against the security of the bank's own shares.	H			
14	No loan/advance is provided to any company for the buy-back of shares/ securities.	H			
15	No loan/advance is granted against the security of partly paid shares.	H			
16	No loan /advance is granted to partnership / proprietorship concerns against the primary security of shares and debentures.	H			
17	No loan/advance is granted against the security of physical shares.	H			
18	No individual is granted loan/advance exceeding the specified limit (Rs.20 lakhs) against the security of	H			

No.	Compliance Rules	Risk	Complied		
			Yes	No	Business Nil
	shares in Demat form.				
19	The amount of shares obtained as security is strictly within the cap of 30% of the paid-up share capital of the company or 30% of the bank's own paid-up share capital and reserves, whichever is less.	H			
Advances for Housing / Real Estate					
20	No facility (either fund based or non-fund based) is granted to private builders for acquisition of land, even as a part of housing project.	H			
21	No finance is granted for construction of buildings meant purely for Govt./Semi-Govt. offices including Municipal and Panchayat Offices.	H			
22	In case of real estate and housing loans all requisite clearances are obtained from the government authorities before disbursement.	H			
23	No loan is granted in respect of properties meant for residential use but which the applicant intends to use for commercial purposes.	H			
L/Cs, Guarantees					
24	No L/Cs are opened and bills under L/Cs are purchased /discounted / negotiated to non-constituent borrowers.	H			
25	No Bank guarantee is issued for more than 10 years maturity (excluding the claim period).	H			
26	No bank guarantees covering intercompany deposits / loans which guarantee refund of deposits/loans accepted by NBFC/firms from other NBFC/firms is issued.	H			
27	Wherever guarantees are invoked, payment is made to the beneficiaries without any delay and demur. (unless there is a court order restraining the payment)	H			
OTHERS					
28	Pre-sanction inspection has been conducted in all new accounts sanctioned and the reports are kept on record.	H			

No.	Compliance Rules	Risk	Complied		
			Yes	No	Business Nil
29	Techno Economic Viability Study (TEVS) has been conducted in respect of all eligible projects as prescribed.	M			
30	No deposit/resource is raised through agents / intermediaries to meet the credit needs of existing/prospective borrowers.	H			
31	No loan is granted to intermediaries based on the consideration of deposit mobilization.	H			
32	No advance against bullion or primary gold is sanctioned.	H			
33	Best Practices Code book is available and the procedural systems described therein are implemented.	H			
34	No loan/advance is granted against the FDRs or other term deposits of OTHER banks.	H			
35	No loan is granted against Certificates of Deposits (other than the exceptions permitted specifically if any).	H			
36	No penal interest/service charges/inspection charges have been levied/charged on PRIORITY SECTOR advances upto Rs. 25000/-	L			
Supervision and Monitoring					
37	No ad-hoc limits have been allowed beyond the stipulated period (90 days)	H			
38	No temporary over draft/over limit has been allowed beyond the stipulated period. (30 days)	H			
39	Delegation of powers has been adhered to in conducting the business.	H			
40	Wherever delegation has been exceeded, confirmation of the appropriate authority has been sought /obtained.	H			
41	While undertaking review of borrowal accounts, the financial statements of group companies are obtained on a common balance sheet date and analysed.	H			
42	Stock/Book Debts statements have been obtained, wherever stipulated.	H			

No.	Compliance Rules	Risk	Complied		
			Yes	**No**	**Business Nil**
43	Securities charged to the Bank are insured as prescribed with Bank's charge mentioned thereon and these policies are held on record.	H			
44	In all cases where vehicles have been financed, a copy of the registration certificate with the Bank's charge noted thereon is held on record.	H			
45	In all cases where a corporate entity (Public Ltd. /Pvt. Ltd. Co.) has been financed, the Bank's charge is noted in the records of the Registrar of Companies.	H			
46	Register for recording loan applications received, sanctioned, pending and rejected is maintained.	M			
47	No account is overdue for review beyond three months.	H			
48	CPA and vetting of documents is carried out in all a/cs with limit of Rs.50 lakhs and above.	H			
49	CPA for all Home loans is done, irrespective of sanctioned limit.	H			
50	Details of defaulters with dues of Rs.1 crore and above, and where suits have NOT been filed is reported to RBI. (through ZO/HO).	M			
51	Details of defaulters with dues of Rs.1 crore and above and where suits have been filed is reported to CIBIL. (through ZO/HO).	M			
52	Details of Wilful Defaulters, if any, with dues of Rs.25 lakhs and above have been conveyed to H. O. (through Z.O.) every quarter (separate lists for suit filed and non-suit filed Wilful defaulters).	M			
53	In case of mortgage of property as primary or collateral security the advocate has furnished Title opinion confirming having verified the original title deeds and their genuineness from the concerned office of the Registrar/Registration Authority.	H			
Income Recognition & Asset Classification Norms					
54	Loan account, where interest and/or installment is overdue for a period of more than 90 days is classified as a Non-Performing Asset.	H			

No.	Compliance Rules	Risk	Complied		
			Yes	No	Business Nil
55	Cash Credit / Overdraft account which is out-of-order for 90 days or more is categorized as a Non-Performing Asset.	H			
56	Bills purchased or discounted which are overdue for a period of more than 90 days are classified as a Non-Performing Asset.	H			
57	Crop loans where the installment of principal or interest remains overdue for two crop seasons, for short duration crops or one crop season for long duration crops are classified as NPA.	H			
58	NPA accounts with nil security (or security less than 10%) are categorized as loss assets, irrespective of NPA period.	M			
59	In all advance accounts which become NPA during reporting period, interest accrued but not realized during that financial year is reversed and not booked as income.	M			
60	Wherever a suit has been filed in Court/DRT/BIFR in NPA account and compromise settlement is reached in such NPA account, consent decree is obtained from the Court/DRT /BIFR.	H			
SARFAESI Act, 2002					
61	Wherever action under SARFAESI Act, 2002, is initiated, it is ensured that: i) account is NPA. ii) outstanding is above Rs.1.00 lac and amount due is equal to or more than 20% of the principal amount and interest thereon. iii) property secured is not agricultural land. iv) claim made in respect of the financial asset is within limitation period.	H			
62	Notice in writing is issued to the borrower to discharge in full his liabilities within 60 days from the date of such notice.	H			
63	Recourse to take possession of the secured assets of the borrower is taken only in case the borrower fails to discharge in full his liability within the period	H			

No.	Compliance Rules	Risk	Complied		
			Yes	**No**	**Business Nil**
	specified in the notice sent U/S 13 (2) of the SARFAESI Act, 2002.				

NOTE:

(i) Non-compliance to the above rules will be considered a violation of the provisions of the Banking Regulation Act,1949 and the guidelines issued by RBI.

(ii) Wherever the response to any Rule hereinabove is "No", reasons for non-compliance along with corrective action taken are to be given in a separate sheet, format attached to this Annexure.

We certify that the compliance stated by us to the above rules is true and that we have also complied with all other statutory, regulatory and internal guidelines in respect of **all** credit matters.

Branch Manager/Zonal Manager

_______________Branch/Zone

MODULE IV
REGULATORY COMPLIANCES

CHAPTERS

CHAPTER 19

EXPOSURE NORMS

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Learn the meanings of key terms connected with credit risk
- Know about the regulatory norms for exposures
- Know about the exposures for which banks need to set own ceilings
- Learn about restrictions on investments/ loans against shares and debentures

19.1 INTRODUCTION AND KEY TERMS

For better credit risk management and avoiding concentration of credit risks, credit exposures are contained within predetermined ceilings. Certain exposure ceilings are prescribed by the regulator, while others are determined by the bank itself. Regulatory ceilings cannot be breached, whereas the internal ceilings can be changed by the bank. A bank may fix an exposure limit lower than the regulatory ceiling. Exposure ceilings may be fixed on multiple bases – viz. borrower, economic activity of the borrower, loan products, and geographical location. RBI has prescribed exposure ceilings for certain criteria. It has also advised banks to fix own exposure ceilings for certain other criteria. Besides, a bank can fix exposure ceilings for additional criteria, at its choice.

Exposure includes credit exposure (funded and non-funded credit limits) and investment exposure (including underwriting and similar commitments). Higher of the sanctioned limit or outstanding amount is reckoned for exposure. For limits that are fully drawn and no more drawal would be permitted, the outstanding amount is considered. A bank is required to compute its credit exposure, arising on account of the interest rate and foreign exchange derivative transactions and gold.

In connection with exposure norms the under mentioned key terms are relevant. These should be understood clearly.

i. *Exposure*: It includes credit exposure (funded and non-funded) and investment exposure (including underwriting and similar commitments). Higher of the sanctioned limits or outstanding amount, is reckoned for exposure. For fully drawn term loans, where no further drawals will happen the outstanding amount is considered.

ii. *Credit Exposure*: It includes (a) all types of funded and non-funded credit limits, and (b) facilities like equipment leasing, hire purchase finance and factoring services.

iii. *Investment Exposure*: It includes (a) investments in shares and debentures; (b) investment in PSU bonds; and (c) investments in Commercial Papers (CPs). It also includes investments (as compensation) in debentures/ bonds / security receipts / pass-through certificates (PTCs) of an Asset Reconstruction Company on sale of financial assets. Investment in bonds and debentures of corporates guaranteed by a PFI (specified by RBI) is an exposure on the PFI and not on the corporate. Guarantees issued by a PFI to the bonds of a corporate are a non-funded exposure of the PFI to the corporate.

iv. *Net worth (For Capital Market Exposure Norms):* It comprises –
Paid-up Capital

Plus: Free Reserves (including Share Premium but excluding Revaluation Reserves), Investment Fluctuation Reserve and credit balance in Profit & Loss account,

Less: debit balance in Profit and Loss account, Accumulated Losses and Intangible Assets.

No general or specific provision is included in computation of net worth. Capital infused as equity shares after the published balance sheet date, is also considered for determining the ceiling on exposure to capital market. An external auditor's certificate regarding this should be submitted to RBI (DBS).

v. *Infrastructure Lending*: RBI has advised banks to be guided by the Gazette Notifications issued by the Department of Economic Affairs, Ministry of Finance, Government of India updating the Harmonised Master List of Infrastructure sub-sectors, from time to time.

19.2 LARGE EXPOSURE FRAMEWORK (LEF)

In December, 2016 RBI had issued guidelines for ushering in Large Exposures Framework on the lines of Basel Committee on Banking Supervision (BCBS) supervisory guidance on large exposures. In June 2019, this framework had replaced the exposure norms in respect of individual and group exposures that were in vogue till then. Fundamentally, this framework is based on the framework of Basel III Norms for capital adequacy purposes. The framework has adopted BCBS Standards on 'Supervisory framework for measuring and controlling large exposures' issued in April 2014.

I. Definitions

The following terms are specifically relevant in connection with the Large Exposure Framework.

i. *Large Exposure*: The sum of all exposure values of a bank (measured as specified) to a counterparty or a group of connected counterparties is treated as a 'Large Exposure (LE)', if it is equal to or above 10 percent of the bank's eligible capital base (i.e., Tier 1 capital as specified).

ii. *Connected Counterparties*: A group of counterparties with specific relationships or dependencies such that were one of the counterparties to fail, all of the counterparties would very likely fail. A group of this sort, referred to in this framework as a group of connected counterparties, must be treated as a single counterparty. The sum of the bank's exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements. The specific criteria to establish the existence of a group of connected counterparties have been spelt out in the RBI guidelines cited at the end of this chapter.

iii. *Definitions of Various Exposure Values*:

   a. *Banking book on-balance sheet non-derivative assets*: The exposure value is defined as the accounting value of the exposure. As an alternative, a bank may consider the exposure value gross of specific provisions and value adjustments.

   b. *Banking book and trading book OTC derivatives (and any other instrument with counterparty credit risk)*: The exposure value for instruments which give rise to counterparty credit risk and are not securities financing transactions, should be determined as per the extant instructions as prescribed by the Reserve Bank (on exposure at default) for the counterparty credit risk.

c. *Securities financing transactions (SFTs)*: Banks should use the method they currently use for calculating their risk-based capital requirements against SFTs.
d. *Banking book "traditional" off-balance sheet commitments*: For the purpose of the LEF, off-balance sheet items will be converted into credit exposure equivalents through the use of credit conversion factors (CCFs) by applying the CCFs set out for the Standardised Approach for credit risk for risk-based capital requirements, with a floor of 10 percent.

II. Scope of Large Exposure Framework

An exposure to counterparty will constitute both on and off-balance sheet exposures included in either the banking or trading book and instruments with counterparty credit risk.

A bank shall comply with the LEF norms at two levels: (a) Consolidated (Group1) level and (b) Solo level. For application at the consolidated level, a bank must consider exposures of all the banking group entities (including overseas operations through branches and subsidiaries), which are under regulatory scope of consolidation, to counterparties and compare the aggregate of those exposures with the banking group's eligible consolidated capital base.

A bank's exposure to all its counterparties and groups of connected counterparties will be considered for exposure limits, except those mentioned below:

a. Exposures to the Government of India and State Governments which are eligible for zero percent Risk Weight under the Basel III – Capital Regulation framework of the Reserve Bank of India;
b. Exposures to Reserve Bank of India;
c. Exposures where the principal and interest are fully guaranteed by the Government of India;
d. Exposures secured by financial instruments issued by the Government of India, to the extent that the eligibility criteria for recognition of the Credit Risk Mitigation (CRM) are met as per extant guidelines;
e. Intra-day interbank exposures;
f. Intra-group exposures (RBI "Guidelines on Management of Intra-Group Transactions and Exposures") are applicable);
g. Borrowers, to whom limits are authorised for food credit;
h. Banks' clearing activities related exposures to Qualifying Central Counterparties (QCCPs);
i. Deposits maintained with NABARD on account of shortfall in achievement of targets for priority sector lending.
j. Exposures to foreign sovereigns or their central banks that are: subject to a 0% risk weight as per Basel III Norms; and denominated in the domestic currency of that sovereign and met out of resources of the same currency.

Two (or more) entities that are outside the scope of the sovereign exemption and are controlled by or are economically dependent on an entity that falls within the scope of the sovereign exemption, and are otherwise not connected, those entities will not be deemed to constitute a group of connected counterparties.

A bank's exposure to an exempted entity hedged by a credit derivative shall be treated as an exposure to the counterparty providing the credit protection even though the original exposure is exempted.

III. Large Exposure Limits

Single Counterparty: The sum of all the exposure values of a bank to a single counterparty must not be higher than 20 percent of the bank's available eligible capital base at all times. In exceptional cases, Board of banks may allow an additional 5 percent exposure of the bank's available eligible capital base. Banks should have a Board approved policy in this regard.

Groups of Connected Counterparties: The sum of all the exposure values of a bank to a group of connected counterparties must not be higher than 25 percent of the bank's available eligible capital base at all times.

Eligible Capital Base: It is the effective amount of Tier 1 capital fulfilling the criteria defined in Master Circular on Basel III – Capital Regulation as per the last audited balance sheet. The infusion of capital under Tier I after the published balance sheet date may also be taken into account for the purpose of Large Exposures Framework. For Indian Banks, profits accrued during the year, subject to provisions, will also be reckoned as Tier I capital for the purpose of Large Exposures Framework.

Any breach of the above LE limits shall be under exceptional conditions only and shall be reported to RBI (DBS, CO) immediately and rectified at the earliest but not later than a period of 30 days from the date of the breach.

The above LE limits will be modulated in cases of certain counterparties as specified in the guidelines. Briefly the provisions for this are given below:

i. Exposures to Central Counter Parties (CCPs): Banks' exposures to QCCPs Qualified Central Counterparty) related to clearing activities will be exempted from the LE framework. Criteria for determining QCCP have been spelt out in the guidelines. In the case of non-QCCPs, exposure should be taken as a sum of both the clearing exposures and the non-clearing exposures (as specified) and it will be subject to the general LE limit of 25 percent of the eligible capital base. The concept of connected counterparties does not apply in for exposures to CCPs specifically related to clearing activities.
ii. Exposures to NBFCs: Exposures to a single NBFC (excluding gold loan companies) is restricted to 20 percent of eligible capital base. Bank finance to NBFCs predominantly engaged in lending against gold will continue to be governed by limits prescribed in RBI Guidelines for Bank Finance to NBFCs Predominantly Engaged in lending

against Gold vide circular DBOD.BP.BC.No.106/21.04.172/2011-12 dated May 18, 2012. Based on the risk perception, more stringent exposure limits may be considered for certain categories. Exposures to a group of connected NBFCs or groups of connected counterparties having NBFCs in the group will be restricted to 25 percent of Tier I Capital. These exposure limits are subject to all other instructions in relation to banks' exposures to NBFCs in the Master Circular on Exposure Norms.

iii. Large exposures rules for global systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs): The limit for a G-SIB's exposure to another G-SIB is 15 percent of the eligible capital base. The LE limit of a non G-SIB in India to a G-SIB in India or overseas will be 20 percent of the eligible capital base. For Indian branches of foreign G-SIBs, exposure limit on a G-SIB, including their head office, other overseas branches and subsidiaries, is 20% of eligible capital base and exposure limit on any other bank (i.e. not G-SIB) is 25% of eligible capital base. Similarly, for Indian branches of foreign non-GSIBs, exposure limit on a non-GSIB, including their head office, other overseas branches and subsidiaries, is 25% of eligible capital base and exposure limit on a G-SIB is 20% of eligible capital base. There is no separate exposure limit applicable to D-SIBs and they continue to be governed by interbank exposure limits under the LEF.

IV. Other Aspects

LEF guidelines also contain norms for other related aspects, mainly pertaining to:

i. Eligible credit risk mitigation (CRM) techniques
ii. Recognition of CRM techniques in reduction of original exposure
iii. Recognition of exposures to CRM providers
iv. Calculation of exposure value for Trading Book positions
v. Offsetting long and short positions in the trading book
vi. Treatment of specific exposure types
vii. Identification of additional risks

In order to capture exposures and concentration risk more accurately and to align the extant instructions with international norms, the following amendments have been incorporated in the instructions:

i. Exclusion of entities connected with the sovereign from definition of group of connected counterparties.
ii. Introduction of economic interdependence criteria in definition of connected counterparties.
iii. Mandatory application of look-through approach (LTA) in determination of relevant counterparties in case of collective investment undertakings, securitisation vehicles and other structures.

V. Reporting Requirements

The framework has also laid down requirements for monthly reporting of exposures details to RBI, Department of Banking Supervision. The exposures that are exempted from the ceilings under LEF are also required to be reported in the monthly report, as indicated.

19.3 CREDIT EXPOSURE TO INDUSTRY AND CERTAIN SECTORS

Internal Exposure Limits

- Banks may evenly spread their exposures over various sectors.
- Internal limits for aggregate commitments to specific sectors, e.g. textiles, jute, tea, etc., may be fixed.
- These limits are based on the performance and the risks perceived of different sectors.
- A bank may fix internal limits for aggregate exposure to all NBFCs put together.
- The limits may be reviewed periodically and revised.

Unhedged Foreign Currency Exposure of Corporates

- Banks should explicitly recognise and take account of risks arising out of foreign exchange exposure of their clients.
- Foreign currency loans above US $10 million (a bank may set a lower threshold) to any client should be hedged as per the Bank's policy.
- Following types of exposure may be excluded for hedging:
    - Loans financing exports (if the customers have uncovered receivables to cover the loan amount)
    - Loans for meeting forex expenditure.
- Aggregate unhedged foreign exchange exposure of clients should include exposure from all sources including foreign currency borrowings and External Commercial Borrowings.
- Monthly review of unhedged exposures of clients should be done for SMEs and clients with large total foreign currency exposure (say, about US $ 25 million).
- In all other cases, quarterly review should be done.
- For consortium/ multiple banking arrangements, monitoring should be done by the consortium leader/ bank having the largest exposure.
- RBI instructions relating to information sharing among themselves should be adhered to.

Exposure to Real Estate:

- Banks' board-approved policy to have comprehensive prudential norms for real estate loans – the ceiling on the total amount, single/ group exposure limits, margins, security, repayment schedule and availability of supplementary finance.
- Exposure for setting up Special Economic Zones (SEZs) or acquisition of units in SEZs is treated as exposure to commercial real estate sector for capital adequacy and risk weight. It is treated as exposure to Infrastructure sector only for relaxations in Exposure norms.

Exposure to Leasing, Hire Purchase and Factoring Services

Where these activities are done departmentally, a balanced portfolio of equipment leasing, hire purchase and factoring services vis-à-vis the aggregate credit should be maintained. The exposure to each of these activities should not exceed 10 per cent of total advances.

Exposure to Indian Joint Ventures/ Wholly-owned Subsidiaries Abroad and Overseas Step-down Subsidiaries of Indian Corporates:

Exposure limit for credit/non-credit facilities (viz. letters of credit and guarantees) to Indian Joint Ventures/Wholly-owned Subsidiaries abroad and step-down subsidiaries which are wholly owned by the overseas subsidiaries of Indian Corporates; and buyer's credit/ acceptance finance to overseas parties for facilitating export of goods & services from India is 20 percent of banks' unimpaired capital funds.

19.4 EXPOSURE TO CAPITAL MARKETS

19.4.1 Components of Capital Market Exposure (CME)

Capital market exposure includes both direct and indirect exposures. The aggregate exposure (both fund and non- fund based) to capital markets in all forms includes the following:

i. Direct investment in equity shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds the corpus of which is not exclusively invested in corporate debt;
ii. Advances against shares/bonds/debentures or other securities or on clean basis to individuals for investment in shares (including IPOs/ESOPs), convertible bonds, convertible debentures, and units of equity-oriented mutual funds;
iii. Advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are taken as primary security;
iv. Advances for any other purposes to the extent secured by the collateral security of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds i.e. where the primary security other than shares/convertible bonds/convertible debentures/units of equity oriented mutual funds does not fully cover the advances;
v. Secured and unsecured advances to stockbrokers and guarantees issued on behalf of stock brokers and market makers;
vi. Loans sanctioned to corporates against the security of shares/bonds/debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources;
vii. Bridge loans to companies against expected equity flows/issues;
viii. Underwriting commitments taken up by the banks in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds. However, with effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure of the solo bank as well as the consolidated bank. The position in this regard would be reviewed at a future date.
ix. Financing to stockbrokers for margin trading;
x. All exposures to Venture Capital Funds (both registered and unregistered)
xi. Irrevocable Payment Commitments issued by custodian banks in favour of stock exchanges

19.4.2 Items Excluded from Capital Market Exposure

The following items are excluded from the aggregate exposure ceiling of 40 per cent of net worth and direct investment exposure ceiling of 20 per cent of net worth (wherever applicable).

i. Banks' investments in own subsidiaries, joint ventures, sponsored Regional Rural Banks (RRBs) and investments in shares and convertible debentures, convertible bonds issued by institutions forming crucial financial infrastructure. After listing, the exposures in excess of the original investment (i.e. prior to listing) would form part of the Capital Market Exposure.
ii. Tier I and Tier II debt instruments issued by other banks;
iii. Investment in Certificate of Deposits (CDs) of other banks;
iv. Preference Shares;
v. Non-convertible debentures and non-convertible bonds;
vi. Units of Mutual Funds under schemes where the corpus is invested exclusively in debt instruments;
vii. Shares acquired by banks as a result of conversion of debt/overdue interest into equity under Corporate Debt Restructuring (CDR) mechanism;
viii. Term loans sanctioned to Indian promoters for acquisition of equity in overseas joint ventures/wholly owned subsidiaries under the refinance scheme of Export Import Bank of India (EXIM Bank).
ix. With effect from April 16, 2008, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process, for the purpose of arriving at the capital market exposure of the solo bank as well as the consolidated bank. (However, the position in this regard would be reviewed at a future date).
x. Promoters' shares in the SPV of an infrastructure project pledged to the lending bank for infrastructure project lending.
xi. Bank's exposure to brokers under the currency derivatives segment

19.4.3 Statutory limit on shareholding in companies

In terms of Section 19(2) of the Banking Regulation Act, 1949, no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30 percent of the paid-up share capital of that company or 30 percent of its own paid-up share capital and reserves, whichever is less, except as provided in sub-section (1) of Section 19 of the Act. Shares held in demat form should also be included for the purpose of determining the exposure limit. This is an aggregate holding limit for each company.

19.4.4 Regulatory limits

RBI has prescribed maximum ceilings for the following exposures of a bank in terms of its net worth for solo basis / consolidated net worth for consolidated basis, as on March 31 of the previous year –

i. Aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) – 40 per cent

ii. Direct investment in shares, convertible bonds/debentures, units of equity- oriented mutual funds and all exposures to Venture Capital Funds (VCFs) [both registered and unregistered]. – 20 per cent

Banks may adopt lower limits than those stated above, if they so desire. The limits are to be adhered to on on-going basis.

A 'consolidated bank' is a group of entities, which include a licensed bank, which may or may not have subsidiaries.

Restructuring Programme: If the limit is exceeded due to equity shares acquired under a restructuring programme (upfront as compensation of for loss/sacrifice) it is not considered as a breach. It is reported to RBI and disclosed in the Notes to Accounts in Annual Financial Statements.

Disinvestment Programme for PSUs: If a bank is likely to exceed the regulatory ceiling on account of financing acquisition of PSU shares under the Government of India disinvestment programmes, RBI will consider requests for relaxation of the ceiling, subject to adequate safeguards regarding margin, bank's exposure to capital market, internal control and risk management systems, etc. The bank's exposure to capital market, net of its advances for financing of acquisition of PSU shares should be within the ceiling.

19.4.5 Computation of Exposure to the Capital Markets

a) Exposure Parameters

The parameters reckoned as exposure for different types of facilities are as shown below:

  i) Loans/advances sanctioned and guarantees issued for capital market operations: Sanctioned limits or outstanding, whichever is higher.
  ii) Fully drawn term loans (with no scope for re-drawal of any portion of the sanctioned limit) - the outstanding amount.
  iii) Direct investment in shares, convertible bonds, convertible debentures and units of equity-oriented mutual funds: Amount calculated at their cost price.
  iv) Irrevocable Payment Commitments (by custodian banks favoring a stock exchange): Essentially, the maximum risk to the custodian banks has been limited to 50% of the settlement amount at T+1. In case of an early payment there is no capital market exposure. Where cash margin is paid, the margin amount is deducted from the 50% amount of the settlement price. For margin in the form of permitted securities, the value of securities less haircut amount is deducted from the 50% amount of the settlement price. The capital is maintained on the amount taken for CME and the risk weight is 125% thereon.

b) Other Aspects:

  i) Intra-day Exposures: Intra-day exposures to the capital markets are inherently risky. The Board of a bank should evolve a policy for fixing intra-day limits and have an appropriate system to monitor such limits.
  ii) Enhancement in limits: Banks with sound internal controls and robust risk management systems can approach the RBI for higher limits.

19.5 PRUDENTIAL LIMITS ON INTRA-GROUP EXPOSURE

To contain concentration and contagion risks arising out of Intra-Group Transactions and Exposures (ITEs), certain quantitative limits on financial ITEs and prudential measures for the non-financial ITEs have been imposed as under:

i. Exposure includes:
    - Credit exposure (funded and non-funded credit limits), and
    - Investment exposure (including underwriting and similar commitments).

   Exclusions: Exposure on account of equity and other regulatory capital instruments is excluded.

ii. Intra-group exposure limits for banks: Under mentioned limits in terms of paid-up capital and reserves have been prescribed by RBI.
   a) Single Group Entity Exposure –
      For non-financial companies and unregulated financial services companies – 5%
      For regulated financial services companies – 10%
   b) Aggregate Group Exposure -
      For all non-financial companies and unregulated financial services companies taken together - 10%
      For all group entities (financial and non-financial) taken together: 20%

   Exemptions: The following intra-group exposures are excluded from the exposure ceilings:
      (1) Exposure of a bank in form of equity and other capital instruments, to other banks/financial institutions in the group. Other instructions continue to apply.
      (2) Inter-bank exposures among banks in the group operating in India. The instructions on Call/Notice Money Market Operations will apply to both outstanding borrowing and lending transactions.
      (3) Letters of Comfort issued by parent bank in favour of overseas group entities to meet regulatory requirements.

iii. Prohibited Exposures: A bank that is set-up under a Non-Operating Financial Holding Company (NOFHC) structure cannot -
   a) Take any credit or investments (including in the equity/debt instruments) exposure on the NOFHC, its Promoters/Promoter Group entities or individuals associated with the Promoter Group.
   b) Invest in the equity/debt instruments of any financial entity under the NOFHC.

19.6 FINANCING OF EQUITIES AND INVESTMENTS IN SHARES

I. Facilities to Individuals

Advances against shares to individuals

The norms for loans to individuals against security of shares, convertible bonds, convertible debentures and units of equity oriented mutual funds are as follows:

i. *Limit on loan amount*: Loans to an individual from the banking system should not exceed:
    - Against securities in physical form - ₹10 lakh
    - Against securities in demat form - ₹20 lakh

ii. *Purpose of loan*: It is meant for genuine individual investors.

iii. *Restrictions*: It should not support collusive action by a large group of individuals belonging to the same corporate or their inter-connected entities to take multiple loans in order to support particular scrips or stock-broking activities of the concerned firms.
iv. *Exposure Category*: It is reckoned as an exposure to capital market.
v. *Internal Policy*: There should be a Board approved Policy for this activity.
vi. *Prudential Measures*: A bank lay down appropriate aggregate sub-limits of such advances.
vii. *Margin*: Minimum margin required on the market value of the securities is as follows:
On equity shares/convertible debentures in physical form - 50 percent
On equity shares/convertible debentures in dematerialised form - 25 percent
A bank may stipulate higher margin at its choice.

For advances against preference shares/non-convertible debentures and bonds margin requirements may be determined by the banks themselves.

Financing of Initial Public Offerings (IPOs)

Banks may grant advances to individuals against security of shares, convertible bonds, convertible debentures, units of equity oriented mutual funds and PSU bonds for subscribing to IPOs, including Follow-on Public Offers (FPOs).

i. *Limit on loan amount*: Loans to an individual from the banking system should not exceed Rs. 10 lakh.
ii. *Restrictions*: Following restrictions apply on bank credit for subscribing to IPOs –
   - The corporates should not be extended credit for investment in other companies' IPOs.
   - Banks should not finance to NBFCs for further lending to individuals for IPOs.
iii. *Exposure Category*: It is reckoned as an exposure to capital market.

Bank finance to assist Employees to buy Shares of their own Companies

Banks may extend finance to employees for purchasing shares of their own companies under Employees Stock Option Plan (ESOP)/reserved by way of employees' quota under IPO.

i. Limit on loan amount: The finance can be to the extent of 90% of the purchase price of the shares or ₹20 lakh, whichever is lower.
ii. Exposure Category: It is reckoned as an exposure to capital market.
iii. Exclusion: Banks are not allowed to extend advances including advances to their employees/ Employees' Trusts set up by them for the purpose of purchasing their own banks' shares under ESOPs/IPOs or from the secondary market. This prohibition applies irrespective of whether the advances are secured or unsecured.

Declaration from the Borrower

The ceiling on loan facility to individuals for investment in shares is on the amount borrowed from the banking system. Banks therefore should obtain a declaration from the borrower indicating the details of the loans/advances availed against shares and other securities specified above, from any other bank/s in order to ensure compliance with the ceilings prescribed for the purpose.

Finance to Individuals against Shares to Joint holders or Third party beneficiaries

For advances against shares to joint holders or to third party beneficiaries, banks should ensure that the objective of the regulation is not defeated by such advances, through circumvention of various limits.

Advances against units of mutual funds

The banks should adhere to the following guidelines for this activity:

i. *Exit Route*: The units should be listed in the stock exchanges or repurchase facility should be available at the time of lending.
ii. *Lock-in-period*: The units should have completed the minimum lock-in-period stipulated in the relevant scheme.
iii. *Purpose of Loan:* The advances should take into account the credit requirement of the investor. It should not be granted for subscribing to or boosting up the sales of another scheme of a mutual fund or for the purchase of shares/debentures/bonds etc.
iv. *Amount of Advance*: It should be linked to the Net Asset Value (NAV)/ repurchase price or the market value, whichever is less.
v. *Quantum of Loan and Margin*: The quantum and margin requirements applicable to advances against shares and debentures also apply to advances against units of mutual funds (except units of exclusively debt oriented mutual funds). These requirements for loans/advances to individuals against units of exclusively debt-oriented mutual funds may be decided by individual banks themselves.

II. Facilities to Corporates and Others

Advances against Shares to Stock Brokers & Market Makers

Banks can provide credit facilities to stock brokers and market makers as per their commercial judgment, within their Board approved policy framework.

i. *Prudential Measure*: In order to avoid any nexus emerging between inter-connected stock broking entities and banks, the Board of a bank should fix a sub-ceiling for total advances to -
    - All the stock brokers and market makers (both fund based and non-fund based); and
    - Any single stock broking entity, including its associates/ inter-connected companies.
ii. *Restrictions*: Banks should not extend credit facilities directly or indirectly to stock brokers for arbitrage operations in Stock Exchanges.

Advances to Other Borrowers

i. Restriction: Normally, there advances are not granted to industrial, corporate or other borrowers against primary security of shares and debentures including promoters' shares.
ii. Permitted Collateral: Such securities are accepted as collateral for secured loans granted as working capital or for other productive purposes from borrowers other than NBFCs. In such cases, shares should be only in dematerialised form.

iii. Collateral as Margin: For meeting margin requirements when setting up of new projects or expansion of existing business or for the purpose of raising additional working capital required by units other than NBFCs, in anticipation of mobilising of long-term resources, banks can obtain collateral security of shares and debentures by way of margin. This should be of a temporary nature and may not be continued beyond a period of one year.

Bank Loans for Financing Promoters' Contributions

These loans will also be subject to various norms pertaining to loans against shares.

Bridge Loans

i. Banks can extend Bridge Loans to companies for up to one year against expected equity flows/issues. This is included in the CME.
ii. Banks may also extend bridge loans against the expected proceeds of Non-Convertible Debentures, External Commercial Borrowings, Global Depository Receipts and/or funds in the nature of Foreign Direct Investments, if firm arrangements for such facilities have been made. These bridge loans are not included in CME.

Margin Trading

Banks may extend finance to stockbrokers for margin trading. The Bank should formulate internal guidelines for this approved by its Board, RBI norms for this activity are as follows:

i. Exposure Category: It is reckoned for CME, and subject to prudential ceilings.
ii. Margin Amount: Minimum 50 per cent on the funds lent for margin trading.
iii. Security: Shares purchased should be in demat mode under pledge to the lending bank.
iv. Safeguards: Internal safeguards to ensure that no "nexus" develops between inter-connected stock broking entities/stockbrokers and the bank. The facility should be spread out among a reasonable number of stock brokers and stock broking entities.
v. Monitoring: The Audit Committee of the Board should monitor periodically the exposure by way of financing for margin trading and ensure that the internal guidelines are complied with.
vi. Disclosure: The total finance extended for margin trading should be disclosed in the "Notes on Account" to the Balance Sheet.

Cross holding of Capital among Banks/Financial Institutions

i. Banks' investment in the following instruments, issued by other banks/FIs and eligible for capital status for the investee bank should not exceed 10 percent of the investing bank's capital funds (Tier I plus Tier II):
    a. Equity shares;
    b. Preference shares eligible for capital status;
    c. Subordinated debt instruments;
    d. Hybrid debt capital instruments; and
    e. Any other instrument approved as in the nature of capital.

ii. Banks should not acquire any fresh stake in a bank's equity shares, if the investing bank's holding will cross 5 percent of the investee bank's equity capital.
iii. A bank's equity holdings in another bank held under provisions of a Statute is outside the purview of this ceiling.

Investments in the instruments mentioned above, if not deducted from Tier I capital of the investing bank will attract 100 percent risk weight for credit risk for capital adequacy purposes.

19.7 OTHER RESTRICTIONS FOR SHARES/ DEBENTURES RELATED LOANS

'Safety Net' Schemes for Public Issues of Shares, Debentures, etc.

Banks or their subsidiaries are not permitted to extend any 'Safety Net' facility that provides buy- back facilities in respect of issues of shares/ debentures at any time during a stipulated period at a price determined at the time of issue, irrespective of the prevailing market price.

Provision of buy back facilities

In some cases, the issuers provide buy-back facilities to original investors up to ₹40,000/- in respect of non-convertible debentures after a lock-in-period of one year, to provide liquidity to debentures issued by them. If a bank or its subsidiary provides, at the request of the issuer company, such a facility to small investors subscribing to new issues, the following norms should be followed:

i. It should not entail any commitment to buy the securities at pre-determined prices.
ii. The price should be determined from time to time, based on the stock market prices for the securities.
iii. The bank's commitment should be limited to a moderate proportion of the total issue in terms of the amount and should not exceed 25 percent of the owned funds of the banks/ their subsidiaries.
iv. These commitments are also subject to various prescribed exposure limits.

19.8 LET US SUM UP

For better credit risk management and avoiding concentration of credit risks, credit exposures are contained within predetermined ceilings. Certain exposure ceilings are prescribed by the regulator, while others are determined by the bank itself. Different levels are prescribed depending mainly on the counterparty, the sector, and the security. Products like derivatives have embedded credit risk. Certain exposures are exempted from these norms. For exposures to industry and sectors banks are required to set their own ceilings. Banks also need to reckon additional risks due to unhedged foreign currency exposures of their borrowers.

19.9 KEY WORDS

Credit exposure; Investment Exposure; Central Counterparty (CCP); Qualifying CCP (QCCP); Clearing exposure Current Exposure Method; Large Exposure Framework; Credit equivalent amount; Unhedged Foreign Currency Exposure; Capital Market Exposure; Irrevocable Payment Commitments; Statutory limit; Regulatory limits; Intra-day Exposures; Intra-Group Transactions; Intra-Group Exposures; Lock-in-period; Promoters' Contributions; Bridge Loans; Hybrid debt capital; 'Safety Net' Schemes.

19.10 CHECK YOUR PROGRESS

1) The sum of all the exposure values of a bank to a single counterparty must not be higher than ____ percent of the bank's available eligible capital base.
   a) 15
   b) 10
   c) 40
   d) 20
2) The exposure to Leasing Companies should not exceed _____ per cent of total advances.
   a) 25
   b) 15
   c) 20
   d) 10
3) There is a ceiling for this exposure: ______.
   a) Rehabilitation of Sick/Weak Industrial Units
   b) Loans against Own Term Deposits
   c) Exposure on NABARD
   d) Exposure to Capital markets

19.11 KEY TO 'CHECK YOUR PROGRESS'

1 (d); 2 (d); 3 (d)

References:

(1) RBI Circular DBR.No.Dir.BC.12/13.03.00/2015-16 dated July 1, 2015 - Master Circular – Exposure Norms
(https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9875)
(2) RBI Circular DBR.No.BP.BC.43/21.01.003/2018-19 dated June 03, 2019 Large Exposures Framework
(https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11573&Mode=0#F4)
(3) RBI Circular DOR.No.CRE.BC.45/21.01.003/2020-21 dated February 24, 2021 Large Exposures Framework - Exemptions
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12036)

CHAPTER 20

LOANS AND ADVANCES - STATUTORY AND OTHER RESTRICTIONS

STRUCTURE

OBJECTIVES

In this Chapter the learner will –

- Know about statutory restrictions for loans and advances
- Learn about certain regulatory restrictions on loans and advances
- Know about the norms for opening current accounts for borrowers of banking system

20.1 STATUTORY RESTRICTIONS

a) Advances against bank's own shares:

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

b) Advances to bank's Directors:

i. Section 20(1) of the Banking Regulation Act, 1949 also lays down the restrictions on loans and advances to the directors and the firms in which they hold substantial interest. Purchase of or discount of bills from directors and their concerns, which is in the nature of clean accommodation, is reckoned as 'loans and advances' for the purpose of Section 20 of the Banking Regulation Act, 1949.

ii. Banks are prohibited from entering into any commitment for granting any loan or advance to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor, or any company (not being a subsidiary of the banking company or a company registered under Section 8 of the Companies Act, 2013, or a Government company) of which, or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or any individual in respect of whom any of its directors is a partner or guarantor.

iii. Certain clarifications in this regard are as follows:

1) A foreign bank branch in India should not lend to a firm/company in India, if a director in the foreign bank's Board abroad has (i) an interest in the firm/company or (ii) if the company is a subsidiary of any Indian/foreign parent in which the director is interested viz. is a director / partner/ managing agent / manager / employee or guarantor.
2) In case of any loan or advance granted to a subsidiary of the holding company, is prohibited if any of the directors of the banking company is a director of the holding company.
3) These provisions are not attracted for advances granted or commitment made to a company prior to appointment of the Director of the company on the Board of the bank.
4) The bank is precluded from renewing the loan/limit after its expiry or enhancing the limit that may have been sanctioned prior to the date of company's Director becoming a Director of the bank.
5) The prohibitions stipulated under Section 20 are applicable to nominee directors also.
6) Purchase of cheques is specifically exempted from prohibitory provisions of section 20. However, withdrawal against uncleared effects is not permitted.

7) Derivative transactions are off balance sheet items and are treated on similar lines with non-fund based transactions and are out of purview of Section 20, till no liability devolves on banks.
8) The Priority Sector lending by itself is not given any exemption under Section 20.
9) In case the trust is a public trust, the provisions of Section 20 are not attracted.
10) For the purpose of advances to bank's Directors, the term 'loans and advances' shall not include:
    a. Loans or advances against Government securities, life insurance policies or fixed deposit.
    b. Loans or advances to the Agricultural Finance Corporation Ltd;
    c. Loans or advances to any of its directors in his capacity of an employee, prior to becoming a director;
    d. Loans or advances granted to its Chairman and Chief Executive Officer, who was not an employee immediately prior to his appointment as Chairman/Managing Director/CEO, or to whole-time director for the purpose of purchasing a car, personal computer, furniture or constructing/acquiring a house for his personal use and festival advance, with the prior approval of the RBI and on such terms and conditions as may be stipulated by it;
    e. Call loans made by banking companies to one another;
    f. Facilities like bills purchased/discounted (whether documentary or clean and sight or usance and whether on D/A basis or D/P basis), purchase of cheques, other non-fund based facilities like acceptance/co-acceptance of bills, opening of L/Cs and issue of guarantees, purchase of debentures from third parties, etc.;
    g. Line of credit/overdraft facility extended by settlement bankers to National Securities Clearing Corporation Ltd. (NSCCL)/Clearing Corporation of India Ltd. (CCIL) to facilitate smooth settlement; and
    h. A credit limit granted under credit card facility provided by a bank to its directors on the criteria as applied by it in the normal conduct of the credit card business.
11) If any question arises whether any transaction is a loan or advance for the purpose of Section 20, it shall be referred to RBI, whose decision thereon shall be final.
12) On giving guarantees and opening of L/Cs on behalf of the bank's directors, it is pertinent to note that in the event of the principal debtor committing default in discharging his liability and the bank being called upon to honour its obligations under the guarantee or L/C, the relationship between the bank and the director could become one of the creditor and debtor. Also, it is possible for the directors to evade the provisions of Section 20 by borrowing from a third party against the guarantee given by the bank. Hence, when extending non-fund based facilities such as guarantees, L/Cs, acceptance on behalf of directors and the companies/firms in which the directors are interested; it should be ensured that –
    a. adequate and effective arrangements have been made to the satisfaction of the bank that the commitments would be met by the openers of L/Cs, or acceptors, or guarantors out of their own resources,

b. the bank will not be called upon to grant any loan or advance to meet the liability consequent upon the invocation of guarantee, and
c. no liability would devolve on the bank on account of L/Cs/ acceptances.

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

c) ***Restrictions on Holding Shares in Companies:***
While granting loans and advances against shares, statutory provisions contained in Section 19(2) and 19(3) of the Banking Regulation Act, 1949 should be strictly observed.

d) ***Restrictions on Credit to Companies for Buy-back of their Securities:***
In terms of provisions of the Companies Act, 2013, companies are permitted to purchase their own shares or other specified securities out of their - free reserves, or securities premium account, or the proceeds of any shares or other specified securities, subject to compliance of various conditions specified therein. Therefore, banks should not provide loans to companies for buy-back of shares/securities.

20.2 REGULATORY RESTRICTIONS

Guidelines on Loan system for Delivery of Bank Credit to Large Borrowers

RBI has issued guidelines in Dec 2018 with a view to enhance credit discipline among the large borrowers and put a criteria of a minimum level of loan component in respect of borrowers having aggregate fund based working capital limit of INR 1500 million (Rs 150 Cr) and above from the banking system. Accordingly, a minimum level of loan component of 60 percent should be granted on aggregate fund based working capital including adhoc limits and TODs. These rules are applicable in respect of consortium and multiple banking arrangements also. The amount and tenor of the loan component is to be fixed / assessed as per need of the borrowers, subject to tenor being not less than 7 days, loan component should be split into WCDLs with different maturity.

Repayment/ Renewal / Rollover of Loan Component

Banks/ consortia / syndicates have been given discretion to stipulate repayment of WCLs in instalments or by way of a bullet repayment, subject to IRAC norms. Banks have been advised to consider rollover of the WCLs at the request of the borrower, subject to compliance with the extant IRAC norms.

Granting loans and advances to relatives of Directors:

Without prior approval/ information of the Board, no loans and advances should be granted to relatives of the bank’s Chairman/Managing Director or other Directors, Directors of other banks and their relatives, Directors of Scheduled Co-operative Banks and their relatives, Directors of Subsidiaries/Trustees of Mutual Funds/Venture Capital Funds set up by the financing banks or other banks. The norms applicable for such loans are as under.

i. Unless sanctioned by the Board of Directors/Management Committee, banks should not grant loans and advances aggregating ₹5 crore and above to -

a) directors (including the Chairman/Managing Director) of other banks/ subsidiaries/trustees of mutual funds/venture capital funds;
b) any firm in which any of the directors of other banks subsidiaries/trustees of mutual funds/venture capital funds is interested as a partner or guarantor; and
c) any company in which any of the directors of other banks subsidiaries/trustees of mutual funds/venture capital funds holds substantial interest or is interested as a director or as a guarantor.
d) any relative other than spouse and minor / dependent children of their own Chairmen/Managing Directors or other Directors;
e) any relative other than spouse and minor / dependent children of the Chairman/Managing Director or other directors of other banks/subsidiaries/trustees of mutual funds/venture capital funds;
f) any firm in which any of the relatives other than spouse and minor / dependent children as mentioned in (d) & (e) above is interested as a partner or guarantor; and
g) any company in which any of the relatives other than spouse and minor / dependent children as mentioned in (d) & (e) above is interested as a major shareholder or as a director or as a guarantor or is in control.

ii. The restrictions also apply to grant of loans and advances to spouse and minor / dependent children of the Directors of banks. There is an exception, subject to conditions, made in case the spouse has his / her own independent source of income.

iii. The proposals for credit facilities of an amount less than ₹25 lakh or ₹5 crore (as the case may be) to these borrowers may be sanctioned by the appropriate authority in the financing bank under powers vested in such authority, but the matter should be reported to the Board.

iv. The Chairman/Managing Director or other director who is directly or indirectly concerned or interested in any proposal should disclose the nature of his/her interest to the Board when any such proposal is discussed. He/she should not be present in the meeting unless his/her presence is required by the other directors for the purpose of eliciting information and the director so required to be present shall not vote on any such proposal.

v. These norms relating to grant of loans and advances will equally apply to awarding of contracts.

vi. For these stipulations the following terms mean:
a) "major shareholder" shall mean a person holding 10% or more of the paid-up share capital or five crore rupees in paid-up shares, whichever is less.
b) "control" shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders' agreements or voting agreements or in another manner.
c) "relative" – includes the following –

Table 20.1: Relative includes:

Spouse	Father	Mother (including step-mother)
Son (including step-son)	Son's Wife	Daughter (including step-daughter)
Daughter's Husband	Brother (including step-brother)	Brother's wife
Sister (including step-sister)	Sister's husband	Brother (including step-brother) of the spouse
Sister (including step-sister) of the spouse		

d) 'loans and advances' – does not include loans or advances against –

Government securities	Life insurance policies
Fixed or other deposits	Stocks and shares
Temporary overdrafts for small amounts, i.e. up to ₹25,000/-	Casual purchase of cheques up to ₹5,000/- at a time
Housing loans, car advances, etc. granted to an employee of the bank under any scheme applicable generally to employees.	

e) 'substantial interest' - same meaning as assigned to it in Section 5(ne) of the BR Act, 1949.

vii. Banks should evolve a procedure for ascertaining the interest of a director of a financing bank or of another bank, or his relatives, in credit proposals/ award of contracts placed before the Board/Committee or other appropriate authority of the financing banks.

viii. To ensure compliance with the instructions, banks should forthwith recall the loan when it transpires that the borrower has given a false declaration.

ix. These guidelines should also be followed by banks when granting loans and advances and awarding of contracts to directors of scheduled co-operative banks or their relatives; and to directors of subsidiaries/ trustees of mutual funds/ venture capital funds set up by them as also other banks.

Loan to Officers and Relatives of Senior Officers of Banks:

The statutory regulations and/or the rules and conditions of service applicable to officers or employees of public sector banks indicate, to a certain extent, the precautions to be observed while sanctioning credit facilities to such officers and employees and their relatives. Following guidelines should be followed by all the banks in this regard:

i. No officer or any Committee comprising, inter alia, an officer as member, shall, while exercising powers of sanction of any credit facility, sanction any credit facility to his/her relative. Such a facility shall ordinarily be sanctioned only by the next higher sanctioning authority. Credit facilities sanctioned to senior officers of the financing bank should be reported to the Board.

ii. Proposals for credit facilities to the relatives of senior officers of the bank, or to any of the under mentioned entity, sanctioned by the appropriate authority should be reported to the Board.
   a) any firm in which a relative of any senior officer of the financing bank holds substantial interest, or is a partner or guarantor; or
   b) any company in which a relative of any senior officer of the financing bank holds substantial interest, or a director or as a guarantor,

iii. These norms relating to grant of credit facility will equally apply to the awarding of contracts.

iv. In case of consortium arrangements, the norms will apply to the relatives of senior officers of all the participating banks.

v. Following expressions in this context mean as indicated below –
   a) 'Relative' – means as stated in table 20.1 above.
   b) 'Senior Officer' – This refers to any officer in senior management level in Grade IV and above in a nationalised bank, and any officer in equivalent scale in the State Bank of India and in any banking company incorporated in India.
   c) 'credit facility' – This term will not include loans or advances against -

Government securities	Life insurance policies
Fixed or other deposits	Housing loans, car advances, consumption loans, etc. granted to an officer of the bank under any scheme applicable generally to officers.
Temporary overdrafts for small amounts, i.e. up to ₹25,000/-	Casual purchase of cheques up to ₹5,000/- at a time

   d) 'substantial interest' – This has the same meaning assigned to it in Section 5(ne) of the BR Act, 1949.

vi. Banks need to put in place following measures –
   a) Have a procedure to ascertain the interest of the relatives of a senior officer of the bank in any credit proposal/award of contract.
   b) Obtain a declaration from every borrower – the borrower/ the partners/ the members of the HUF/ the directors of the company is/ are not a near, specified relation of any senior officer of the bank, or provide particulars of the relationship, if any, to any senior officer of the financing bank.
   c) Make a condition for any credit facility that if the aforesaid declaration made by a borrower is found to be false, then the bank will be entitled to revoke and/or recall the credit facility.
   d) Have appropriate regulations or rules dealing with the service conditions of officers of the bank to give effect to these guidelines.

Restrictions on Grant of Financial Assistance to Industries Producing/Consuming Ozone Depleting Substances (ODS):

Banks should not extend finance for setting up of new units consuming/producing the Ozone Depleting Substances (ODS). No financial assistance should be extended to small/medium scale units engaged in the manufacture of the aerosol units using chloro fluoro carbons (CFC) and no refinance would be extended to any project assisted in this sector.

Restrictions on Advances against Sensitive Commodities under Selective Credit Control (SCC):

With a view to preventing speculative hoarding of essential commodities with the help of bank credit and the resultant rise in their prices, in exercise of powers conferred by Sections 21 & 35A of the BR Act, 1949, the RBI, issues, from time- to-time, directives to all commercial banks, stipulating specific restrictions on bank advances against specified sensitive commodities such as, food grains, i.e., cereals and pulses, selected major oil seeds indigenously grown, viz., groundnut, rapeseed/mustard, cottonseed, linseed and castor seed, oils thereof, vanaspati and all imported oils and vegetable oils, kapas and raw cotton sugar/gur/ khandsari, cotton textiles which include cotton yarn, man-made fibres and yarn and fabrics made out of man-made fibres and partly out of cotton yarn and partly out of man-made fibres.

Banks are free to fix prudential margins on advances against these sensitive commodities. However, in case of advance against Levy Sugar, a minimum margin of 10% will apply.

Restriction on payment of commission to staff members including officers:

In view of the provisions of the BR Act, banks should not pay commission to staff members and officers for recovery of loans.

Restrictions on offering incentives on any banking products:

Banks should not offer any banking products, including online remittance schemes etc., with prizes/lottery/ free trips (in India and/or abroad), etc. or any other incentives having an element of chance, except inexpensive gifts costing not more than ₹250/-, as such products involve non-transparency in the pricing mechanism and therefore go against the spirit of the guidelines.

20.3 RESTRICTIONS ON OTHER LOANS AND ADVANCES

Salient aspects related to advances of various natures are given below. Further details for these are available in the relevant RBI Master Circular.

Loans and Advances against Shares, Debentures and Bonds:

i. *Advances to individuals* - The maximum loan amount permitted per individual is ₹10 lakh for shares held in physical form and ₹20 lakh for shares held in dematerialised form. Loans against shares / debentures / bonds are reckoned as an exposure to capital market. Banks should not support collusive action by a large group of individuals to take multiple loans in order to support particular scrip or stock-broking activities of the connected firms. Margin on the market value should be minimum 50% for physical shares, and minimum 25% for dreamt shares. A declaration should be taken from the borrower of the extent of loans availed by him from other banks. A bank must ensure that the accommodation from different banks is not obtained against shares of a single company or a group of companies. A bank may also consider laying down appropriate aggregate sub-limits of such advances.

ii. *Advances to Share and Stock Brokers/ Commodity Brokers* - Banks and their subsidiaries should not finance 'Badla' transactions. Banks shall grant advances only to share and stock brokers registered with SEBI and who comply with capital adequacy norms. They can be provided need based overdraft facilities/ line of credit against shares and debentures held by them as stock-in-trade, based on appropriate appraisal. The securities should be easily marketable. Working capital facility to meet the cash flow gap between delivery and payment for Delivery versus Payment (DVP) transactions on behalf of institutional clients viz. FIs, Flls, mutual funds and banks, is permitted, for short duration. Banks may issue guarantees on behalf of share and stock brokers/commodity brokers in favour of stock/ commodity exchanges in lieu of security deposit; and in lieu of margin requirements. In case of a default in the account, the bank should exercise the option to get the shares transferred in its name.

iii. *Bank Finance for Market Makers* – Banks may provide need based finance to meet the genuine credit requirements of Market Makers approved by a stock exchange for equity and also for debt securities including State and Central Government securities. Advances provided for Market Making should not be diverted for investment in shares other than the scrip earmarked for Market Making.

iv. *Advances against shares* - to Joint holders or third party beneficiaries – Banks should be circumspect while considering advances against shares held in joint names to joint holders or third party beneficiaries. They need to ensure that such loans are not used to circumvent the limits placed on loans/advances against shares and other securities.

v. *Financing of Initial Public Offerings (IPOs)* - Loans/advances to any individual from banking system against security of shares, convertible bonds, convertible debentures, units of equity oriented mutual funds and PSU bonds, for subscribing to IPOs, should not exceed the limit of ₹10 lakh. The corporate should not be extended credit by banks for investment in other companies' IPOs. Similarly, banks should not provide finance to NBFCs for further lending to individuals for IPOs.

vi. *Bank Finance to assist employees to Buy shares of their own companies* - Banks may extend finance to employees for purchasing shares of their own companies under Employees Stock Option Plan (ESOP)/ reserved by way of employees' quota under IPO including Follow-on Public Offer) to the extent of 90% of the purchase price of the shares or ₹ 20.00 lakh, whichever is lower. Banks should obtain declaration from the borrower indicating the details of the loan/advances availed against shares and other securities specified above, from any other bank/s in order to ensure compliance with the ceilings prescribed for the purpose. Banks are not allowed to extend advances (whether secured or unsecured) including advances to their employees/ Employees' Trusts set up by them for the purpose of purchasing their own banks' share under ESOPs/IPOs or from the secondary market.

vii. *Advances to other borrowers against shares/ debentures/ bonds* – In the normal course there should be no occasion for granting advances against Primary Security (i.e. the asset created out of the credit facility extended to the borrower) of shares and debenture including promoters' shares to industrial, corporate or other borrowers. Such securities can be accepted as collateral for secured loans granted as working capital or for other productive purposes from borrowers other than NBFCs. These shares, including the promoters' shares must be accepted only in dematerialised form.

viii. *Bank Loans for Financing Promoters' Contribution* - The promoters' contribution towards the equity capital of a company should come from their own resources and the bank should not normally grant advances to take up shares of other companies. However, banks are permitted to extend loans to corporates against the security of shares (as far as possible in dematerialised form) held by them to meet the promoters' contribution to the equity of new companies in anticipation of raising resources subject to specific terms and conditions, in addition to the general guidelines. These loans should be treated as a bank's investments in shares which would thus come under the ceiling of 40 percent of the bank's net worth as on March 31 of the previous year prescribed for the bank's total exposure including both fund based and non-fund based to capital market in all forms.

ix. *Advances against Units of Mutual Funds* – The Units should be listed in the Stock Exchanges or repurchase facility for these should be available at the time of lending, the stipulated lock-in period should have completed. The norms for the loan quantum and margin as applicable to advance against shares and debentures will apply, except for wholly debt-oriented funds.

x. *Margin Trading* - Banks may extend finance to stockbrokers for margin trading, with certain prescribed minimum parameters. This should be within the ceiling of 40% of net-worth for capital market exposure. There should be safeguards to ensure that no "nexus" develops between inter-connected stock broking entities/ stockbrokers and the bank in respect of margin trading.

xi. *Arbitrage Operations* – Banks should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in Stock Exchanges. While banks are permitted to acquire shares from the secondary market, they should ensure that no sale transaction is undertaken without actually holding the shares in their investment accounts.

xii. General guidelines applicable to advances against shares / debentures / bonds:

a) Statutory provisions regarding the grant of advances against shares (including dematerialsed shares) contained in Sections 19(2) and (3) and 20(1) (a) of the BR Act 1949 should be strictly observed.

b) Banks should be concerned with what the advances are for, rather than what the advances are against.

c) Advances against the primary security of shares / debentures / bonds should be kept distinct and separate and not combined with any other advance.

d) Banks should satisfy themselves about the marketability of the shares / debentures and the net worth and working of the company whose shares / debentures / bonds are offered as security.

e) Shares / debentures / bonds should be valued at prevailing market prices when they are lodged as security for advances.
f) Banks should exercise particular care when advances are sought against large blocks of shares by a borrower or a group of borrowers, that these are not used to enable the borrower to acquire or retain a controlling interest in the company.
g) No advance against partly paid shares shall be granted.
h) No loans to be granted to partnership / proprietorship concerns against the primary security of shares and debentures.
i) Banks should not be a party to transactions such as making advances or issuing back-up guarantees favouring other banks for extending credit to clients of Indian nationality / origin by some of their overseas branches, to enable the borrowers to make investments in shares and debentures / bonds of Indian companies.
j) A uniform margin of 50% shall be applied on all advances against shares/financing of IPOs/issue of Guarantees. A minimum cash margin of 25% (within margin of 50%) shall be maintained in respect of guarantees issued by banks for capital market operations. These margin requirements will also be applicable in respect of bank finance to stock brokers by way of temporary overdrafts for DVP transactions.

Advances against Fixed Deposit Receipts:

i. Banks should desist from sanctioning advances against FDRs, or other term deposits of other banks.
ii. Grant of advance against NR(E) and FCNR(B) deposits would be subject to the guidelines issued under Foreign Exchange Management Act, 1999

Advances to Agents/ Intermediaries based on Consideration of Deposit Mobilisation:

Banks should desist from being party to unethical practices of raising of resources through agents/intermediaries to meet the credit needs of the existing/prospective borrowers or from granting loans to intermediaries, based on the consideration of deposit mobilisation, who may not require the funds for their genuine business requirements.

Loans against Certificate of Deposits (CDs):

Banks may lend against CDs and buy back their own CDs, until further notice, only in respect of CDs held by mutual funds, subject to the provisions of paragraph 44(2) of the SEBI (Mutual Funds) Regulations, 1996. Further, such finance if extended to equity-oriented mutual funds will form part of banks' capital market exposure, as hitherto.

Finance for and Loans/Advances against Indian Depository Receipts (IDRs):

No bank should grant any loan/advance for subscription to Indian Depository Receipts (IDRs). Further, no bank should grant any loan/advance against security/collateral of IDRs issued in India.

Bank Finance to Non-Banking Financial Companies (NBFCs):
Banks may be guided by the Master Circular on Bank Finance to Non-Banking Financial Companies (NBFCs) dated July 1, 2015 in this regard.

Financing Infrastructure/ Housing Projects:

i. Housing Finance - Banks may refer to the Master Circular on Housing Finance dated July 1, 2015 in this regard.

ii. Guidelines for Financing Infrastructure Projects - In order to harmonise the definition of 'infrastructure lending for the purpose of financing of infrastructure by the banks and Financial Institutions' with that of the Master List of Infrastructure sub-sectors' notified by the Government of India on October 7, 2013, the definition of 'infrastructure lending' has been revised. Banks/FIs are free to finance technically feasible, financially viable and bankable projects undertaken by both public sector and private sector undertakings subject to prescribed conditions. In order to meet financial requirements of infrastructure projects, banks may extend credit facility by way of working capital finance, term loan, project loan, subscription to bonds and debentures/ preference shares/ equity shares acquired as a part of the project finance package which is treated as "deemed advance” and any other form of funded or non-funded facility.

Issue of Bank Guarantees in favour of Financial Institutions:
Banks may issue guarantees favouring other banks/FIs/other lending agencies for the loans extended by the latter, subject to strict compliance with prescribed guidelines. The Board of Directors should reckon the integrity/robustness of the bank’s risk management systems and, accordingly, put in place a well-laid out policy in this regard. The guarantee shall be extended only in respect of borrower constituents and to enable them to avail of additional credit facility from other banks/FIs/lending agencies. The guaranteeing bank shall assume a funded exposure of at least 10% of the exposure guaranteed. Banks should not extend guarantees or letters of comfort in favour of overseas lenders including those assignable to overseas lenders, except for the relaxations permitted under FEMA.

Discounting/Rediscounting of Bills by Banks:
Banks may sanction working capital limits as also bills limit to borrowers after proper appraisal of their credit needs and in accordance with their loan policy, approved by their Board of Directors. Banks may take advantage of improved computer / communication networks like the Structured Financial Messaging system (SFMS) and adopt the system of ‘value dating’ of their clients’ accounts in managing these facilities. Banks should open letters of credit (LCs) and purchase / discount / negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks. Banks should not, therefore, extend fund-based (including bills financing) or non-fund based facilities like opening of LCs, providing guarantees and acceptances to non-constituent borrower or / and non-constituent member of a consortium / multiple banking arrangement.

Advances for purchase of Gold and lending against Bullion/Primary gold:

No advances should be granted by banks for purchase of gold in any form including primary gold, gold bullion, gold jewellery, gold coins, units of Gold Exchange Traded Funds (ETF) and units of gold Mutual Funds. However, banks can provide finance for genuine working capital requirements of jewellers. The scheme of Gold (Metal) Loan as amended from time to time, continues to be in force. Banks should not grant any advance against bullion/Primary gold. However, specially minted gold coins sold by banks cannot be treated as "bullion" or "primary gold" and hence there is no objection to the bank granting loans against the coins. While granting advance against the security of specially minted gold coins sold by them, banks should ensure that the weight of the coin(s) does not exceed 50 grams per customer and the amount of loan to any customer against gold ornaments, gold jewellery and gold coins (weighing up to 50 grams) should be within the Board approved limit.

Advances against Gold Ornaments & Jewellery:

Loans (including bullet repayment loans) sanctioned by banks against pledge of gold ornaments and jewellery for non-agricultural purposes should not exceed 75% of the value of gold ornaments and jewellery. Further, LTV of 75% shall be maintained throughout the tenure of the loan for all loans extended against pledge of gold ornaments and jewellery for non-agricultural end uses. LTV ratio shall be computed against the total outstanding in the account, including accrued interest, and current value of gold jewellery accepted.

Gold (Metal) Loans:

Presently, nominated banks can extend Gold (Metal) Loans to exporters of jewellery who are customers of other scheduled commercial banks, by accepting stand-by letter of credit or bank guarantee issued by their bankers in favour of the nominated banks. Banks may also extend the facility to domestic jewellery manufacturers. The stand-by LC/ BG shall be extended only on behalf of domestic jewellery manufacturers and shall cover at all times the full value of the quantity of gold borrowed by these entities. The stand-by LC / BG shall be issued by scheduled commercial banks in favour of a nominated bank (list appended) only and not to any other entity which may otherwise be having permission to import gold.

Loans and advances to Real Estate Sector:

While appraising loan proposals involving real estate, banks should ensure that the borrowers have obtained prior permission from government / local governments / other statutory authorities for the project, wherever required. In order that the loan approval process is not hampered on account of this, while the proposals could be sanctioned in normal course, the disbursements should be made only after the borrower has obtained requisite clearances from the government authorities.

Loans and advances to Micro and Small Enterprises (MSEs):

MSE units having working capital limits of up to ₹ 5 crore from the banking system are to be provided working capital finance computed on the basis of 20% of their projected annual turnover. The banks should adopt the simplified procedure in respect of all MSE units (new as well as existing).

Loan system for delivery of bank credit:
In the case of borrowers enjoying working capital credit limits of ₹10 crore and above from the banking system, the loan component should normally be 80%. Banks have the freedom to change the composition of working capital by increasing the cash credit component beyond 20% or to increase the 'Loan Component' beyond 80%. Banks are expected to appropriately price each of the two components of working capital finance, taking into account the impact of such decisions on their cash and liquidity management. In the case of borrowers enjoying working capital credit limit of less than ₹10 crore, banks may persuade them to go in for the 'Loan System' by offering an incentive in the form of lower rate of interest on the loan component, as compared to the cash credit component. In respect of certain business activities, which are cyclical and seasonal in nature or have inherent volatility, the strict application of loan system may create difficulties for the borrowers, banks may identify such business activities, which may be exempted from the loan system of delivery.

Lending under Consortium Arrangement/ Multiple Banking Arrangement: Banks are encouraged to strengthen their information back-up about the borrowers enjoying credit facilities from multiple banks as under:

i. At the time of granting fresh facilities, banks may obtain declaration from the borrowers about the credit facilities already enjoyed by them from other banks in the prescribed format. (RBI circulars DBOD.No.BP.BC.46/08.12.001 /2008-09 dated September 19, 2008 and DBOD.No.BP.BC.94/08.12.001 /2008-09 dated December 08, 2008)
ii. Banks should exchange information at quarterly intervals about the conduct of the borrowers' accounts with other banks in the prescribed format. The information exchange should also, inter alia, cover information relating to borrowers' derivative transactions and unhedged foreign currency exposures. (Circulars DBOD.No.BP.BC.46/08.12.001/2008-09 dated September 19, 2008 and DBOD.No.BP.BC.94/08.12.001/2008-09 dated December 08, 2008, circular DBOD.BP.BC.No.62/ 21.04.103/ 2012-13 dated November 21, 2012,)
iii. Obtain regular certification by a professional, preferably a Company Secretary, Chartered Accountant or Cost Accountant, regarding compliance of various statutory prescriptions that are in vogue, as per prescribed specimen. (Circulars DBOD.No.BP.BC.46/08.12.001/2008-09 dated September 19, 2008, DBOD.No.BP.BC.94/08.12.001/2008-09 dated December 08, 2008 and DBOD.No.BP.BC.110/08.12.001/2008-09 dated February 10, 2009)
iv. Make greater use of credit reports available from a credit information company which has obtained Certificate or Registration from RBI.
v. The banks should incorporate suitable clauses in the loan agreements in future (at the time of next renewal in the case of existing facilities) regarding exchange of credit information so as to address confidentiality issues.

Working Capital Finance to Information Technology and Software Industry: Reserve Bank has framed guidelines for extending working capital to the said industry. Banks are however free to modify the guidelines based on their own experience without reference to the Reserve Bank of India to achieve the purpose of the guidelines in letter and spirit. In the case of the borrowers with working capital limits of up to ₹ 2 crore, assessment may be made at 20% of the projected turnover. in other cases, the banks may consider assessment of MPBF on the basis of the monthly cash budget system. For the borrowers enjoying working capital limits of ₹ 10 crore and above from the banking system the guidelines regarding the loan system would be applicable. Banks can stipulate reasonable amount as promoters' contribution towards margin. Banks may obtain collateral security wherever available. First/ second charge on current assets, if available, may be obtained.

Grant of Loans for acquisition of Kisan Vikas Patras (KVPs):
Banks should ensure that no loans are sanctioned for acquisition of/ investing in Small Savings Instruments including Kisan Vikas Patras. The grant of loans for acquiring/investing in KVPs does not promote fresh savings and, rather, channelises the existing savings in the form of bank deposits to small savings instruments and thereby defeats the very purpose of such schemes.

7% Savings Bonds 2002, 6.5% Savings Bonds 2003 (Non-taxable) & 8% Savings (Taxable) Bonds 2003-Collateral facility:
Government of India has allowed pledge or hypothecation or lien of the bonds issued under the captioned schemes as collateral for obtaining loans from scheduled banks. Accordingly, the holders of the said bonds will be entitled to create pledge or hypothecation or lien in favour of scheduled banks. Banks are permitted to extend collateral facility through pledge or hypothecation or lien of these bonds, to the bondholder but not to any third party.

Guidelines on Settlement of Non-Performing Assets- Obtaining Consent Decree from Court:
Banks are advised to invariably ensure that once a case is filed before a Court / DRT any settlement arrived at with the borrower is subject to obtaining a consent decree from the Court / DRT concerned.

Project Finance Portfolio of Banks:
Banks are advised in their own interest to have a clear policy regarding the Debt Equity Ratio (DER) and to ensure that the infusion of equity/fund by promoters should be such that the stipulated level of DER is maintained at all times. Further they may adopt funding sequences so that possibility of equity funding by banks is obviated.

Bridge Loans against receivables including from Government:
Banks should not extend bridge loans against amounts receivable from Central/State Governments by way of subsidies, refunds, reimbursements, capital contributions, etc. The exemptions to this are;

i. Banks may continue to finance subsidy receivable under the normal Retention Price Scheme (RPS) for periods up to 60 days in case of fertilizer industry, as a temporary measure.
ii. Banks may continue to grant finance against receivables from Government by exporters (viz. Duty Draw Back and IPRS).
iii. Banks have been permitted to sanction to companies for a period not exceeding one year against expected equity flows/issues.
iv. Banks may extend bridge loans against the expected proceeds of Non-Convertible debentures, External Commercial Borrowings, Global Depository receipts and/or funds in the nature of Foreign Direct Investments, provided the banks are satisfied that the borrowing company has already made firm arrangements for raising the aforesaid resources/funds.

Transfer of borrowal accounts from one bank to another:

i. Banks should put in place a Board approved policy with regard to take-over of accounts from another bank.
ii. Before taking over an account, the transferee bank should obtain necessary credit information from the transferor bank as per the prescribed format. (Annex II of RBI circular DBOD.No.BP.BC.94/ 08.12.001/2008-09 dated December 8, 2008).
iii. The transferor bank, on receipt of a request from the transferee bank, should share necessary credit information as per the prescribed format at the earliest.

Guidelines on Fair Practices Code for Lenders:

On the basis of the recommendations of the Working Group on Lenders' Liability Laws constituted by the Government of India, these guidelines have been finalised and banks/all India Financial Institutions are advised to adopt these and frame the Fair Practices Code duly approved by their Board of Directors.

i. Applications for loans and their processing-
    a) Loan application forms should be comprehensive. Banks must transparently disclose to the borrower all information about various fees, charges, and penalty such as fees/charges payable for processing the loan application, the amount of fees refundable if loan amount is not sanctioned/disbursed, pre-payment options and charges, penalty for delayed repayments, etc. Levying such charges subsequently without disclosing the same to the borrower is an unfair practice. Banks must inform 'all-in-cost' to the customer to enable him to compare the rates/ charges with other sources of finance. Such charges/fees should be non-discriminatory.
    b) There should be a system of giving acknowledgement for receipt of all loan applications.
    c) Timelines for Credit Decisions - Banks should clearly delineate the procedure for disposal of loan proposals, with appropriate timelines, and institute a suitable monitoring mechanism for reviewing applications pending beyond the specified period. Suitable disclosures on the timelines should be made through their websites, notice-boards, product literature, etc.

d) Banks/financial institutions should verify the loan applications within a reasonable period of time.

e) For all categories of loans (including credit card applications) lenders should convey in writing, within stipulated time, the main reason/reasons for rejection of the loan applications.

ii. Loan appraisal and terms/conditions -

a) There should be proper assessment of credit application by borrowers. Banks should not use margin and security stipulation as a substitute for due diligence on credit worthiness.

b) The lender should convey to the borrower the credit limit along with the terms and conditions thereof.

c) Terms and conditions and other caveats arrived at after negotiation by lending institution and the borrower should be reduced in writing. A copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement should be furnished to the borrower.

d) As far as possible, the loan agreement should clearly stipulate credit facilities that are solely at the discretion of lenders.

iii. Disbursement of loans including changes in terms and conditions - Lenders should ensure timely disbursement of loans sanctioned in conformity with the terms and conditions governing such sanction. Changes in interest rates and charges should be effected only prospectively after giving due notice.

iv. Post disbursement supervision -

a) For loans up to ₹ 2 lakh the supervision should be constructive with a view to taking care of any "lender-related" genuine difficulty that the borrower may face.

b) Before deciding to recall/accelerate payment or performance under the agreement or seeking additional securities, lenders should give notice to borrowers, as specified in the loan agreement or of a reasonable period.

c) Lenders should release all securities on receiving payment of loan or realisation of loan subject to any legitimate right or lien for any other claim lenders may have against borrowers, with due notice and process.

v. General -

a) Lenders should restrain from interference in the affairs of the borrowers except for what is provided in the terms and conditions of the loan sanction documents, or if new information, has come to the notice of the lender.

b) Lenders must not discriminate on grounds of sex, caste and religion in the matter of lending.

c) In the matter of recovery of loans, the lenders should not resort to undue harassment viz. persistently bothering the borrowers at odd hours, use of muscle power for recovery of loans, etc.

d) In case of receipt of request for transfer of borrowal account, either from the borrower or from a bank/financial institution, which proposes to take over the account, the consent or otherwise i.e., objection of the lender, if any, should be conveyed within 21 days from the date of receipt of request.

Guidelines on Recovery Agents engaged by banks:

i. 'Agent' - includes agencies engaged by the bank and the agents/employees of the concerned agencies.

ii. Banks should have a due diligence process in place for engagement of recovery agents, which should be so structured to cover also individuals involved in the recovery process, and conform to the guidelines on outsourcing of financial services. Banks should ensure that the agents engaged by them in the recovery process carry out verification of the antecedents of their employees, at periodicity decided by the bank.

iii. Banks should inform the borrower the details of recovery agency firms/companies while forwarding default cases to the recovery agency. The agent should also carry a copy of the notice and the authorization letter from the bank along with the identity card issued by the bank or the agency firm/company.

iv. The notice and the authorization letter should, among other details, also include the telephone numbers of the relevant recovery agency. Banks should ensure that there is a tape recording of the content/text of the calls made by recovery agents to the customers, and vice-versa. Banks may take reasonable precaution such as intimating the customer that the conversation is being recorded, etc.

v. The up to date details of the recovery agency firms/companies engaged by banks may also be posted on the bank's website.

20.4 OPENING OF CURRENT ACCOUNTS AND CC/OD ACCOUNTS BY BANKS

Definitions:

i. "Exposure" - for this purpose shall mean sum of sanctioned fund based and non-fund-based credit facilities availed by the borrower carried in the Indian books.

ii. "Banking System" for this purpose shall include Scheduled Commercial Banks and Payments Banks only.

Borrowers availing Cash Credit/ Overdraft Facilities from the Banking System:

i. With aggregate exposure less than ₹5 crore: Banks can open current accounts without any restrictions. Need to obtain an undertaking from the customers that they shall inform the bank, if and when the credit facilities availed by them from the banking system becomes ₹5 crore or more

ii. With aggregate exposure is ₹5 crore or more:

a) Borrowers can open current accounts with only one bank – which has provided CC/OD facility, has at least 10% share of the aggregate exposure, or has the highest exposure among CC/OD providing banks.

b) Other lending banks may open only collection accounts. Funds deposited in these will be remitted within two working days, to the CC/OD account with the bank maintaining current account as mentioned in preceding paragraph. The balances in the collection accounts shall not be used for repayment of any credit facilities provided by the bank, or as collateral/ margin for availing any fund or non-fund based credit facilities. Banks maintaining collection accounts are permitted to debit fees/ charges from such accounts before transferring funds to CC/OD account.

c) Non-lending banks are not permitted to open current/ collection accounts.

Borrowers not availing Cash Credit/ Overdraft Facilities from the banking system:

i. Where aggregate exposure of the banking system is ₹50 crore or more:
   a) Banks shall be required to put in place an escrow mechanism. Borrower can choose any lending bank as escrow managing bank. Current account will be maintained only at this bank.
   b) All lending banks should be part of the escrow agreement. The terms and conditions may be decided mutually by the banks and the borrower.
   c) Other lending banks can open 'collection accounts' subject to the condition that funds will be remitted from these accounts to the said escrow account at the frequency agreed between the bank and the borrower. Other operating norms are similar to those stated for 'collection accounts' for borrowers with CC/OD facility.
   d) Non-lending banks shall not open any current account for such borrowers.

ii. Where aggregate exposure of the banking system is ₹5 crore or more but less than ₹50 crore:
   a) There is no restriction on opening of current accounts by the lending banks.
   b) Non-lending banks may open only collection accounts as in case of borrowers with exposure of ₹50 crore or more.
   c) Where aggregate exposure of the banking system is less than ₹5 crore: Banks can open current accounts without any restrictions. Need to obtain an undertaking from the customers that they shall inform the bank, if and when the credit facilities availed by them from the banking system becomes ₹5 crore or more. On their exposures increasing, the regime as applicable to the level of exposure will apply.

Customers who have not availed any credit facilities from the banking system:
Banks can freely open the current accounts for these, subject to applicable due diligence. This is also applicable for those customers having credit facilities only from NBFCs/ FIs/ co-operative banks/ non-bank institutions, etc.

Opening of Cash Credit/ Overdraft Facilities:

i. Bank can provide CC/OD facility to a borrower if the aggregate exposure of the banking system to that borrower is less than ₹5 crore. However, the bank must obtain an undertaking from such borrowers that they (the borrowers) shall inform the bank(s), if and when the credit facilities availed by them from the banking system becomes ₹5 crore or more.

ii. For borrowers, where the aggregate exposure of the banking system is ₹5 crore or more:
   a) Banks having a share of 10 per cent or more in the aggregate exposure of the banking system or the bank having the highest exposure among CC/OD facility providing banks can provide CC/OD facility.
   b) Operations in CC/OD accounts with banks having less than 10% share of aggregate exposure of the banking system to the borrower:
      i) Credits are freely permitted to these accounts.
      ii) Debits will be only for transfer to the CC/OD account with the bank having more than 10% share of aggregate exposure of the banking system to the

borrower, at a frequency agreed between the bank and the borrower. In case there is more than one such bank, the bank to which the funds are to be remitted may be decided mutually between the borrower and the banks.

iii) Credit balances in such collection accounts shall not be used for repayment of any credit facilities provided by the bank, or as collateral/ margin for availing any fund or non-fund based credit facilities.

iv) However, banks are permitted to debit interest/ charges pertaining to the said CC/OD account and other fees/ charges before transferring the funds.

v) Banks with exposure to the borrower of less than 10 per cent of the aggregate exposure of the banking system can offer working capital demand loan (WCDL)/ working capital term loan (WCTL) facility to the borrower.

Exemptions Regarding Specific Accounts:

Banks are permitted to open and operate certain specified accounts (like specific accounts which are stipulated under various statutes, Nodal or escrow accounts of payment aggregators/ prepaid payment instrument issuers for specific activities, Accounts for the purpose of IPO/ NFO/ FPO, etc.) without any of the aforesaid restrictions.

Other Instructions:

i. All banks, whether lending banks or otherwise, shall monitor all accounts regularly, at least on a half-yearly basis, specifically with respect to the aggregate exposure of the banking system to the borrower, and the bank's share in that exposure, to ensure compliance with these instructions.

ii. If there is a change in exposure of a particular bank or aggregate exposure of the banking system to the borrower which warrants implementation of new banking arrangements, such changes shall be implemented within a period of three months from the date of such monitoring.

iii. Banks should not route drawal from term loans through CC/ OD/ Current accounts of the borrower. Since term loans are meant for specific purposes, the funds should be remitted directly to the supplier of goods and services. In cases where term loans are meant for purposes other than for supply of goods and services and where the payment destination is identifiable, banks shall ensure that payment is made directly, without routing it through an account of the borrower.

iv. However, where the payment destination is unidentifiable, banks may route such term loans through an account of the borrower opened as per the provisions of the circular. Expenses incurred by the borrower for day-to-day operations may be routed through an account of the borrower.

20.5 LET US SUM UP

There are statutory restrictions on the loans and advances by banks, contained in the Banking Regulation Act, 1949. Section 20 of the BR Act specifies curbs on advances to directors, senior officers, etc. There are also ceilings on shareholdings in any manner in companies. Besides, RBI has stipulated several regulatory restrictions on loans for various purposes. RBI has also placed restrictions on opening of current accounts, and CC/OD accounts of the persons having borrowings from the banking system.

Banks are required to follow the Code of Fair Practice for Lenders so that the borrowers are treated fairly and in a transparent manner in every aspect.

20.6 KEY WORDS

Buy-back of Securities; Selective Credit Control (SCC); Market Makers; Primary Security; Promoters' Contribution; Margin Trading; Arbitrage Operations; Indian Depository Receipts; Gold (Metal) Loan; Consortium Arrangement; Project Finance; Bridge Loans; Collection accounts.

20.7 CHECK YOUR PROGRESS

1) Choose the incorrect option
   a) a bank cannot grant any loans and advances on the security of its own shares;
   b) Banks are prohibited from entering into any commitment for granting any loans or advances to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor,
   c) Unless sanctioned by the Board of Directors/Management Committee, banks should also not grant loans and advances aggregating Rupees fifty lakhs and above to any relative other than spouse and minor/dependent children of their own Chairmen/Managing Directors or other Directors;
   d) banks should not provide loans to companies for buy-back of shares/ securities.

2) Which of the following commodities is under RBI stipulations as a sensitive commodity?
   a) Levy Sugar
   b) Cotton
   c) Foodgrains
   d) Textiles

3) Choose the Incorrect option
   a) Bank can grant loans against the gold coins
   b) Banks cannot grant loans against certificate of deposits (CDs).
   c) No bank should grant any loan/advance for subscription to Indian Depository Receipts (IDRs).
   d) Banks should not desist from sanctioning advances against FDRs, or other term deposits of other banks

20.8 KEY TO 'CHECK YOUR PROGRESS'

1 (c); 2 (a); 3 (d).

References:

1) RBI Master Circular- Loans and Advances – Statutory and Other Restrictions - DBR.No.Dir.BC.10/13.03.00/2015-16 dated July 1, 2015 (https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9902)
2) RBI Circular - Consolidated Circular on Opening of Current Accounts and CC/OD Accounts by Banks – No. DOR.CRE.REC.23/21.08.008/2022-23 dated April 19, 2022 (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12293&Mode=0)

CHAPTER 21

CASH RESERVE RATIO (CRR) AND STATUTORY LIQUIDITY RATIO (SLR)

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Learn about the purpose of CRR and SLR requirements
- Know about the CRR stipulation
- Understand the provisions for CRR
- Know about the SLR stipulation
- Understand the provisions for SLR

.

21.1 INTRODUCTION

The pre-emption of bank funds in India has historically been exercised through three channels - the cash reserve ratio (CRR), statutory liquidity ratio (SLR) and directing credit to preferred sectors based on so-called priority sector norms. The CRR is partly a prudential requirement for banks to maintain a minimum amount of cash reserves to meet their payments obligations in a fractional reserve system. CRR has also been used as an instrument of sterilisation and a monetary tool.

Like CRR, SLR is also a hybrid instrument of a different variety. The SLR, according to some, is not a monetary tool and is only a prudential requirement to serve as a cushion for safety of bank deposits. But it is also a way of finding a captive market for government securities, particularly when bearing below market interest rates. This ratio touched about 38 per cent around 1991. As an important tool of the monetary policy these instruments control inflation and put brakes on runaway credit dispensation.

21.2 KEY TERMS

Following key terms are important in the context of CRR and SLR norms.

i. *Aggregate Deposits*: are aggregation of demand and time deposits.

ii. *Approved Securities/ SLR Securities*: Following securities are approved securities:

1) Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilization Scheme;
2) Treasury Bills of the Government of India; and
3) State Development Loans (SDLs) of the State Governments issued from time to time under the market borrowing programme.
4) Any other instrument as may be notified by the RBI.

iii. *Assets with Banking System* include the following assets –

a) balances with banks in current account, balances with banks and notified financial institutions in other accounts, funds made available to banking system by way of loans or deposits repayable at call or short notice of a fortnight or less and loans other than money at call and short notice made available to the banking system.

b) any other amounts due from the banking system which cannot be classified under any of the above items are also to be taken as assets with the banking system.

iv. *Average daily balance*: is average of the balances held at the close of business on each day of a fortnight.

v. *Bank credit in India*: is all outstanding loans and advances including advances for which provisions have been made and/or refinance has been received {but excludes rediscounted bills without recourse and advances written off at Head Office level (i.e. technical write off)}.

vi. *Banking System*: It comprises following banks and financial institutions –
   a) State Bank of India;
   b) Corresponding new banks or IDBI Bank Ltd.
   c) Regional Rural banks;
   d) Banking Companies;
   e) Other financial institutions, if any, notified by the Central Government in this behalf
   f) (It does not include: (a) EXIM Bank; (b) NABARD; (c) SIDBI; (d) IFCI; (e) IIBI.)

vii. *Cash to be maintained*:
   1. By Scheduled commercial banks, Small Finance Bank, Payments Bank and Local Area Banks includes - cash in hand; the net balance in current accounts with other scheduled commercial banks in India; the deposit to be held with the RBI by a banking company incorporated outside India; any balance maintained by a scheduled bank with the RBI in excess of the balance required under Section 42 of the Reserve Bank of India Act,1934.
   2. By Primary (urban) co-operative bank/State co-operative bank /District Central Co-operative bank includes –
      a. for a scheduled co-operative bank: cash in hand; any balances with the RBI in excess of the required balance under Section 42 of the Reserve Bank of India Act, 1934; and Net balances in current accounts in excess of the required amount as per Sections 18 and 56 of the Banking Regulation Act, 1949;
      b. for a non-scheduled co-operative bank: Cash in hand in excess of the cash or balance required under Section 18 and section 56 of the Banking Regulation Act, 1949; any balances in excess of the required balance under Sections 18 and 56 of the Banking Regulation Act, 1949; and Net balances in current accounts in excess of the required amount as per Sections 18 and 56 of the Banking Regulation Act, 1949;

viii. *Cash in India/ hand*: is total amount of rupee notes and coins held by bank branches / ATMs / Cash deposit machines of the bank in India, transit cash on bank’s books, and cash with Business Correspondents (BCs). It excludes cash, where physical possession is with outsourced vendors/ BCs, which is not replenished in bank’s ATM and/or is not reflected on bank’s books. It consists of the following –
   a. Cash in hand;
   b. Deposit kept by a bank incorporated outside India with RBI under sub-section (2) of Section 11 of the Banking Regulation Act, 1949
   c. Any balance of a scheduled bank with the RBI in excess of the required balance under Section 42 of the Reserve Bank of India Act, 1934;
   d. Net balance in current accounts with other SCBs in India.

ix. *Current deposits*: These include (a) call deposit which require a notice period of 14 days or less (b) credit balance in cash credit account, (c) fixed deposits matured but not withdrawn etc.

x. *Demand Deposit*: is a deposit withdrawable on demand. It includes current deposits, demand portion of savings deposits, credit balances in overdrafts, cash credit accounts, deposits payable at call, overdue deposits, cash certificates, etc.

xi. *Demand Liabilities*: are liabilities payable on demand. These include the following:
   a. current deposits,
   b. demand liabilities portion of savings bank deposits,
   c. margins held against letters of credit/guarantees,
   d. balances in overdue fixed deposits, cash certificates and cumulative/recurring deposits,
   e. outstanding Telegraphic Transfers (TTs), Mail Transfers (MTs), Demand Drafts (DDs),
   f. unclaimed deposits,
   g. credit balances in the Cash Credit account,
   h. deposits held as security for advances which are payable on demand.

Money at Call and Short Notice from outside the banking system - as liability to others.

xii. *Fixed Deposits*: These include - (a) employees' provident fund deposits, (b) staff security deposits, (c) recurring deposits, (d) cash certificates, (e) call deposits requiring notice period of more than 14 days, (f) provident deposits, (g) other miscellaneous deposits like earnest money deposits of contractors etc.

xiii. *Fortnight*: is the period from Saturday, following a reporting Friday, to the second following Friday, both days inclusive.

xiv. *Investment in India*: It is investment in approved government securities and other approved securities, both encumbered and unencumbered securities as per bank's investment book. It excludes securities acquired under RBI-LAF and market repo.

xv. *Investment in India in other Government Securities*: is investment in Government securities which are not approved securities, like state development loans (SDLs) issued as UDAY bonds.

xvi. *Liabilities to the 'Banking System'*: These include (a) Deposits of the banks; (b) Borrowings from Banks (Call Money / Notice deposits); (c) Other miscellaneous items of liabilities to the banks like Participation Certificates issued to banks, interest accrued on bank deposits, etc.

xvii. *Demand Liabilities to the 'Banking System*': These are (1) Balances in current accounts of – SBI /Nationalised Banks; (2) Other demand liabilities comprising – (i) Balances in current accounts of – RRB; Banking Companies i.e. Private Sector Banks and Foreign Banks; Co-operative Banks (applicable to Scheduled UCBs for computation of DTL for CRR); Other 'Notified' financial institutions; (ii) Balances of overdue time deposits of above named banks; (iii) Participation Certificates payable on demand issued to banks; (iv) Interest accrued on deposits of banks (RRBs).; (v) Call Money Borrowings from the banks.

xviii. *Time Liabilities to the 'Banking System'*: These are (1) All types of time deposits from the banks; (2) Certificates of deposits from the banks; (3) Participation Certificates issued to banks which are not payable on demand; (4) Interest accrued on time deposits / CDs of banks

xix. *Liquidity Adjustment Facility (LAF):* is fixed and variable rate Repo operations (for injection of liquidity) and reverse repo operations (for absorption of liquidity) conducted by the RBI.

xx. *Marginal Standing Facility*: is the facility under which the eligible banks can avail liquidity support from the RBI against excess SLR holdings. Additionally, overnight liquidity can be availed against stipulated SLR, up to a certain per cent of respective NDTL outstanding at the last Friday of the second preceding fortnight.

xxi. *Market Borrowing Programme*: is managed by the RBI for domestic rupee loans raised from the public by issue of marketable securities for the Government of India and the State Governments through an auction or any other method. These securities are governed by the provisions of the Government Securities Act, 2006, Public Debt Act, 1944 and the Regulations framed under those Acts.

xxii. *Net Liabilities*: While computing liabilities for the purpose of CRR and SLR, the net liabilities of the bank to other banks in India in the 'banking system' shall be reckoned, i.e., assets in India with other banks in the 'banking system' will be reduced from total liabilities to the 'banking system'.

xxiii. *Other Approved Securities*: are Government Securities, other than the approved securities specified separately, if they are notified as approved securities.

xxiv. *Other Demand and Time Liabilities (ODTL*): include the following:

a) Interest accrued on deposits, bills payable, unpaid dividends, suspense account balances representing amounts due to other banks or public, net credit balances in branch adjustment account, and any amounts due to the banking system which are not in the nature of deposits or borrowing.

b) The balance outstanding in the blocked account pertaining to segregated outstanding credit entries for more than five years in inter-branch adjustment account, the margin money on bills purchased/discounted and gold borrowed by banks from abroad.

c) Borrowings through instruments qualifying for Upper Tier 2 and Tier 2 capital

d) Such liabilities may arise due to items like collection of bills on behalf of other banks, interest due to other banks and so on.

Cash collaterals received under collateralised derivative transactions should be included in the bank's NDTL for the purpose of reserve requirements as these are in the nature of 'outside liabilities'. Interest accrued on deposits should be calculated on each reporting fortnight so that the bank's liability in this regard is fairly reflected in the total NDTL of the same fortnightly return.

xxv. *Time Deposits*: are deposits other than demand deposits.

xxvi. *Time Liabilities*: are payable otherwise than on demand and include the following:

a. fixed deposits,
b. cash certificates,
c. cumulative and recurring deposits,
d. time liabilities portion of savings bank deposits,
e. staff security deposits,
f. margin held against letters of credit, if not payable on demand,
g. deposits held as securities for advances which are not payable on demand
h. gold deposits

21.3 CASH RESERVE RATIO (CRR)

A bank shall maintain in India by way of cash reserve, a sum equivalent to such percent of the total of its Net Demand and Time Liabilities (NDTL) in India, in such manner and for such dates as prescribed by the RBI. The RBI determines Cash Reserve Ratio (CRR) level primarily having regard to the needs of securing the monetary stability in the country. The provisions for CRR are contained in Section 42(1) of the RBI Act, 1934 and Section 18(1) of BR Act, 1949 [including provisions of Section 18 (1) of the BR Act as applicable to cooperative banks].

Incremental CRR: A scheduled bank may be required to maintain, in addition to CRR, an additional average daily balance at a rate prescribed by RBI. The provisions for incremental CRR are contained in Section 42(1A) of the RBI Act, 1934. The additional balance is calculated with reference to the excess of the total of NDTL of the bank over the total of its NDTL at the close of the business on the date specified in the RBI notification of incremental CRR.

Maintaining CRR: The norms for maintaining CRR are as follows:

i. For Scheduled Bank: It has to maintain an average daily balance of at least four per cent of the total NDTL in India as on the last Friday of the second preceding fortnight. This also applies to Small Finance Banks (SFBs) and Payments Banks (PBs).

ii. For co-operative bank (not scheduled): It has to maintain on daily basis a sum equivalent to four per cent of its NDTL in India, as on the last Friday of the second preceding fortnight in one or more of the under mentioned ways.
   - a) Cash reserve with itself; or
   - b) Balance in current account with RBI or the state co-operative bank of the State concerned; or
   - c) Net balance in current accounts; or
   - d) in case of a primary (Urban) co-operative bank - balances with District Central Co-operative bank of the district concerned.

iii. For Local Area Bank: It has to maintain a sum equivalent to four per cent of its NDTL in India, as on the last Friday of the second preceding fortnight in one or more of the under mentioned ways.
   - a) Cash reserve with itself; or
   - b) Balance in current account with RBI or the state co-operative bank of the State concerned; or
   - c) Net balance in current accounts.

Minimum CRR on Daily Basis: Every scheduled bank, small finance bank and payments bank should maintain on all days during the reporting fortnight at least ninety per cent of the required CRR, in addition to maintaining average CRR at the prescribed level.

21.4 COMPUTATION OF NET DEMAND AND TIME LIABILITIES (NDTL) FOR CRR

The key norms for determining Net Demand and Time Liabilities are as follows:

i. NDTL includes –
   a. liabilities towards the banking system net of assets with the banking system*; and
   b. liabilities towards others in the form of demand and time deposits or borrowings or other miscellaneous items of liabilities.

   *(*As defined in following legal provisions –*
   For scheduled banks, Small Finance Banks and Payments Banks - Section 42 of the RBI Act, 1934.
   For non-scheduled banks - Section 18 of the Banking Regulation Act, 1949.
   For non-scheduled co-operative banks - Section 18 and Section 56 of the Banking Regulation Act, 1949.)

ii. RBI may specify for any transaction or class of transactions to be regarded as liability in India.

In addition to the general provisions to determine a liability of bank the RBI Master Direction lists out for several specific transactions their liability category, and their treatment for netting.

The liabilities mentioned below do not form part of liabilities for the purpose of CRR and SLR:

i. Paid up capital, reserves, borrowings through instruments qualifying for Tier1 and additional Tier1 capital; any credit balance in the Profit & Loss Account of the bank; amount of any loan /refinance taken from RBI, Exim Bank, NHB, NABARD and SIDBI. The funds collected and held pending finalization of allotment of the additional Tier1 preference shares are taken into account for reserve requirements.

ii. For a State Co-operative Bank/ District Central Co-operative Bank, any loan from the State Government or National Co-operative Development Corporation, any deposit of money representing reserve fund maintained by any co-operative society within its area of operation. For a District Central Co-operative bank, also an advance taken from the concerned State Co-operative Bank.

   For any advance granted by the State Co-operative Bank / District Central Co-operative Bank against balance maintained with it, such balance to the extent of amount outstanding in it.

   Any advance or other credit arrangement drawn and availed against approved securities is not included for NDTL computation for SLR purposes (for Scheduled St CBs); and for both CRR and SLR purposes (for other StCBs / District Central Co-operative Banks).

iii. For a Regional Rural Bank, any loan taken from its sponsor bank.

iv. For a Primary Cooperative Bank - any advance taken from State Government, National Co-operative Development Corporation, State Co-operative bank of the State concerned or District Central Co-operative Bank of the district concerned; and any advance or credit arrangement drawn or availed of against approved securities. An advance granted against any balance maintained with it such balance to the extent of the amount of advance outstanding is excluded from the NDTL for SLR (in case of Scheduled Primary Co-operative Bank) and for both CRR and SLR (in case of other Primary Co-operative Banks).

In addition, the RBI Master Direction specifies several other liabilities that are not considered as part of liabilities for CRR or SLR purposes.

Scheduled Banks are exempted from maintaining CRR on the following liabilities:

a) Net of liabilities to the banking system from the assets with the banking system defined in Section 42 (1) (d) and 42 (1) (e) of the RBI Act, 1934.
b) Credit balances in ACU (US$) Accounts;
c) Demand and Time Liabilities in respect of their Offshore Banking Units (OBUs).
d) Minimum of Eligible Credit (EC) and outstanding Long-term Bonds (LB) to finance infrastructure loans and affordable housing loans as per RBI guidelines (DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014) issued on July 15, 2014 and November 27, 2014;
e) Liabilities in respect of the bank's International Financial Services Centre(IFSC) Banking Units (IBUs); and
f) Funds Borrowed under market repo against Government securities.
g) Incentivising Bank Credit to Specific Sectors – Exemption from CRR Maintenance has been provided equivalent to the incremental credit disbursed by them as retail loans to automobiles, residential housing, and loans to micro, small and medium enterprises (MSMEs) as per specified provisions.

21.5 OTHER PROVISIONS FOR CRR

CRR Computation: As a measure of simplification, a lag of one fortnight is allowed to banks to maintain CRR based on the NDTL of the last Friday of the second preceding fortnight.

Interest on CRR Balances: With effect from the fortnight beginning March 31, 2007 RBI does not pay any interest on CRR balances maintained by SCBs.

Penalty for Default in CRR: A bank is liable to pay to the Reserve Bank, penal interest as mentioned below, if the daily balance of cash reserve (CRR) held by the bank during any fortnight is below the minimum prescribed by or under these Directions.

i. For scheduled Commercial banks (including Regional Rural Banks), Small Finance Banks, Payments Banks, all Scheduled Primary (Urban) Co-operative Banks and all Scheduled State Co-operative Banks:
    a. For shortfall in daily basis CRR requirement penal interest for that day is 3% p.a. above the Bank Rate on the amount of shortfall; and if the shortfall continues on the next succeeding day/s, the penal interest is charged at 5% p.a. above the Bank Rate.
    b. For shortfall in average CRR during a fortnight, penal interest is recovered as envisaged in sub-section (3) of Section 42 of Reserve Bank of India Act, 1934.

ii. For a non- scheduled co-operative bank: if the daily balance of CRR maintained by the bank falls below the prescribed minimum CRR, penal interest as envisaged in sub-section (1-A) of Section 18 read with Section 56 of the B.R. Act, 1949 is payable.
iii. For Local Area Banks: if the daily balance of CRR maintained by the bank falls below the prescribed minimum CRR, penal interest as envisaged in sub-section (1A) Section 18 of B.R. Act, 1949, is payable.

Reporting by banks: Banks are required to furnish the particulars of default such as date, amount, percentage, reason for default in maintenance of requisite CRR and also action taken to avoid recurrence of such default.

Continued Default: For continued default even after the penal interest at the increased rate of 5 per cent is levied, and the default continues in the next succeeding fortnight –

i. An official of the scheduled bank/ Small Finance Bank/ Payment Bank who is knowingly and wilfully a party to the default, shall be punishable with fine up to ₹500/- and with additional ₹500/- for each subsequent fortnight during which default continues.
ii. RBI may prohibit a scheduled bank/ Small Finance Bank/ Payments Bank from receiving any fresh deposit after the said fortnight of default. In case of default of this prohibition, every officer who is knowingly and wilfully a party or who through negligence or otherwise contributes to such default for each default is punishable with fine up to ₹500/- and with additional ₹500/- for each day after the first, on which such deposit is retained by the scheduled bank.

Fortnightly CRR Return in Form A / Form B/ Form I: The requirements of fortnightly returns are as follows:

i. Every scheduled commercial bank (including RRBs), scheduled state co-operative bank, Small Finance Bank, Payments Bank and Local Area Bank shall submit to RBI a provisional Return in Form 'A' / Form ‘B’ (for Scheduled State Co-operative Banks), at the close of business on each alternate Friday and within seven days after the date of the relevant fortnight to which it relates.
ii. Every Scheduled Primary Co-operative banks shall submit the above-mentioned Return in Form ‘B’ at the close of business on each alternate Friday within seven days after the date to which it relates.
iii. In case the reporting Friday is a public holiday under the Negotiable Instruments Act, 1881 for certain offices their figures for the preceding working day are to be included.
iv. The final Return in Form 'A' or Form ‘B’ shall be submitted to Reserve Bank within 20 days from expiry of the relevant fortnight along with following:
    a. the Memorandum - giving details of paid-up capital, reserves, time deposits comprising short-term (of contractual maturity of one year or less) and long-term (of contractual maturity of more than one year), certificates of deposits, NDTL, total CRR requirement, etc.,
    b. Annex A / Annex - I - showing all foreign currency liabilities and assets and

c. Annex B / Annex – II - giving details about investment in approved securities, investment in unapproved securities, memo items such as subscription to shares/debentures/bonds in primary market and subscriptions through private placement.

v. On the last Friday of a month (not being the Reporting Friday), a special Return in Form A or Form B as at the close of business on such last Friday is submitted within seven days after the date to which it relates. In case it is a public holiday under Negotiable Instruments Act, 1881, the figures as at the close of business on the preceding working day are reported.

vi. Every non-scheduled co-operative bank shall submit a Return in Form I together with the prescribed Appendix, to the regional office concerned of the Reserve Bank, not later than 20 days after the end of the month to which it relates showing the position, inter alia, of cash reserves maintained by the bank under Section 18 of the B.R. Act, 1949 read with Section 56, ibid, as at the close of business on each alternate Friday during the month.

vii. Non Scheduled Primary (Urban) Co-operative Banks shall furnish in the prescribed Appendix, along with the Return in Form I showing the position of the Cash Reserve to be maintained under Section 18 of the BR Act, 1949 (AACS); Cash Reserve actually maintained; and Extent of deficit / surplus, if any, for each day of the month.

viii. When variations between the sources and uses of funds as being reported in the fortnightly Return exceed 20% reasons for the same should be given in the Return.

ix. The Scheduled Commercial banks have to submit these returns in electronic form on XBRL live site using digital signatures of two authorised officials, ensuring compliance with the prevalent IT laws.

x. For non-submission or delayed submission of the Returns a bank is liable to pay penalties to RBI.

21.6 STATUTORY LIQUIDITY RATIO (SLR)

A bank is required to maintain in India, assets of the value not less than the percentage prescribed by RBI, maximum forty per cent of its total demand and time liabilities in India as on the last Friday of the second preceding fortnight as RBI may specify, and such assets shall be maintained in specified form and manner. The CRR as at 31st March, 2022 is 18%.

SLR – Eligible Assets: Every scheduled commercial banks (including RRBs), Local Area Banks, Small Finance Banks, Payments Bank, Primary Co-operative Bank, State Co-operative Bank and District Central Co-operative Bank shall maintain in India, at the close of business on any day, assets (i.e. SLR assets) of value not less than 18 per cent of their total net demand and time liabilities in India as on the last Friday of the second preceding fortnight.

Marginal Standing Facility (MSF): Banks permitted by RBI have the option to participate in its Marginal Standing Facility (MSF) Scheme. The salient features of the scheme are as follows:

i. Amount Permitted: An eligible bank has the option to borrow up to three per cent of its NDTL outstanding at the end of the second preceding fortnight.

ii. Against Excess Holdings: A bank can access overnight funds against its excess SLR holdings.
iii. Shortfall in SLR Holdings: If SLR holding falls below the required level by up to three per cent of NDTL, the bank is not required to seek a specific waiver for default in SLR compliance.

High Quality Liquid Assets (HQLAs): Within the mandatory SLR requirement, the Govt. securities as much allowed under MSF are considered as the Level 1 High Quality Liquid Assets (HQLAs) for computing Liquidity Coverage Ratio (LCR) of banks. Also, additional 15 per cent of NDTL within the mandatory SLR requirement is considered as Level 1 HQLA. This facility enables a bank to maintain liquidity for Liquidity Coverage Ratio.

SLR Assets: SLR assets shall be maintained by banks as under:

A. For Scheduled Commercial Banks (Including RRBs), Local Area Banks, Small Finance Banks and Payments Banks.

a) Cash, or;
b) Gold, valued at a price not exceeding the current market price, or;
c) Unencumbered investment in any of the following instruments [i.e. Statutory Liquidity Ratio securities (SLR securities)], namely:
   i. Dated securities of the Government of India issued under the Market Borrowing Programme and the Market Stabilization Scheme; or
   ii. Treasury Bills of the Government of India; or
   iii. State Development Loans (SDLs) of the State Governments issued under the market borrowing programme:
   iv. Any other instrument notified by RBI.
d) the deposit and unencumbered approved securities required to be made with RBI by a banking company incorporated outside India;
e) any balance maintained by a scheduled bank with the RBI in excess of the balance required to be maintained under CRR;

The SLR securities acquired from RBI under reverse repo are eligible assets for SLR maintenance.

Following SLR-securities are not considered encumbered for SLR assets:

a) securities lodged with another institution for an advance or any other credit arrangement to the extent to which such securities have not been drawn against or availed of;
b) securities offered as collateral to RBI for liquidity assistance under MSF up to the permissible extent carved out of the required SLR portfolio;
c) securities offered as collateral to the RBI for liquidity assistance under Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR).

B. **For primary (Urban) Co-operative Banks/ State Cooperative Banks/ District Central Cooperative Banks**,

a) Cash, or
b) Gold valued at a price not exceeding the current market price: or
c) Unencumbered investment in approved securities.

The SLR securities acquired from RBI under reverse repo are eligible assets for SLR maintenance. Following SLR-securities are not considered encumbered for SLR assets:

a) securities lodged with another institution for an advance or any other credit arrangement to the extent to which such securities have not been drawn against or availed of;
b) securities offered as collateral to RBI for liquidity assistance under MSF up to the permissible extent carved out of the required SLR portfolio;

Inclusions in SLR securities:

i. Securities in the Gilt Account maintained with Clearing Corporation of India Ltd. (CCIL) under Constituent Subsidiary General Ledger account (CSGL) facilities remaining unencumbered at the end of any day is reckoned for SLR purposes.
ii. Funds borrowed under repo including tri-party repo in government securities are exempted from CRR/SLR computation and the security acquired under repo is eligible for SLR provided the security is primarily eligible as per the Act under which it is required to be maintained.
iii. Borrowings through repo in corporate bonds and debentures are liabilities for CRR/ SLR requirement and, to the extent these liabilities are to the banking system, they are netted.

All banks shall maintain investments in Government Securities only in Subsidiary General Ledger (SGL) Accounts with RBI or in CSGL Accounts of scheduled commercial banks, Primary Dealers (PDs), State Co-operative Banks, and Stock Holding Corporation of India Ltd.(SHCIL) or in the dematerialised accounts with depositories such as National Securities Depositories Ltd (NSDL), Central Depository Services Ltd. (CDSL), and National Securities Clearing Corporation Ltd. (NSCCL).

21.7 COMPUTATION OF NET DEMAND AND TIME LIABILITIES (NDTL) FOR SLR

Total NDTL for the purpose of SLR is computed in the manner followed for CRR. The following norms also apply:

i. The liabilities not included in NDTL for CRR purposes not form part of liabilities for SLR also.
ii. SCBs are required to include inter-bank term deposits/ term borrowing liabilities of all maturities in 'Liabilities to the Banking System'.
iii. Banks shall include their inter-bank assets of term deposits and term lending of all maturities in 'Assets with the Banking System'.
iv. Following liabilities are exempt from SLR requirement:

a) Minimum of Eligible Credit (EC) and outstanding Long-term Bonds (LB) to finance infrastructure loans and affordable housing loans as per guidelines

(DBOD.BP.BC.No.25/08.12.014/2014-15 dated July 15, 2014) issued on July 15, 2014 and November 27, 2014;

b) Liabilities in respect of the bank's International Financial Services Centre (IFSC) Banking Units (IBUs); and
c) Funds Borrowed under market repo against Government securities.

Classification and Valuation of Eligible Securities: The provisions of RBI Master Circular on Prudential Norms for Classification, Valuation and Operation of Investment Portfolio by banks are followed for this purpose.

21.8 OTHER PROVISIONS FOR SLR

Penalty for default in SLR Maintenance: A bank is liable to pay to RBI penal interest in case of default in maintaining SLR. In case of persistent default, in addition to levying penalty, RBI may consider cancelling the licence in case of licensed banks and refuse licence in case of unlicensed banks.

Submission of Returns: In connection with SLR following Returns are required to be submitted:

i. Form VIII: Every scheduled commercial bank (including RRB), Small Finance Bank, Payments Bank and Local Area Bank shall submit to the RBI before the 20th of every month, a Return in Form VIII showing the amount of SLR held on alternate Fridays during the immediate preceding month with particulars of their DTL in India held on such Fridays or if any such Friday is a public holiday under the Negotiable Instruments Act, 1881, at the close of business on the preceding working day.
ii. Annex to Form VIII: Every scheduled bank shall also submit a statement as Annex to Form VIII Return giving daily position of (a) assets held for the purpose of compliance with SLR, (b) excess cash balances maintained by them with RBI in the prescribed format, and (c) mode of valuation of securities.
iii. Form I: All Co-operative Banks (scheduled and non-scheduled), are required to submit a Return in Form I under Section 24 of the BR Act, 1949 (AACS) every month showing the position of liquid assets maintained as at the close of business on each alternate Friday during the month not later than twenty days after the end of the month. In respect of Non-Scheduled UCBs, Return in Form I is common for reporting cash reserves and statutory liquid assets.
iv. Appendix II: All Primary Co-operative Banks (scheduled and non-scheduled) are required to furnish Appendix II, as per proforma given in the Master Direction, together with the Return in Form I showing the position of –
    a. statutory liquid assets required to be maintained under Section 24 of the BR Act,1949 (AACS).
    b. liquid assets actually maintained, and
    c. the extent of deficit/surplus for each day of the month.
v. All Primary Co-operative Banks (scheduled and non-scheduled) should furnish the information on valuation of securities for SLR, as per prescribed format, as an Annex, to return in Form I, to the Regional Office concerned of Department of Supervision.

The monthly Return should contain information of the fortnights falling in the respective months.

Certification by Statutory Auditors: A certificate of the Statutory Auditors that all items of outside liabilities, as per the bank's books had been duly compiled by the bank and correctly reflected under NDTL in the fortnightly/monthly statutory returns submitted to RBI for the financial year.

21.9 LET US SUM UP

CRR and SLR are hybrid instruments serving dual purposes viz. prudential requirement for banks and monetary tools. A bank shall maintain as cash reserve, certain percent of its NDTL in India in the prescribed manner. This is CRR. The CRR is required to be maintained on daily basis as also on fortnightly average basis. RBI may stipulate incremental CRR requirement also. A bank is required to maintain assets of prescribed percent of its total demand and time liabilities in India. These assets could be in the form of investment in approved or eligible securities i.e. SLR securities.

21.10 KEY WORDS

Cash reserve ratio; Statutory liquidity ratio; Demand Liabilities; Time Liabilities; Liquidity Adjustment Facility; Marginal Standing Facility; Incremental CRR; SLR – Eligible Assets; High Quality Liquid Assets (HQLAs)

21.11 CHECK YOUR PROGRESS

1) Banks in India are required to maintain a portion of their demand and time liabilities in India as a reserve in as balances or cash. This portion is called _____.
   a) Statutory Liquidity Ratio
   b) Cash Reserve Ratio
   c) Bank Deposit
   d) Reverse Repo

2) One of the following is part of DTL for calculation of CRR
   a) Paid up capital, reserves, credit balance in the Profit & Loss Account, loan taken from the RBI, refinance taken from Exim Bank, NHB, NABARD, SIDBI;
   b) Bill rediscounted by a bank with eligible financial institutions as approved by RBI and,
   c) The liabilities arising on account of utilization of limits under Bankers' Acceptance Facility (BAF);
   d) margin held against letters of credit

3) There is a difference between the computation of NDTL for SLR and CRR. Of the following items, _____ is not considered as liability for both.
   a) all interbank liabilities and assets
   b) Non-Resident Deposits (NRE and NRNR);
   c) FCNR (B) - Short term and Long term;
   d) Paid up capital, reserves

21.12 KEY TO 'CHECK YOUR PROGRESS'

1 (b); 2 (d); 3 (d).

References:

(1) Master Direction - Reserve Bank of India [Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions - 2021 dated 20th July, 2021. (Updated – April 6, 2022) (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12131)

CHAPTER 22

CAPITAL ADEQUACY

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Understand the objectives of Basle III Norms
- Know about the guidelines of minimum capital requirements
- Understand determining capital charge for Market risk, Credit risk, and Operations risk
- Know about Supervisory review and evaluation process
- Understand market discipline

22.1 OBJECTIVES/AIMS OF THE BASEL III MEASURES

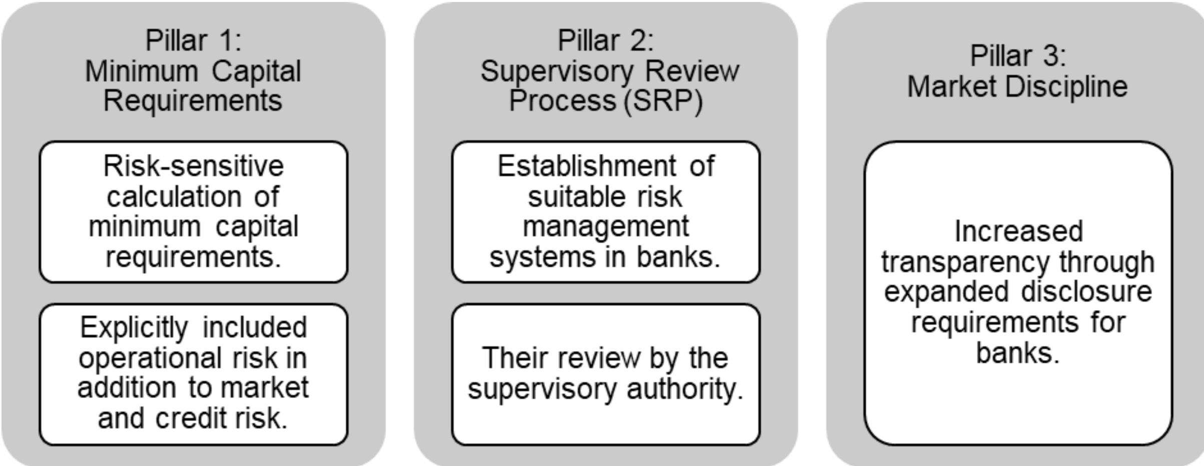
Basel Committee on Banking Supervision (BCBS) released comprehensive reform package entitled "Basel III: A global regulatory framework for more resilient banks and banking systems" (known as Basel III capital regulations) in December 2010. Basel III reforms strengthen the bank-level i.e. micro prudential regulation, with the intention to raise the resilience of individual banking institutions in periods of stress. Besides, the reforms have a macro prudential focus also, addressing system wide risks, which can build up across the banking sector, as well as the pro-cyclical amplification of these risks over time. These global regulatory and supervisory standards mainly seek to raise the quality and level of capital to ensure banks are better able to absorb losses on both a going concern and a gone concern basis, increase the risk coverage of the capital framework, introduce leverage ratio to serve as a backstop to the risk-based capital measure, raise the standards for the supervisory review process (Pillar 2) and public disclosures (Pillar 3) etc. The macro prudential aspects of Basel III are largely enshrined in the capital buffers. Both the buffers i.e. the capital conservation buffer and the countercyclical buffer are intended to protect the banking sector from periods of excess credit growth. Thus, Basel III measures mainly aim to:

i. Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whichever the source.
ii. Improve risk management and governance in banks.
iii. Strengthen banks' transparency and disclosures.

22.2 TRANSITION FROM BASEL I TO BASEL III

Basel I framework was confined to the prescription of only minimum capital requirements for banks, whereas the Basel II framework expanded this approach not only to capture certain additional risks for the minimum capital ratio but also included two additional areas, namely, the Supervisory Review Process and Market Discipline through increased disclosure requirements for banks. Thus, the Basel II framework rested on the following three mutually-reinforcing pillars.

Fig. 22.1: Pillars of Basel Framework



These three mutually reinforcing pillars allow a bank to evaluate various risks vis-a-vis the existing capital structure and the need to realign regulatory capital more closely with underlying risks. Each of these three pillars has risk mitigation as its central plank.

Basel II, initially published in June 2004, was intended to create an international standard for banking regulators to control how much capital banks need to put aside to guard against the types of financial and operational risks banks (and the whole economy) face. One focus was to maintain sufficient consistency of regulations so that this does not become a source of competitive inequality amongst internationally active banks. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

The Basel II document also laid down four key principles in regard to SRP under Pillar 2:

Fig. 22.2: Four Key Principles in regard to SRP

Principle 1	• Banks should have a process for assessing overall capital adequacy in relation to their risk profile and a strategy for maintaining capital levels (ICAAP).
Principle 2	• Supervisors should review and evaluate the banks' internal capital adequacy assessments and strategies, their ability to monitor and ensure compliance with the regulatory capital ratios. They should take appropriate supervisory action if not satisfied with the result.
Principle 3	• Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require the banks to hold capital in excess of the minimum.
Principle 4	• Supervisors should intervene at an early stage to prevent capital from falling below the minimum levels required for a particular bank and should require rapid remedial action if capital is not maintained or restored.

Basel III was a continuation of effort initiated by the BCBS to enhance the banking regulatory framework under Basel I and Basel II. It has sought to improve the banking sector's ability to deal with financial and economic stress, improve risk management and strengthen the banks' transparency. Under Pillar 1, the Basel III framework continued to offer three options for computing capital requirement for credit risk (Standardised Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach), and three options for computing capital requirement for operational risk [Basic Indicator Approach (BIA), The Standardised Approach (TSA) and Advanced Measurement Approach (AMA)], with certain modifications/enhancements. These options are based on increasing risk sensitivity and allowed banks to select an approach that is most appropriate to the stage of development of bank's operations.

Based on bank's internal assessment and its preparation, a bank was to choose a suitable date to apply for implementation of advanced approach. Besides, banks, at their discretion, had the option of adopting the advanced approaches for one or more of the risk categories, as per their preparedness. The Basel III capital regulations were implemented in India with effect from April 1, 2013 and have been fully implemented as on October 1, 2021. Banks have to comply with the regulatory limits and minimal as prescribed under Basel III capital regulations, on an ongoing basis.

22.3 GUIDELINES ON MINIMUM CAPITAL REQUIREMENT

Scope of Application of Capital Adequacy Framework

A bank shall comply with the capital adequacy ratio requirements at two levels: – (a) Consolidated ("Group") level, (b) Standalone ("Solo") level.

a) Consolidated ("Group") level requirements: this measure the capital adequacy of a bank based on its capital strength and risk profile after consolidating the assets and liabilities of its subsidiaries/joint ventures/associates etc. except those engaged in insurance and any non-financial activities. The equity and other regulatory capital investments in the insurance and non-financial subsidiaries will be deducted from consolidated regulatory capital of the group. All regulatory adjustments are required to be made to the consolidated Common Equity Tier 1 capital of the banking group. In case of any shortfall in the regulatory capital requirements in the unconsolidated entity, the shortfall shall be fully deducted from the Common Equity Tier 1 capital.
b) Standalone ("Solo") level requirements: These measure the capital adequacy of a bank based on its standalone capital strength and risk profile. All regulatory adjustments are required to be made. Investments in the capital instruments of the subsidiaries (consolidated in the financial statements) will have to be deducted from the corresponding capital instruments issued by the bank. Any shortfall in the regulatory capital requirements in the unconsolidated entity shall be fully deducted from the Common Equity Tier 1 capital.

Accordingly, overseas operations of a bank through its branches will be covered in both the scenarios. For foreign banks operating in India under the Wholly Owned Subsidiary (WOS) model the provisions related to components, elements and eligibility criteria of the regulatory capital instruments would be as applicable to the other domestic banks.

Composition of Regulatory Capital

A. General

Banks are required to maintain a minimum Pillar 1 Capital to Risk-weighted Assets Ratio (CRAR) of 9% on an on-going basis (other than capital conservation buffer and countercyclical capital buffer etc.). RBI will take into account, inter alia, the effectiveness of the bank's risk management systems in identifying, assessing / measuring, monitoring and managing various risks including interest rate risk in the banking book, liquidity risk, concentration risk and residual risk to determine that the capital held by a bank is commensurate with the bank's overall risk profile. RBI (Central bank) was advised to consider prescribing a higher level of minimum capital ratio for each bank under the Pillar 2 framework on the basis of their respective risk profiles and their risk management systems. Banks are expected to operate at a level well above the minimum requirement.

B. Capital Ratios Under Basel III

A bank should compute Basel III capital ratios in the following manner:

Common Equity Tier 1 capital ratio	(Common Equity Tier 1 Capital)/(Credit Risk RWA* + Market Risk RWA + Operational Risk RWA)
Tier 1 capital ratio	(Eligible Tier 1 Capital)/(Credit Risk RWA* + Market Risk RWA + Operational Risk)
Total Capital Ratio (CRAR#)	(Eligible Total Capital)/(Credit Risk RWA* + Market Risk RWA + Operational Risk RWA)
* RWA = Risk weighted Assets; # Capital to Risk Weighted Asset Ratio	

With full implementation of Capital Ratios and CCB the capital requirements are summarised as follows:

	Regulatory Capital	**% to RWAs**
(*i*)	Minimum Common Equity Tier 1 Ratio	5.5
(*ii*)	Capital Conservation Buffer (comprised of Common Equity Tier 1)	2.5
(*iii*)	Minimum Common Equity Tier 1 Ratio plus Capital Conservation	8.0
(*iv*)	Additional Tier 1 Capital (Maximum)	1.5
(*v*)	Minimum Tier 1 Capital Ratio [(i) +(iv)]	7.0
(*vi*)	Tier 2 Capital (Maximum)	2.0
(*vii*)	Minimum Total Capital Ratio (MTC) [(v)+(vi)] (CRAR: Capital Risk Weighted Assets Ratio)	9.0
(*viii*)	Minimum Total Capital Ratio plus Capital Conservation Buffer [(vii)+(ii)]	11.5

C. Regulatory Capital

(I) Components of Capital

Total regulatory capital will consist of the sum of the categories as indicated below. Various criteria have been prescribed to determine the types of capital instruments and the types of reserve/debt funds that can be included under each component.

	Component of Capital	Capital Instruments/Reserve Funds	Character
(i)	**Tier 1 Capital (going-concern capital)**		
(*a*)	Common Equity Tier 1	(i) Common Shares (Paid up Equity Capital) – Indian Banks (ii) Common Equity Funds – Foreign Banks	Common Equity is recognised as the highest quality component of capital and is the primary form of funding which ensures that a bank remains solvent.
(*b*)	Additional Tier 1	(i) Perpetual Non-Cumulative Preference Shares (ii) Perpetual Debt Instruments	Instruments to be included in Additional Tier 1 capital have improved loss absorbency to a higher degree than those in Tier 2 capital.
(ii)	**Tier 2 Capital (gone-concern capital)**	(i) Debt Capital Instruments (ii) Perpetual Cumulative Preference Shares (iii) Redeemable Cumulative Preference Shares	Instruments to be included in Tier 2 capital have improved loss absorbency than in the earlier regime.

(II) Constituents of Different Tiers of Capital

I	Tier 1 Capital
(*a*)	***Common Equity Tier 1 Capital – Indian Banks***
(*i*)	Common shares (paid-up equity capital) issued (meeting the prescribed criteria for classification)
(*ii*)	Stock surplus (share premium) resulting from the issue of common shares;
(*iii*)	Statutory reserves;
(*iv*)	Capital reserves representing surplus arising out of sale proceeds of assets;
(v)	Revaluation reserves arising out of change in the carrying amount of a bank's property, duly adjusted. (At the discretion of the bank)
(vi)	Foreign currency translation reserve arising due to translation of financial statements of their foreign operations, duly adjusted. (At the discretion of the bank)
(*vii*)	Other disclosed free reserves, if any;
(*viii*)	Balance in Profit & Loss Account at the end of the previous financial year;
(*ix*)	Profits in current FY on a quarterly basis (provided the incremental provisions for

	NPAs for any of the 4 quarters of the previous FY did not deviate more than 25% from the average of the 4 quarters)
(*x*)	For consolidated level, common shares issued by consolidated subsidiaries of the bank and held by third parties (i.e. minority interest) (meeting the prescribed criteria for classification); and
(*xi*)	Less: Regulatory adjustments/deductions applied in the calculation of Common Equity Tier 1 capital [i.e. to be deducted from the sum of items (*i*) to (*x*)].
(*b*)	***Additional Tier 1 Capital – Indian Banks***
(*i*)	Perpetual Non-Cumulative Preference Shares (PNCPS) (meeting the prescribed criteria for classification)
(*ii*)	Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital;
(*iii*)	Debt capital instruments eligible for inclusion in Additional Tier 1 capital (meeting the prescribed criteria for classification);
(*iv*)	Any other type of instrument generally notified by the Reserve Bank from time to time for inclusion in Additional Tier 1 capital;
(*v*)	At the consolidated level, Additional Tier 1 instruments issued by consolidated subsidiaries of the bank and held by third parties (meeting the prescribed criteria for classification); and
(*vi*)	Less: Regulatory adjustments/deductions applied in the calculation of Additional Tier 1 capital [i.e. to be deducted from the sum of items (*i*) to (*v*)].
II	**Tier 2 Capital- Indian Banks**
(*i*)	General Provisions and Loss Reserves subject to following:
	(a) Provisions or loan-loss reserves held against future, presently unidentified losses, which are freely available to meet losses which subsequently materialize. (Like, General Provisions on Standard Assets, Floating Provisions, Provisions held for Country Exposures, etc.) (Maximum (as % of the total credit RWAs) - Standardized approach: 1.25; Internal Ratings Based (IRB) approach: 0.6) *(b)* Investment Fluctuation Reserve shall also qualify for inclusion in Tier 2 capital, without any ceiling11 (*c*) Provisions for identified deterioration of particular assets or loan liabilities, whether individual or grouped should be excluded. (Like specific provisions on NPAs, both at individual account or at portfolio level, etc.)
(*ii*)	Debt Capital Instruments issued by the banks;
(*iii*)	Preference Share Capital Instruments [Perpetual Cumulative Preference Shares

	(PCPS)/Redeemable Non-Cumulative Preference Shares (RNCPS)/Redeemable Cumulative Preference Shares (RCPS)] issued by the banks;
(*iv*)	Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;
(*v*)	At the consolidated level, Tier 2 capital instruments issued by consolidated subsidiaries of the bank and held by third parties (meeting the prescribed criteria for classification);
(*vi*)	Revaluation reserves at a discount of 55%
(*vii*)	Any other type of instrument generally notified by the Reserve Bank from time to time for inclusion in Tier 2 capital; and
(*viii*)	Less: Regulatory adjustments/deductions applied in the calculation of Tier 2 capital [i.e. to be deducted from the sum of items (*i*) to (*vii*)].

D. Treatment of Minority Interest

Under Basel III, the minority interest is recognised only in cases where there is considerable explicit or implicit assurance that the minority interest which is supporting the risks of the subsidiary would be available to absorb the losses at the consolidated level. Further, the minority interest in relation to all the components (Common Equity Tier1, Additional Tier1, and Tier 2) of regulatory capital will be recognized.

E. Regulatory Adjustments/Deductions

a) Various regulatory adjustments/deductions are to be applied to regulatory capital both at solo and consolidated level to arrive at the eligible level of capital under the three components. These would include deductions/adjustments for Goodwill and all Other Intangible Assets, Deferred Tax Assets (DTAs), Cash Flow Hedge Reserve, Shortfall of the Stock of Provisions to Expected Losses, Gain-on-Sale Related to Securitisation Transactions, Cumulative Gains and Losses due to Changes in Own Credit Risk on Fair Valued Financial Liabilities, Defined Benefit Pension Fund Assets and Liabilities, Investments in Own Shares (Treasury Stock), Investments in the Capital of Banking, Financial and Insurance Entities.

b) The requirements for these adjustments/deductions have been summarized in the Table below.

1	***Goodwill and all Other Intangible Assets*** (*i*) Goodwill and all other intangible assets should be deducted from Common Equity Tier 1 capital including any goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities which are outside the scope of regulatory consolidation. (*ii*) The full amount of the intangible assets is to be deducted net of any associated deferred tax liabilities which would be extinguished if the intangible assets become impaired or derecognized under the relevant accounting standards.
2	***Deferred Tax Assets* (*DTAs*)** To be deducted from Common Equity Tier 1 capital: (*a*) DTA associated with accumulated losses; and (*b*) The DTA (excluding DTA associated with accumulated losses), net of DTL, subject to specific conditions.
3	***Cash Flow Hedge Reserve*** Cash flow hedge reserve which relates to the hedging of items that are not fair valued should be de-recognised in the calculation of Common Equity Tier 1. (Positive amounts should be deducted and negative amounts should be added back.)
4	***Shortfall of the Stock of Provisions to Expected Losses*** The deduction from capital in respect of a shortfall of the stock of provisions to expected losses under the Internal Ratings Based (IRB) approach should be made in the calculation of Common Equity Tier 1.
5	***Gain -on-Sale Related to Securitisation Transactions*** Provisions contained in Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021. no. DOR.STR.REC.53/21.04.177/2021-22 dated September 24, 2021 apply.
6	***Cumulative Gains and Losses due to Changes in Own Credit Risk on Fair Valued Financial Liabilities*** To de-recognise from Common Equity Tier 1 capital, all un-realised gains and losses which have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk. Also, with regard to derivative liabilities, de-recognise all accounting valuation adjustments arising from the bank's own credit risk. The offsetting between valuation adjustments arising from the bank's own credit risk and those arising from its counterparties' credit risk is not allowed.
7	***Defined Benefit Pension Fund* (*including other defined employees' funds*) *Assets and Liabilities*** For each defined benefit pension fund that is an asset on the balance sheet, the asset should be deducted in the calculation of Common Equity Tier 1 net of any associated deferred tax liability.

8	***Investments in Own Shares*** **(*Treasury Stock*)** Banks should not repay their equity capital without specific approval of Reserve Bank of India. Repayment of equity capital can take place by way of share buy-back, investments in own shares (treasury stock) or payment of dividends out of reserves, none of which are permissible. However, banks should look through holdings of index securities to deduct indirect investments in their own stock (on account of investments in mutual funds or index funds/securities) from their Common Equity Tier 1 capital. Banks must make similar deductions in respect of investments in their own Additional Tier 1/ Tier 2 capital respectively from their Additional Tier 1/Tier 2 capital. If the amount of indirect investments in the bank's capital is not specifically known then 10% of the bank's capital will be deducted entirely from Common Equity Capital
9	***Investments in the Capital of Banking, Financial and Insurance Entities*** The investment of banks in the regulatory capital instruments of other financial entities contributes to the inter-connectedness amongst the financial institutions. In addition, these investments also amount to double counting of capital in the financial system. Therefore, these investments have been subjected to stringent treatment in terms of deduction from respective tiers of regulatory capital.
10	***Various Adjustments at Consolidated Level*** The adjustments at Consolidated level will be in addition to those made for the bank at the Solo level.

c) Ceilings on investments (as indicated in the Table below) by a banking company in Capital of Banking, Financial and Insurance Entities, as also in entities providing non-financial services have been prescribed. Also, such investments are subject to several adjustments specified under the Basel III norms.

	Nature of Investment	**Restrictions**
1	Investments in the capital instruments issued by banking, financial and insurance entities (after all deductions).	10% of its capital funds
2	Investing bank's holding in a bank's equity shares	10% of the investee bank's equity capital
3	Shares in any company whether as pledge or mortgagee or absolute owner	Not exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less.

	Nature of Investment	Restrictions
4	Equity investment in a subsidiary company, financial services company, financial institution, stock and other exchanges	10% of the bank's paid-up share capital and reserves
5	Equity investment in companies engaged in non-financial services activities	10% of the investee company's paid up share capital or 10% of the bank's paid up share capital and reserves, whichever is less
6	Equity investments in any non-financial services company held by (a) a bank; (b) bank's subsidiaries, associates or joint ventures or entities directly or indirectly controlled by the bank; and (c) mutual funds managed by AMCs controlled by the bank should in the aggregate not exceed	20% of the investee company's paid up share capital
7	Equity investments in subsidiaries and other entities that are engaged in financial services activities together with equity investments in entities engaged in non-financial services activities not to exceed	20% of the bank's paid-up share capital and reserves.

Indicative list of institutions deemed to be financial institutions (other than banks and insurance companies) for capital adequacy purposes

i. Asset Management Companies of Mutual Funds/Venture Capital Funds/Private Equity Funds etc.;
ii. Non-Banking Finance Companies;
iii. Housing Finance Companies;
iv. Primary Dealers;
v. Merchant Banking Companies;
vi. Entities engaged in activities which are ancillary to the business of banking under the B.R. Act, 1949; and
vii. Central Counterparties (CCPs).

d) Investments made by a banking subsidiary/associate in the equity or non-equity regulatory capital instruments issued by its parent bank should be deducted from such subsidiary's regulatory capital following corresponding deduction approach, in its capital adequacy assessment on a solo basis. The regulatory treatment of investment by the non-banking financial subsidiaries/associates in the parent bank's regulatory capital would, however, be governed by the applicable regulatory capital norms of the respective regulators of such subsidiaries/associates.

F. Intra Group Transactions and Exposures

As per RBI Guidelines on Management of Intra-Group Transactions and Exposures issued in February 2014, subsequent to March 31, 2016 intra-group exposures beyond permissible limits, if any, would be deducted from Common Equity Tier 1 capital of the bank.

22.4 CAPITAL CHARGE FOR CREDIT, MARKET AND OPERATIONS RISKS

I. For Credit Risk

Under the Standardised Approach, banks may rely upon the rating assigned by the RBI chosen external credit rating agencies for assigning risk weights for capital adequacy purposes as per the mapping guidelines.

a. *Claims on Domestic Sovereigns and Specified Institutions*: Risk weights prescribed for such claims are summarised below:

	Category of Exposure	**Risk Weight**
(*a*)	(i) Fund based and non-fund based claims on the central government (ii) Central Government guaranteed claims (iii) Claims on specified institutions/ organisations like the Reserve Bank of India, DICGC, etc. and claims under schemes guaranteed by the Central Govt. like Credit Guarantee Fund Trust for Low Income Housing (CRGFTLIH), etc. (iv)'Amount receivable from Government of India under Agricultural Debt Waiver Scheme, 2008'	Zero
(*b*)	Exposures to the State Governments – (i) Direct loan/credit/overdraft exposure (ii) Investment in securities issued by State Govt. (iii) Claims guaranteed by State Govt.	(i) 0% (ii) 0% (iii) 20%
(*c*)	Claims on ECGC	20%
(*d*)	For NPAs of the categories (*a*) to (*c*)	As applicable to NPAs
(*e*)	Outstanding's in the accounts covered by the Debt Relief Scheme	As per asset classification
The above risk weights will be applied if such exposures are denominated in Indian Rupees and also funded in Indian Rupees.		

b. *Claims on Foreign Sovereigns and Foreign Central Banks*: Claims on foreign sovereigns and their central banks will attract risk weights (ranging from 0 to 150%) as per the rating assigned to those sovereigns and central banks/ sovereign and central bank claims, by international rating agencies. These are subject to prescribed guidelines.

c. *Claims on Public Sector Entities (PSEs):* For domestic PSEs risk weights similar to corporates apply. For foreign PSEs, the claims are risk weighted (ranging from 20% to 150%) as per the rating assigned by the international rating agencies.
d. *Claims on Multilateral Development Banks (MDBs), Bank for International Settlements (BIS) and International Monetary Fund (IMF):* These are treated as scheduled banks meeting the capital adequacy criteria and assigns a uniform risk weight of 20%. In case of MDBs, it is applicable to 13 specified MDBs evaluated by BCBS.
e. *Claims on Banks (Exposure to capital instruments):* Those investments that are not required to be deducted as per the extant guidelines, will be risk weighted as prescribed. The risk weights range from 20% to 625% depending on the bank being being scheduled or non-scheduled and the levels of various types of capital of the bank. Claims on foreign banks are risk weighted ranging from 0 to 150% depending on the credit rating assigned by the international credit rating agencies.
f. *Claims on Primary Dealers*: For these risk weights similar to corporates apply.
g. *Claims on Corporates and NBFCs (excluding Core Investment Companies):* These are risk weighted as per the ratings assigned by the rating agencies registered with SEBI and accredited by the Reserve Bank of India, in case of non-residents corporates, the risk rating of international rating agencies are considered.
h. *Claims on Core Investment Companies (CICs):* These (both rated and unrated) are risk-weighted at 100%.
i. *Claims included in the Regulatory Retail Portfolios*:
Claims (fund-based and non-fund based) that meet the four criteria listed below are included in a regulatory retail portfolio for regulatory capital purposes, and assigned a risk-weight of 75%. As part of the supervisory review process, the RBI may consider prescribing for a bank a higher standard risk weight.

(*i*) Orientation Criterion	Exposure is to: (*a*) An individual person or persons (any legal person capable of entering into a contract including HUF), or (*b*) A small business (including partnership firm, trust, private limited companies, public limited companies, co-operative societies etc.) - Total average annual turnover (for 3 years) is less than ₹50 crore (For existing – Actual; For New Projected; For functioning less than 3 years – Actual & Projected)
(*ii*) Product Criterion	Exposure form is of: (*a*) Revolving credits and lines of credit (including overdrafts) (*b*) Term loans and leases (e.g. instalment loans and leases, student and educational loans) and (*c*) Small business facilities and commitments

(*iii*) Granularity Criterion	Sufficiently diversified to a degree that reduces the risks in the portfolio. Like no aggregate exposure to one counterpart should exceed 0.2 % of the overall regulatory retail portfolio. Aggregate Exposure - Gross amount (i.e. not taking any benefit for credit risk mitigation into account) of all forms of debt exposures (e.g. loans or commitments) that individually satisfy the three other criteria. 'One Counterpart' - One or several entities that may be considered as a single beneficiary (e.g. in the case of a small business that is affiliated to another small business, the limit would apply to the bank's aggregated exposure on both businesses). Retail portfolio NPAs to be excluded while assessing the granularity.
(*iv*) Low value of individual exposures	The maximum aggregated retail exposure to one counterpart should not exceed the absolute threshold limit of ₹7.5 crore.

The following claims (fund based and non-fund based) shall be excluded from the regulatory retail portfolio:

i. Exposures by way of investments in securities (such as bonds and equities), whether listed or not;
ii. Mortgage Loans to the extent that they qualify for treatment as claims secured by residential property or claims secured by commercial real estate;
iii. Loans and Advances to bank's own staff which are fully covered by superannuation benefits and/or mortgage of flat/house;
iv. Consumer Credit, including Personal Loans and credit card receivables;
v. Capital Market Exposures;
vi. Venture Capital Funds.

j. Claims secured by Residential Property: Following norms apply for these -

i. Risk weights for Individual housing loans vary depending on the loan amount and the LTV Ratio and may be 50% or 35%. The risk weights for the individual housing loans sanctioned between 16th October 2020 to 31st March 2022, irrespective of the loan amount were 35% or 50% depending on the LTV ratio. Bank's exposure to an individual for the third dwelling unit onwards is treated as Commercial Real Estate exposure. Loans for Commercial Real Estate (Retail Housing) the Risk weight is 75% and that for Loans to Commercial Real Estate (CRE) is 100%.
ii. All other claims secured by residential property would attract the higher of the risk weight applicable to the counterparty or to the purpose for which the bank has extended finance.
iii. Loans/exposures to intermediaries for on-lending are treated as claims on corporates or claims included in the regulatory retail portfolio as the case may be.
iv. Investments in mortgage backed securities (MBS) backed by exposures of the above categories are governed by the guidelines pertaining to securitisation exposures.

k. *Claims Classified as Commercial Real Estate Exposure*: These attract a risk weight of 100 per cent. Investments in mortgage backed securities (MBS) backed by exposures are governed by the guidelines pertaining to securitisation exposures.

l. *Non-Performing Assets (NPAs)*: The risk weights vary according to the extent of security cover and the specific provision held as indicated below.

Nature of Security of NPA	**Extent of Specific Provision (as % of the outstanding amount of NPA)**	**Risk Weight**
Unsecured portion of NPA (other than a qualifying residential mortgage loan), net of specific provisions (including partial write-offs)	Less than 20%	150%
	At least 20% but less than 50%.	100%
	At least 50%	50%
Claims which are NPA secured by residential property	Less than 20%	100%
	At least 20% but less than 50%	75%
	50% or more	50%

Level of specific provisions in NPAs: All funded NPA exposures of a single counterparty (without netting the value of the eligible collateral) should be reckoned in the denominator.

Secured portion of the NPA: Eligible collateral will be the same as recognised for credit risk mitigation purposes. Other forms of collateral like land, buildings, plant, machinery, current assets, etc. will not be reckoned while computing the secured portion of NPAs for capital adequacy purposes. Where a NPA is fully secured by the following forms of collateral that are not recognised for credit risk mitigation purposes a 100 per cent risk weight may apply, net of specific provisions, when provisions reach 15 per cent of the outstanding amount.

i. Land and building which are valued by an expert valuer and where the valuation is not more than three years old, and
ii. Plant and machinery in good working condition at a value not higher than the depreciated value as reflected in the audited balance sheet of the borrower, which is not older than eighteen months.

m. *Other Specified Categories*: For various other exposures of specific nature like claims on Venture Capital Funds, consumer credit like credit card receivables, loans against gold & jewellery, investments in capital instruments and equity instruments specific risk weights have been prescribed. These are briefly summarized for certain significant types of exposures in the Table below. Besides, RBI may prescribe higher risk weight of 150% for any exposure considered by it as carrying high risk.

S. No.	Nature of Exposure	Risk Weight
1	Claims on Venture Capital Funds	150%
2	Consumer credit, including personal loans (excluding credit card receivables)	100%
3	Credit card receivables (as warranted by the external rating (or, the lack of it) of the counterparty)	125% or higher
4	Personal loans secured by gold and gold jewellery (exposure to be as per the comprehensive approach) for the 'exposure value after risk mitigation'.	125%
5	Capital market exposures (as warranted by the external rating (or, the lack of it) of the counterparty)	125% or higher
6	All banking book exposures, which are exempted from capital market exposure ceilings for direct investments/total capital market exposures	125% or higher
7	Exposure to capital instruments issued by NBFCs which are not deducted, depending on the external rating	125% or higher
8	Exposure to equity instruments issued by NBFCs which are not deducted, and are risk weighted	250%
9	Exposure to capital instruments issued by financial entities (other than banks and NBFCs) which are not deducted, depending on the external rating	125% or higher

n. *Unhedged Foreign Currency Exposure*: The unhedged foreign currency exposures of entities can increase the probability of default in times of high currency volatility, hence an increase of 25% in the risk weight has been prescribed for bank exposures to entities with unhedged foreign currency exposures (i.e. over and above the present capital requirements), where the ratio of likely Loss/EBID exceeds 75%.

o. *Enhancing Credit Supply for Large Borrowers through Market Mechanism:* Additional Risk weight of 75% over and above the applicable risk weight for the exposure to the specified borrower shall apply on the incremental exposure of the banking system to a specified borrower beyond Normally permitted lending limit (NPLL). This is distributed in proportion to each bank's funded exposure to the specified borrower.
   - 'Specified borrower':, a borrower having an Aggregate Sanctioned Credit Limit (ASCL) of more than ₹10,000 crore at any time from April 1, 2019 onwards.

- Aggregate Sanctioned Credit Limit (ASCL): Aggregate of the fund based credit limits sanctioned or outstanding, whichever is higher, to a borrower by the banking system. ASCL would also include unlisted privately placed debt with the banking system.
- Normally permitted lending limit (NPLL):, 50% of the incremental funds raised by the specified borrower over and above its ASCL as on the reference date, in the financial years (FYs) succeeding the FY in which the reference date falls. Funds raised by way of equity shall be deemed to be part of incremental funds raised from outside the banking system in the given year; Where a borrower has already raised funds by way of market instruments having amount outstanding as on the reference date of 15% or more of ASCL on that date, the NPLL will mean 60% of the incremental funds raised, in the financial years (FYs) succeeding the FY in which the reference date falls.

p. *Other Assets*:

a) Loans and advances to bank's own staff: Risk weights for these depend on the nature/purpose/security of the advance.
   i) Fully covered by superannuation benefits and/or mortgage of flat/house: 20% (without any adjustment of the outstanding amount).
   ii) Against eligible collateral: The outstanding amount may be adjusted to the extent permissible.
   iii) Other loans and advances: Eligible for inclusion under regulatory retail portfolio with risk weight of 75%.

b) All other assets will attract a uniform risk weight of 100%.

q. *Off-Balance Sheet Items*:

i. *Categories*: Off-balance sheet credit exposure is bifurcated in two categories: Market related, and Non-market related

ii. *Risk-weighted Credit Exposure*: The risk-weighted amount of credit exposure of an off-balance sheet item is calculated in this manner –

   Credit Equivalent Amount (CEA) = (Notional amount) x (Credit Conversion Factor (CCF)), or

   Current Exposure Method used to determine CEA

   Risk-weighted Credit Exposure = (Credit Equivalent Amount (CEA)) x (Applicable Risk-weight)

   Where the off-balance sheet item is secured by eligible collateral or guarantee, the credit risk mitigation guidelines are applied.

iii. *Non-market Related Off- Balance Sheet Items*:
   a) For such items like, direct credit substitutes, trade and performance related contingent items and commitments with certain drawdown, other commitments, etc. CEA = (Contracted amount of the transaction) x (Relevant CCF).
   b) For such item being an undrawn or partially undrawn fund-based facility, the maximum amount of undrawn commitment that could be drawn is off-balance sheet non-market related credit exposure.

c) For irrevocable commitments to provide off-balance sheet facilities, the original maturity will be measured from the commencement of the commitment until the time the associated facility expires.

d) The following transactions with non-bank counterparties will be treated as claims on banks:

   i. Guarantees issued against the counter guarantees of other banks.

   ii. Rediscounting of documentary bills discounted by other banks and discounting of bills accepted by another bank will be treated as a funded claim on a bank. If bank is satisfied that the exposure is on the other bank these exposures will be assigned the risk weight applicable to banks.

e) Irrevocable Payment Commitment by banks to various Stock Exchanges on behalf of Mutual Funds and FIIs is a financial guarantee with CCF of 100. Risk weight of 125% is applied on the 50% amount which is taken as CME, the balance being covered by cash/securities, admissible risk mitigants.

f) Classification of Bank Guarantees: These could be direct credit substitutes and transaction-related contingent items and are accordingly classified as follows.

   i. Financial guarantees: These are direct credit substitutes wherein a bank irrevocably undertakes to guarantee the repayment of a contractual financial obligation. Hence the risk of loss is directly linked to the creditworthiness of the counterparty against whom a potential claim is acquired. Hence the CCF is 100.

Indicative List of Financial Guarantees
Guarantees for credit facilities
Guarantees in lieu of repayment of financial securities
Guarantees in lieu of margin requirements of exchanges
Guarantees for mobilisation advance, advance money before the commencement of a project and for money to be received in various stages of project implementation
Guarantees towards revenue dues, taxes, duties, levies etc. in favour of Tax/Customs/Port/Excise Authorities and for disputed liabilities for litigation pending at courts
Credit Enhancements
Liquidity facilities for securitisation transactions
Acceptances (including endorsements with the character of acceptance)
Deferred payment guarantees

   ii. Performance guarantees: These are essentially transaction-related contingencies undertaking to pay a third party if the counterparty fails to fulfill or perform a contractual non-financial obligation. Hence, the risk of loss is not necessarily related to the creditworthiness of the counterparty. The CCF for these is 50%.

Indicative List of Performance Guarantees
Bid bonds;
Performance bonds and export performance guarantees;
Guarantees in lieu of security deposits/earnest money deposits (EMD) for participating in tenders;
Retention money guarantees;
Warranties, indemnities and standby letters of credit related to particular transaction.

iv. *Treatment of Total Counterparty Credit Risk*:

The total capital charge for counterparty credit risk will cover the default risk as well as credit migration risk of the counterparty reflected in mark-to-market losses on the expected counterparty risk (such losses being known as credit value adjustments, CVA). Counterparty risk may arise in the context of OTC derivatives and Securities Financing Transactions. Such instruments generally exhibit the following abstract characteristics:

a. The transactions have a current exposure or market value, and also an associated random future market value based on market variables.
b. The transactions generate an exchange of payments or an exchange of a financial instrument against payment.
c. Collateral may be used to mitigate risk exposure and is inherent in the nature of some transactions.
d. Short-term financing may be a primary objective in that the transactions mostly consist of an exchange of one asset for another (cash or securities) for a relatively short period of time, usually for the business purpose of financing. The two sides of the transactions are not the result of separate decisions but form an indivisible whole to accomplish a defined objective.
e. Netting may be used to mitigate the risk.
f. Positions are frequently valued (most commonly on a daily basis), according to market variables.
g. Re-margining may be employed.

There are separate procedures for calculating capital charges for default risk and for CVA risk.

v. *Capital requirement for exposures to Central Counterparties (CCPs)*: Following terms need to be understood in this context.

a) A central counterparty (CCP) is a clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the future performance of open contracts. A CCP becomes counterparty to trades with market participants through novation, an open offer system, or another legally binding arrangement. For the purposes of the capital framework, a CCP is a financial institution.

b) A qualifying central counterparty (QCCP) is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator / overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.

c) A clearing member is a member of, or a direct participant in, a CCP that is entitled to enter into a transaction with the CCP, regardless of whether it enters into trades with a CCP for its own hedging, investment or speculative purposes or whether it also enters into trades as a financial intermediary between the CCP and other market participants.

d) A client is a party to a transaction with a CCP through either a clearing member acting as a financial intermediary, or a clearing member guaranteeing the performance of the client to the CCP.

Exposures to central counterparties arising from OTC derivatives transactions, exchange traded derivatives transactions and securities financing transactions (SFTs) will be subject to the counterparty credit risk treatment specifically prescribed for this purpose. Exposures arising from the settlement of cash transactions (equities, fixed income, spot FX, commodity etc.) are subject to different treatment prescribed for failed transactions.

There are several Trade Exposures associated with transactions carried out through QCCPs:

- Clearing member exposures to QCCPs
- Clearing member exposures to clients
- Client bank exposures to clearing member (where bank is a client of the clearing member)

Besides, there is additional exposure to QCCP i.e. Default fund exposure.
All these exposures are treated differently, as prescribed.

For exposures to non-qualifying CCPs banks are required to apply the Standardised Approach for credit risk according to the category of the counterparty. Besides, for default fund contributions to a non-qualifying CC a risk weight of 1250% is to be applied.

r. Securitisation Exposures:

The treatment of securitisation exposures for capital adequacy has been specified in the Master Direction– Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021.

Lenders must maintain capital against all securitisation exposure amounts, including those arising from the provision of credit risk mitigants to a securitisation transaction, investments in asset-backed or mortgage-backed securities, retention of a subordinated tranche, and extension of a liquidity facility or credit enhancement. For the purpose of capital computation, whenever securitisation exposures are a subject of repurchase agreements and repurchased by a lender, the exposure must be treated as retained exposure and not a fresh exposure. Lenders shall apply Securitisation External Ratings Based approach (SEC-ERBA) for calculation of risk weighted assets for credit risk of securitisation exposures. For unrated securitisation exposures, lender shall maintain capital charge equal to the actual exposure. The capital charges computed based on the prescribed risk weights are subject to a cap of the actual exposure in respect of which capital adequacy is being computed such that the capital requirement for any securitisation position does not exceed the securitisation exposure amount.

s. Credit Default Swap (CDS) Positions in the Banking Book

In case of Banking Book positions hedged by bought CDS positions, no exposure will be reckoned against the reference entity/underlying asset in respect of the hedged exposure, and exposure will be deemed to have been substituted by the protection seller, if the following conditions are satisfied:

i. Prescribed operational requirements for Credit Default Swaps (CDS) are met.
ii. The risk weight applicable to the protection seller under the Standardised Approach for credit risk is lower than that of the underlying asset.
iii. There is no maturity mismatch between the underlying asset and the reference/deliverable obligation.

If the conditions (i) and (ii) are not satisfied, the bank shall reckon the exposure on the underlying asset; and the CDS position will be transferred to Trading Book where it will be subject to specific risk, counterparty credit risk and general market risk (wherever applicable) capital requirements as applicable to Trading Book.

The unprotected portion of the underlying exposure should be risk-weighted as applicable under the Standardised Approach for credit risk. The amount of credit protection shall be adjusted if there are any mismatches between the underlying asset/ obligation and the reference / deliverable asset / obligation with regard to asset or maturity.

t. External Credit Assessments:

a) *Eligible Credit Rating Agencies*: RBI has decided that banks may use the ratings of the following domestic credit rating agencies for the purposes of risk weighting their claims for capital adequacy purposes:
   i) Acuite Ratings & Research Limited (Acuite)
   ii) Brickwork Ratings India Pvt. Limited (Brickwork);
   iii) Credit Analysis and Research Limited (CARE);
   iv) CRISIL Ratings Limited;
   v) ICRA Limited;
   vi) India Ratings and Research Private Limited (India Ratings); and
   vii) INFOMERICS Valuation and Rating Pvt. Ltd. (INFOMERICS)

RBI has decided that banks may use the ratings of the following international credit rating agencies for the purposes of risk weighting their claims for capital adequacy purposes where specified:

i. Fitch;
ii. Moody's; and
iii. Standard & Poor's

b) *Scope of Application of External Ratings*: The chosen credit rating agencies and their ratings need to be used consistently for each type of claim, for both risk weighting and risk management purposes. There cannot be "cherry pick" of the assessments provided by different credit rating agencies and to arbitrarily change the use of credit rating agencies. Banks shall not use one agency's rating for one corporate bond, while using another agency's rating for another exposure to the same counterparty, unless the respective exposures are rated by only one of the chosen credit rating agencies, whose ratings the bank has decided to use. External assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group. Banks must disclose the names of the credit rating agencies that they use for the risk weighting of their assets, the risk weights associated with the particular rating grades.

c) To be eligible for risk-weighting purposes the external credit assessment must satisfy following conditions:
   i) It must take into account and reflect the entire amount of credit risk exposure the bank has with regard to all payments owed to it.
   ii) The rating should be in force and confirmed from the monthly bulletin of the concerned rating agency. The rating agency should have reviewed the rating at least once during the previous 15 months.
   iii) The credit assessment must be publicly available, It must be published in an accessible form and included in the external credit rating agency's transition matrix.

d) For assets with contractual maturity less than or equal to one year, short term ratings would be relevant. For assets with contractual maturity of more than one year, long term ratings would be relevant. Cash credit exposures should be reckoned as long-term exposures and accordingly the long term ratings will be relevant. Similarly, banks may use long-term ratings of counterparty as a proxy for an unrated short-term exposure on the same counterparty, subject to strict compliance with the requirements for use of multiple rating assessments and applicability of issue rating to issuer / other claims.

e) Use of Unsolicited Ratings: A rating would be treated as solicited only if the issuer of the instrument has requested the credit rating agency for the rating and has accepted the rating assigned by the agency. No ratings issued by the credit rating agencies on an unsolicited basis should be considered for risk weight calculation as per the Standardised Approach.

f) Use of Multiple Rating Assessments: In respect of exposures/obligors having multiple ratings from the chosen credit rating agencies chosen by the bank for the purpose of risk weight calculation:

i) For only one rating for a particular claim, that rating would be used to determine the risk weight.
ii) For two ratings that map into different risk weights, the higher risk weight should be applied.
iii) For three or more ratings the second lowest risk weight should be applied.

u. Credit Risk Mitigation:

A. General Principles

Banks use a number of techniques to mitigate the credit risks to which they are exposed. The revised approach to credit risk mitigation allows a wider range of credit risk mitigants to be recognised provided these techniques meet the requirements for legal certainty. Credit risk mitigation approach is applicable to the banking book exposures, and also for calculation of the counterparty risk charges for OTC derivatives and repo-style transactions in the trading book. The general principles for use of credit risk mitigation techniques are:

i. No transaction in which Credit Risk Mitigation (CRM) techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.
ii. The effects of CRM will not be double counted. No additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects the CRM usage.
iii. Principal-only ratings will not be allowed within the CRM framework.
iv. Use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks.

B. Legal Certainty

In order for banks to obtain capital relief for any use of CRM techniques, certain minimum standards for legal documentation must be met – (a) All documentation used in collateralised transactions and guarantees must be binding on all parties. (b) These must be legally enforceable in all relevant jurisdictions. (c) Banks must have conducted sufficient well documented legal review. and (d) Such verification should have a well-founded legal basis for reaching the conclusion about the binding nature and enforceability of the documents and conduct such further review as necessary to ensure continuing enforceability.

C. ***Credit Risk Mitigation Techniques -Collateralised Transactions***:

I. A Collateralised Transaction is one in which -
   i. The credit exposure is hedged in whole or in part by collateral posted by counterparty or by a third party on behalf of the counterparty.
   ii. There is a specific lien on the collateral and the requirements of legal certainty are met.
   iii. Overall framework and minimum conditions:

The framework allows banks to adopt either the simple approach, which substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collateralised portion of the exposure (generally subject to a 20% floor), or the comprehensive approach, which allows fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral. Banks in India shall adopt the Comprehensive Approach and reduce the exposure amount by the value of the collateral. Under this approach, banks are allowed to reduce the credit exposure to a counterparty to take account of the mitigating effect of eligible financial collateral. Credit risk mitigation is allowed only on an account-by-account basis, even within regulatory retail portfolio.

II. The Comprehensive Approach*:*

In the comprehensive approach, banks need to calculate their adjusted exposure to a counterparty for capital adequacy purposes in order to take account of the effects of the collateral. For this, banks are required to adjust both the amount of the exposure to the counterparty and the value of any collateral to take account of possible future fluctuations in the value of either, occasioned by market movements. These adjustments are referred to as 'haircuts'. The application of haircuts will produce volatility adjusted amounts for both the exposure and the collateral. The volatility adjusted amount for the exposure will be higher than the exposure and the volatility adjusted amount for the collateral will be lower than the collateral, unless either side of the transaction is cash. In other words, the 'haircut' for the exposure will be a premium factor and the 'haircut' for the collateral will be a discount factor. Where the exposure and the collateral are held in different currencies an additional downwards adjustment must be made to take account of possible future fluctuations in exchange rates.

III. Eligible Financial Collateral:

The following collateral instruments are eligible for recognition in the comprehensive approach:

a) Cash (as well as certificates of deposit or comparable instruments, including fixed deposit receipts, issued by the lending bank).
b) Gold: Gold would include both bullion and jewellery.
c) Securities issued by Central and State Governments
d) Kisan Vikas Patra and National Savings Certificates provided no lock-in period is operational and if they can be encashed within the holding period.
e) Life insurance policies with a declared surrender value of an insurance company which is regulated by an insurance sector regulator.
f) Rated Debt securities with prescribed minimum rating (having market liquidity)
g) Unrated Debt Securities issued by a bank as senior debt and listed on a recognised exchange; where other similar security of the issuer has minimum prescribed rating (having market liquidity)
h) Units of Mutual Funds (regulated by the securities regulator) where the daily NAV is available in public domain, and Mutual fund is limited to investing in the instruments eligible as financial collateral.

i) Re-securitisations, irrespective of any credit ratings, are not eligible financial collateral.

IV. Haircuts*:* In principle, there are two ways of calculating the haircuts: (i) standard supervisory haircuts, using parameters set by the Basel Committee, and (ii) own-estimate haircuts, using banks own internal estimates of market price volatility. Banks in India can use only the standard supervisory haircuts for both the exposure as well as the collateral.

D. ***Credit Risk Mitigation Techniques – On-Balance Sheet Netting****:*

On-balance sheet netting is confined to loans/advances and deposits, where banks have legally enforceable netting arrangements, involving specific lien with proof of documentation. Capital requirements on the basis of net credit exposures are permitted subject to the following conditions:

a) There is a well-founded legal basis for the netting or offsetting agreement being considered as enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt.
b) The bank is able at any time to determine the loans/advances and deposits with the same counterparty that are subject to the netting agreement.
c) The bank monitors and controls the relevant exposures on a net basis.
d) The bank monitors and controls its roll-off risks.

Loans/advances are treated as exposure and deposits as collateral. The haircuts will be zero except when a currency mismatch exists.

E. Credit Risk Mitigation Techniques -Guarantees

Where guarantees are direct, explicit, irrevocable and unconditional banks may take account of such credit protection in calculating capital requirements.

Only guarantees issued by entities with a lower risk weight than the counterparty will lead to reduced capital charges since the protected portion of the counterparty exposure is assigned the risk weight of the guarantor, whereas the uncovered portion retains the risk weight of the underlying counterparty.

II. For Market Risk

1) *Definition*:

Market risk is defined as the risk of losses in on-balance sheet and off-balance sheet positions arising from movements in market prices. The market risk positions subject to capital charge requirement are:

a) The risks pertaining to interest rate related instruments and equities in the trading book; and
b) Foreign exchange risk (including open position in precious metals) throughout the bank (both banking and trading books).

2) *Scope and Coverage of Capital Charge for Market Risks*

The banks are required to compute capital charges for interest rate related instruments in the trading book, equities in the trading book and foreign exchange risk (including gold and other precious metals) in both trading and banking books. Trading book for the purpose of capital adequacy will include:

a) Securities included under the Held for Trading category
b) Securities included under the Available for Sale category
c) Open gold position limits
d) Open foreign exchange position limits
e) Trading positions in derivatives, and
f) Derivatives entered into for hedging trading book exposures.

Market risks are required to be managed on an ongoing basis and that the capital requirements for market risks are to be maintained on a continuous basis, i.e. at the close of each business day. Banks are also required to monitor and control intra-day exposures to market risks.

Capital for market risk would not be relevant for securities, which have already matured and remain unpaid. These securities will attract capital only for credit risk. On completion of 90 days' delinquency, these will be treated on par with NPAs for deciding the appropriate risk weights for credit risk.

3) *Measurement of Capital Charge for Interest Rate Risk:*

The capital charge for interest rate related instruments would apply to current market value of these items in bank's trading book. Banks are required to mark-to-market their trading positions on a daily basis. The current market value will be determined as per extant RBI guidelines on valuation of investments.

The minimum capital requirement is expressed in terms of two separately calculated charges - (i) "**specific risk**" charge for each security, to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer, both for short (short position is not allowed in India except in derivatives and Central Government Securities) and long positions, and (ii) "**general market risk**" charge towards interest rate risk in the portfolio, where long and short positions (which is not allowed in India except in derivatives and Central Government Securities) in different securities or instruments can be offset.

For the debt securities held under AFS category, in view of the possible longer holding period and attendant higher specific risk, the banks shall hold total capital charge for market risk equal to greater of (a) or (b) below:

a) Specific risk capital charge, computed notionally for the AFS securities treating them as held under HFT category plus the General Market Risk Capital Charge.
b) Alternative total capital charge for the AFS category computed notionally treating them as held in the banking book.

General Market Risk:

The capital requirements for general market risk capture the risk of loss arising from changes in market interest rates. The capital charge is the sum of four components:

i. the net short (short position is not allowed in India except in derivatives and Central Government Securities) or long position in the whole trading book;
ii. a small proportion of the matched positions in each time-band (the "vertical disallowance");
iii. a larger proportion of the matched positions across different time-bands (the "horizontal disallowance"), and
iv. a net charge for positions in options, where appropriate.

Separate maturity ladders should be used for each currency and capital charges should be calculated for each currency separately and then summed with no offsetting between positions of opposite sign. In the case of those currencies in which business is insignificant (where the turnover in the respective currency is less than 5 per cent of overall foreign exchange turnover), separate calculations for each currency are not required.

Standardised Method: The Basel Committee has suggested two broad methodologies for computation of capital charge for market risks – (i) Standardised method and (ii) the banks' internal risk management models method. As banks in India are still in a nascent stage of developing internal risk management models, to start with, banks in India need to adopt the standardised method.

Under the standardised method there are two principal methods of measuring market risk – (i) "maturity" method and (ii) "duration" method. As "duration" method is more accurate method of measuring interest rate risk, the banks have been advised to adopt standardised duration method to arrive at the capital charge. Accordingly, banks are required to measure the general market risk charge by calculating the price sensitivity (modified duration) of each position separately.

4) *Measurement of Capital Charge for Equity Risk*:

The capital charge for equities would apply on their current market value in bank's trading book. This is applied to all instruments that exhibit market behaviour similar to equities but not to non-convertible preference shares (which are covered by the interest rate risk requirements). The instruments covered include equity shares, whether voting or non-voting, convertible securities that behave like equities, for example: units of mutual funds, and commitments to buy or sell equity.

Specific and General Market Risk:

Equity positions: Capital charge for specific risk (akin to credit risk) will be 11.25% or in accordance with the risk warranted by external rating (or lack of it) of the counterparty, whichever is higher. Specific risk is computed on banks' gross equity positions (i.e. the sum of all long equity positions and of all short equity positions - short equity position is, however, not allowed for banks in India). The general market risk charge will be 9% on the gross equity positions. These capital charges will also be applicable to all trading book exposures, which are exempted from capital market exposure ceilings for direct investments.

Security receipts: Specific Risk Capital Charge for investment in Security Receipts will be 13.5% (equivalent to 150 per cent risk weight). Since the Security Receipts are by and large illiquid and not traded in the secondary market, there will be no General Market Risk Capital Charge on them.

5) *Measurement of Capital Charge for Foreign Exchange Risk:*
This capital charge is in addition to the capital charge for credit risk on the on-balance sheet and off-balance sheet items pertaining to foreign exchange and gold transactions.

Foreign exchange open positions and gold open positions are at present risk-weighted at 100%. Thus, capital charge for market risks in foreign exchange and gold open position is 9%. These open positions, limits or actual whichever is higher, would continue to attract capital charge at 9%.

6) *Capital Charge for Credit Default Swap (CDS) in the Trading Book:*

i. General Market Risk: A credit default swap does not normally create a position for general market risk for either the protection buyer or protection seller. However, the present value of premium payable/receivable is sensitive to changes in the interest rates. In order to measure this interest rate risk, the protection buyer/seller will treat the present value of the premium payable/receivable equivalent to a short/long notional position in Government securities of relevant maturity.
ii. Specific Risk for Exposure to Reference Entity: A CDS creates a notional long/short position for specific risk in the reference asset/obligation for protection seller/protection buyer. For calculating specific risk capital charge, the notional amount of the CDS and its maturity should be used.

7) *Aggregation of the capital charge for Market Risks*:
Capital charges for specific risk and general market risk are computed separately before aggregation. The total capital charge and Risk Weighted Assets for market risks can be computed as indicated in the Table below.

Risk Category	**Capital charge**	**Risk Weighted Assets (RWA)**
I. **Interest Rate (a+b)**		12.5 times the capital charge
a. General market risk		
(*i*) Net position (parallel shift) (*ii*) Horizontal disallowance (curvature) (*iii*) Vertical disallowance (basis) (*iv*) Options		

Risk Category	Capital charge	Risk Weighted Assets (RWA)
b. Specific risk		
II. **Equity (a+b)**		12.5 times the capital charge
a. General market risk		
b. Specific risk		
III. **Foreign Exchange and Gold**		12.5 times the capital charge
IV. **Total capital charge and RWA for market risks** (I+II+III)		

III. For Operational Risk

a) *Definition of Operational Risk:*
Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

b) *The Measurement Methodologies*:
The New Capital Adequacy Framework outlines three methods for calculating operational risk capital charges of increasing sophistication and risk sensitivity: (i) the Basic Indicator Approach (BIA); (ii) the Standardised Approach (TSA); and (iii) Advanced Measurement Approaches (AMA).

Banks are encouraged to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices. Basle guidelines provide that internationally active banks and banks with significant operational risk exposures are expected to use an approach that is more sophisticated than the Basic Indicator Approach and that is appropriate for the risk profile of the institution.

To begin with, banks in India shall compute the capital requirements for operational risk under the Basic Indicator Approach. RBI will review the capital requirement produced by the Basic Indicator Approach for general credibility, especially in relation to a bank's peers and in the event that credibility is lacking, appropriate supervisory action under Pillar 2 will be considered.

c) *The Basic Indicator Approach*:
Under this, banks must hold capital for operational risk equal to the average over the previous 3 years of a fixed percentage (denoted as Alpha) of positive annual gross income. The Alpha has been set at 15% by BCBS. The figures for a year, in which

annual gross income is negative or zero, should be excluded from both the numerator and denominator. If negative gross income distorts a bank's Pillar 1 capital charge, RBI will consider appropriate supervisory action under Pillar 2.

Capital charge for operational risk under the Basic Indicator Approach is computed as follows:
(a) Average of [Gross Income * Alpha] for each of the last three financial years, excluding years of negative or zero gross income
(b) Gross Income = Net profit (+) Provisions & Contingencies (+) Operating Expenses
(c) Alpha = 15 per cent
The notional Risk Weighted Asset (RWA) for operational risk is calculated by multiplying the computed capital charge with 12.5.

22.5 SUPERVISORY REVIEW AND EVALUATION PROCESS (SREP)

a) *Introduction to the SREP under Pillar 2:*
Supervisory Review Process (SRP) is the Pillar 2 of the Capital Adequacy Framework. Under the New Capital Adequacy Framework (NCAF), based on the Basel II Framework the banks were required to have a Board-approved policy on Internal Capital Adequacy Assessment Process (ICAAP) and to assess the capital requirement as per ICAAP.
b) *ICAAP*:
The objective of the SRP is to ensure that banks have adequate capital to support all the risks in their business as also to encourage them to develop and use better risk management techniques for monitoring and managing their risks. This requires banks to have a well-defined internal assessment process through which they assure the RBI that adequate capital is indeed held towards the various risks to which they are exposed. The process of assurance could also involve an active dialogue between the bank and the RBI so that, when warranted, appropriate intervention could be made to reduce the risk exposure of the bank or to augment/restore its capital. Thus, ICAAP is an important component of the SRP.

The main aspects to be addressed under the SRP and the ICAAP, would include:
a) the risks not fully captured by the minimum capital ratio under Pillar 1;
b) the risks not at all taken into account by the Pillar 1; and
c) the factors external to the bank.

Since the capital adequacy ratio prescribed by the RBI under the Pillar 1 of the Framework is only the regulatory minimum level, addressing just the three specified risks (viz., credit, market and operational risks), holding additional capital might be necessary for banks, on account of both –
i. the possibility of some under-estimation of risks under the Pillar 1, and
ii. the actual risk exposure of a bank vis-à-vis the quality of its risk management architecture.

Some of the risks that are not captured or not fully captured in the regulatory CRAR would include:

i. Interest rate risk in the banking book;
ii. Credit concentration risk;
iii. Liquidity risk;
iv. Settlement risk;
v. Reputational risk;
vi. Strategic risk;
vii. Risk of under-estimation of credit risk under the Standardised approach;
viii. Model risk i.e., risk of under-estimation of credit risk under the IRB approaches;
ix. Risk of weakness in the credit-risk mitigants;
x. Residual risk of securitisation, etc.

The quantification of currency induced credit risk will form a part of banks' Internal Capital Adequacy Assessment Programme (ICAAP) and banks are expected to address this risk in a comprehensive manner.

There is no one single approach for conducting the ICAAP and the market consensus in regard to the best practice for undertaking ICAAP is yet to emerge. The methodologies and techniques are still evolving particularly in regard to measurement of non-quantifiable risks, such as reputational and strategic risks. Banks were advised to develop and put in place, with the approval of their Boards, an ICAAP commensurate with their size, level of complexity, risk profile and scope of operations. The ICAAP, which would be in addition to a bank's calculation of regulatory capital requirements under Pillar 1.

The ICAAP document should, inter alia, include the capital adequacy assessment and projections of capital requirement for the ensuing year, along with the plans and strategies for meeting the capital requirement. The ICAAP documents of the banks could vary in length and format, in tune with their size, level of complexity, risk profile and scope of operations.

c) *Need for Improved Risk Management*:

While financial institutions have faced difficulties over the years for a multitude of reasons, the major causes of serious banking problems continue to be lax credit standards for borrowers and counterparties, poor portfolio risk management, and a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties. This experience is common in both advanced and developing countries.

The financial market crisis of 2007-08 has underscored the critical importance of effective credit risk management to the long-term success of any banking organisation and as a key component to financial stability. It has also provided a stark reminder of the need for banks to understand how credit risk interacts with other types of risk (including market, liquidity and reputational risk). The essential elements of a comprehensive credit risk management programme include (i) establishing an appropriate credit risk environment; (ii) operating under a sound credit granting process; (iii) maintaining an appropriate credit administration, measurement and monitoring process; and (iv) ensuring adequate controls over credit risk.

An effective capital planning process requires a bank to assess both the risks to which it is exposed and the risk management processes in place to manage and mitigate those risks; evaluate its capital adequacy relative to its risks; and consider the potential impact on earnings and capital from economic downturns. A bank's capital planning process should incorporate rigorous, forward looking stress testing.

Rapid growth in any business activity can present banks with significant risk management challenges. This was the case with the expanded use of the "originate-to-distribute" business model, off-balance sheet vehicles, liquidity facilities and credit derivatives. The inability to properly identify and measure risks may lead to unintended risk exposures and concentrations, which in turn can lead to concurrent losses arising in several businesses and risk dimensions due to a common set of factors. Furthermore, many banks had insufficient risk management processes in place to address the risks associated with exposures held on their balance sheet, as well as those associated with off-balance sheet entities, such as asset backed commercial paper (ABCP) conduits and structured investment vehicles (SIVs). Innovation has increased the complexity and potential illiquidity of structured credit products. This, in turn, can make such products more difficult to value and hedge, and may lead to inadvertent increases in overall risk.

d) *Guidelines for the SREP of the RBI and the ICAAP of Banks*:

1. *The ICAAP and SREP are the two important components of Pillar 2*.

ICAAP comprises a bank's procedures and measures designed to ensure:

a) An appropriate identification and measurement of risks;
b) An appropriate level of internal capital in relation to the bank's risk profile; and
c) Application and further development of suitable risk management systems in the bank.

SREP consists of a review and evaluation process adopted by the supervisor, which covers all the processes and measures defined in the principles listed above. Essentially, these include the review and evaluation of the bank's ICAAP, conducting an independent assessment of the bank's risk profile, and if necessary, taking appropriate prudential measures and other supervisory actions.

2. *Conduct of the SREP by the RBI:*

Regulatory capital ratios permit some comparative analysis of capital adequacy across regulated banking entities because they are based on certain common methodology/assumptions. However, supervisors need to perform a more comprehensive assessment of capital adequacy that considers risks specific to a bank, conducting analyses that go beyond minimum regulatory capital requirements.

The RBI generally expects banks to hold capital above their minimum regulatory capital levels, commensurate with their individual risk profiles, to account for all material risks.

Under the SREP, the RBI will assess the overall capital adequacy of a bank through a comprehensive evaluation taking into account all relevant available information.

This evaluation would consider the combined implications of:

a) The bank's compliance with regulatory minimum capital requirements,
b) The quality and results of the bank's ICAAP,
c) Supervisory assessment of the bank's risk management processes, control systems and other relevant information relating to the bank's risk profile and capital position.

The SREP of banks would, thus, be conducted as part of the RBI's Risk Based Supervision (RBS) of banks and in the light of the data in the off-site returns received from banks in the RBI, in conjunction with the ICAAP document, which is required to be submitted every year by banks to the RBI. Banks would be expected to demonstrate to the RBI that the ICAAP adopted by them is fully responsive to their size, level of complexity, scope and scale of operations and the resultant risk profile / exposures, and adequately captures their capital requirements. The SREP could also involve a dialogue between the bank's top management and the RBI from time to time. Independent external experts may also be commissioned by the RBI, if deemed necessary, to perform ad hoc reviews and comment on specific aspects of the ICAAP process of a bank.

Under the SREP, RBI would also seek to determine whether a bank's overall capital remains adequate as the underlying conditions change. Generally, material increases in risk that are not otherwise mitigated should be accompanied by commensurate increases in capital. Conversely, reductions in overall capital (to a level still above regulatory minima) may be appropriate if the RBI's supervisory assessment leads it to a conclusion that risk has materially declined or that it has been appropriately mitigated. Based on such assessment, the RBI could consider initiating appropriate supervisory measures to address its supervisory concerns.

3. *The Structural Aspects of the ICAAP*

The ICAAP shall be prepared, on a solo basis, at every tier for each banking entity within the banking group, as also at the level of the consolidated bank. ICAAP will encompass the firm-wide risk profile. The structure, design and contents of a bank's ICAAP should be approved by the Board of Directors to ensure that the ICAAP forms an integral part of the management process and decision making culture of the bank. Firm-wide risk management programmes should include detailed policies that set specific firm-wide prudential limits on the principal risks relevant to a bank's activities. As the ICAAP is an ongoing process, a written record on the outcome of the ICAAP should be periodically submitted by banks to their board of directors. Such written record of the internal assessment of its capital adequacy should include, inter alia, the risks identified, the manner in which those risks are monitored and managed, the impact of the bank's changing risk profile on the bank's capital position, details of stress tests/scenario analysis conducted and the resultant capital requirements. The reports shall be sufficiently detailed to allow the Board of Directors to evaluate the level and trend of material risk exposures, whether the bank maintains adequate capital against the risk exposures and in case of additional capital being needed, the plan for augmenting capital. The board of directors would be expected make timely adjustments to the strategic plan, as necessary. Based on the outcome of the ICAAP as submitted to and approved by the Board, the ICAAP Document, in the prescribed format, should be furnished to the RBI. The document should reach the RBI latest by end of the first quarter (i.e., April-June) of the relevant financial year.

e) Various Aspects Related to ICAAP:

i. *Review of the ICAAP Outcomes*: The board of directors shall, at least once a year, assess and document whether the processes relating to the ICAAP implemented by the bank successfully achieve the objectives envisaged by the board. The senior management should also receive and review the reports regularly to evaluate the sensitivity of the key assumptions and to assess the validity of the bank's estimated future capital requirements. In the light of such an assessment, appropriate changes in the ICAAP should be instituted to ensure that the underlying objectives are effectively achieved.

ii. *Integral to Decision Making Culture*: The ICAAP should from an integral part of the management and decision-making culture of a bank. The integration would also mean that ICAAP should enable the bank management to assess, on an ongoing basis, the risks that are inherent in their activities and material to the institution. The implementation of ICAAP should be guided by the principle of proportionality. RBI would expect the degree of sophistication adopted to be commensurate with the nature, scope, scale and the degree of complexity in the bank's business operations.

iii. *Independent Review*: The ICAAP should be subject to regular and independent review through an internal or external audit process, separately from the SREP conducted by the RBI, to ensure that the ICAAP is comprehensive and proportionate to the nature, scope, scale and level of complexity of the bank's activities so that it accurately reflects the major sources of risk that the bank is exposed to.

iv. *Forward-looking Process*: The ICAAP should be forward looking in nature, and thus, should take into account the expected / estimated future developments such as strategic plans, macro-economic factors, etc., including the likely future constraints in the availability and use of capital. The ICAAP should demonstrate as to how the strategy dovetails with the macro-economic factors. Thus, banks shall have an explicit, Board-approved capital plan which should spell out the institution's objectives in regard to level of capital, the time horizon for achieving those objectives, and in broad terms, the capital planning process and the allocated responsibilities for that process.

v. *Risk- based Process*: The adequacy of a bank's capital is a function of its risk profile. Banks shall, therefore, set their capital targets which are consistent with their risk profile and operating environment. As a minimum, a bank shall have in place a sound ICAAP, which shall include all material risk exposures incurred by the bank. There are some types of risks (such as reputation risk and strategic risk) which are less readily quantifiable; for such risks, the focus of the ICAAP should be more on qualitative assessment, risk management and mitigation than on quantification of such risks.

vi. *Stress Test and Scenario Analysis*: As part of the ICAAP, the management of a bank shall, as a minimum, conduct relevant stress tests periodically, particularly in respect of the bank's material risk exposures, in order to evaluate the potential vulnerability of the bank to some unlikely but plausible events or movements in the market conditions that could have an adverse impact on the bank. The use of stress testing framework can provide a bank's management a better understanding of the bank's likely exposure in extreme circumstances.

vii. *Use of Capital Models*: RBI does not expect the banks to use complex and sophisticated econometric models for internal assessment of their capital requirements, and there is no RBI-mandated requirement for adopting such models, the banks, with international presence, were required to develop suitable methodologies, by March 31, 2001, for estimating and maintaining economic capital. Some of the banks, which have relatively complex operations and are adequately equipped in this regard, may like to place reliance on such models as part of their ICAAP.

22.6 MARKET DISCIPLINE

(a) *General*:

The purpose of Market discipline is to complement the minimum capital requirements (detailed under Pillar 1) and the supervisory review process (detailed under Pillar 2). The banks' disclosures should be consistent with how senior management and the Board of Directors assess and manage the risks of the bank. In principle, banks' disclosures should be consistent with how senior management and the Board of Directors assess and manage the risks of the bank. It is believed that providing disclosures that are based on a common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and comprehensive disclosure framework that enhances comparability.

(b) *Achieving Appropriate Disclosure*:

Market discipline can contribute to a safe and sound banking environment. Non-compliance with the prescribed disclosure requirements would attract a penalty, including financial penalty. Where disclosure is a qualifying criterion under Pillar 1 to obtain lower risk weightings and/or to apply specific methodologies, there would be a direct sanction (not being allowed to apply the lower risk weighting or the specific methodology).

(c) *Interaction with Accounting Disclosures*:

The Pillar 3 disclosure framework does not conflict with requirements under accounting standards, which are broader in scope.

i. *Validation*: The disclosures in this manner should be subjected to adequate validation. For example, since information in the annual financial statements would generally be audited, the additional material published with such statements must be consistent with the audited statements. In addition, supplementary material (such as Management's Discussion and Analysis) that is published should also be subjected to sufficient scrutiny (e.g. internal control assessments, etc.) to satisfy the validation issue. If material is not published under a validation regime, for instance in a stand-alone report, then banks should ensure that appropriate verification of the information takes place. Pillar 3 disclosures will not be required to be audited by an external auditor, unless specified.

ii. *Materiality*: A bank should decide which disclosures are relevant for it based on the materiality concept. Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions. A qualitative judgment is required that whether, in light of the particular circumstances, a user of financial information would consider the item to be material (user test).

iii. Proprietary and Confidential Information: Proprietary information encompasses information (for example on products or systems), that if shared with competitors would render a bank's investment in these products/systems less valuable, and hence would undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship. This has an impact on what banks should reveal in terms of information about their customer base, as well as details on their internal arrangements.

iv. *General Disclosure Principle*: Banks should have a formal disclosure policy approved by the Board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process. Banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency.

v. *Implementation Date*: Pillar 3 disclosures as introduced under Basel III have become effective from July 1, 2013. The first set of disclosures as required by these guidelines was to be made by banks as on September 30, 2013 (with the exception of the Post March 31, 2017 template).

vi. *Scope and Frequency of Disclosures*: Disclosures related to individual banks within the groups would not generally be required to be made by the parent bank. In the disclosure of capital ratios an analysis of significant bank subsidiaries within the group is appropriate. Pillar 3 disclosures will be required to be made by the individual banks on a stand-alone basis when they are not the top consolidated entity in the banking group.

Banks are required to make Pillar 3 disclosures at least on a half yearly basis, irrespective of whether financial statements are audited, with the exception of following disclosures which will be made at least on a quarterly basis:

i. Table DF-2: Capital Adequacy;
ii. Table DF-3: Credit Risk: General Disclosures for All Banks; and
iii. Table DF-4: Credit Risk: Disclosures for Portfolios Subject to the Standardised Approach.

All disclosures must either be included in a bank's published financial results/statements or, at a minimum, must be disclosed on bank's website. In latter case the financial results/statements should contain a direct link to the Pillar 3 disclosures on the bank's website. The Pillar 3 disclosures should be concurrent with publication of financial results/statements.

The main features template and provision of the full terms and conditions of capital instruments are required to be updated concurrently whenever a new capital instrument is issued and included in capital or whenever there is redemption, conversion/write-down or other material change in the nature of an existing capital instrument.

vii. *Regulatory Disclosure Section*: The disclosures should be made in the specified format. Banks have to maintain a 'Regulatory Disclosures Section' on their websites, where all the information relating to disclosures will be made available to the market participants. The direct link to this page should be prominently provided on the home page of a bank's website and it should be easily accessible. An archive for at least three years of all templates relating to prior reporting periods should be made available by banks on their websites.

viii. Pillar 3 under Basel III Framework

BCBS rules on 'composition of capital disclosure requirements' has been adopted along with previous disclosure requirements for disclosures guidelines. It is important to disclose details of items of regulatory capital and various regulatory adjustments to it.

Disclosure Template: Further, to improve consistency and ease of use of disclosures relating to the composition of capital and to mitigate the risk of inconsistent reporting format undermining the objective of enhanced disclosures, banks across Basel member jurisdictions are required to publish their capital positions according to common templates. Post March 31, 2017, a common template (designed to meet the Basel III requirement to disclose all regulatory adjustments) was to be used by banks to report the details of their regulatory capital after March 31, 2017. The template enhances consistency and comparability in the disclosure of the elements of capital between banks and across jurisdictions.

a) *Reconciliation Requirements* - A three-step approach has been devised to ensure that the Basel III requirement to provide a full reconciliation of all regulatory capital elements back to the published financial statements is met in a consistent manner.
b) *Main Features Template* - A common template captures the main features of all regulatory capital instruments issued by a bank at one place to meet the Basel III requirement to provide a description of the main features of capital instruments.
c) *Other Disclosure Requirements* - This disclosure enables banks in meeting the Basel III requirement to provide the full terms and conditions of capital instruments on their websites.
d) *Other Aspects* - Pillar 3 disclosure requirements also include certain aspects that are not specifically required to compute capital requirements under Pillar 1. Banks are also responsible for conveying their actual risk profile to market participants. The information

banks disclose must be adequate to fulfill this objective. Hence, banks operating in India should also make additional disclosures in the following areas:

(i) Securitisation exposures in the trading book;
(ii) Sponsorship of off-balance sheet vehicles;
(iii) Valuation with regard to securitisation exposures; and
(iv) Pipeline and warehousing risks with regard to securitisation exposures.

22.7 LET US SUM UP

Basel III reforms strengthen the banks with the intention to raise the resilience of individual banking institutions in periods of stress. They also aim at addressing system wide risks. There are three options for computing capital requirement for credit risk (Standardised Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach), and three options for computing capital requirement for operational risk [Basic Indicator Approach (BIA), The Standardised Approach (TSA) and Advanced Measurement Approach (AMA)]. Capital adequacy is applied at both the standalone level and the consolidated level.

Regulatory Retail Portfolios are determined based on Orientation Criterion, Product Criterion, Granularity Criterion and Low value of individual exposures.

Banks were required to have a Board-approved policy on Internal Capital Adequacy Assessment Process (ICAAP) and to assess the capital requirement as per ICAAP. Supervisory Review Process (SRP) is the Pillar 2 of the Capital Adequacy Framework. The objective of the SRP is to ensure that banks have adequate capital to support all the risks in their business.

Banks may hold capital above their minimum regulatory capital levels, commensurate with their individual risk profiles.

The purpose of Market discipline is to complement the minimum capital requirements (detailed under Pillar 1) and the supervisory review process (detailed under Pillar 2). Banks' disclosures should be consistent with how senior management and the Board of Directors assess and manage the risks of the bank.

22.8 KEY WORDS

Supervisory Review Process; Market Discipline; Standardised Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach; Basic Indicator Approach (BIA), The Standardised Approach (TSA) and Advanced Measurement Approach (AMA); Regulatory Capital; Capital to Risk-weighted Assets Ratio; Common Equity Tier 1 Capital; Capital Conservation Buffer; Regulatory Retail Portfolios; Orientation Criterion; Product Criterion; Granularity Criterion; Credit Conversion Factor; Counterparty Credit Risk; Credit Default Swap; Internal Capital Adequacy Assessment Process; Risk Based Supervision.

22.9 CHECK YOUR PROGRESS

1) Which kind of risks were not tackled by Basel I:
   a) Credit risk
   b) Market risk
   c) Operational risk
   d) None of the above

2) Which one of the following is not a Tier I capital?
   a) Statutory reserves
   b) Disclosed reserves
   c) Capital reserves
   d) Revaluation reserves

3) Basel II consists of three mutually reinforcing pillars viz; minimum capital requirement, supervising review of capital adequacy and the 3rd one is ___.
   a) Internal Audit
   b) USGAAP
   c) CRA
   d) Market Discipline

22.10 KEY TO 'CHECK YOUR PROGRESS'

1(c); 2 (d); 3(d).

References:

(1) RBI Circular No. DOR.CAP.REC.3/21.06.201/2022-23 dated April 1, 2022 (first issued July 1, 2015) - Master Circular – Basel III Capital Regulations (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12278)

CHAPTER 23

PRIORITY SECTORS AND MICRO, SMALL & MEDIUM ENTERPRISES

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Know about Priority Sectors
- Learn about the Targets for Priority Sector Lending
- Understand the MSME Classification
- Know common guidelines for MSME Lending
- Understand various modes of indirect lending to Priority Sector

23.1 PRIORITY SECTORS

Priority sectors refer to those sectors of the economy which may not get timely and adequate credit in the absence of special dispensation. Typically, these are small value loans to farmers for agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections. In recent years there has been comprehensive review of classification and categorisation of priority sectors. The RBI norms have also been revised in the light of the recommendations of the 'Expert Committee on Micro, Small and Medium Enterprises (Chairman: Shri U.K. Sinha) and the 'Internal Working Group to Review Agriculture Credit' (Chairman: Shri M. K. Jain).

Priority Sectors include the following major categories:

i. Agriculture
ii. Micro, Small and Medium Enterprises
iii. Export Credit
iv. Education
v. Housing
vi. Social Infrastructure
vii. Renewable Energy
viii. Others

For detailed description of various items included under Priority Sectors in the above categories along with the ceilings prescribed for credit, please refer to RBI Master Directions – Priority Sector Lending (PSL) – Targets and Classification dated 4th September 2020.

23.2 TARGETS AND SUB-TARGETS FOR BANKS

Targets and Sub-targets under priority sector differ for various categories of banks viz. Domestic Commercial Banks, Foreign Banks, Small Finance Banks, RRBs, and Primary Urban Co-operative Banks. The targets and sub-targets set under priority sector lending, to be computed on the basis of the ANBC/ CEOBE as applicable as on the corresponding date of the preceding year, are as under:

Categories	**Domestic commercial banks (excl. RRBs & SFBs) & foreign**	**Foreign banks with less than 20 branches**	**Regional Rural Banks**	**Small Finance Banks**

	banks with 20 branches and above			
Total Priority Sector	40 per cent of ANBC as computed in para 6 below or CEOBE whichever is higher	40 per cent of ANBC as computed in para 6 below or CEOBE whichever is higher; out of which up to 32% can be in the form of lending to Exports and not less than 8% can be to any other priority sector	75 per cent of ANBC as computed in para 6 below or CEOBE whichever is higher; However, lending to Medium Enterprises, Social Infrastructure and Renewable Energy shall be reckoned for priority sector achievement only up to 15 per cent of ANBC.	75 per cent of ANBC as computed in para 6 below or CEOBE whichever is higher.
Agriculture	18 per cent of ANBC or CEOBE, whichever is higher; out of which a target of 10 percent# is prescribed for Small and Marginal Farmers (SMFs)	Not applicable	18 per cent ANBC or CEOBE, whichever is higher; out of which a target of 10 percent# is prescribed for SMFs	18 per cent of ANBC or CEOBE, whichever is higher; out of which a target of 10 percent# is prescribed for SMFs
Micro Enterprises	7.5 per cent of ANBC or CEOBE, whichever is higher	Not applicable	7.5 per cent of ANBC or CEOBE, whichever is higher	7.5 per cent of ANBC or CEOBE, whichever is higher
Advances to Weaker Sections	12 percent# of ANBC or CEOBE, whichever is higher	Not applicable	15 per cent of ANBC or CEOBE, whichever is higher	12 percent# of ANBC or CEOBE, whichever is higher
# Revised targets for SMFs and Weaker Section will be implemented in a phased manner.				

<table>
<tr><th>Categories</th><th>Primary Urban Co-operative Bank</th></tr>
<tr><td>Total Priority Sector</td><td>40 per cent of ANBC or CEOBE, whichever is higher, which shall stand increased to 75 per cent of ANBC or CEOBE, whichever is higher, with effect from March 31, 2024. UCBs shall comply with the stipulated target as per the following milestones:
<table>
<tr><th>March 31, 2020</th><th>March 31, 2021</th><th>March 31, 2022</th><th>March 31, 2023</th><th>March 31, 2024</th></tr>
<tr><td>40%</td><td>45%</td><td>50%</td><td>60%</td><td>75%</td></tr>
</table></td></tr>
<tr><td>Micro Enterprises</td><td>7.5 per cent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher</td></tr>
<tr><td>Advances to Weaker Sections</td><td>12 per cent# of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.</td></tr>
<tr><td colspan="2"># Revised targets for weaker sections will be implemented in a phased manner as indicated below</td></tr>
</table>

The targets for lending to SMFs and for Weaker Sections shall be revised upwards from FY 2021-22 onwards as follows:

Financial Year	**Small and Marginal Farmers target ***	**Weaker Sections target ^**
2020-21	8%	10%
2021-22	9%	11%
2022-23	9.5%	11.5%
2023-24	10%	12%

* Not applicable to UCBs
^ Weaker Sections target for RRBs will continue to be 15% of ANBC or CEOBE, whichever is higher.

All domestic banks (other than UCBs) and foreign banks with more than 20 branches need to ensure that the overall lending to Non-Corporate Farmers (NCFs) does not fall below the system-wide average of the last three years' achievement which will be separately notified every year. The applicable target for lending to the non-corporate farmers for FY 2021-22 was 12.73% of ANBC or CEOBE whichever is higher. Banks need to endeavour to reach the level of 13.5 percent of ANBC (erstwhile target for direct lending to agriculture sector).

23.3 COMPUTATION OF ADJUSTED NET BANK CREDIT (ANBC)

Adjusted Net Bank Credit denotes the outstanding bank credit in India for the purpose of priority sector lending. It may be computed as follows.

Bank Credit in India [As prescribed in item No.VI of Form `A' under Section 42(2) of the RBI Act, 1934]	I
Bills Rediscounted with RBI and other approved Financial Institutions	II
Net Bank Credit (NBC)*	III (I-II)
Outstanding Deposits under RIDF and other eligible funds with NABARD, NHB, SIDBI and MUDRA Ltd in lieu of non-achievement of priority sector lending targets/sub-targets + outstanding PSLCs	IV
Eligible amount for exemptions on issuance of long-term bonds for infrastructure and affordable housing as per circular DBOD.BP.BC. No.25/08.12.014/2014-15 dated July 15, 2014	V
Advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements, as per the Reserve Bank's circulars DBOD.No.Ret.BC.36/12.01.001/2013-14 dated August 14, 2013 read with DBOD.No.Ret.BC.93/12.01.001/2013-14 dated January 31, 2014, DBOD mailbox clarification issued on February 6, 2014 and UBD.BPD.(PCB).CIR.No.5/13.01.000/2013-14 dated August 27, 2013 read with UBD.BPD.(PCB).Cir.No.72/13.01.000/2013-14 dated June 11, 2014.	VI
Investments made by public sector banks in the Recapitalization Bonds floated by Government of India	VII
Other investments eligible to be treated as priority sector (e.g. investments in securitised assets)	VIII
Face Value of securities acquired and kept under HTM category under the TLTRO 2.0 (Press Release 2019-2020/2237 dated April 17, 2020 read with Q.11 of FAQ and SLF-MF- Press Release 2019-2020/2276 dated April 27, 2020 and also Extended Regulatory Benefits under SLF-MF Scheme vide Press Release 2019-2020/2294 dated April 30, 2020.	IX
Bonds/debentures in Non-SLR categories under HTM category	X
For UCBs: investments made after August 30, 2007 in permitted non SLR bonds held under 'Held to Maturity' (HTM) category	XI
ANBC (Other than UCBs) III + IV- (V+VI+VII) +VIII - IX + X	
ANBC for UCBs III + IV - VI - IX + XI	
* For the purpose of priority sector computation only. Banks should not deduct / net any amount like provisions, accrued interest, etc. from NBC.	

For the purpose of calculation of CEOBE (Credit Equivalent of Off Balance Sheet Exposures), the provisions contained in RBI Master Circular on Exposure Norms and RBI Master Circular on 'Prudential Norms on Capital Adequacy'.

Banks subtracting prudential write off at Corporate/Head Office level while reporting Bank Credit as above, must ensure that bank credit to priority sector and all other sub-sectors so written off should also be subtracted category wise from priority sector and sub-target achievement.

All types of loans, investments or any other items which are treated as eligible for classification under priority sector target/sub-target achievement should also form part of Adjusted Net Bank Credit.

23.4 ADJUSTMENTS FOR WEIGHTS IN PSL ACHIEVEMENT

For addressing regional disparities in the flow of priority sector credit at the district level, various districts have been ranked on the basis of per capita credit flow to priority sector, and a framework has been designed with incentive for districts with comparatively lower flow and dis-incentives for districts with comparatively higher flow. From FY 2021-22 onwards following weights apply to the incremental priority sector credit -

i. Identified districts with comparatively lower credit flow (per capita PSL less than ₹6000),- 125%
ii. (ii)Identified districts with comparatively higher credit flow (per capita PSL greater than ₹25,000) – 90%
iii. All other districts – 100%

These lists will be reviewed post FY 2023-24.

The reporting by banks is of the actual figures and the adjustment for weights is done by RBI. RRBs, UCBs, LABs and foreign banks (including WoS) are exempted from adjustments of weights in PSL achievement due to their currently limited area of operation/catering to a niche segment.

23.5 DEFINITIONS/ CLARIFICATIONS

i. *On-lending*: Loans sanctioned by banks to eligible intermediaries for onward lending only for creation of priority sector assets. The average maturity of priority sector assets thus created should be broadly co-terminus with maturity of the bank loan.
ii. *Contingent liabilities/ off-balance sheet items* do not form part of priority sector target achievement. However, foreign banks with less than 20 branches have an option to reckon the credit equivalent of off-balance sheet items, extended to borrowers for eligible priority sector activities, along with priority sector loans for the purpose of computation of priority sector target achievement. In that case, the credit equivalent of all off-balance sheet items (both priority sector and non-priority sector excluding interbank) should be added to the ANBC in the denominator for computation of Priority Sector Lending targets.
iii. *Off-balance sheet interbank exposures* are excluded for computing Credit Equivalent of Off -Balance Sheet Exposures for the priority sector targets.
iv. The term "*all-inclusive interest*" includes interest (effective annual interest), processing fees and service charges.
v. Banks should ensure that loans extended under priority sector are for approved purposes and the end use is continuously monitored. The banks should put in place proper internal controls and systems in this regard.

23.6 MICRO, SMALL AND MEDIUM ENTERPRISES

Bank loans to Micro, Small and Medium Enterprises (MSMEs), for both manufacturing and service sectors are eligible to be classified under the priority sector subject to the prescribed norms. These are given in the description of the eligible categories under Priority Sector.

Classification of Enterprises: The criteria for classification of MSMEs was revised with effect from 1st July 2020 vide Gazette Notification S.O. 2119 (E) dated June 26, 2020. The criteria are as under:

An enterprise shall be classified as a Micro, Small or Medium enterprise on the basis of the following criteria, namely:

i. ***a micro enterprise***, where the investment in plant and machinery or equipment does not exceed one crore rupees and turnover does not exceed five crore rupees;
ii. ***a small enterprise***, where the investment in plant and machinery or equipment does not exceed ten crore rupees and turnover does not exceed fifty crore rupees; and
iii. ***a medium enterprise***, where the investment in plant and machinery or equipment does not exceed fifty crore rupees and turnover does not exceed two hundred and fifty crore rupees.

All enterprises are required to register online and obtain 'Udyam Registration Certificate'. All lenders may, therefore, obtain 'Udyam Registration Certificate' from the entrepreneurs.

Composite Criteria of Investment and Turnover for Classification: A composite criterion of investment and turnover shall apply for classification of an enterprise as micro, small or medium.

i. If an enterprise crosses the ceiling limits specified for its present category in either of the two criteria of investment or turnover, it will cease to exist in that category and be placed in the next higher category but no enterprise shall be placed in the lower category unless it goes below the ceiling limits specified for its present category in both the criteria of investment as well as turnover.
ii. All units with Goods and Services Tax Identification Number (GSTIN) listed against the same Permanent Account Number (PAN) shall be collectively treated as one enterprise and the turnover and investment figures for all of such entities shall be seen together and only the aggregate values will be considered for deciding the category as micro, small or medium enterprise.

Calculation of investment in plant and machinery or equipment: The norms for the purpose of arriving at investment in plant and machinery or equipment are:

i. The calculation of investment in plant and machinery or equipment will be linked to the Income Tax Return (ITR) of the previous years filed under the Income Tax Act, 1961.
ii. In case of a new enterprise, where no prior ITR is available, the investment will be based on self- declaration of the promoter of the enterprise and such relaxation shall end after the 31st March of the financial year in which it files its first ITR.
iii. The expression "plant and machinery or equipment" of the enterprise, shall have the same meaning as assigned to the plant and machinery in the Income Tax Rules, 1962

framed under the Income Tax Act, 1961 and shall include all tangible assets (other than land and building, furniture and fittings).

iv. The purchase (invoice) value of a plant and machinery or equipment, whether purchased first hand or second hand, shall be taken into account excluding Goods and Services Tax (GST), on self- disclosure basis, if the enterprise is a new one without any ITR.

v. The cost of certain items specified in the Explanation I to sub-section (1) of section 7 of the Act shall be excluded from the calculation of the amount of investment in plant and machinery.

vi. The online form for Udyam Registration captures depreciated cost as on 31st March each year of the relevant previous year. Therefore, the value of Plant and Machinery or Equipment for all purposes of the Notification No. S.O. 2119(E) dated June 26, 2020 and for all the enterprises shall mean the Written Down Value (WDV) as at the end of the Financial Year as defined in the Income Tax Act and not cost of acquisition or original price, which was applicable in the context of the earlier classification criteria.

Calculation of turnover: The norms for the purpose of arriving at the turnover of an enterprise during a year are:

i. Exports of goods or services or both, shall be excluded while calculating the turnover of any enterprise whether micro, small or medium, for the purposes of classification.

ii. Information as regards turnover and exports turnover for an enterprise shall be linked to the Income Tax Act or the Central Goods and Services Act (CGST Act) and the GSTIN.

iii. The turnover related figures of such enterprise which do not have PAN will be considered on self- declaration basis for a period up to 31st March, 2021 and thereafter, PAN and GSTIN shall be mandatory.

In case of an upward change in terms of investment in plant and machinery or equipment or turnover or both, and consequent re-classification, an enterprise will maintain its prevailing status till expiry of one year from the close of the year of registration. In case of reverse-graduation of an enterprise, whether as a result of re-classification or due to actual changes in investment in plant and machinery or equipment or turnover or both, and whether the enterprise is registered under the Act or not, the enterprise will continue in its present category till the closure of the financial year and it will be given the benefit of the changed status only with effect from 1st April of the financial year following the year in which such change took place.

23.7 COMMON GUIDELINES / INSTRUCTIONS FOR LENDING TO MSME SECTOR

Certain salient guidelines for handling loan applications from MSMEs are as follows -

i. *Acknowledgement of Loan Applications*: To mandatorily acknowledge all loan applications and ensure a running serial number is recorded. To put in place a system of Central Registration, online submission of loan applications, and a system of e-tracking of MSE loan applications.

ii. *Collateral*: Not to accept collateral security in the case of loans up to ₹10 lakhs to units in the MSE sector, and units financed under the Prime Minister Employment Generation Programme (PMEGP) administered by KVIC. On the basis of good track record and financial position of the MSE units, increase the limit for collateral free loans up to ₹25 lakhs (with the approval of the appropriate authority).
iii. *Composite loan*: A composite loan limit of ₹1 crore can be sanctioned by banks to enable the MSE entrepreneurs to avail of their working capital and term loan requirement through Single Window.
iv. *Revised General Credit Card (GCC) Scheme*: To ensure greater credit linkage for all productive activities within the overall Priority Sector guidelines and to capture all credit extended by banks to individuals for non-farm entrepreneurial activity, the GCC guidelines were revised on December 2, 2013.
v. *Delayed Payment*: In view of the provisions of the Interest on Delayed Payment Act, 1998 to Small Scale and Ancillary Industrial Undertakings, banks have been advised to fix sub-limits within the overall working capital limits to the large borrowers specifically for meeting the payment obligation in respect of purchases from MSMEs.
vi. *Credit Linked Capital Subsidy Scheme (CLSS):* Government of India, Ministry of Micro, Small and Medium Enterprises had launched Credit Linked Capital Subsidy Scheme (CLSS) for Technology Upgradation of Micro and Small Enterprises. SIDBI and NABARD are the implementing agencies of the scheme.
vii. *Credit Guarantee Scheme*: Banks are advised to strongly encourage their branch level functionaries to avail of the Credit Guarantee Scheme cover of CGTMSE.

23.8 FRAMEWORK FOR REVIVAL AND REHABILITATION OF MSMES

The guidelines on the Framework for Revival and Rehabilitation of MSMEs were issued on March 17, 2016. This is applicable for MSME units having loan limits up to Rs.25 crore. The salient features of the Framework are as under:

i. Before a loan account of an MSME turns into a Non-Performing Asset (NPA), banks or creditors should identify incipient stress in the account by creating three sub-categories under the Special Mention Account (SMA) category as given in the Framework
ii. Any MSME borrower may also voluntarily initiate proceedings under this Framework
iii. Committee approach to be adopted for deciding corrective action plan
iv. Timelines have been fixed for taking various decisions under the Framework.

23.9 WEAKER SECTIONS UNDER PRIORITY SECTOR

Priority sector loans to the following borrowers are considered under Weaker Sections category:

i. Small and Marginal Farmers
ii. Artisans, village and cottage industries where individual credit limits do not exceed ₹1 lakh
iii. Beneficiaries under Government Sponsored Schemes such as National Rural Livelihood Mission (NRLM), National Urban Livelihood Mission (NULM) and Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS)

iv. Scheduled Castes and Scheduled Tribes
v. Beneficiaries of Differential Rate of Interest (DRI) scheme
vi. Self Help Groups
vii. Distressed farmers indebted to non-institutional lenders
viii. Distressed persons other than farmers, with loan amount not exceeding ₹1 lakh per borrower to prepay their debt to non-institutional lenders
ix. Individual women beneficiaries up to ₹1 lakh per borrower (For UCBs, existing loans to women will continue to be classified under weaker sections till their maturity/repayment.)
x. Persons with disabilities
xi. Minority communities as may be notified by Government of India from time to time.

Overdraft availed by PMJDY account holders as per limits and conditions prescribed by Department of Financial Services, Ministry of Finance from time to time may be classified under Weaker Sections.

In States, where one of the minority communities notified is, in fact, in majority, item (xi) will cover only the other notified minorities. These States/ Union Territories are Punjab, Meghalaya, Mizoram, Nagaland, Lakshadweep and Jammu & Kashmir.

23.10 INVESTMENTS BY BANKS IN SECURITISED ASSETS

11.1 Investments by banks in securitised assets, representing loans to various categories of priority sector, except 'others' category, are eligible for classification under respective categories of priority sector depending on the underlying assets provided:

i. these are originated by banks and financial institutions, are eligible priority sector advances, and fulfill RBI guidelines on securitisation.
ii. the all-inclusive interest charged to the ultimate borrower by the originating entity should not exceed the investing bank's MCLR + 10% or EBLR + 14%.
iii. The securitised assets originated by MFIs, which comply with the prescribed guidelines are exempted from this interest cap.
iv. Investments by banks in securitised assets originated by NBFCs, of loans against gold jewellery, are not eligible for priority sector status.

23.11 TRANSFER OF ASSETS THROUGH DIRECT ASSIGNMENT /OUTRIGHT PURCHASE

Assignment/ outright purchase of pool of assets by banks representing loans under various categories of priority sector, except the 'others' category, will be eligible for classification under respective categories of priority sector provided:

i. The assets are originated by banks and financial institutions, are eligible priority sector advances and fulfil the guidelines on outright purchase/assignment issued vide circular DBOD.No.BP.BC-103/21.04.177/2011-12 dated May 7, 2012 and updated from time to time.

ii. The all-inclusive interest charged to the ultimate borrower by the originating entity should not exceed the investing bank's MCLR + 10% or EBLR + 14%.
iii. Assignments/ Outright purchases of eligible priority sector loans from MFIs, as per RBI guidelines, are exempted from this interest rate cap.
iv. For loan assets purchased outright from banks/ financial institutions, banks must report the outstanding amount actually disbursed to borrowers and not include the embedded premium amount paid to the seller.
v. Purchase/ assignment transactions with NBFCs, for loans against gold jewellery, are not eligible for priority sector status.

This is not available to RRBs and UCBs.

23.12 INTER BANK PARTICIPATION CERTIFICATES

Inter Bank Participation Certificates (IBPCs) bought by banks, on a risk sharing basis, are eligible for classification under respective categories of priority sector, provided the underlying assets are eligible to be categorized under the respective categories of priority sector and the banks fulfil the RBI guidelines on IBPCs. IBPCs bought by banks on risk sharing basis relating to 'Export Credit' may be classified as priority sector by the purchasing bank, if the issuing bank certifies it as Export Credit, apart from the due diligence of the purchasing bank. This is not available to UCBs.

23.13 PRIORITY SECTOR LENDING CERTIFICATES

The outstanding priority sector lending certificates bought by the banks will be eligible for classification under respective categories of priority sector provided the assets are originated by banks, are eligible priority sector advances and fulfill the RBI guidelines on priority sector lending certificates.

23.14 BANK LOANS FOR ON-LENDING

A. To Micro Finance Institutions (MFIs)

Banks extend loans to micro finance institutions (MFIs) for on-lending to individuals availing small loans for pursuit of income generating activities.

a) Banks other than SFBs can extend credit to registered NBFC-MFIs and other MFIs (Societies, Trusts etc.) which are members of RBI recognised SRO for the sector, for on-lending to individuals and also to members of SHGs / JLGs.
b) AS a temporary measure, with effect from May 5, 2021, SFBs were allowed to extend fresh credit to registered NBFC-MFIs and other MFIs (Societies, Trusts etc.) which are members of RBI recognised 'Self-Regulatory Organisation' of the sector, and which have a 'gross loan portfolio' of up to ₹500 crore as on 31 March 2021, for the purpose of on-lending to individuals. Bank credit as above was permitted up to 10% of the bank's total priority sector portfolio as on 31 March, 2021. This was available up to March 31, 2022. The loans thus disbursed will continue to be classified under Priority Sector till the date of repayment/maturity whichever is earlier.
c) The loans disbursed under the above mechanisms are eligible for categorisation as priority sector advance under respective categories viz., Agriculture, MSME, Social Infrastructure and Others.

This mode is not applicable to RRBs, UCBs, SFBs and LABs.

B. To Non-Banking Finance Companies (NBFCs)

Bank credit to registered NBFCs (other than MFIs) for on-lending is eligible for classification as priority sector under respective categories subject to the following conditions:

i. Agriculture: On-lending by NBFCs for 'Term lending' component under Agriculture will be allowed up to ₹ 10 lakh per borrower.
ii. Micro & Small enterprises: On-lending by NBFC will be allowed up to ₹ 20 lakh per borrower.

The above dispensation was valid up to March 2022. However, loans disbursed under the on-lending model will continue to be classified under Priority Sector till the date of repayment/ maturity. This mode was not applicable to RRBs, UCBs, SFBs and LABs.

C. To Housing Finance Companies (HFCs)

Bank credit to Housing Finance Companies (HFCs), approved by NHB for their refinance, for on-lending for the purpose of purchase/construction/ reconstruction of individual dwelling units or for slum clearance and rehabilitation of slum dwellers, subject to an aggregate loan limit of ₹20 lakh per borrower. Banks should maintain necessary borrower-wise details of the underlying portfolio.

This mode is not applicable to RRBs, SFBs and LABs .

Bank credit to NBFCs (including HFCs) for on-lending as stated above, is allowed up to an overall limit of five percent of individual bank's total priority sector lending. Banks shall compute the eligible portfolio under on-lending mechanism by averaging across four quarters, to determine adherence to the prescribed cap.

23.15 CO-LENDING BY BANKS AND NBFCS TO PRIORITY SECTOR

All Scheduled Commercial Banks (excluding SFBs, RRBs, UCBs and LABs) are permitted to co-lend with all registered Non-Banking Financial Companies (including Housing Finance Companies) for lending to the priority sector. For the sake of business continuity and to ensure uninterrupted flow of credit to the priority sector, banks were permitted to continue arrangement as per earlier RBI guidelines on co-origination.

23.16 NON-ACHIEVEMENT OF PRIORITY SECTOR TARGETS

Compliance of banks with priority sector targets is monitored on 'quarterly' basis. The data on priority sector advances has to be furnished by banks at quarterly and annual intervals as per the reporting formats prescribed. Following measures are taken in case of any shortfall in achieving the priority sector targets.

i. Banks are allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD and other funds with NABARD/NHB/SIDBI/ MUDRA Ltd., as decided by the RBI from time to time. With effect from March 31, 2021, this is applicable to all UCBs (excluding those under all-inclusive directions).

ii. While computing priority sector target achievement, shortfall / excess lending for each quarter is monitored separately. A simple average of all quarters is arrived at and considered for computation of overall shortfall / excess at the end of the year. The same method is followed for calculating the achievement of priority sector sub-targets.

iii. The interest rates on banks' contribution to RIDF or any other funds, tenure of deposits, etc. is fixed by RBI from time to time.

iv. The mis-classifications reported by the RBI's Department of Supervision (DoS) is adjusted/ reduced from the achievement of that year, to which the amount of misclassification pertains, for allocation to various funds in subsequent years.

v. Non-achievement of priority sector targets and sub-targets is taken into account while granting regulatory clearances/approvals for various purposes.

23.17 LET US SUM UP

There are eight major categories of priority sectors for bank finance categorisation. Different targets have been stipulated for Domestic commercial banks (excl. RRBs & SFBs) & foreign banks with 20 branches and above; Foreign banks with less than 20 branches; Regional Rural Banks; and Small Finance Banks; and Primary Urban Co-operative Banks. Loans to certain borrowers are considered under Weaker Sections category. Compliance of banks with priority sector targets is monitored on 'quarterly' basis.

Various districts have been ranked on the basis of per capita credit flow to priority sector for incentivizing for districts with lower flow and dis-incentivising for districts with higher flow.
The criteria for classification of MSMEs is now based on the investment in plant and machinery or equipment and turnover. All enterprises are required to obtain 'Udyam Registration Certificate'. Certain guidelines have been laid down for handling loan applications from MSME, and for Revival and Rehabilitation of MSMEs.

23.18 KEY WORDS

Priority sectors; Net Bank Credit (NBC); Adjusted Net Bank Credit (ANBC); Credit Equivalent of Off Balance Sheet Exposures (CEOBE); On-lending; Securitised assets; Outright purchase of pool; Assignment of pool; Inter Bank Participation Certificates (IBPCs); Micro-finance Institutions; Rural Infrastructure Development Fund (RIDF).

23.19 CHECK YOUR PROGRESS

1) For foreign banks operating in India with more than 20 branches the exposure to priority sectors including small and micro industries should be at least___% of ANBC by 2020.
   a) 10
   b) 18
   c) 32
   d) 40

2) As per definition of micro enterprises one of the criteria is ________.
   a) Investment in plant and machinery/ equipment is up to ₹ 5 crore
   b) Turnover is up to ₹ 5 crore

c) Investment in plant and machinery/ equipment is up to ₹10 crore
d) Turnover is up to ₹10 crore

3) Achievement of priority sectors targets is monitored on ______ basis.
   a) quarterly
   b) yearly
   c) monthly
   d) half-yearly

23.20 KEY TO 'CHECK YOUR PROGRESS'

1(d); 2(b); 3(a).

References:

1. RBI Master Directions – Priority Sector Lending (PSL) – Targets and Classification dated 4th September, 2020 (updated 26th October 2021). (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11959)
2. RBI Master Direction - Lending to Micro, Small & Medium Enterprises (MSME) Sector dated 24th July, 2017 (updated 25th April 2018). (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11060)
3. RBI Circular No. FIDD.MSME & NFS.BC.No.3/06.02.31/2020-21 dated July 2, 2020 - on Credit flow to Micro, Small and Medium Enterprises Sector (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11934)
4. RBI Circular FIDD.MSME & NFS.BC.No.4/06.02.31/2020-21 dated August 21, 2020 - New Definition of Micro, Small and Medium Enterprises – clarifications (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11951)
5. RBI Circular FIDD.MSME & NFS.BC.No.12/06.02.31/2021-22 dated June 25, 2021- New Definition of Micro, Small and Medium Enterprises (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12122)
6. RBI Circular FIDD.MSME & NFS.BC.No.13/06.02.31/2021-22 dated July 7, 2021- New Definition of Micro, Small and Medium Enterprises - Addition of Retail and Wholesale Trade (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12126)
7. RBI Circular FIDD.MSME & NFS.BC.No.16/06.02.31/2021-22 dated February 18, 2022 - New Definition of Micro, Small and Medium Enterprises - Clarification (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12233)

CHAPTER 24

INTEREST RATES ON ADVANCES

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Learn about the regulatory framework for determining interest rates on advances
- Understand the concept of Marginal cost of funds
- Learn about external benchmarks for linking interest rates

24.1 INTRODUCTION

After the interest rates to be charged by banks on advances were deregulated by the RBI, normative regulations were issued by RBI containing the basic principles for the framework to determine the interest rates for various loan products. These regulations have over the period undergone several changes. The initial approach was based on the Prime Lending Rate as an internal benchmark. Banks were then advised to switch over to the system of Base Rate with effect from July 1, 2010. The Base Rate system was aimed at enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy. In December 2015 This was further modified to adopt Marginal Cost of Funds Based Lending Rate (MCLR) as internal benchmark. Further modifications have been done to encourage switching over to external benchmark for lending rates.

24.2 DEFINITIONS

i. Benchmark Prime Lending Rate (BPLR) means internal benchmark rate used to determine the interest rates on advances/loans sanctioned up to June 30, 2010.
ii. Benchmark rate means the reference rate used to determine the interest rates on loans.
iii. External benchmark rate means the reference rate published by an independent benchmark administrator.
iv. Fixed rate loan means a loan on which the interest rate is fixed for the entire tenor of the loan.
v. Floating rate loans means a loan on which interest rate does not remain fixed during the tenor of the loan.
vi. Internal benchmark rate means a reference rate determined internally by the bank.
vii. Rests refers to periodicity of charging interest to borrowers.
viii. Term loan means a loan which is repayable after a specified term period.

24.3 GENERAL GUIDELINES

A. Interest Rate Framework

RBI has issued guidelines to the Scheduled commercial banks to charge interest on advances on the terms and conditions specified in those directions. The general norms required to be followed are enumerated below. These are also applicable to Rupee advances granted against FCNR(B) deposits to a third party or out of resources mobilized under the FCNR(B) scheme.

i. Banks should have a comprehensive policy on interest rates on advances.
ii. All floating rate loans, except those excluded, shall be priced with reference to the benchmark as indicated by the RBI.
iii. Banks are permitted to offer all categories of advances on fixed or floating interest rates.

iv. For the floating rate linked to an internal benchmark, the lending rate should be arrived at by adding the components of spread to the internal benchmark rate.
v. The reference benchmark rate for pricing the loans should be stated in the loan contract.
vi. Interest rates on fixed rate loans of tenor below 3 years shall not be less than the benchmark rate for similar tenor, and shall be as per applicable directions.
vii. Interest shall be charged on all advances at monthly rests. For agricultural advances and advance to farmers the rates are to be determined as per the respective norms.
viii. Interest chargeable on rupee advances shall be rounded off to the nearest rupee.
ix. Interest charged on small value loans, particularly, personal loans and such other loans of similar nature shall be justifiable having regard to the total cost incurred by the bank in extending the loan and the extent of return that could be reasonably expected from the transaction.
x. In case of takeover of bank branches in rural and semi urban centres from one commercial bank to another commercial bank, transfer of borrowal accounts of the existing branch to the branch of acquiring bank shall be on mutually agreed terms of contract. The existing borrowers shall not be put into any disadvantage and shall have the option of continuing with the existing bank or the acquiring bank.
xi. There shall be no lending below the benchmark rate for a particular maturity for all loans linked to that benchmark.
xii. Banks shall formulate a Board approved policy for charging penal interest on advances which shall be fair and transparent. Penal interest may be levied for reasons such as default in repayment, non-submission of financial statements, etc. However, the policy on penal interest should be governed by well-accepted principles of transparency, fairness, incentive to service the debt and genuine difficulties of customers. The rate of penal interest shall be decided after taking into account incentive to service the debt and due regard to genuine difficulties of customers. Currently (as at end- March 2022), no penal interest should be charged by banks for loans under priority sector up to Rs 25,000.

24.4 MARGINAL COST OF FUNDS BASED LENDING RATE

a) Internal Benchmark

i. All rupee loans sanctioned and credit limits renewed w.e.f. April 1, 2016 are being priced with reference to the Marginal Cost of Funds based Lending Rate (MCLR) which is the internal benchmark for such purposes. Where external benchmark rate is required to be adopted, such advances are excluded.
ii. The MCLR comprises the following components:
    a. Marginal cost of funds: This is determined from marginal cost of borrowings and return on net worth.
    b. Negative carry on account of CRR: As the cash reserves do not earn any interest, the negative carry on the mandatory CRR is determined based on the computed marginal cost of funds.
    c. Operating costs: All operating costs associated with providing the loan product including cost of raising funds will be included in this. Costs of providing

those services which are separately recovered by way of service charges should be excluded.

d. Tenor premium: These costs arise from loan commitments with longer tenor. This will be uniform for all types of loans for a given residual tenor, and also will not be borrower specific.

iii. MCLR is a tenor linked benchmark, and the MCLR of a particular maturity is arrived at by adding the corresponding tenor premium.

iv. Banks are required to publish the internal benchmark at least for the following maturities, and may publish it for longer maturities:
   a. overnight MCLR,
   b. one-month MCLR,
   c. three-month MCLR,
   d. six-month MCLR,
   e. One year MCLR.

b) Spread

i. Banks should have a Board approved policy delineating the components of spread to be charged to a customer. The policy shall include these principles:
   a. To determine the quantum of each component of spread.
   b. To determine the range of spread for a given category of borrower/type of loan.
   c. To delegate powers in respect of loan pricing.

ii. For uniformity all banks shall adopt the following broad components of spread:
   a. Business strategy: This will be based on the business strategy, market competition, embedded options in the loan product, market liquidity of the loan, etc.
   b. Credit risk premium: This represents the default risk and should be arrived at based on credit risk rating/scoring model and taking into consideration customer relationship, expected losses, collaterals, etc.

iii. The spread for an existing borrower should not be increased except on deterioration in the credit risk profile of the customer. Any change in spread on change in credit risk profile should be supported by a full-fledged risk profile review of the customer. This is not applicable to loans under consortium/multiple banking arrangements.

c) Interest Rates on Loans

i. Actual lending rates will be determined by adding the components of spread to the MCLR. Accordingly, there will be no lending below the MCLR of a particular maturity for all loans linked to that benchmark.

ii. The reference benchmark rate used for pricing the loans should form part of the terms of the loan contract.

d) Review of MCLR

Banks need to review and publish Marginal Cost of Funds based Lending Rate (MCLR) of different maturities every month on a pre-announced date approved by the Board/any other committee authorized.

e) Reset of interest rates

i. To specify interest reset dates on their floating rate loans. Reset dates may be linked either to the date of loan sanction or to the date of review of MCLR.
ii. MCLR prevailing on the date of first disbursement, whether partial or full, shall be applicable till the next reset date, irrespective of the changes in the benchmark during the interim. Future reset dates shall be determined accordingly.
iii. The periodicity of reset shall be one year or lower, and the exact periodicity of reset shall form part of the terms of the loan contract.

24.5 EXEMPTIONS

The following types of loans are exempted from the norms of linking to the internal benchmark:

i. Loans covered by schemes specially formulated by Government of India having specific interest rates.
ii. Working Capital Term Loan (WCTL), Funded Interest Term Loan (FITL), etc. granted as part of the rectification/restructuring package.
iii. Loans granted under refinance schemes of Government of India or any Government Undertakings with prescribed interest rates to the extent refinance is available. Interest rate on the part not covered under refinance should adhere to the MCLR guidelines.
iv. Following categories of loans:
   a. Advances to banks' depositors against their own deposits.
   b. Advances to banks' own employees including retired employees.
   c. Advances granted to the Chief Executive Officer/ Whole Time Directors.
   d. Loans linked to a market determined external benchmark. (floating rate loans based on external benchmark sanctioned before April 01, 2016 shall be equal to or above the Base Rate at the time of sanction or renewal)
   e. Fixed rate loans of tenure above three years. Provided that in case of hybrid loans where the interest rates are partly fixed and partly floating, interest rate on the floating portion shall not be exempted from MCLR system.
   Provided further that interest rates for fixed rate loans (including fixed rate portion of hybrid loans) of tenor up to three years shall not be less than the sum of following:
      i. Marginal Cost of Funds
      ii. Negative Carry on CRR
      iii. Operating Cost
      iv. Tenor premium for corresponding maturity on the date of sanction

24.6 EXTERNAL BENCHMARK

An Internal Study Group (ISG) of RBI that reviewed the MCLR system recommended switching over to external benchmark based rate in a phased manner. In September 2019, RBI issued instructions for linking certain categories of loans to one of the prescribed external benchmarks, with effect from October 1, 2019.

A. Basic Norms for External Benchmark Based Rates

a) All new floating rate personal or retail loans (housing, auto, etc.) and floating rate loans extended to Micro and Small Enterprises from October 01, 2019 and floating rate loans to Medium Enterprises from April 01, 2020 are benchmarked to one of the following:
   i) Reserve Bank of India policy repo rate
   ii) Government of India 3-Months Treasury Bill yield published by the Financial Benchmarks India Private Ltd. (FBIL)
   iii) Government of India 6-Months Treasury Bill yield published by the FBIL
   iv) Any other benchmark mark interest rate published by the FBIL.
b) Banks are free to offer such external benchmark linked loans to other types of borrowers as well.
c) In order to ensure transparency, standardisation, and ease of understanding of loan products by borrowers, a bank must adopt a uniform external benchmark within a loan category; in other words, the adoption of multiple benchmarks by the same bank is not allowed within a loan category.

B. Transition to External Benchmarks from MCLR/Base Rate/ BPLR

a) Existing loans and credit limits linked to the MCLR/Base Rate/BPLR shall continue till repayment or renewal, as the case may be.
b) Floating rate term loans sanctioned to borrowers who are eligible to prepay a floating rate loan without pre-payment charges, shall be eligible for switchover to External Benchmark without any charges/fees, except reasonable administrative/ legal costs. The final rate charged to this category of borrowers, post switchover to external benchmark, shall be same as the rate charged for a new loan of the same category, type, tenor and amount, at the time of origination of the loan.
c) Other existing borrowers shall have the option to move to External Benchmark at mutually acceptable terms.
d) The switch-over shall not be treated as a foreclosure of existing facility.

24.7 FOREIGN CURRENCY ADVANCES

Banks are free to determine the interest rates on advances in foreign currency as per their comprehensive policy. These rates should be with reference to a market determined external benchmark. The actual lending rates shall be determined by adding the components of spread to the external benchmark.

For a long time, LIBOR (London Interbank Offered Rate) was an international benchmark for all contracted interest rates whether on financial or commercial transactions. Even under FEMA for several transactions related to Trade Credit or External Commercial Borrowings, RBI regulations used LIBOR as a reference rate. After it was detected that LIBOR was being rigged by the banks that jointly determined it, it was decided to discontinue LIBOR. This has led to a situation that there was no ready substitute that could be used.

RBI permitted AD banks to use any other widely accepted/ Alternative reference rate in the currency concerned for such transactions. These include:

i. Pre-shipment Credit in Foreign Currency (PCFC)
ii. Advance Payment received for exports
iii. Export/ Import Transactions

Roadmap for LIBOR Transition

In August 2020, RBI had advised banks to frame a Board-approved plan for adoption of Alternative Reference Rates (ARR) in lieu of LIBOR. The Financial Conduct Authority (FCA), UK announced on March 05, 2021 that LIBOR will either cease to be provided by any administrator or no longer be a representative rate:

a) Immediately after December 31, 2021, in the case of all Pound sterling, Euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month US dollar settings; and
b) Immediately after June 30, 2023, in the case of the remaining US dollar settings.

In July 2021, banks were therefore advised as follows:

i. To cease, and also encourage their customers to cease, entering into new financial contracts that reference LIBOR as a benchmark and instead use any widely accepted ARR at the latest by 31st December 2021.
ii. After December 31, 2021, contracts referencing LIBOR may generally be undertaken only for managing risks arising out of LIBOR contracts (e.g. hedging contracts, novation, market-making in support of client activity, etc.), contracted on or before December 31, 2021.
iii. To incorporate robust fallback clauses, preferably well before the respective cessation dates, in all financial contracts that reference LIBOR and the maturity of which is after the announced cessation date of the respective LIBOR settings.
iv. To ensure that new contracts entered into before December 31, 2021 that reference LIBOR and maturity of which is after the date on which LIBOR ceases or become non-representative include fallback clauses.
v. Banks may refer to the standard fallback clauses developed by various agencies such as International Swaps and Derivatives Association, Indian Banks' Association, Loan Markets' Association, Asia Pacific Loan Markets Association and Bankers Association for Finance & Trade.
vi. To cease using the Mumbai Interbank Forward Outright Rate (MIFOR), published by the Financial Benchmarks India Pvt. Ltd (FBIL), which references the LIBOR latest by December 31, 2021. FBIL has started publishing daily adjusted MIFOR rates from June 15, 2021 and modified MIFOR rates from June 30, 2021 which could be used for legacy contracts and fresh contracts respectively.
vii. After December 31, 2021, banks may trade in MIFOR only for certain specific purposes such as transactions executed to support risk management activities such as hedging, required participation in central counterparty procedures (including transactions for hedging the consequent MIFOR exposure), market-making in support of client activities or novation of MIFOR transactions in respect of transactions executed on or before December 31, 2021.

Banks were also advised to take following strategic measures:

i. Banks/ financial institutions were asked to undertake a comprehensive review of all direct and indirect LIBOR exposures and put in place a framework to mitigate risks arising from such exposures on account of transitional issues including valuation and contractual clauses.

ii. They were also required to put in place the necessary infrastructure to be able to offer products referencing the ARR.

iii. They were required to make continued efforts to sensitise clients about the transition as well as the methodology and convention changes involved in the alternatives to LIBOR.

24.8 LET US SUM UP

Banks should have a comprehensive policy on interest rates on advances. Banks are permitted to offer all categories of advances on fixed or floating interest rates. There shall be no lending below the benchmark rate for a particular maturity for all loans linked to that benchmark. Marginal Cost of Funds based Lending Rate (MCLR) is the internal benchmark. Banks need to review and publish Marginal Cost of Funds based Lending Rate (MCLR) of different maturities every month. Banks may adopt external bench mark for certain advances. Banks are free to determine the interest rates on advances in foreign currency as per their comprehensive policy. With phasing out of LIBOR banks may use any Alternative Reference Rate for benchmarking of interest rate on foreign currency advances.

24.9 KEY WORDS

Marginal Cost of Funds Based Lending Rate (MCLR); external benchmark; Benchmark Prime Lending Rate (BPLR); Rests; Floating rate; Fixed rate; Negative carry; Operating costs; Tenor premium; Credit risk premium; Financial Benchmarks India Private Ltd. (FBIL); Alternative reference rate.

24.10 CHECK YOUR PROGRESS

1) Banks are now required to price all rupee loans with reference to _______, an internal benchmark.
   a) Prime Lending Rate (PLR)
   b) Base Rate
   c) Marginal Cost based Lending Rate (MCLR)
   d) Advance Rate

2) Of the following, __________ is not a component of Marginal Cost based Lending Rate (MCLR).
   a) Marginal cost of funds
   b) Negative carry on account of CRR
   c) Operating cost
   d) Spread

3) Of the following, __________ is not exempted from being linked to MCLR.
   a) Working capital term loan

b) Loans against property
c) Advances against own fixed deposits
d) Funded interest term loan

24.11 KEY TO 'CHECK YOUR PROGRESS'

1 (c); 2 (d); 3 (b).

References:

1) Master Direction - Reserve Bank of India (Interest Rate on Advances) Directions, 2016 dated March 03, 2016 (Updated as on June 10, 2021) (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10295)
2) RBI Circulars on LIBOR Transition:
   i. RBI Circular CO.FMRD.DIRD.S39/14.02.001/2021-22 dated July 08, 2021 - Roadmap for LIBOR Transition (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12128)
   ii. RBI Circular DOR.DIR.REC.37/04.02.002/2021-22 dated August 6, 2021 - Export Credit in Foreign Currency – Benchmark Rate (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12139)
   iii. RBI Circular A.P. (DIR Series) Circular No.13 dated September 28, 2021 - Use of any Alternative reference rate in place of LIBOR for interest payable in respect of export / import transactions (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12168)
   iv. RBI Circular A.P. (DIR Series) Circular No. 19 dated December 08, 2021 - External Commercial Borrowings (ECB) and Trade Credits (TC) Policy – Changes due to LIBOR transition (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12204)

CHAPTER 25

PRUDENTIAL NORMS FOR INCOME RECOGNITION AND ASSET CLASSIFICATION AND WILFUL DEFAULTERS

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Learn about classification of assets
- Know about norms for recognition of income
- Understand the provisioning norms

25.1 BASIC ASPECTS

In line with the international practices, RBI introduced prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the banks. The fundamental principles of these norms are:

(i) The policy of income recognition should be objective and based on record of recovery.

(ii) Classification of assets of banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application.

(iii) Provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realisable value thereof

25.2 KEY TERMS

A. Non-Performing Asset (NPA)

An asset (including a leased asset) which ceases to generate income is treated as non-performing asset (NPA). NPA is a classification used by financial institutions that refer to loans that are in jeopardy of default. Non-performing assets are problematic for financial institutions since they depend on interest payments for income.

NPA Criteria: A non-performing asset (NPA) is a loan or an advance where an amount is overdue as per various criteria stated below;

i. For Term Loan: interest and/ or instalment of principal remains overdue for a period of more than 90 days,
ii. For an Overdraft/Cash Credit (OD/CC): the account remains 'out of order'
iii. For bills purchased and discounted: the bill remains overdue for a period of more than 90 days
iv. For agriculture loans: the instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,
v. For agriculture loans: the instalment of principal or interest thereon remains overdue for one crop season for long duration crops,
vi. For securitisation transaction (as per RBI Master Directions): the amount of liquidity facility remains outstanding for more than 90 days,
vii. For derivative transactions: if the overdue receivables (representing positive mark-to-market value of a derivative contract), remain unpaid for a period of 90 days from the specified due date for payment.

An account may also be classified as NPA in terms of certain specific provisions made in the RBI Master Circular.

'Out of Order' status:

a) For CC/OD Account: It is treated as 'out of order' if:
   i) The outstanding balance in the CC/OD account remains continuously in excess of the sanctioned limit/drawing power for 90 days, or
   ii) The outstanding balance in the CC/OD account is less than the sanctioned limit/drawing power but – either there are no credits continuously for 90 days, or the credits are not enough to cover the interest debited during the previous 90 days period.

b) Loan Products offered as an overdraft (even if not for business purpose) and entail interest repayments as the only credits: 'Out of order' criteria is applicable to them.

c) 'Overdue' status: Any amount due under any credit facility is 'overdue' if not paid on the due date fixed by the bank.

25.3 INCOME RECOGNITION

Income Recognition Policy: It should be objective and based on the record of recovery. The following norms apply for income recognition:

i. Income from NPA assets is to be recognized only when it is actually received, even in case of Government guaranteed accounts.

ii. Interest on advances against term deposits, NSC, IVPs, KVPs, and Life policies may be taken into income account on the due date, if adequate margin is available in the accounts.

iii. Fees and commissions earned as a result of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.

iv. For loans where moratorium has been granted for repayment of interest, income may be recognised on accrual basis for accounts which continue to be classified as 'standard'. This shall be evaluated against the definition of 'restructuring'.

v. Income recognition norms for: (a) loans towards projects under implementation involving deferment of Date of Commencement of Commercial Operations (DCCO) shall be subject to the related instructions; (b) loans against gold ornaments and jewellery for non-agricultural purposes where interest is charged at monthly rests and may be recognised on accrual basis provided the account is classified as 'standard' account.

Reversal of income: Apart from not recognizing income on a non-performing asset, there is also a need to reverse the unrealized income that was booked prior to the account being classified as NPA. The provisions for this are as follows:

i. On an account (including bills purchased and discounted and Government guaranteed accounts) turning NPA, the entire interest accrued and credited to income account in the past periods, if it is not realised should be reversed.

ii. If loans with moratorium on payment of interest (permitted at the time of sanction of the loan) become NPA after the moratorium period is over, the capitalized interest, if any, corresponding to the interest accrued during such moratorium period need not be reversed.

iii. For NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed with respect to past periods, if uncollected.

iv. Leased Assets - The finance charge component of finance income on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.

Appropriation of Recovery in NPAs: The following norms should be adopted:

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

ii. If there is no agreement between the bank and the borrower that the amount recovered is to be appropriated. towards principal or interest due, banks should adopt an accounting principle in a uniform and consistent manner and accordingly appropriate the recoveries.

Interest Application: In consonance with the income recognition and reversal of income norms, the interest already charged on a NPA account and not collected is reversed by debiting Profit and Loss account, also further application of interest is stopped. Such accrued interest may be recorded in a Memorandum account in the books. The amount in this account should not be reckoned for computing Gross Advances.

Computation of NPA Levels: Computation of Gross Advances, Net Advances, Gross NPAs and Net NPAs should be done as per the format given below.

Part A			
(Rs. in Crore up to two decimals)			
Particulars			**Amount**
1	Standard Advances		
2	Gross NPAs *		
3	Gross Advances ** (1+2)		
4	Gross NPAs as a percentage of Gross Advances (2/3) (in %)		
5	Deductions		
	(i)	Provisions held in the case of NPA Accounts as per asset classification (including additional Provisions for NPAs at	
	(ii)	DICGC / ECGC claims received and held pending	
	(iii)	Part payment received and kept in Suspense Account or any other similar account	

	(iv)	Balance in Sundries Account (Interest Capitalization - Restructured Accounts), in respect of NPA Accounts	
	(v)	Floating Provisions***	
6	Net Advances(3-5)		
7	Net NPAs {2-5(i + ii + iii + iv + v)}		
8	Net NPAs as percentage of Net Advances (7/6) (in %)		
*	Principal dues of NPAs plus Funded Interest Term Loan (FITL) where the corresponding contra credit is parked in Sundries Account (Interest Capitalization - Restructured Accounts), in respect of NPA Accounts.		
**	For the purpose of this Statement, 'Gross Advances' mean all outstanding loans and advances including advances for which refinance has been received but excluding rediscounted bills, and advances written off at Head Office level (Technical write off).		
***	Floating Provisions would be deducted while calculating Net NPAs, to the extent, banks have exercised this option, over utilising it towards Tier II capital.		

Part B		
Supplementary Details		
(Rs. in Crore up to two decimals)		
Particulars		**Amount**
1	Provisions on Standard Assets in Part A above	
2	Interest recorded as Memorandum Item	
3	Amount of cumulative Technical Write - Off in respect of NPA accounts reported in Part A above	

25.4 ASSET CLASSIFICATION

Categories of NPAs

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:

i. Sub-standard Assets: A sub-standard asset is one which has been classified as NPA for a period not exceeding 12 months. 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.

ii. Doubtful Assets: A doubtful asset is one which has remained NPA for a period exceeding 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.

iii. Loss Assets: A loss asset is one where loss has been identified by the bank, internal or external auditor or central bank inspectors but the amount has not been written off, wholly or partly. 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.

Guidelines for Classification of Assets

i. General: NPA classification should be done taking into account the degree of well-defined credit weaknesses.

ii. Appropriate internal systems for proper and timely identification of NPAs:
Appropriate internal systems (including technology enabled processes) should be set up for proper and timely identification of NPAs. The necessary infrastructure for compliance with the requirements of automation of Income Recognition, Asset Classification and Provisioning processes in banks.

iii. Availability of security / net worth of borrower/ guarantor: The availability of security or net worth of borrower/ guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise. It is used for limited purpose.

iv. Accounts with temporary deficiencies: The classification of an asset as NPA should be based on the record of recovery. But an advance account should not be classified as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. For such situations following guidelines apply:

a) Drawings in the working capital accounts should be covered by the adequacy of current assets, since current assets are first appropriated in times of distress. The drawing power should be based on current stock statement, in any case not older than three month old.

b) Outstanding in the account based on drawing power calculated from stock statements older than three months is considered irregular. If such irregular drawings remain for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

c) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. If delayed due to constraints, the renewal/ review process is continuing should be established. An account, where the regular/ ad hoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of ad hoc sanction, it will be treated as NPA.

v. Upgradation of loan accounts classified as NPAs: The loan accounts classified as NPAs may be upgraded as ‘standard’ asset only if entire arrears of interest and principal are paid by the borrower. When a borrower has more than one credit facility from a bank, loan accounts are upgraded from NPA to standard asset only upon repayment of entire arrears of interest and principal for all the credit facilities. For upgradation of accounts classified as NPA due to restructuring, non-achievement of date of commencement of commercial operations (DCCO), etc., the instructions as specified for such cases shall continue to be applicable.

vi. Accounts regularised near about the balance sheet date: Borrowal accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity in asset classification. If inherent weakness is noticed on the basis of the data available, the account should be deemed as a NPA. In genuine cases, satisfactory evidence should be furnished to the Statutory Auditors/ Inspecting Officers about the manner of regularisation of the account to eliminate doubts on their performing status.

vii. Asset Classification to be borrower-wise and not facility-wise: All the facilities granted to a borrower and investment in all the securities issued by the borrower will have to be treated as NPA/NPI and not just the particular facility/investment or part thereof which has become irregular. For certain specific situations NPA status is determined as indicated below.

a) *LC Devolvement/ Invoked Guarantees*: If the amounts paid are parked in a separate account, the balance outstanding in it is treated as a part of the borrower's principal operating account for IRAC and provisioning norms.

b) *Bills discounted under LC:* These may not be classified as a NPA when any other facility is classified as NPA. But, if documents under LC are not accepted on presentation or on the due date the LC issuing bank does not make payment under the LC; and the borrower does not immediately repay the amount disbursed, the outstanding amount should be classified as NPA, effective from the date other facilities were classified as NPA.

c) *Derivative Contracts*: In case of derivatives contract, the borrower is required to pay the positive mark-to-market value, and if it remains unpaid for 90 days after due date it is treated as NPA. So in case of forward contracts and plain vanilla swaps and options, if such receivables held separately become NPA, all other funded facilities are also classified as NPAs. If the borrower has CC/OD account such dues under derivatives should be debited to that account on the due date. If positive MTM value is required to be settled before maturity, only the current credit exposure amount is treated as NPA. On any amount becoming NPA, the unrealized income booked on accrual basis is also reversed by debiting the Profit and Loss account and parked in the suspense account. The positive MTM values pertaining to future receivables are debited to a suspense account for positive MTM values, and the amounts receivable or payable due to fluctuations in MTM values are settled through this account. When the borrower pays any overdue amount, equivalent amount is transferred from the suspense account to the P&L account. The MTM values for all the derivatives contracts of a borrower are dealt with in similar manner, if - some amount pertaining to any one derivative contract becomes NPA, or any fund-based facility becomes NPA.

d) Advances under consortium arrangements:

Asset classification of accounts under consortium is based on the record of recovery of the individual member banks; hence the NPA status with different member banks may be different. If all receipts are pooled with one bank, if it is not shared with other banks, the account will be treated as overdue/ NPA in the books of the other member banks. The consortium members should ensure sharing of receipts by the bank receiving the remittance.

e) Accounts where there is erosion in the value of security/frauds committed by borrowers:

Asset Classification: Accounts, for which recovery is in doubt due to erosion in the value of security or non-availability of security and other factors such as frauds by borrowers, need not go through various stages of asset classification. Such accounts are straightaway classified as doubtful or loss asset as appropriate:

- If the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection (significant erosion), the account is classified as doubtful asset.
- If the realisable value of the security is less than 10 per cent of the outstanding in the borrowal accounts, the account is classified as loss asset straight away.

Provisioning in case of Frauds: Following norms should be followed for making provisions in case of frauds:

- Immediately, on detecting a fraud, provision to be made for the entire amount due to the bank or for which the bank is liable, adjusted by any financial collateral available.
- The provisioning can be spread over next four quarters, in order to spread the impact on the quarterly results.
- If part of the provision to be made spills over to another financial year, the un-provided amount should be debited to 'Other Reserves' and credited to the provision account.

Following disclosures need to be made - number of frauds reported, amount involved in such frauds, quantum of provision made during the year and quantum of unamortised provision debited from 'other reserves' as at the end of the year.

f) *Advances to Primary Agricultural Credit Societies (PACS)/Farmers' Service Societies (FSS) ceded to Commercial Banks*: For all advances to PACs/ FSSs under the on-lending system, only that particular credit facility in default is classified as NPA, if the period of default is one season (long duration crops) or two seasons (short duration crops). Any direct loans/ advances granted outside the on-lending arrangement will become NPA even if one of the credit facilities to the same borrower becomes NPA.

g) *Advances against Term Deposits, NSCs, KVPs, etc.*: Such advances need not be treated as NPA, provided adequate margin is available in the accounts. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.

h) *Loans with moratorium for payment of interest*: For loans for industrial projects or agricultural plantations, the interest becomes due for payment on completion of the moratorium period. They become overdue after due date for payment of interest, if uncollected. For loans to staff (like housing loans) where the interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. These should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates.

i) *Agricultural advances*: The crop season (period up to harvesting of the crops raised) is determined by the State Level Bankers' Committee (SLBC). "Long duration" crops have crop season longer than one year; and crops which are not "long duration" crops, are treated as "short duration" crops. The loan is NPA if the instalment of principal or interest thereon remains overdue for one season for long duration crops; and two season for short duration crops. This applies only to Farm Credit extended to agricultural activities as specified under RBI guidelines. For all other Agricultural advances, the norms followed for non-agricultural loans are followed. In case of any natural calamity impairing the repayment capacity, if permitted restructuring or re-schedulement is done, the term loan as well as fresh short-term loan may be treated as current dues, and the asset classification will be based on the revised terms and conditions. The repayment schedule in case of rural housing advances granted to agriculturists under Indira Awas Yojana / Pradhan Mantri Gram Awas Yojana and Golden Jubilee Rural Housing Finance Scheme, banks should ensure that the interest/instalment payable on such advances are linked to crop cycles.

j) *Government guaranteed advances*: Any credit facility guaranteed by the Central Government is treated as NPA only when the Government repudiates its guarantee when invoked, and not when it becomes overdue, However, recognition of income is linked to the overdue status. In case of State Government guaranteed advances and investments in State Government guaranteed securities, the usual norms apply for both classification and income recognition.

k) *Projects under implementation*: Project finance have specific features of long construction phase (pre-operative phase), gestation period i.e. reaching break-even stage, long tenor of term loans, cost over runs, and time overruns. Hence application of the norms for asset classification and income recognition requires different treatment. In the context of project finance the 'Date of Commencement of Commercial Operations' is of significance. The DCCO of the project should be clearly mentioned at the time of financial closure and should be formally documented, including in the appraisal note of the bank. Various factors beyond the control of the promoters, may lead to delay in project implementation and involve restructuring / re-schedulement of loans by banks. Hence, specific norms for the stage before commencement of commercial operations, have been specified by RBI, separately for Project Loans for infrastructure sector, and Project Loans for non-infrastructure sector. Norms covering specifically following situations have been spelt out in the RBI Master Circular:
   - Deferment of DCCO and restructuring
   - Infrastructure Projects involving court cases

- Infrastructure Projects delayed for other reasons beyond the control of promoters
- Project Loans for Non-Infrastructure Sector (Other than Commercial Real Estate Exposures)
- Project Loans for Commercial Real Estate Exposures delayed for reasons beyond the control of promoter(s)
- Projects under Implementation – Change in Ownership
- Deemed DCCO
- Financing of Cost Overruns for Projects under Implementation
- Asset classification and Income recognition for projects under implementation relating to Deferment of DCCO and Cost Overruns

Briefly, the salient norms are given below.

- An infrastructure project loan would be classified as NPA before the date of commencement of commercial operations (DCCO) as per record of recovery (90 days) unless it is restructured and eligible for classification as standard asset.
- An infrastructure project would be classified as NPA if it fails to commence commercial operations within 2 years from the original DCCO.
- If a project loan classified as standard asset is restructured any time during the period up to two years from the original date of DCCO, it can be retained as a standard asset if the fresh DCCO is fixed within certain limit as under and the account continues to be serviced as per the restructured terms subject to the application for restructuring should be received before the expiry of period of two years from the original DCCO and when the account is still standard as per record of recovery.
- Delay in infrastructure projects involving court cases and projects in other than court cases, extension of DCCO up to another 2 years (beyond the existing extended period of 2 years i.e. total extension of 4 years) and up to another 1 year (beyond the existing extended period of 2 years i.e. total extension of 3 years) respectively is considered for treating them as NPA.
- A loan for a non-infrastructure project (Other than Commercial Real Estate Exposures) will retain the 'standard' asset classification, if the fresh DCCO is fixed up to another one year (beyond the one-year period permitted generally, i.e., total extension of two years).
- A loan for a project will be classified as NPA during any time before commencement of commercial operations as per record of recovery (90 days overdue).
- If the non-infrastructure project fails to commence commercial operations within 6 months from the original DCCO, it is to be treated as NPA, etc.

l) Post-shipment Supplier's Credit: Post-shipment credit covering export of goods to countries for which the Export Credit Guarantee Corporation's (ECGC) cover is available, EXIM Bank has introduced a guarantee-cum-refinance programme, under which EXIM Bank will pay the guaranteed amount. To the extent payment has been received from the EXIM Bank, the advance may not be treated as a NPA for asset classification and provisioning purposes.

m) Export Project Finance: There could be instances where the actual importer has paid the dues to the bank abroad but the bank in turn is unable to remit the amount due to political developments such as war, strife, UN embargo, etc. If it is established that the importer has cleared the dues in full by depositing the amount in the bank abroad before it turned into NPA in the books of the lending bank, the asset classification may be made after a period of one year from the date the amount was deposited by the importer in the bank abroad.

n) Transfer of Loan Exposures: The regulations laid down in Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 will apply.

o) Credit Card Accounts: These will be treated as non-performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the payment due date mentioned in the statement. These are to be reported as 'past due' to credit information companies (CICs) or levy penal charges, viz. late payment charges, etc., if any, only when a credit card account remains 'past due' for more than three days. The number of 'days past due' and late payment charges shall, however, be computed from the payment due date mentioned in the credit card statement.

25.5 PROVISIONING NORMS

General: The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank management and the statutory auditors. In conformity with the prudential norms, provisions should be made on the non-performing assets on the basis of classification of assets into prescribed categories. The factors taken into account are –

- the time lag between an account becoming doubtful of recovery, its recognition as such,
- the realisation of the security and
- the erosion over time in the value of security charged to the bank, the banks should make provision.

Provisioning Requirements: In conformity with the prudential norms, and on the basis of classification of assets, etc. banks are required to make provisions on funded outstanding on global loan portfolio basis as under:

Category	Sector	Provision requirement
Standard	*Farm Credit to Agricultural activities, Individual Housing Loans, and Small and Micro Enterprises (SME) Sectors *Medium Enterprises *Commercial real estate *Commercial real estate – Residential Housing	*0.25% of funded outstanding (O/S) *0.40% *1.00% of funded O/S *0.75% of funded O/S

Category	Sector	Provision requirement
	*Housing loans at teaser rates *Restructured accounts *Restructured Advances Under Moratorium *Restructured advances - upgraded from NPA * All other loans and advances * For unhedged foreign currency exposures of the entities – depending on the level, if it exceeds 15%	*2.00% during teaser rate period and 0.40% 1 year after rate reset *for restructured advances 5.0% for 2 years from date of restructuring *for restructured account 5.0% during moratorium and further 2 years *5% in the first year from date of upgradation *0.40% Ranging from 0.20% to 0.80% Provisions on standard assets should not be reckoned for arriving at net NPAs. These should also not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions Others'
Sub-Standard	*All sectors *Unsecured Advances *Leased Assets	*15% of outstanding without making allowance for ECGC guarantee cover and available security *Additional 10% i.e. total 25% and for infrastructure loans total 20% provided escrow mechanism is available. *15% of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component (as per AS19) *Additional 10% for Unsecured lease exposures, i.e., a total of 25%.
Doubtful	*All sectors *Covered by ECGC *Leased Assets	*Secured portion 25/40/100% up to 1 year/1-3 years/more than 3 years respectively. *Unsecured portion - 100% *Net of ECGC guaranteed and realizable value of security at the above rates *Secured portion 25/40/100% up to 1 year/1-3 years/more than 3 years respectively on the sum of the net investment in the lease and the unrealised portion of finance income net of finance

Category	Sector	Provision requirement
		charge component in it. *Unsecured portion - 100% of the finance not secured by the realisable value
Loss	*All sectors *Leased Assets	*To be written off or 100% of the outstanding. * 100% of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component.

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

Prudential norms on creation and utilisation of floating provisions:

a) Banks should have Board approved Policy for holding floating provisions separately for 'advances' and 'investments'.
b) Following are the norms for using floating provisions:
   i. Should not be used for making specific provisions for non-performing assets or for making regulatory provisions for standard assets.
   ii. Can be used only for contingencies under extraordinary circumstances for making specific provisions in impaired accounts after obtaining board's approval and with prior permission of RBI.
c) Boards of the banks should lay down an approved policy as to what circumstances would be considered extraordinary. These refer to losses which do not arise in the normal course of business and are exceptional and non-recurring in nature.
d) These broadly fall under three categories viz. General, Market and Credit. These could be as indicated below:
   - General - Situations where bank is put unexpectedly to loss due to events such as civil unrest or collapse of currency in a country; Natural calamities and pandemics; etc.
   - Market - General melt down in the markets, which affects the entire financial system.
   - Credit - Only exceptional credit losses.
e) In order to mitigate the adverse impact of COVID 19 related stress on banks, banks have been allowed to utilise 100 per cent of floating provisions held by them as on December 31, 2020 for making specific provisions for non-performing assets with prior approval of their Boards. Such utilisation is permitted up to March 31, 2022.

Additional Provisions at higher than prescribed rates

a) For NPAs: Banks may voluntarily make specific provisions for advances at rates higher than those prescribed to provide for estimated actual loss with Board approval and in consistent manner from year to year. These are not to be considered as floating provisions. These may be netted off from gross NPAs to arrive at the net NPAs.
b) For Standard Assets: Banks are encouraged to make provisions at higher rates in respect of advances to stressed sectors of the economy. Banks shall put in place a Board–approved policy for making provisions for standard assets at rates higher than the regulatory minimum, based on evaluation of risk and stress in various sectors. At least on a quarterly basis, banks should review the performance of various sectors of the economy to which the bank has an exposure to evaluate the present and emerging risks and stress therein. The review may include quantitative and qualitative aspects like debt-equity ratio, interest coverage ratio, profit margins, ratings upgrade to downgrade ratio, sectoral non-performing assets/stressed assets, industry performance and outlook, legal/ regulatory issues faced by the sector, etc. The reviews may also include sector specific parameters.

Provisions under Special Circumstances:

a) *Advances against deposits/specific instruments*: Advances against term deposits, NSCs eligible for surrender, KVPs, gold ornaments, government & other securities and life insurance policies would attract provisioning requirements as applicable to their asset classification status.

b) *Treatment of interest suspense account*: Amounts held in Interest Suspense Account should not be reckoned as part of provisions. These should be deducted from the relative advances and thereafter, provisioning as per the norms, should be made on the balances after such deduction.

c) *Advances covered by ECGC guarantee*: In the case of advances classified as doubtful and guaranteed by ECGC, provision should be made only for the balance in excess of the amount guaranteed by the Corporation. Further, while arriving at the provision required to be made for doubtful assets, realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by the Corporation and then provision made.

Example:

Outstanding Balance	₹4 lakhs
ECGC Cover	50 percent
Period for which the advance has remained doubtful	More than 2 years remained doubtful (say as on March 31, 2014)
Value of security held	₹1.50 lakhs

Provision required to be made

Outstanding balance	₹ 4.00 lakhs
Less: Value of security held	₹ 1.50 lakhs
Unrealised balance	₹ 2.50 lakhs
Less: ECGC Cover (50% of unrealisable balance)	₹ 1.25 lakhs
Net unsecured balance	₹ 1.25 lakhs
Provision for unsecured portion of advance	₹ 1.25 lakhs (@ 100 percent of unsecured portion)
Provision for secured portion of advance (as on March 31, 2012)	₹ 0.60 lakhs (@ 40 per cent of the secured portion)
Total provision to be made	₹ 1.85 lakhs (as on March 31, 2014)

d) *Advance covered by guarantees of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) or Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH)*: In case an advance covered by CGTMSE or CRGFTLIH guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing assets.

Example:

Outstanding Balance	₹10 lakhs
CGTMSE/CRGFTLIH Cover	75% of the amount outstanding or 75% of the unsecured amount or ₹37.50 lakh, whichever is the least
Period for which the advance has remained doubtful	More than 2 years remained doubtful (say as on March 31, 2014)
Value of security held Rs. 1.50 lakhs	Value of security held ₹1.50 lakhs

Provision required to be made:

Balance outstanding	₹10.00 lakh
Less: Value of security	₹ 1.50 lakh
Unsecured amount	₹ 8.50 lakh
Less: CGTMSE/CRGFTLIH cover (75%)	₹6.38 lakh
Net unsecured and uncovered portion:	₹ 2.12 lakh
Provision for Secured portion @ 40% of Rs.1.50 lakh	₹ 0.60 lakh
Provision for Unsecured & uncovered portion @ 100% of Rs.2.12 lakh	₹ 2.12 lakh
Total provision required	₹ 2.72 lakh

e) *Reserve for Exchange Rate Fluctuations Account (RERFA):* The outstanding amount of foreign currency denominated loans (disbursed in Indian Rupee) which becomes overdue, goes up with an adverse movement of exchange rate of Indian Rupee, requiring provisions. If such assets need to be revalued for accounting practices or for any other requirement, the following procedure may be adopted:

a) The loss on revaluation of assets has to be booked in the bank's Profit & Loss Account.
b) In addition to the provisions as per Asset Classification, the full amount of the Revaluation Gain, if any, on account of foreign exchange fluctuation should be used to make provisions against the corresponding assets.

f) *Provisioning for country risk*: Banks are required to make provisions on the net funded country exposures on a graded scale ranging from 0.25 to 100 percent according to the risk categories.

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

The norms for country risk provisions are:

i. It is required for a country where the bank's net funded exposure is one per cent or more of its total assets.
ii. It is in addition to the provisions required according to asset classification.
iii. For 'loss assets' and 'doubtful assets' the total provision held may not exceed 100% of the outstanding.
iv. No provision is required for 'home country' exposures i.e. exposure to India.
v. Exposures of foreign branches of Indian banks to the host country should be included.
vi. For foreign banks provisions for the country exposures of Indian branches should be held in their Indian books, after excluding exposures to India.
vii. For short-term exposures (i.e. contractual maturity of less than 180 days) a lower level of provisioning (say 25% of the requirement) may be made.

g) *Provisioning norms for Liquidity facility provided for Securitisation transactions*: Amount of liquidity facility in respect of securitisation transactions undertaken as per RBI Directions remaining outstanding for more than 90 days should be fully provided for.

h) *Provisioning requirements for derivative exposures*: Credit exposures arising on account of the interest rate and foreign exchange derivative transactions, credit default swaps and gold, also attract provisioning requirement as applicable to the loan assets in the 'standard' category, of the concerned counterparties. All conditions applicable for treatment of the provisions for standard assets would also apply to the aforesaid provisions for derivative and gold exposures.

i) *Provisioning for housing loans at teaser rates*: The standard asset provisioning on the outstanding amount of such loans has been increased from 0.40 per cent to 2.00 per cent in view of the higher risk associated with them, viz. borrowers may find it difficult to service the loans once the normal interest rate is applied, at the time of initial loan appraisal the repaying capacity of the borrower at normal lending rates is not considered. The provisioning on these assets would revert to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates if the accounts remain 'standard'.

j) *Provisioning requirement in terms of Guidelines on Enhancing Credit Supply for Large Borrowers through Market Mechanism*: For specified borrowers, as per the provisions of the Guidelines on Enhancing Credit Supply for Large Borrowers through Market Mechanism dated August 25, 2016, additional provisions of 3 percentage points is required over and above the applicable provision on the incremental exposure of the banking system in excess of Normally Permitted Lending Limit (NPLL) as defined in the said guidelines. This higher provision requirement shall be distributed in proportion to each bank's funded exposure.

Provisioning Coverage Ratio

Provisioning Coverage Ratio (PCR) is essentially the ratio of provisioning to gross non-performing assets and indicates the extent of funds a bank has kept aside to cover loan losses.

From a macro-prudential perspective, banks should build up provisioning and capital buffers in good times i.e. when the profits are good, which can be used for absorbing losses in a downturn. RBI initiated this step to enhance the soundness of individual banks, as also the stability of the financial sector. RBI decided that Banks should augment their provisioning cushions consisting of specific provisions against NPAs as well as floating provisions and ensure that their total provisioning coverage ratio, including floating provision, should be not less than 70% as on September 2010. Accordingly, till introduction of a more comprehensive methodology of countercyclical provisioning, following approach is being followed:

a) PCR of 70% to be with reference to the gross NPA position in banks as on September 30, 2010.
b) the surplus vis-a-vis as required as per prudential norms should be segregated into an account styled as "countercyclical provisioning buffer", to be computed as per prescribed procedure.
c) this buffer will be allowed to be used for making specific provisions for NPAs during system wide downturn, with the prior approval of RBI.

25.6 WRITING OFF OF NPAs

Amounts set aside for making provision for NPAs as per regulatory guidelines are not eligible for deductions in computation of Income/ Corporate tax. Banks have been permitted to adopt either of the following practices for NPAs:

a) Make full provision as per the guidelines, and
b) Write-off such advances and claim available tax benefits

These write-offs are 'Technical write-offs'. In cases, where NPAs are so written off, any subsequent recoveries should be included as income for tax computation.

Banks are required to continue recovery efforts for all such NPAs that are written off for the purposes of availing tax deductions. If in any account, only a part of dues are written-off, the balance amount should not be treated as Standard Asset, but as an NPA, and provisions as required to be made for it.

Particulars of all write-offs during the financial year are required to be disclosed in the Annual Report. The details of technical write-offs should be included separately.

25.7 FRAMEWORK FOR RESOLUTION OF STRESSED ASSETS

Early Identification: As good credit risk management practice, banks are required to recognise incipient stress in loan accounts, immediately on default. For this purpose, advances accounts are required to be classified as indicated below, even before the advances become non-performing. This is applicable for all advances, except agricultural advances governed by crop-season based asset classification norms.

SMA Sub-categories	**Basis for classification –** Principal or interest payment or any other amount wholly or partly overdue between
SMA-0	Up to 30 days
SMA-1	More than 30 days and up to 60 days-
SMA-2	More than 60 days and up to 90 days

In the case of revolving credit facilities like cash credit/overdraft, the SMA sub-categories will be as follows:

SMA Sub-categories	**Basis for classification –** Outstanding balance remains continuously in excess of the sanctioned limit or drawing power, whichever is lower, for a period of:
SMA-1	More than 30 days and up to 60 days
SMA-2	More than 60 days and up to 90 days

Daily Identification: Another practice for better credit risk management is undertaking the exercise of classification of an advance in the appropriate category of SMA and NPA as daily end-of day process. The date of classification as SMA or NPA will be the calendar date for which the connected day-end process was run.

Example: For a loan account
Due date: March 31, 2022,
Full dues not received before the bank runs the day-end process for the due date.

Date of overdue: Day-end process of March 31, 2022.
It continues to remain overdue.
Date of SMA-1: Day-end process of April 30, 2022 (i.e. upon completion of 30 days of being continuously overdue).
Date of SMA-1 classification: April 30, 2022.
Still continues to remain overdue,
Date of SMA-2: Day-end process of May 30, 2022 (i.e. upon completion of 60 days of being continuously overdue).
Date of SMA-2 classification: May 30, 2022.
Still continues to remain overdue,
Date of NPA: Day-end process of June 29, 2022 (i.e. upon completion of 90 days of being continuously overdue).
Date of NPA classification: June 29, 2022.

Reporting to CRILC: A scheduled commercial bank shall report on monthly basis credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (CRILC), on all borrowers having aggregate exposure6 of ₹5 crore and above with it. Besides, it shall submit a weekly report of instances of default by all borrowers (with aggregate exposure of ₹5 crore and above) by close of business on every Friday.

Implementation of Resolution Plan:

a) For better credit risk management, banks must initiate the process of implementing a resolution plan (RP) even before a default by the borrower. In any case, once a borrower is reported to be in default by any of the lenders, all lenders to that borrower shall undertake a prima facie review of the borrower account within thirty days from such default ("Review Period").
b) During the Review Period, lenders may decide on the resolution strategy, including the nature of the RP, the approach for implementation of the RP, etc. The lenders may also choose to initiate legal proceedings for insolvency or recovery.
c) All lenders shall enter into an inter-creditor agreement (ICA), during the said Review Period, to provide for ground rules for finalisation and implementation of the RP. The ICA shall provide that any decision agreed by lenders representing 75 per cent by value of total outstanding credit facilities (fund based as well non-fund based) and 60 per cent of lenders by number shall be binding upon all the lenders. It shall also provide for rights and duties of majority lenders, duties and protection of rights of dissenting lenders, treatment of lenders with priority in cash flows/differential security interest, etc. In particular, the RPs shall provide for payment not less than the liquidation value due to the dissenting lenders.

25.8 SALE OF FINANCIAL ASSETS – ASSET RECONSTRUCTION COMPANY (ARC)

Financial Assets which can be sold: Banks sell their financial assets for various reasons including liquidity management, rebalancing their exposures or strategic sales. The regulatory provisions in this regard are contained in Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 dated September 24, 2021. Banks can sell financial assets to scheduled commercial banks, All India Financial Institutions and NBFCs (including HFCs). Financial assets can also be sold to Asset Reconstruction Companies (ARCs).

Banks are permitted to sell or transfer an asset in any category viz. standard asset, SMA or NPA. The transfer of an asset can be done only after a minimum holding period (MHP) (indicated below) which is counted from the date of registration of the underlying security interest:

a) Three months in case of loans with tenor of up to 2 years.
b) Six months in case of loans with tenor of more than 2 years.

MHP in certain specific cases stated below commences from the dates as indicated:

a) Where security does not exist or cannot be registered, from the date of first repayment of the loan.
b) For project loans, from the date of commencement of commercial operations of the Project.

For loans acquired from other entities by a transferor, MHP is six months from the date on which the loan was taken into the books of the transferor.
Stressed asset can be sold to ARCs, apart from other permitted transferees.

General Norms

a) Banks should have Board approved Policy for transfer and acquisition of loan exposures. The policy should cover minimum quantitative and qualitative standards relating to due diligence, valuation, requisite IT systems for capture, storage and management of data, risk management, periodic Board level oversight, etc. in this regard.
b) The transfer of economic interest should be without any change in underlying terms and conditions of the loan contract usually. In case of any change or modification, it should be examined if that amounts to restructuring.
c) Transferor cannot offer credit enhancements or liquidity facilities in any form in the case of loan transfers.
d) A loan transfer should result in immediate separation of the transferor from the risks and rewards associated with loans to the extent that the economic interest has been transferred.
e) The transferee(s) should have the unfettered right to transfer or otherwise dispose of the loans free of any restraining condition to the extent of economic interest transferred to them.
f) The transferor shall have no obligation to re-acquire or fund the re-payment of the loans or any part of it or substitute loans held by the transferee(s) or provide additional

loans to the transferee(s) at any time except those arising out of breach of warranties or representations made at the time of transfer.

g) The transferee(s) may engage a servicing facility provider, which may also be the transferor, to administer or service the acquired exposures.
h) The nature, purpose, extent of the servicing facility and all required standards of performance should be clearly specified in a written agreement. The facility is provided on an 'arm's length basis' on market terms and conditions.
i) The duration of the servicing facility is limited to the earliest of the dates on which: (i) the underlying loans are completely amortised; (ii) all claims connected with the transferee(s)' economic interest in the underlying loans are paid out; or (iii) the lender's obligations as the servicing facility provider are otherwise terminated.

Transfer of Loans which are not in default

a) A transferor can transfer a single loan or a part of such loan or a portfolio of such loans to permitted transferees through assignment or novation or a loan participation contract.
b) Transferor's retention of economic interest, if any, in the loans transferred should be supported by legally valid documentation, along with a legal opinion on key regulatory aspects.
c) There shall not be any difference in the criteria for credit underwriting applied by the transferor to exposures transferred and those held or retained on their book.
d) The transfer shall be only on cash basis, at a consideration determined in a transparent manner on an arm's length basis, .and received not later than at the time of transfer of loans.
e) The transferee has to perform due diligence at the level of each loan. If in case of a portfolio this is difficult, can perform due diligence at the individual loan level for not less than one-third of the portfolio by value and number of loans, and for the remaining at the portfolio level. In such an event, the transferor has to retain at least 10 per cent of economic interest in the transferred loans.

Transfer of Stressed Loans

a) Lenders shall transfer stressed loans, including through bilateral sales, only to permitted transferees and ARCs. These norms also apply to transfers to ARCs.
b) The transfer of stressed loans must be done through assignment or novation only; loan participation is not permitted in the case of stressed loans.
c) The Board approved policies of every lender on transfer and / or acquisition of stressed loans shall, inter alia, cover the following aspects: (i) Valuation methodology to ensure that the realisable value of stressed loans, including the realisability of the underlying security interest, is reasonably estimated; (ii) Risk premium to be applied for the purpose of Clause 67; etc.
d) In identification of stressed loans beyond a specified value the head office/corporate office of the lender shall be actively involved.

e) At a minimum, all loans classified as NPA above a threshold amount decided by the Board/Board Committee shall be reviewed by the Board/Board Committee at periodic intervals to decide on transfer or otherwise.
f) Transferor should have clear policies with regard to valuation of loan exposures proposed to be transferred.
g) Lenders may use e-auction platforms, wherever available. If it is on a bilateral basis, such negotiations must necessarily be followed by an auction through Swiss Challenge method if the aggregate exposure (including investment exposure) of lenders to the borrower/s whose loan is being transferred is Rs.100 crore or more. This will also apply to transfers done under the Resolution Plan in terms of Prudential Framework for Resolution of Stressed Assets.
h) The transferor should not assume any operational, legal or any other type of risks relating to the transferred loans including additional funding or commitments to the borrower / transferee(s) with reference to the loan transferred.
i) The transferor shall transfer the stressed loans to transferee(s) other than ARCs only on cash basis. The entire transfer consideration should be received not later than at the time of transfer of loans, and the loan can be taken out of the books of the transferor only on receipt of the entire transfer consideration.
j) For transferors (other than NBFCs), if the transfer to transferee(s) other than ARCs is at a price below the net NBV at the time of transfer, the shortfall shall be debited to the profit and loss account of the year in which transfer has taken place. If the sale consideration is for a value higher than the NBV at the time of transfer, the excess provisions may be reversed.
k) The lenders are permitted to treat a pool of stressed loans acquired on a portfolio basis as a single asset in their books provided that the pool consists of homogeneous personal loans.
l) Except for ARC, classification of acquired stressed loan in transferee's books will be as follows – (i) if it has no existing exposure to the borrower it shall be classified as "Standard", and thereafter will be subject to IRAC norms based on the performance in its books; and (ii) if it has existing exposure to the borrower, the classification of the acquired exposure shall be the same as the existing classification of the borrower.
m) If the net present value of the cash flows estimated while acquiring the loan is less than the consideration paid for acquiring the loan, provisions shall be maintained to the extent of the difference.
n) In the case of ARCs, the asset classification of stressed loans acquired by them and the associated provisions shall be as per the regulations applicable to them.
o) The lenders shall hold the acquired stressed loans in their books for a period of at least six months before transferring to other lenders.
p) For NPAs acquired, the transferee should account the cash flows received towards the funded outstanding in the books till the acquisition cost is recovered. Any further cash inflows should be recognized as profit.

Transfer of loans to Asset Reconstruction Companies:

a) Stressed loans in default for more than 60 days and NPAs can be transferred to ARCs. This shall include loan exposures classified as fraud as on the date of transfer. For these the responsibilities of the transferor with respect to continuous reporting, monitoring, filing of complaints with law enforcement agencies and proceedings related to such complaints shall also be transferred to the ARC.
b) Transferor(s) can enter into agreement with the ARC to share, in an agreed proportion, any surplus realised by the ARC from the concerned stressed loan.
c) If the transfer is at a price below the net book value (NBV) at the time of transfer, the transferor shall debit the shortfall to the profit and loss account for the year in which the transfer has taken place, or in case of banks use countercyclical and floating provisions.
d) If the transfer is at a price higher than the net book value (NBV) at the time of transfer, the transferor shall debit the shortfall to the profit and loss account for the year in which the transfer has taken place, or in case of banks use countercyclical and floating provisions. The lender shall reckon the NAV obtained from ARC from time to time, for valuation of such investments.
e) Investments by lenders in SRs / PTCs / other securities issued by ARCs in respect of the stressed loans transferred shall be valued periodically in the prescribed manner.
f) SRs/PTCs which are not redeemed as at the end of the resolution period (i.e., five years or eight years as the case may be) shall be treated as loss asset in books of the lenders and fully provided for.
g) A lender cannot at any point of time acquire from ARCs the loan exposures it had earlier transferred to the ARC. But a lender can take over standard accounts from ARCs, where the resolution plan has been successfully implemented and the period equivalent to the 'monitoring period' has elapsed.
h) Stressed loans taken over by ARCs as agents for recovery in exchange for a fee, will not be removed from the books of the transferors, the realisations received shall be credited to the loan accounts, and provisions made on these as required.

National Asset Reconstruction Company Limited (NARCL)

Existing ARCs have been helpful in resolution of stressed assets especially for smaller value loans. Various available resolution mechanisms, like Insolvency and Bankruptcy Code (IBC), strengthening of Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI Act) and Debt Recovery Tribunals, as well as setting up of dedicated Stressed Asset Management Verticals (SAMVs) in banks for large-value NPA accounts have brought sharper focus on recovery. In spite of these efforts, substantial amount of NPAs continue on balance sheets of banks primarily because the stock of bad loans as revealed by the Asset Quality Review is not only large but fragmented across various lenders. Considering the large stock of legacy NPAs, additional options/ alternatives are needed. Hence it was decided to set up an ARC at the national level. National Asset Reconstruction Company Limited (NARCL) has been incorporated under the Companies Act and has been licensed by RBI as an Asset Reconstruction Company (ARC). NARCL has been set up by banks to aggregate and consolidate stressed assets for their subsequent resolution.

Capitalization of NARCL would be through equity from banks and Non-Banking Financial Companies (NBFCs). Public sector banks are expected to maintain 51% ownership in NARCL. It will also raise debt as required.

Resolution mechanisms of this nature which deal with a backlog of NPAs typically require a backstop from Government. This imparts credibility and provides for contingency buffers. Hence, GoI Guarantee of up to Rs 30,600 crore will back Security Receipts (SRs) issued by NARCL. The guarantee will be valid for 5 years. The condition precedent for invocation of guarantee would be resolution or liquidation. The guarantee shall cover the shortfall between the face value of the SR and the actual realisation. The guarantee from Government of India to back SRs issued by NARCL will reduce upfront capitalization requirements and also enhance liquidity of SRs, as such SRs are tradable.

Setting up of NARCL is expected to bring several benefits to banks. It will incentivize quicker action on resolving stressed assets thereby helping in better value realization. It will also free up personnel in banks to focus on increasing business and credit growth. There is strong upside potential due to aggregation of assets with a resolution by experts. As the investors in NARCL and holders of SRs, banks will receive the gains. The banks will benefit from upfront recovery in cash of 15%. Further, it will bring about improvement in bank's valuation and enhance their ability to raise market capital.

NARCL proposes to acquire stressed assets of about Rs. 2 Lakh crore in phases within extant regulations of RBI. It intends to acquire these through 15% Cash and 85% in Security Receipts (SRs). The NARCL will acquire assets by making an offer to the lead bank.

NARCL is intended to resolve stressed loan assets above ₹500 crore each amounting to about ₹2 lakh crore. In phase I, fully provisioned assets of about Rs. 90,000 crore are expected to be transferred to NARCL, while the remaining assets with lower provisions would be transferred in phase II.

India Debt Resolution Company Ltd. (IDRCL)

Along with setting up of NARCL for acquiring stressed assets from various banks, another institution has been set up to manage the resolution of these stressed assets namely India Debt Resolution Company Ltd. (IDRCL). It is a service company/ operational entity which will manage the asset and engage market professionals and turnaround experts. Public Sector Banks (PSBs) and Public FIs will hold a maximum of 49% stake and the rest will be with private sector lenders. Once NARCL's offer is accepted, then, IDRCL will be engaged for management and value addition. IDRCL under an exclusive arrangement will handle the debt resolution process. This exclusive arrangement will be as per the scope defined in the 'Debt Management Agreement' between the two entities. This arrangement will be on a 'Principal-Agent' basis and final approvals and ownership for the resolution shall lie with NARCL as the Principal Bank. This unique Public Private partnership is envisaged to get the best talent in terms of ability to handle large exposures, benefit of aggregation, domain expertise in O&M and debt resolution processes.

25.9 INSOLVENCY AND BANKRUPTCY CODE 2016

Background:

The enactment of the Insolvency and Bankruptcy Code, 2016 (IBC) is a watershed towards improving the credit culture in our country. Even special laws such as the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 have not led to the desired level of resolution of problem loans of banks and financial institutions. Recognizing that reforms in the bankruptcy and insolvency regime are critical for improving the business environment and alleviating distressed credit markets, the Insolvency and Bankruptcy Code (IBC) was enacted. IBC essentially has three sets of provisions covering – (i) matters relating to the insolvency and liquidation of corporate debtors where the minimum amount of the default is one crore rupees; (ii) matters relating to fresh start, insolvency and bankruptcy of individuals and partnership firms where the amount of the default is not less than one thousand rupees; (iii) matters relating to establishment of the Insolvency and Bankruptcy Board of India.

Fundamental Aspects of IBC

a) The objective of the Act is essentially to provide a forum for the entities and individuals that are under severe financial stress to reach a resolution with their creditors in a holistic manner rather than getting caught in a web of numerous legal actions and suits. Essentially, from this perspective IBC is not directly intended for providing another forum to creditors for recovery action. It nevertheless enables the creditors to realise from a distressed borrower the optimal possible equitable recovery. IBC pertains to matters related to insolvency, liquidation, voluntary liquidation or bankruptcy of entities and individuals.
b) The provisions of IBC apply to the following:
   i) Any company incorporated under the Companies Act, 2013 or under any previous law.
   ii) Any other company governed by any special act for the time being in force, except in so far as the said provision is inconsistent with the provisions of such Special Act.
   iii) Any Limited Liability Partnership under the LLP Act 2008.
   iv) Any other body incorporated under any law for the time being in force, as the Central Government may specify.
   v) Personal guarantors to corporate debtors.
   vi) Partnership firms and Proprietorship firms.
   vii) Individuals (other than those in (e).
c) The institutional infrastructure under the IBC rests on five pillars, viz.,
   i) The Insolvency and Bankruptcy Board of India (IBBI).
   ii) Insolvency Professional Agencies (IPA)
   iii) Insolvency Professionals (IP)
   iv) Information Utilities (IU); and
   v) Adjudicating Authorities

d) Adjudicating and Appellate Authorities

Under the IBC different Adjudicating Authorities (AA) have been designated one for Corporate Persons; and other for Individuals and Partnership Firms. Correspondingly, the Appellate authorities are also different. These institutions will seek to achieve smooth functioning of the bankruptcy process.

i. For corporate persons: The AA in relation to insolvency resolution and liquidation for corporate persons including corporate debtors and personal guarantors thereof is the National Company Law Tribunal (NCLT) having territorial jurisdiction over the place where the registered office of the corporate person is located. The Appellate Authority for matters adjudicated by NCLT is National Company Law Tribunal (NCLAT).

   Jurisdiction of NCLT: Where a CIRP or liquidation proceeding of a corporate debtor is pending before a NCLT, an application relating to the insolvency resolution or liquidation or bankruptcy of a corporate guarantor or personal guarantor of such corporate debtor shall be filed before such NCLT. An IRP or liquidation or bankruptcy proceeding of a corporate guarantor or personal guarantor, of the corporate debtor pending in any court or tribunal are transferred to the AA dealing with IRP or liquidation proceeding of such corporate debtor.

   The NCLT is vested with all the powers of the DRT for these matters. The NCLT shall have jurisdiction to entertain -

   a) any application or proceeding by or against the corporate debtor or corporate person;
   b) any claim made by or against the corporate debtor or corporate person, including claims by or against any of its subsidiaries situated in India; and
   c) any question of priorities or any question of law or facts, arising out of or in relation to the insolvency resolution or liquidation proceedings of the corporate debtor or corporate person under IBC.

(ii) For individuals and partnership firms: The AA in relation to insolvency matters of individuals and firms is the Debt Recovery Tribunal having territorial jurisdiction over the place where the individual debtor actually and voluntarily resides or carries on business or personally works for gain and can entertain an application under IBC regarding such person. The Appellate Authority for matters adjudicated by DRT is Debt recovery Appellate Tribunal (DRAT).

Jurisdiction of DRT: The DRT shall have jurisdiction to entertain or dispose of –

a) any suit or proceeding by or against the individual debtor;
b) any claim made by or against the individual debtor;
c) any question of priorities or any other question whether of law or facts, arising out of or in relation to insolvency and bankruptcy of the individual debtor or firm under IBC.

Key Terms

i. *Insolvency*: Insolvency is when an individual or organization is unable to meet its outstanding financial debt towards its lender as it become due. Insolvency can be resolved by way of changing the repayment plan of the loans or writing off a part thereof. If it cannot be resolved, then a legal action may lie against the insolvent and its assets will be sold to pay off the outstanding debts. Generally, an official assignee/ liquidator appointed by the Government of India, realizes the assets and allocates it among the creditors of the insolvent.

ii. *Bankruptcy*: Bankruptcy is a concept slightly different from insolvency, which is rather amicable. A bankruptcy is when a person voluntary declares him as an insolvent and goes to the court. On declaring him as 'bankrupt', the court is responsible to liquidate the personal property of the insolvent and hand it out to its creditors. It provides a fresh lease of life to the insolvent.

iii. *Financial Creditors*: The term financial debt has been defined in section 5(8) of Code "to mean a debt, along with interest, if any, which is disbursed against the consideration for the time value of money." Typically financial creditors are those "whose relationship with the entity is a pure financial contract, such as a loan or a debt security. The key feature of financial transaction as postulated by section 5(8) is its consideration for time value of money. However, homebuyers have also been deemed to be financial creditors under IBC.

iv. *Operational Debt*: Section 5(20) of IBC defines an operational debt as "a claim in respect of the provisions of goods or services including employment or a debt in respect of the payment of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority". Operational creditors are those whose claims arise "from a transaction on operations".

Salient Provisions of IBC:

1) Corporate Insolvency Resolution Process (CIRP): CIRP can be initiated by any Financial Creditor or Operational Creditor or Corporate Debtor, as the case may be, when a default is committed by a corporate debtor. The CIRP should be completed within 180 days, though an extension of 90 days may be permitted by the Adjudicating Authority. The duration for CIRP including the time taken in legal proceedings related to it shall not exceed 330 days from the insolvency commencement date. Once a CIRP is implemented there is prohibition on the following from the date of the moratorium order till completion of CIRP or approval of resolution process or date of liquidation order:
    i) initiating or continuing any suit or any other legal proceedings against the corporate debtor, including execution of any judgment, decree or order;
    ii) dealing in any manner with any of its assets or any legal right or beneficial interest in these by the corporate debtor;
    iii) any action for enforcing any security interest including any action under the SARFAESI Act;
    iv) the recovery of any property in the possession of the corporate debtor by its owner/ lessor.
2) Liquidation Process: The AA orders for liquidation of a corporate debtor in the following circumstances –
    i) A resolution plan is not received within the prescribed period.

ii) The resolution plan has been rejected for non-compliance of the specified requirements.
iii) CoC has decided with minimum 66% voting share to liquidate.
iv) The Corporate Debtor has contravened the resolution plan.

The liquidator is required to verify the claims, and for this purpose call from any person any other document as evidence. Based on verification the liquidator may accept or reject the claim wholly or partly.

3) Fast Track Insolvency Resolution Process: This is available to – (a) a corporate debtor with assets and income below a level notified; or (b) a corporate debtor with notified class of creditors or notified amount of debt; or (c) such other notified category of corporate persons. A creditor or the corporate debtor can file an application for fast track insolvency resolution process along with the proof of the existence of default. FIRP shall be completed within a period of ninety days from the insolvency commencement date. The period can be extended maximum up to 45 days.
4) Pre-Packaged Insolvency Resolution Process: This is for a corporate debtor classified as a micro, small or medium enterprise. The corporate debtor shall obtain an approval from its financial creditors, not being its related parties, representing not less than sixty-six per cent in value of the financial debt due to such creditors, for the filing of an application for initiating PPIRP. If there is no financial creditor, not being a related party, the approval shall be provided by specified persons.
5) Voluntary Liquidation of Corporate Persons: A corporate person may initiate voluntary liquidation proceedings provided as per the prescribed procedure. creditors representing two-thirds in value of the debt of the company shall approve the resolution passed for liquidation within seven days of the resolution of the members of the company.
6) Fresh Start Process: A debtor, who is unable to pay his debt may apply for a fresh start subject to meeting the prescribed ceilings for annual income, value of assets, and qualifying debts. Also, he is not an undischarged bankrupt nor owns any dwelling unit.
7) Insolvency Resolution Process for Individuals/ Partnership Firms: A debtor who commits a default may apply for this. A creditor may also apply for RIP, and in case of a partnership firm it can be against one or more partners of the firm. A repayment plan may be prepared by the debtor containing nay restructuring proposals, if any, and put up to the creditors for approval. If a repayment plan is approved by the Adjudicating Authority it is implemented. If no repayment plan is approved, the debtor and the creditors can file for bankruptcy.
8) Bankruptcy Order for Individuals and Partnership Firm: When an application for bankruptcy is filed an interim-moratorium commences on the date of the application on all actions against the properties of the debtor in respect of his debts and it ceases to have effect on the bankruptcy commencement date. In case of a firm, the interim-moratorium operates against all the partners of the firm. The AA passes a bankruptcy order. On the passing of the bankruptcy order - (a) the estate of the bankrupt shall vest in the bankruptcy trustee; (b) the estate of the bankrupt shall be divided among his creditors; (c) a creditor of the bankrupt shall not— (i) initiate any action against the property of the bankrupt in respect of such debt; or (ii) commence any suit or other legal proceedings except with the leave of the AA and on the terms as the AA may impose. The secured

creditor is required to take action to realise his security within thirty days after the bankruptcy commencement date.

25.10 WILFUL DEFAULTERS

Pursuant to the instructions of the Central Vigilance Commission for collection of information on wilful defaults of Rs.25 lakhs and above by RBI and dissemination to the reporting banks and FIs, a scheme was framed by RBI with effect from 1st April 1999 under which the banks and notified All India Financial Institutions were required to submit to RBI the details of the wilful defaulters. The emphasis on taking strong against borrowers who do not observe financial discipline and/or indulge in diversion of borrowed funds has been in focus. RBI has taken several measures to bring more discipline in monitoring of advances under consortium/multiple lending arrangements. Making the list of defaulters' public has also been examined as a deterrent measure to wilful default by borrowers.

Key Terms: The following terms are to be construed as explained below for these regulations.

i. Lender: The term 'lender' covers all banks/FIs to which any amount is due, provided it is arising on account of any banking transaction, including off balance sheet transactions such as derivatives, guarantees and letters of credit.
ii. Unit: The term 'unit' includes individuals, juristic persons and all other forms of business enterprises, whether incorporated or not. In case of business enterprises (other than companies), banks/FIs may also report (in the Director column) the names of those persons who are in charge and responsible for the management of the affairs of the business enterprise.
iii. Wilful Default: A 'wilful default' would be deemed to have occurred if any of the following events is noted:
    a. The unit has defaulted in meeting its payment/repayment obligations to the lender even when it has the capacity to honour the said obligations.
    b. The unit has defaulted in meeting its payment/repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
    c. The unit has defaulted in meeting its payment/repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.
    d. The unit has defaulted in meeting its payment/repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given for the purpose of securing a term loan without the knowledge of the bank/lender.

The identification of the wilful default should be made keeping in view the track record of the borrowers and should not be decided on the basis of isolated transactions/incidents. The default to be categorised as wilful must be intentional, deliberate and calculated.

iv. *Diversion of Funds*: The term 'diversion of funds' should be construed to include any one of the undernoted occurrences:

a) utilisation of short-term working capital funds for long-term purposes not in conformity with the terms of sanction;
b) deploying borrowed funds for purposes/activities or creation of assets other than those for which the loan was sanctioned;
c) transferring borrowed funds to the subsidiaries/Group companies or other corporates by whatever modalities;
d) routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender;
e) investment in other companies by way of acquiring equities/debt instruments without approval of lenders;
f) shortfall in deployment of funds vis-a-vis the amounts disbursed/drawn and the difference not being accounted for.

v. Siphoning of Funds: The term 'siphoning of funds' should be construed to occur if any funds borrowed from banks/FIs are utilised for purposes unrelated to the operations of the borrower, to the detriment of the financial health of the entity or of the lender. The decision as to whether a particular instance amounts to siphoning of funds would have to be a judgment of the lenders based on objective facts and circumstances of the case.

End-Use of Funds:

An important aspect of monitoring advances is to monitor the end-use of funds. In cases of project financing, the banks/FIs seek to ensure end use of funds by, inter alia, obtaining certification from the Chartered Accountants for the purpose. In case of short-term corporate/clean loans, such an approach ought to be supplemented by 'due diligence' on the part of lenders themselves, and to the extent possible, such loans should be limited to only those borrowers whose integrity and reliability are above board. The banks need to strengthen their internal controls and the credit risk management system to enhance the quality of their loan portfolio. Some illustrative measures that can be used for monitoring and ensuring end-use of funds are:

a) Meaningful scrutiny of quarterly progress reports / operating statements / balance sheets of the borrowers;
b) Regular inspection of borrowers' assets charged to the lenders as security; (c) Periodical scrutiny of borrowers' books of accounts and the 'no-lien' accounts maintained with other banks;
c) Periodical visits to the assisted units;
d) System of periodical stock audit, in case of working capital finance;
e) Periodical comprehensive management audit of the 'credit' function of the lenders, so as to identify the systemic-weaknesses in their credit administration.

Penal Measures:

The under mentioned measures may be initiated by the banks and FIs against the identified wilful defaulters. Banks may apply these to the cases where the outstanding amount is ₹25 lakh or more.

a) No bank or FI should grant any additional facilities to the wilful defaulters listed.

b) Such companies and their entrepreneurs/promoters for whom siphoning/diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions have been detected should be debarred from institutional finance from the scheduled commercial banks, Financial Institutions, and NBFCs, for floating new ventures for a period of 5 years from the date of removal of their name from the list of wilful defaulters as published/disseminated by RBI/CICs.

a) The legal process against the borrowers/guarantors and foreclosure for recovery of dues should be initiated expeditiously. Criminal proceedings may be initiated against wilful defaulters.
b) Adopt a proactive approach for a change of management of the wilfully defaulting borrower unit.
c) A covenant should be included in the loan agreements, that the borrowing company should not induct on its board a person appearing in the list of Wilful Defaulters, and if such a person is found to be on its board, it would be removed expeditiously.

The banks and FIs need to put in place a transparent mechanism for the entire process so that the penal provisions are not misused.

Guarantees furnished by individuals, group companies & non-group companies:
In terms of Section 128 of the Indian Contract Act, 1872, the liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract. If a guarantor refuses to comply with the demand made by the creditor/banker for payment of dues of the borrower, despite having sufficient means, such guarantor would also be treated as a wilful defaulter. Banks/FIs may ensure that this position is made known to all guarantors at the time of accepting guarantees.

Role of auditors:
In case any falsification of accounts on the part of the borrowers is observed by the banks/FIs, and if it is observed that the auditors were negligent or deficient in conducting the audit, banks should complaint against the auditors with the Institute of Chartered Accountants of India (ICAI) to enable the ICAI to examine and fix accountability of the auditors. The complaints should also be forwarded to the RBI (Department of Banking Supervision, Central Office) and IBA. IBA would circulate the names of such CA firms, amongst all banks who should consider this aspect before assigning any work to them. RBI would share such information with other financial sector regulators/Ministry of Corporate Affairs (MCA)/Comptroller and Auditor General (CAG).

The lender gives a separate mandate to the borrower’s auditors for a specific certification regarding diversion/ siphoning of funds by the borrower, a covenant for this purpose may be included in the loan agreements. Lenders could engage own auditors for such specific certification.

Reporting to Credit Information Companies

a) RBI has granted Certificate of Registration to (i) Experian Credit Information Company of India Private Limited, (ii) Equifax Credit Information Services Private

Limited, (iii) CRIF High Mark Credit Information Services Private Limited and (iv) Credit Information Bureau (India) Limited (CIBIL) to commence/carry on the business of credit information.

b) Banks/FIs should submit the list of suit-filed accounts and non-suit filed accounts of wilful defaulters of Rs.25 lakhs and above on a monthly or more frequent basis to all the four Credit Information Companies. This would enable such information to be available to the banks/FIs on a near real time basis.
c) (c) Banks need not report cases where - (i) outstanding amount falls below Rs.25 lakhs, and (ii) where the borrower has fully paid the compromised amount agreed by the bank.
d) Credit Information Companies (CICs) disseminate the information pertaining to suit filed accounts of wilful defaulters on their respective websites.

Credit Information Companies disseminate information on non-suit filed and suit filed accounts respectively of Wilful Defaulters, as reported to them by the banks / FIs and therefore, the responsibility for reporting correct information and also accuracy of facts and figures rests with the concerned banks and financial institutions. Banks / FIs may also ensure the facts about directors, wherever possible, by cross-checking with Registrar of Companies.

Mechanism for identification of Wilful Defaulters

The evidence of wilful default should be examined by a Committee headed by an Executive Director or equivalent and consisting of two other senior officers of the rank of GM/DGM. The Committee, if it considers there is a wilful default, shall issue a Show Cause Notice to the concerned borrower and the promoter / whole-time director and after considering their submissions (including those during personal hearing) issue an order recording the fact of wilful default and the reasons for the same. The Order of the Committee is reviewed by a Review Committee headed by the Chairman/Chairman & Managing Director or the Managing Director & Chief Executive Officer/CEOs and consisting, two independent directors/non-executive directors of the bank. Thereafter the order shall be final. Except in very rare cases, a non-whole time director of the defaulting borrower should not be considered as a wilful defaulter.

Criminal Action against Wilful Defaulters

Consequent upon the recommendations of the Joint Parliamentary Committee, the RBI examined, in consultation with the Standing Technical Advisory Committee on Financial Regulations, the RBI has advised that banks closely monitor the end-use of funds and obtain certificates from the borrowers certifying that the funds have been used for the purpose for which these were obtained. Wrong certification should attract criminal action against the borrower. Besides, there is scope under the existing legislations to initiate criminal action against wilful defaulters, depending upon the facts and circumstances of the case under the provisions of Sections 403 and 415 of the Indian Penal Code (IPC), 1860. Banks/FIs are, therefore, advised to seriously and promptly consider initiating criminal action against wilful defaulters or wrong certification by borrowers, wherever considered necessary, based on the facts and circumstances of each case under the above provisions of the IPC. It should also be ensured that the penal provisions are used effectively and determinedly but after careful consideration and due caution. Towards this end, banks/FIs are advised to put in place a transparent mechanism, with the approval of their Board, for initiating criminal proceedings based on the facts of individual case.

25.11 LET US SUM UP

Income recognition on assets should be objective and based on the record of recovery. Income from NPA assets is to be recognized only when it is actually received. Also the unrealized income booked is reversed. NPAs are classified into three categories based on the period under NPA and realisability of the dues: Sub-standard assets, Doubtful assets, and Loss assets.

The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank managements and the statutory auditors. Banks are required to make provisions based on specified norms. Banks are also required to create floating provisions. PCR of 70% with reference to the gross NPA position as on September 30, 2010 is prescribed. Banks have been permitted 'Technical write-offs' of NPAs.

As good credit risk management practice, banks are required to recognise incipient stress in loan accounts, immediately on default. These accounts are classified as SMA accounts with three sub-categories.

Banks sell their financial assets for various reasons including liquidity management, rebalancing their exposures or strategic sales. Stressed asset can be sold to Asset Reconstruction Companies (ARCs), apart from other permitted transferees.

IBC essentially has three sets of provisions covering – (i) insolvency and liquidation of corporate debtors; (ii) fresh start, insolvency and bankruptcy of individuals and partnership firms; (iii) establishment of the Insolvency and Bankruptcy Board of India. The Adjudicating Authority and the Appellate Authority for corporates are National Company Law Tribunal (NCLT) and National Company Law Tribunal (NCLAT); and for individuals and partnership firms are Debt Recovery Tribunal (DRT) and Debt Recovery Appellate Tribunal (DRAT).

A 'wilful default' would be deemed to have occurred if unit has defaulted: even when it has the capacity to pay; and has not utilised the finance for the specific purposes; and disposed of the security. To monitor the end-use of funds is important. No bank or FI should grant any additional facilities to the wilful defaulters listed.

Banks/FIs are advised to seriously and promptly consider initiating criminal action against wilful defaulters or wrong certification by borrowers, wherever considered necessary.

25.12 KEY WORDS

Non-performing asset; out of order; overdue; Date of Commencement of Commercial Operations; Sub-standard assets; Doubtful Assets; Loss Assets; Past due; Stock audit; Floating provisions; Specific provisions; Interest suspense account; Provisioning Coverage Ratio; Write-off; Technical write-offs; stressed assets; Central Repository of Information on

Large Credits (CRILC); inter-creditor agreement; Asset Reconstruction Companies (ARCs); Credit enhancements; Securitisation receipts; Pass-through-certificates; Financial creditors; Operational Debt; Corporate Insolvency Resolution Process; Liquidation Process; Fast Track Insolvency Resolution Process; Pre-Packaged Insolvency Resolution Process; Fresh Start Process; Insolvency Resolution Process; Bankruptcy Order; Wilful defaults; Diversion of Funds; Siphoning of Funds.

25.13 CHECK YOUR PROGRESS

1) A _____ asset is one which has been classified as NPA for a period not exceeding 12 months.
   a) Sub-standard
   b) Standard
   c) Doubtful
   d) Loss

2) In case of NPA account interest on advances against _____is not recognized
   a) Term deposits,
   b) NSC,
   c) IVPs,
   d) Land

3) Choose the incorrect statement
   a) On an account (incl. bills purchased and discounted and Government guaranteed accounts) turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account and stop further application of interest.
   b) Fees, commission and similar income in respect of past periods, if uncollected, need not be reversed.
   c) Interest realized on NPAs may be taken to income account provided the credits in the accounts towards interest are not out of fresh/additional credit facilities sanctioned to the borrower concerned.
   d) Banks may continue to record such accrued interest, but not realized, in a Memorandum account in their books which should not be taken into account for computing Gross Advances.

4) Choose the incorrect statement
   a) A working capital account would not become NPA, if the irregularity continues beyond 90 days if the unit would be working and its financial position is satisfactory.
   b) A NPA loan account, other than restructured and rescheduled, can be upgraded to standard assets upon payment of arrears of interest and principal.
   c) Finance granted to PACS/FSS under the on-lending system, only that particular portion of credit in default to be classified as NPA.
   d) In staff housing loan or similar other accounts where the interest is to be recovered after repayment of principal, such accounts would become NPA only when there is default in repayment of principal or interest on respective due dates.

5) Purchasing bank can classify in its books the purchased NPA as standard for ______ , and thereafter as per the performance in its books.
   a) 90 days.
   b) 180 days.
   c) 1 year.
   d) None of the above.

6) Wilful defaulters are debarred from institutional finance from the scheduled commercial banks, Financial Institutions, NBFCs, for floating new ventures for ________ from the date of removal of their name from the list of wilful defaulters.
   a) 10 years.
   b) always.
   c) 5 years.
   d) 20 years.

25.14 KEY TO 'CHECK YOUR PROGRESS'

1(a); 2(d); 3(b); 4(a); 5(a); 6(c).

References:

1) RBI Circular DOR.STR.REC.4/21.04.048/2022-23 dated April 1, 2022 - Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.
(https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=12281)
2) RBI Circular DOR.STR.REC.51/21.04.048/2021-22 dated September 24, 2021- Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021
(https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12166)
3) RBI Circular DBR.No.CID.BC.22/20.16.003/2015-16 dated July 1, 2015 - Master Circular on Wilful Defaulters
(https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9907)
4) The Insolvency and Bankruptcy Code, 2016
(https://www.indiacode.nic.in/handle/123456789/2154?sam_handle=123456789/1362)

CHAPTER 26

FOREX OPERATIONS UNDER FEMA

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Know about various aspects of Foreign Exchange related Regulations
- Learn about the regulations pertaining to Foreign Investments in India
- Understand the regulations pertaining to investments overseas by residents in India
- Know the provisions related to external commercial borrowings and trade credits
- Learn about the norms related to transactions for export/ import of goods/ services
- Know about forex facilities for individuals viz. Liberalised remittances scheme, and various accounts for NRIs

26.1 FOREIGN DIRECT INVESTMENT

26.1.1 Key Terms

i. '*Equity Instruments*' are equity shares, convertible debentures, preference shares and share warrants issued by an Indian company.

ii. '*Convertible Note*' is an instrument issued by a start-up company evidencing receipt of money initially as debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of such start-up company, within a period not exceeding five years from the date of issue of the convertible note, upon occurrence of specified events as per the other terms and conditions agreed to and indicated in the instrument.

iii. '*E-commerce*' is buying and selling of goods and services including digital products over digital & electronic network.

iv. '*E-commerce entity*' are the following entities conducting the e-commerce business
   a) a company incorporated under the Companies Act, 1956 or the Companies Act, 2013 or
   b) a foreign company covered under section 2 (42) of the Companies Act, 2013 or
   c) an office, branch or agency in India owned or controlled by a person resident outside India and

v. '*Inventory based model of e-commerce*' means an e-commerce activity where inventory of goods and services is owned by e-commerce entity and is sold to the consumers directly.

vi. '*Market place model of e-commerce*' means providing of an information technology platform by an e-commerce entity on a digital & electronic network to act as a facilitator between buyer and seller.
   (Foreign investment is not permitted in Inventory based model of e-commerce.)

vii. '*FDI linked performance conditions*' is the sector specific conditions stipulated in Schedule I of the NDI Rules for companies receiving foreign investment.

viii. '*Foreign Portfolio Investor (FPI)*' is a person registered in accordance with the provisions of Securities Exchange Board of India (SEBI) (Foreign Portfolio Investors) Regulations, 2014, as amended from time to time.

ix. '*Foreign Institutional Investor (FII)*' or a sub account registered under the Securities Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 and holding a valid certificate of registration from SEBI was deemed to be a FPI till the expiry of the block of three years from the enactment of the SEBI (Foreign Portfolio Investors) Regulations, 2014.

x. ‘*Fully diluted basis*’ means the total number of shares that would be outstanding if all possible sources of conversion are exercised.

xi. ‘*Group company*’ is two or more enterprises which, directly or indirectly, are in a position to (a) exercise 26 percent, or more of voting rights in other enterprise; or (b) appoint more than 50 percent of members of board of directors in the other enterprise.

xii. ‘*Indian entity*’ is an Indian company or an LLP.

xiii. ‘*Investment*’ is to subscribe, acquire, hold or transfer any security or unit issued by a person resident in India.

(Investment will include acquisition, holding or transfer of depository receipts issued outside India, the underlying of which is a security issued by a person resident in India.)

(For the purpose of an LLP, investment shall mean capital contribution or acquisition/ transfer of profit shares.)

xiv. '*Investment on repatriation basis*' is an investment, the sale/ maturity proceeds of which are, net of taxes, eligible to be repatriated and the expression 'Investment on non-repatriation basis', will be construed accordingly.

xv. ‘*Investment Vehicle’* is an entity registered and regulated under relevant regulations framed by SEBI or any other authority designated for the purpose and will be Real Estate Investment Trusts (REITs) governed by the SEBI (REITs) Regulations, 2014, Infrastructure Investment Trusts (InvITs) governed by the SEBI (InvITs) Regulations, 2014 and Alternative Investment Funds (AIFs) governed by the SEBI (AIFs) Regulations, 2012.

(A Venture Capital Fund (VCF) established in the form of a trust or a company or a body corporate and registered under the SEBI (Venture Capital Fund) Regulations, 1996 will not be considered as an Investment Vehicle for the purpose of the NDI Rules and this Master Direction.)

xvi. ‘*Limited Liability Partnership (LLP)*’ is a partnership formed and registered under the Limited Liability Partnership Act, 2008.

xvii. ‘*Listed Indian Company’* is an Indian company which has any of its equity instruments listed on a recognized stock exchange in India and the expression ‘Unlisted Indian Company’ shall be construed accordingly

xviii. ‘*Non-Debt Instruments’* as determined by Central Government by Gazette Notification S.O. 3722 (E) dated October 16, 2019, means the following instruments; namely: -

a) all investments in equity instruments in incorporated entities: public, private, listed and unlisted;
b) capital participation in LLP;
c) all instruments of investment recognised in the FDI policy notified from time to time;
d) investment in units of Alternative Investment Funds (AIFs), Real Estate Investment Trust (REITs) and Infrastructure Investment Trusts (InvITs);
e) investment in units of mutual funds or Exchange-Traded Fund (ETFs) which invest more than fifty per cent in equity;

f) junior-most layer (i.e. equity tranche) of securitisation structure;
g) acquisition, sale or dealing directly in immovable property;
h) contribution to trusts; and
i) depository receipts issued against equity instruments.

xix. '*Non-Resident Indian (NRI)*' is an individual resident outside India who is citizen of India.

xx. '*Overseas Citizen of India (OCI)*' is an individual resident outside India who is registered as an Overseas Citizen of India Cardholder under Section 7(A) of the Citizenship Act, 1955.

xxi. '*Resident Indian citizen*' is an individual who is a person resident in India and is citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955 (57 of 1955).

xxii. '*Real estate business*' is dealing in land and immovable property with a view to earning profit therefrom and does not include development of townships, construction of residential/ commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships.

Explanation:

1) Investment in units of Real Estate Investment Trusts (REITs) registered and regulated under the SEBI (REITs) regulations 2014 shall also be excluded from the definition of "real estate business".
2) Earning of rent income on lease of the property, not amounting to transfer, shall not amount to real estate business.
3) Transfer in relation to real estate includes,
   a) the sale, exchange or relinquishment of the asset; or
   b) the extinguishment of any rights therein; or
   c) the compulsory acquisition thereof under any law; or
   d) any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act,1882 (4 of 1882); or
   e) any transaction, by acquiring capital instruments in a company or by way of any agreement or any arrangement or in any other manner whatsoever, which has the effect of transferring, or enabling the enjoyment of, any immovable property.

   Real estate broking services is excluded from the definition of "real estate business" and 100% foreign investment is allowed in real estate broking services under automatic route.

xxiii. '*Sectoral cap*' is the maximum investment including both foreign investment on a repatriation basis by persons' resident outside India in equity instruments of a company or the capital of a LLP, as the case may be, and indirect foreign investment, unless provided otherwise. This shall be the composite limit for the investee Indian entity.

(FCCBs and DRs having underlying of instruments being in the nature of debt shall not be included in the sectoral cap.)

(Any equity held by a person resident outside India resulting from conversion of any debt instrument under any arrangement shall be reckoned under the sectoral cap.)

xxiv. ‘*Unit*’ is the beneficial interest of an investor in an investment vehicle.

26.1.2 Fundamental Aspects

i. A person resident outside India may hold foreign investment either as Foreign Direct Investment or as Foreign Portfolio Investment in any particular Indian company.

ii. ‘Foreign Investment’ is any investment made by a person resident outside India on a repatriable basis in equity instruments of an Indian company or to the capital of an LLP.

   a) Issue/ transfer of ‘participating interest/ right’ in oil fields by Indian companies to a person resident outside India would be treated as foreign investment.)

   b) If a declaration is made by persons as per the provisions of the Companies Act, 2013 about a beneficial interest being held by a person resident outside India, then even though the investment may be made by a resident Indian citizen, the same shall be counted as foreign investment.

iii. ‘Foreign Direct Investment’ (FDI) is the investment through equity instruments by a person resident outside India (a) in an unlisted Indian company; or (b) in 10% or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company.

   a) If an existing investment by a person resident outside India in equity instruments of a listed Indian company falls to a level below 10% of the post issue paid-up equity capital on a fully diluted basis, the investment will continue to be treated as FDI.

iv. ‘Foreign Portfolio Investment’ is any investment made by a person resident outside India in equity instruments where such investment is (a) less than 10% of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company or (b) less than 10% of the paid-up value of each series of equity instruments of a listed Indian company.

26.1.3 Entry routes and Permitted sectors

a) *Entry Routes*: Foreign investment in the equity instruments of an Indian company can be made through two routes,

   i. Automatic Route - is the entry route in which investment by a person resident outside India does not require the prior approval from the Central Government.

   ii. Government Route - is the entry route in which investment by a person resident outside India requires prior Government approval. Foreign investment received under this route shall be in accordance with the conditions stipulated by the Government in its approval.

   iii. 'Government approval' means approval from the erstwhile Secretariat for Industrial Assistance (SIA)/ Department of Industrial Policy and Promotion (DIPP)/ the erstwhile Foreign Investment Promotion Board (FIPB) and/ or any of the ministry/ department of the Government of India. Aggregate Foreign Portfolio Investment up to forty-nine (49) percent of the paid-up capital on a fully diluted basis or the sectoral or statutory cap, whichever is lower, shall not require Government approval or compliance of sectoral conditions as the case may be, if such investment does not result in transfer of ownership and control of the resident Indian company from resident Indian citizens or transfer of ownership or control to persons resident outside India. Other investments by a person resident outside India shall be subject to conditions of Government approval and compliance of sectoral conditions as laid down in Schedule I of the NDI Rules.

b) *Sectoral caps*:

i. It means the maximum permissible foreign investment in an Indian entity, including both (a) foreign investment on a repatriation basis by person residents outside India in equity instruments of a company or the capital of a LLP and (b) indirect foreign investment. Sectoral cap for the sectors/ activities is the limit indicated against each sector. The total foreign investment shall not exceed the sectoral/ statutory cap.

ii. Foreign investment in the sectors/ activities given in Schedule I of the NDI Rules is permitted up to the limit indicated against each sector/ activity, subject to various conditions.

iii. Foreign investment is permitted up to 100% on the automatic route, subject to applicable laws/rules/regulations, security and other conditionalities, in sectors/ activities not listed in Schedule I of the NDI Rules and not prohibited under Para (2) of Schedule I of the NDI Rules. This condition is not applicable for activities in financial services.

iv. Foreign investment in financial services other than those indicated in Schedule I of the NDI Rules would require prior Government approval.

v. Investing companies: Foreign Investment in investing companies not registered as Non-Banking Financial Companies with the RBI and in core investment companies (CICs), both engaged in the activity of investing in the capital of other Indian entities, will require prior Government approval. Foreign investment in investing companies registered as NBFCs with the RBI, will be under 100% automatic route.

vi. Indian Company (No operations): Foreign Investment in equity instruments of an Indian company, which does not have any operations and also has not made any downstream investment for undertaking activities which are under automatic route and without FDI linked performance conditions, may be received under automatic route. However, Government approval will be required for such companies for undertaking activities which are under Government route. Also, when such a company commences business(s) or makes downstream investment, it will have to comply with the relevant sectoral conditions on entry route, conditionalities and caps.

vii. Aggregate Foreign Portfolio Investment up to (a) 49% of the paid-up capital on a fully diluted basis or (b) the sectoral or (c) statutory cap, whichever is lower, shall not require Government approval or compliance of sectoral conditions as the case may be, if such investment does not result in transfer of ownership and control of the resident Indian company from resident Indian citizens or transfer of ownership or control to persons resident outside India. Other investments by a person resident outside India shall be subject to conditions of Government approval and compliance of sectoral conditions as laid down in Schedule I of the NDI Rules.

viii. The onus of compliance with the sectoral/ statutory caps on foreign investment and attendant conditions if any, will be on the company receiving foreign investment.

26.1.4 Prohibited sectors/ persons

a) Investment by a person resident outside India is prohibited in the following sectors:

i. Lottery Business including Government/ private lottery, online lotteries.

ii. Gambling and betting including casinos.

iii. Chit funds

iv. Nidhi company

v. Trading in Transferable Development Rights (TDRs).

vi. Real Estate Business or Construction of farm houses. (Excludes - development of townships, construction of residential or commercial premises, roads or bridges and Real Estate Investment Trusts (REITs) registered and regulated under the SEBI (REITs) Regulations, 2014)

vii. Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.

viii. Activities/sectors not open to private sector investment viz., (i) Atomic energy and (ii) Railway operations

ix. Foreign technology collaboration in any form including licensing for franchise, trademark, brand name, management contract is also prohibited for lottery business and gambling and betting activities.

b) Investment from following specified countries requires Government approval:

i. By an entity of a country with land border with India or the beneficial owner of the investment is situated or is a citizen of such country.

ii. A person who is a citizen of Pakistan or an entity incorporated in Pakistan. It cannot invest in defence, space, atomic energy and sectors/ activities prohibited for foreign investment.

iii. If on transfer of ownership of any existing or future FDI in an entity in India, directly or indirectly, the beneficial ownership falls within the restriction or purview of the preceding two stipulations, it shall also require government approval.

26.1.5 Permitted Investments by persons resident outside India

a) General modes for Investments

Persons resident outside India, in different categories, may make investment in India though any of the under mentioned modalities, subject to specific conditions laid down for each of these.

i. Subscribe/ purchase/ sale of equity instruments of an Indian company

ii. Purchase/ sale of equity instruments of a listed Indian company on a recognised stock exchange in India by Foreign Portfolio Investors

iii. Purchase/ sale of equity instruments of a listed Indian company on a recognised stock exchange in India by Non-Resident Indian (NRI) or Overseas Citizen of India (OCI) on repatriation basis

iv. Purchase/ sale of equity instruments of an Indian company or Units or contribution to capital of a LLP or a firm or a proprietary concern by Non-Resident Indian (NRI) or Overseas Citizen of India (OCI) on a Non-Repatriation basis

v. Investment in a Limited Liability Partnership (LLP)

vi. Investment by a Foreign Venture Capital Investor (FVCI)

vii. Investment in an Investment Vehicle.

viii. Issue/ transfer of eligible instruments to a foreign depository for the purpose of issuance of depository receipts by eligible person(s)

ix. Purchase/ sale of Indian Depository Receipts (IDRs) issued by Companies Resident outside India

x. Investment by other non-resident Investors

b) Specific modes of Investments

i. Acquisition through rights issue or bonus issue

A person resident outside India having investment in an Indian company is permitted to invest in the equity instruments (other than share warrants) issued by such company as a rights issue or a bonus issue subject to conditions specified for the purpose.

A person resident outside India exercising a right which was issued when he/ she was a person resident in India can hold the equity instruments so acquired on exercising the right on a non-repatriation basis.

Indian company may allot to existing shareholders who are persons resident outside India additional equity instruments (other than share warrants) as a rights issue over and above their rights entitlement subject to individual or sectoral caps, as the case may be.

ii. Renunciation of rights

A person resident outside India may acquire a right from a person resident in India who has renounced it, and the equity instruments so acquired shall be subject to the conditions applicable to the original shareholding.

iii. Employees' Stock Options (ESOP) and Sweat Equity Shares

An Indian company can issue "employees' stock option" and/ or "sweat equity shares" to its employees/ directors or employees/ directors of its holding company or joint venture or wholly owned overseas subsidiary/ subsidiaries who are resident outside India, subject to certain specific conditions. Such issues to a citizen of Bangladesh/ Pakistan requires prior Government approval.

iv. Issue of Convertible Notes by an Indian startup company

Investment in convertible notes issued by an Indian startup company for an amount of ₹25 lakh or more in a single tranche, is permitted subject to certain conditions. This is not permitted for an individual who is citizen of Pakistan or Bangladesh or an entity which is registered/ incorporated in Pakistan or Bangladesh. An NRI or an OCI may acquire convertible notes on a non-repatriation basis. A person resident outside India can acquire or transfer by way of sale, convertible notes, from or to, a person resident in or outside India, in accordance with the entry routes and pricing guidelines. The convertible note may either be converted to equity shares or repaid within 5 years from the date of the issue at the option of the holder.

v. *Merger or demerger or amalgamation of Indian companies*

In case of merger/ amalgamation/ reconstruction/ demerger pertaining to Indian company(ies) approved by the National Company Law Tribunal (NCLT)/ Competent Authority, the transferee company/ the new company, can issue equity instruments to the existing holders of the transferor company who are resident outside India, subject to certain conditions.

26.1.6 Transfer of equity instruments of an Indian company by or to a person resident outside India

I. *A person resident outside India can transfer the equity instruments of an Indian company or units through various modes*, subject to specified conditions.

i. Sale or gift to any person resident outside India except to NRI, OCI or OCB.

ii. Transfer pursuant to merger, de-merger and amalgamation of entities/ companies incorporated or registered outside India.

iii. Prior Government approval is required for a company engaged in a sector requiring prior government approval.

iv. In case of an FPI, if there is a breach of the applicable aggregate FPI limits or sectoral limits, the FPI is required to sell such equity instruments within five trading days after settlement to a person resident in India eligible to hold such instruments.

II. *Transfer by an NRI/ OCI by way of gift or sale to any person resident outside India*

i. An NRI or an OCI holding equity instruments of an Indian company or units on repatriation basis can transfer the same by way of sale or gift to any person resident outside India.

ii. Prior Government approval is required for a company engaged in a sector requiring prior government approval.

iii. In case of an NRI/ OCI, if there is a breach of the applicable aggregate NRI/OCI limits or sectoral limits, the FPI is required to sell such equity instruments within five trading days after settlement to a person resident in India eligible to hold such instruments.

III. *Transfer by a NRI/ OCI holding equity instruments on a non-repatriable basis or a person resident in India by way of sale to any person resident outside India*

i. NRI/ OCI or a company/ trust/ partnership firm incorporated outside India and owned and controlled by NRIs or OCIs holding equity instruments on a non-repatriable basis or a person resident in India may transfer the same to a person resident outside India by way of sale, subject to the adherence to entry routes, sectoral caps/ investment limits, pricing guidelines and other attendant conditions, as applicable.

ii. The entry routes, sectoral caps/ investment limits, pricing guidelines and other attendant conditions, however, will not apply in case the transferee is an NRI or an

OCI or a company/ trust/ partnership firm incorporated outside India and owned and controlled by NRIs or OCIs acquiring such investment on a non-repatriation basis.

IV. *Transfer by an NRI/ OCI holding equity instruments on a non-repatriable basis by way of gift to another NRI/ OCI who will hold such equity instruments on a non-repatriable basis*
Such transfers have been permitted.

V. *Transfer by person resident outside India to person resident in India or sale on recognised stock exchange in India*
A person resident outside India is permitted to transfer the shares to a person resident in India by way of sale/ gift or may sell the same on a recognised stock exchange in India.

VI. *Transfer by way of gift by an NRI/ OCI holding securities on a non-repatriable basis or a resident to a person resident outside India*
An NRI or an OCI holding securities of an Indian company on a non-repatriation basis or a person resident in India may transfer the securities so held by them to a person resident outside India by way of gift with the prior approval of the RBI, and subject to certain conditions.

VII. *Transfer by way of Pledge*

i. Any person being a promoter of a company registered in India (borrowing company), which has raised external commercial borrowing (ECB) in compliance with the Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2000 may pledge the equity instruments of the borrowing company or that of its associate resident companies for the purpose of securing the ECB raised by the borrowing company subject to specified conditions.
ii. Any person resident outside India holding equity instruments in an Indian company or units may pledge the equity instruments or units, to a bank in India or to an overseas bank or to an NBFC subject to specified conditions.
iii. Any other transfer by way of pledge would require the prior approval of the RBI..

VIII. *Transfer from a resident to a person resident outside India where the investee company is in the financial sector*
In case of transfer of equity instruments of a company in the financial sector from a resident to a person resident outside India, 'fit and proper/ due diligence' requirement as regards the non-resident investor as stipulated by the respective financial sector regulator shall have to be complied with by the AD bank.

IX. *Mode of payment*
The amount of consideration for transfer of equity instruments between a person resident in India and a person resident outside India should be received from abroad or

remitted from India, as the case may be, through banking channels in India or paid out from or received in, as the case may be, NRE/ FCNR(B)/ Escrow accounts. In case of investments on non-repatriation basis, the funds transfer can also be through the NRO account.

26.1.7 Taxes and remittance of sale proceeds

An authorised dealer bank may permit the remittance of sale proceeds of a security (net of applicable taxes) to the seller resident outside India provided:

a) the security was held by the seller on repatriation basis; and
b) either the security has been sold in compliance with the pricing guidelines or the RBI's approval has been obtained in other cases for sale of the security and remittance of the sale proceeds thereof.

26.2 DIRECT INVESTMENT BY RESIDENTS IN JOINT VENTURE (JV) / WHOLLY OWNED SUBSIDIARY (WOS) ABROAD

26.2.1 General

a) Definitions:

i. "*Alternative Investment Fund*" means a fund as defined under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012;

ii. "*American Depository Receipt (ADR)*" means a security issued by a bank or a depository in United States of America (USA) against underlying rupee shares of a company incorporated in India;

iii. "*Core Activity*" means an activity carried on by an Indian entity, turnover wherefrom constitutes not less than 50% of its total turnover in the previous accounting year;

iv. "*Direct investment outside India*" means investment by way of contribution to the capital or subscription to the Memorandum of Association of a foreign entity or by way of purchase of existing shares of a foreign entity either by market purchase or private placement or through stock exchange, but does not include portfolio investment;

(Sponsor contribution from an Indian Party to an Alternative Investment Fund (AIF) set up in an overseas jurisdiction, including International Financial Services Centres (IFSCs) in India, as per the laws of the host jurisdiction; shall be treated as Direct Investment outside India.)

v. "*Domestic Depository*" shall have the same meaning as assigned to it in the Companies (Issue of Indian Depository Receipts) Rules, 2004;

vi. "*Eligible Company*" means a Company eligible to issue Indian Depository Receipts under rule 4 of the Companies (Issue of Indian Depository Receipts) Rules, 2004;

vii. "*Financial Commitment*" means the amount of direct investment by way of contribution to equity, loan and 100 per cent of the amount of guarantees and 50 per cent of the performance guarantees issued by an Indian Party to or on behalf of its overseas Joint Venture Company or Wholly Owned Subsidiary;

viii. "*Foreign Currency Convertible Bond (FCCB)*" means a bond issued by an Indian company expressed in foreign currency, and the principal and interest in respect of which is payable in foreign currency;

ix. "*Global Depository Receipt (GDR)"* means a security issued by a bank or a depository outside India against underlying rupee shares of a company incorporated in India;

x. "*Host country*" means the country in which the foreign entity receiving the direct investment from an Indian Party is registered or incorporated;

xi. "*Indian Depository Receipts*" shall have the same meaning as assigned to it in the Companies (Issue of Indian Depository Receipts) Rules, 2004

xii. "*Indian Party*" means a company incorporated in India or a body created under an Act of Parliament or a partnership firm registered under the Indian Partnership Act, 1932, or a Limited Liability Partnership (LLP), registered under the Limited Liability Partnership Act, 2008 (6 of 2009), making investment in a Joint Venture or Wholly Owned Subsidiary abroad, and includes any other entity in India as may be notified by the Reserve Bank:

(Provided that when more than one such company, body or entity make an investment in the foreign entity, all such companies or bodies or entities shall together constitute the "Indian Party";)

xiii. "*Investment Banker*" means an investment banker registered with the Securities and Exchange Commission in USA, or the Financial Services Authority in UK, or appropriate regulatory authority in Germany, France, Singapore or Japan;

xiv. "*Joint Venture (JV)"* means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country in which the Indian Party makes a direct investment;

xv. "*Real estate business*" means buying and selling of real estate or trading in Transferable Development Rights (TDRs) but does not include development of townships, construction of residential/commercial premises, roads or bridges;

xvi. "*Wholly Owned Subsidiary (WOS)"* means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country, whose entire capital is held by the Indian Party;

xvii. "*Venture Capital Fund*" means a fund as defined under the Securities and Exchange Board of India (Venture Capital Fund) Regulations, 1996;

xviii. "*Agricultural operations*" means agricultural operations as defined in the 'National Bank for Agriculture and Rural Development Act, 1981';

xix. "*Foreign Currency Exchangeable Bond*" means a bond expressed in foreign currency, the principal and interest in respect of which is payable in foreign currency, issued by an issuing company and subscribed to by a person who is a resident outside India in foreign currency and exchangeable into equity share of offered company, in any manner, either wholly, or partly or on the basis of any equity related warrants attached to debt instruments;

xx. "*Issuing company*" means a company registered under the Companies Act, 1956 (1 of 1956) and eligible to issue Foreign Currency Exchangeable Bond under these regulations;

xxi. "*Offered company*" means a company registered under the Companies Act, 1956 (1 of 1956) and whose equity share/s is/are offered in exchange of the Foreign Currency Exchangeable Bond;

xxii. "*Promoter group*" has the same meaning as defined in the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000;]

b) Prohibitions

i. Indian Parties are prohibited from making investment (or financial commitment) in foreign entity engaged in real estate (meaning buying and selling of real estate or trading in Transferable Development Rights (TDRs) but does not include development of townships, construction of residential/commercial premises, roads or bridges) or banking business, without the prior approval of the Reserve Bank.

ii. An overseas entity, having direct or indirect equity participation by an Indian Party, shall not offer financial products linked to Indian Rupee (e.g. non-deliverable trades involving foreign currency, rupee exchange rates, stock indices linked to Indian market, etc.) without the specific approval of the Reserve Bank.

c) General Permission

Persons resident in India can purchase / acquire securities in the following manner - (a) out of the funds held in RFC account; (b) as bonus shares on existing holding of foreign currency shares; and (c) when not permanently resident in India, out of their foreign currency resources outside India. General permission is also available to sell the shares so purchased or acquired.

26.2.2 Direct Investment (or financial commitment) outside India

There are two routes for permission to make investments outside India – i) Automatic Route and ii) Approval Route.

A. Automatic Route

(I) General Aspects

i) An Indian Party can make investment/ undertake financial commitment in overseas Joint Ventures (JV) / Wholly Owned Subsidiaries (WOS), as per the ceiling prescribed by the RBI (currently 400% of the net worth as per the last audited balance sheet).

ii) Any financial commitment (FC) exceeding USD 1 billion (or its equivalent) in a financial year would require prior approval of the RBI even when the total FC of the Indian Party is within the eligible limit under the automatic route.

iii) The Indian Party has to apply to the AD for such investment.

iv) The total financial commitment of the Indian Party in all the JVs/ WOSs shall comprise the following:

  a) Equity shares and/ or Compulsorily Convertible Preference Shares (CCPS);
  b) Other preference shares;
  c) Loan;
  d) Guarantee (other than performance guarantee) issued by the Indian Party;

e) Bank guarantee issued by a resident bank on behalf of JV or WOS of the Indian Party (if backed by a counter guarantee/ collateral by the Indian Party).
f) 50% of the performance guarantee issued by the Indian Party. (If the outflow on account of invocation results in the breach of the limit of the financial commitment in force, prior permission of the RBI is to be obtained for executing remittance beyond the limit.)

v) Such investments by the Indian Party are subject to prescribed conditions. Following are certain salient conditions:
a) Loan guarantee is permitted only to an overseas JV/ WOS in which it has equity participation. Other cases may be referred to RBI under approval route.
b) Indian Party should not be on RBI's Exporters' caution list; or list of defaulters to the banking system – of RBI/ CIBIL / or any other approved CIC as approved by RBI; or under investigation by any investigation/ enforcement agency or regulatory body.
c) All transactions relating to a JV/ WOS should be routed through one branch of an AD bank designated by the Indian Party.
d) For partial/ full acquisition of an existing foreign company, with investment more than USD 5 million, valuation should be done by an authorised agency.
e) For investment by way of swap of shares, valuation should be done by an authorised agency.
f) An Indian company may issue capital instruments to a person resident outside India under the Automatic Route or the Government route depending on the sector to which it belongs.

vi) Investments/ financial commitments in Nepal are permitted only in Indian Rupees. Investments / financial commitments in Bhutan are permitted in Indian Rupees as well as in freely convertible currencies. Amounts receivable on account of investments made in freely convertible currencies are required to be repatriated to India in freely convertible currencies only.

vii) Investments/ financial commitments are not permitted in an overseas entity located in the countries identified by the Financial Action Task Force (FATF) as "non-cooperative countries and territories". Investments / financial commitments in Pakistan are permissible under the approval route.

(II) Funding/ Consideration for Investment

i) Method of Funding
a) Investment (or financial commitment) in an overseas JV / WOS may be funded out of one or more of the following sources:
1) drawal of foreign exchange from an AD bank in India;
2) capitalisation of exports;
3) swap of shares (valuation as mentioned above);
4) proceeds of External Commercial Borrowings (ECBs) / Foreign Currency Convertible Bonds (FCCBs);
5) in exchange of ADRs/GDRs issued in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository

Receipt Mechanism) Scheme, 1993, and the guidelines issued thereunder from time to time by the Government of India;
6) balances held in EEFC account of the Indian Party and
7) proceeds of foreign currency funds raised through ADR / GDR issues.

In respect of (6) and (7) above, the limit of financial commitment vis-à-vis the net worth will not apply. However, all investments (or financial commitment) made in the financial sector will be subject to compliance with Regulation 7 of the Notification ibid, irrespective of the method of funding.

b) General permission has been granted to persons resident in India for purchase/ acquisition of securities in the following manner:
   1) out of funds held in RFC account;
   2) as bonus shares on existing holding of foreign currency shares; and
   3) when not permanently resident in India, out of their foreign currency resources outside India

ii) Capitalisation of exports and other dues
   a) Indian Party is permitted to capitalise the payments due from the foreign entity towards exports, fees, royalties or any other dues from the foreign entity for supply of technical know-how, consultancy, managerial and other services within the ceilings applicable. Capitalisation of export proceeds remaining unrealised beyond the prescribed period of realization will require prior approval of the Reserve Bank.
   b) Indian software exporters are permitted to receive 25 per cent of the value of their exports to an overseas software start-up company in the form of shares without entering into Joint Venture Agreements, with prior approval of the Reserve Bank.

(III) Specific Investment Modes

Following modes of investment (or financial commitment) are permitted under the Automatic Route, subject to specifically prescribed conditions in each case.

i) Investment/ FC through Special Purpose Vehicle (SPV) - Indian Parties whose names appear in the defaulters' list require prior approval of the RBI.
ii) Issue of guarantee to step down subsidiary of JV/ WOS set up by their JV/ WOS is permitted. For second generation or subsequent level step down (Indian Party holds 51% or more stake) will require prior approval of RBI.
iii) Investment/ FC in unincorporated/ incorporated entities overseas in oil sector (i.e. for exploration and drilling for oil and natural gas, etc.) - by Navaratna PSUs, ONGC Videsh Ltd (OVL) and Oil India Ltd (OIL) provided such investments are approved by the competent authority.
iv) Other Indian companies are also permitted up to the prescribed limit, if proposal has been approved by the competent authority.
v) Construction and maintenance of submarine cable systems - permitted to participate in a consortium with other international operators to construct and maintain submarine cable systems on co-ownership basis. The Indian company has obtained necessary licence from the Department of Telecommunication, Ministry of Telecommunication & Information Technology, Government of India.

vi) Investment/ FC in Financial Services Sector - Indian Party should be registered with the regulatory authority in India for conducting the financial sector activities, and fulfill other prescribed conditions. Unregulated entities in financial services sector in India may invest in non-financial sector activities subject to compliance with prescribed conditions. Trading in commodities exchanges overseas and setting up JV/WOS for trading in overseas exchanges will be reckoned as financial services activity and require clearance from SEBI.

vii) Investment in equity of companies registered overseas/ rated debt instruments – This is permitted in the following manner –

   a) Portfolio investments by listed Indian companies – can invest up to 50% of their net worth as on the date of the last audited balance sheet in (i) shares and (ii) bonds / fixed income securities, (rated not below investment grade) issued by listed overseas companies.
   b) Investment by Indian Mutual Funds – can invest within an overall cap of USD 7 billion in various specified types of securities.
   c) Restricted Investment by qualified Indian Mutual Funds - invest cumulatively up to USD 1 billion in overseas Exchange Traded Funds as permitted by SEBI.
   d) Domestic Venture Capital Funds / Alternative Investment Funds – can invest in equity and equity linked instruments of off-shore Venture Capital Undertakings, subject to an overall limit of USD 41500 million
   e) General permission is also available to these categories of investors for sale of securities so acquired.

B. Approval of the Reserve Bank

(I) General Aspects

   i) Prior approval of the Reserve Bank would be required in all other cases of Investment/ FC abroad.
   ii) RBI would, inter alia, take into account the following factors while considering such applications:
      a) Prima facie viability of the JV/ WOS outside India;
      b) Contribution to external trade and other benefits which will accrue to India;
      c) Financial position and business track record of the Indian Party and the foreign entity; and
      d) Expertise and experience of the Indian Party in the same or related line of activity.

(II) Specific Investment Sectors/ Modes

Investment in various sectors and through different modes considered under approval route are as follows.

i) Investments in energy and natural resources sector - Applications for investment/ FC in the energy and natural resources sectors (e.g. oil, gas, coal and mineral ores) in excess of the prescribed limit are considered under approval route.

ii) Investments by proprietorship concerns and registered Trust/ Society – These are considered under approval route subject to fulfilment of certain prescribed criteria/ conditions.

C. Permissions for Other Aspects

a) Post investment changes / additional investment (or financial commitment) in existing JV / WOS – A JV/WOS may diversify its activities / set up step down subsidiary / alter the shareholding pattern in the overseas entity, subject to reporting to RBI.
b) Restructuring of the balance sheet of the overseas entity involving write off of capital and receivables - Indian promoters may write off capital (equity / preference shares) or other receivables, such as, loans, royalty, technical knowhow fees and management fees in respect of the JV /WOS, even while such JV /WOS continues to function, as specifically permitted.
c) Acquisition of a foreign company through bidding or tender procedure – Remittance of EMD and issue of Bid bond guarantee is permitted.
d) Transfer by way of sale of shares of a JV / WOS – An Indian Party can do this subject to the prescribed conditions, without RBI approval.
e) Transfer by way of sale of shares of a JV / WOS involving write off of the investment (or financial commitment) – In certain cases as specified and subject to prescribed conditions the Indian Party may disinvest where the amount repatriated after disinvestment is less than the original amount invested. In other cases, prior approval of RBI will be required.
f) Pledge of shares of Joint Venture (JV), Wholly Owned Subsidiary (WOS) and Step Down Subsidiary (SDS) – Indian Party is permitted to do this in favour of an AD or a public financial institution in India or an overseas lender, for availing of fund based or non-fund based facility for itself or for its JV/ WOS/ SDS whose shares are pledged, or for any other JV/ WOS/ SDS of the Indian Party subject to the prescribed conditions.
g) Rollover of guarantees – Renewal / rollover of an existing / original guarantee, which is part of the total financial commitment of the Indian Party is not treated as a fresh commitment. This is subject to specified conditions.
h) Creation of charge on domestic and foreign assets - An Indian Party may create charge on its assets and also assets of its group company, sister concern or associate company in India, promoter and / or director in favour of an overseas lender as security for availing of the fund based and/or non-fund based facility for its JV or WOS or SDS outside India subject to prescribed conditions. Also, an Indian Party may create charge on the assets of its overseas JV or WOS or SDS in favour of an AD bank in India as security for availing of the fund based and/or non-fund based facility for itself or its JV or WOS or SDS outside India subject to the terms and conditions prescribed
i) Overseas Direct Investments by resident individuals - A resident individual (single or in association with another resident individual or with an 'Indian Party') satisfying the specified criteria, may make overseas direct investment in the equity shares and compulsorily convertible preference shares of a JV or WOS outside India. This shall be within the overall limit prescribed by the RBI under the provisions of Liberalised Remittance Scheme.
j) Hedging of overseas direct investments - Resident entities are permitted to hedge the foreign exchange rate risk arising out of such investments.

k) Opening of Foreign Currency Account abroad by an Indian Party - An Indian party may open, hold and maintain Foreign Currency Account (FCA) abroad for the purpose of making overseas direct investments subject to the prescribed conditions.

D. Other Investments in Foreign Securities:

Following modes of investments in foreign securities are also permitted –

i) Permission for purchase/ acquisition of foreign securities in certain cases –
   a) An individual has a general permission for acquiring foreign securities/ shares from any person outside India as gift, or inheritance (even from a person resident in India), under ESOP (cashless or through purchase),
   b) A person resident in India may sell the shares acquired as stated above provided that the proceeds are repatriated immediately on receipt thereof and in any case not later than 90 days from the date of sale.
   c) Foreign companies can repurchase the shares issued to residents in India under any ESOP Scheme provided the repurchase is in terms of the initial offer document.
   d) In all other cases, not covered by general or special permission, approval of the Reserve Bank is required to be obtained before acquisition of a foreign security.

ii) Pledge of a foreign security by a person resident in India- This is allowed for obtaining credit facilities in India from an AD Category – I bank / Public Financial Institution.

iii) General permission in certain cases –
   Residents are permitted to acquire a foreign security, if it represents the following –
   a) qualification shares for becoming a director of a company outside India, if it does not exceed the limit under the LRS,
   b) part / full consideration of professional services rendered to the foreign company or in lieu of Director’s remuneration.
   c) rights shares provided that the rights shares are being issued by virtue of holding shares in accordance with the provisions of law
   d) purchase of shares of a JV/ WOS abroad of the Indian promoter company by the employees/directors of the latter which is engaged in the field of software where the consideration for purchase does not exceed the prescribed ceiling.
   e) An Indian company in the knowledge based sector may allow its resident employees (including working directors) to purchase foreign securities under the ADR/GDR linked stock option schemes.
   f) Acquiring the shares of SWIFT by a resident bank - A bank in India may acquire the shares of Society for Worldwide Interbank Financial Telecommunication (SWIFT) as per the by-laws of SWIFT, provided the bank has been permitted by the RBI for admission to the ‘SWIFT User’s Group in India’ as member.
   g) Issue of Indian Depository Receipts (IDRs) - Eligible companies resident outside India may issue Indian Depository Receipts (IDRs) through a Domestic Depository.
   h) Maintenance of collateral by FIIs for transactions in derivative segment- opening of demat accounts by Clearing Corporations and Clearing Members: Clearing corporations of stock exchanges and their clearing members may undertake the following transactions -

1) to open and maintain demat accounts with foreign depositories and to acquire, hold, pledge and transfer the foreign sovereign securities, offered as collateral by FIIs;
2) to remit the proceeds arising from corporate action, if any, on such foreign sovereign securities; and
3) to liquidate such foreign sovereign securities if the need arises.

E. Obligations of Indian Party (IP) and Resident Individual (RI)

i) To receive share certificates or any other document as an evidence of investment, within 6 months from the date of effecting remittance or the date on which the amount to be capitalised became due to the Indian Party or the date on which the amount due was allowed to be capitalized;
   a) To repatriate to India, all dues receivable from the foreign entity, like dividend, royalty, technical fees etc., within 60 days of its falling due;
   b) To submit to the Reserve Bank, through the designated Authorised Dealer, every year on or before December 31, an Annual Performance Report (APR) in Part II of Form ODI in respect of each JV or WOS outside India.

ii) Reporting requirements including submission of Annual Performance Report are also applicable for investors in unincorporated entities in the oil sector.

iii) Where the law of the host country does not mandatorily require auditing of the books of accounts of JV / WOS, the Annual Performance Report (APR) may be submitted by the Indian Party based on the un-audited annual accounts of the JV / WOS, subject to certain specified provisions.

iv) An annual return on Foreign Liabilities and Assets (FLA) is required to be submitted directly by all the Indian companies which have received FDI and/or made FDI abroad (i.e. overseas investment) in the previous year(s) including the current year, to the RBI.

F. Operational Instructions to AD Banks (AD Category I Banks)

i) Designated branches

The investing Indian Party should route all transactions relating to the investment (or financial commitment) through one branch of an AD bank designated by it. Different AD banks/ branches may be designated for different JV/ WOS. The designated AD bank should forward to RBI the requests with its comments/ recommendations.

ii) Allotment of Unique Identification Number (UIN)

A UIN is allotted to each JV or WOS abroad (even when there more than one Indian party invest jointly), and is required to be quoted in all correspondence with the RBI. Investment (or financial commitment) is permitted only after the allotment of UIN.

iii) *Permitting Investments under Regulation 6* of Notification No. FEMA 120/2004-RB dated July 7, 2004

AD banks may permit transactions up to the permissible limits based on ODI application with form A-2, if found in order.

iv) General Procedural Instructions

a) The Overseas Investment Application (OIA) for online reporting of the ODI forms is operational. It enables generation of the UIN, acknowledgment of remittance/s (or financial commitment), filing of the Annual Performance Reports (APRs), disinvestment report and easy accessibility to data at the AD level.

1) In case of disinvestment by way of closure / winding up / voluntary liquidation / merger/ amalgamation of JV/ WOS under the Automatic Route, the designated AD bank should submit report in the online application.
2) In all other cases of disinvestment, an application along with the necessary supporting documents should be submitted to the RBI as per the existing procedure.

b) Remittance towards loan and / or issue guarantee to / on behalf of the JV / WOS abroad should be permitted only after ensuring that the Indian Party has an equity stake in the JV / WOS. If the laws of the host country permit incorporation of a company without equity participation by the Indian Party, prior approval from the RBI is required.

c) Verification of evidence of investment
The share certificates, if not issued or any other document as evidence of investment, shall be retained by the designated AD bank. It should monitor their receipt and satisfy themselves about their bonafides.

d) Opening of Foreign Currency Account abroad by an Indian Party
Wherever, the host country Regulations stipulate that the investments (or financial commitment) into the country are required to be routed through a designated account, an Indian Party is allowed to open, hold and maintain Foreign Currency Account (FCA) abroad for the purpose of overseas direct investments (or financial commitment) subject to certain prescribed conditions.

v) *Transactions Permitted Under Different Modes*:

a) Investments (or financial commitment) under Regulation 11 of Notification No. FEMA.120/2004-RB dated July 7, 2004 (Capitalisation of dues)
Direct investment is permitted abroad by way of capitalisation of exports or other dues/entitlements like royalties, technical know-how fees, consultancy fees, etc. The details of the dues to be capitalised should be submitted to the designated branch of the AD bank. The banks should obtain a custom certified copy of the invoice and forward it to RBI together with the revised form ODI. Where the said dues are overdue, these would require prior approval of the RBI.

b) Investment by way of share swap
The details of transactions such as number of shares received/ allotted, premium paid/ received, brokerage paid/ received, etc., should be submitted to RBI. To ensure (i) the inward leg has been approved by FIPB (if required), and (ii) the valuation has been done as per the laid-down procedure, and (iii) that the overseas company’s shares are issued/ transferred in the name of the Indian investing company.

c) Purchase of foreign securities under ADR/ GDR linked Stock Option Scheme
Remittances (up to the stipulated ceiling) for purchase of foreign securities in the knowledge based sector under the ADR/ GDR linked ESOPs are permitted. After satisfying that the issuing company has followed the relevant guidelines.

d) Remittance towards Earnest Money Deposit or Issue of Bid Bond Guarantee

Remittance towards Earnest Money Deposit (EMD) to the extent eligible or issue of bid bond guarantee for participation in bidding or tender procedure for acquisition of a company incorporated outside India can be permitted based on Form A2. On winning the bid, the acquisition value can be remitted after obtaining Form A2 duly filled in. If not successful, the EMD amount should be repatriated.

On successful bid / tender if the Indian Party does not proceed further with the investment, AD banks should submit full details of remittance allowed towards EMD/ invoked bid bond guarantee.

If successful in the bid, but the terms and conditions of acquisition are not in conformity with the provisions of Regulations, or different from those for which approval was obtained, the Indian entity should obtain approval from RBI.

e) Transfer by way of sale of shares of a JV/ WOS outside India

The Indian Party should report details of the disinvestment in OIA through the AD bank within 30 days of disinvestment. Sale proceeds shall be repatriated to India immediately on receipt, within 90 days from the date of sale, in any case.

26.3 EXTERNAL COMMERCIAL BORROWING (ECB) AND TRADE CREDITS (TC)

26.3.1 Important Terms Used under ECB and TC Frameworks

1) *All-in-Cost*: It includes rate of interest, other fees, expenses, charges, guarantee fees, ECA charges, whether paid in foreign currency or INR but will not include commitment fees and withholding tax payable in INR. Under TC Framework, all-in-cost shall include rate of interest, other fees, expenses, charges, guarantee fees whether paid in foreign currency or INR. Withholding tax payable in INR shall not be a part of all-in-cost. (For certain components of all-in-costs ceilings have been prescribed). Various components of all-in-cost have to be paid by the borrower without taking recourse to the drawdown of ECB/TC, i.e., ECB/TC proceeds cannot be used for payment of interest/charges.
2) *Approval route*: ECB/TC can be raised either under the automatic route or under the approval route. Under the approval route, the prospective borrowers are required to send their requests to the RBI through their AD Banks for examination.
3) *Automatic route*: For the automatic route, the cases are examined by the AD Category-I banks.
4) *Benchmark rate*: Benchmark rate in case of FCY ECB/TC refers to any widely accepted interbank rate or ARR of 6-month tenor, applicable to the currency of borrowing. Benchmark rate in case of Rupee denominated ECB/TC will be prevailing yield of the Government of India securities of corresponding maturity.
5) *Designated Authorised Dealer Category I Bank*: It is the bank branch which is designated by the ECB/TC borrower for meeting the reporting requirements including obtaining of the LRN/LIN from the Reserve Bank, exercising the delegated powers under these guidelines and monitoring of ECB/TC transactions.
6) *ECB liability -Equity ratio*: For this purpose, ECB amount will include outstanding amounts of all ECBs (other than INR denominated) and the proposed one (only outstanding ECB amounts in case of refinancing) while equity will include the paid-up

capital and free reserves (including the share premium received in foreign currency). Both ECB and equity amounts will be calculated with respect to the foreign equity holder. Where there is more than one foreign equity holder in the borrowing company, the portion of the share premium in foreign currency brought in by the lender(s) concerned shall only be considered for calculating the ratio. The ratio will be calculated as per latest audited balance sheet.

7) *FATF compliant country*: A country that is a member of the Financial Action Task Force (FATF) or a member of a FATF-Style Regional Body; and should not be a country identified in the public statement of the FATF as (i) A jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or (ii) A jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies.
8) *Foreign Currency Convertible Bonds (FCCBs):* It refers to foreign currency denominated instruments which are issued in accordance with the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993. Issuance of FCCBs shall also conform to other applicable regulations. Further, FCCBs should be without any warrants attached.
9) *Foreign Currency Exchangeable Bonds (FCEBs):* It refers to foreign currency denominated instruments which are issued in accordance with the Issue of Foreign Currency Exchangeable Bonds Scheme, 2008. FCEBs are exchangeable into equity share of another company, to be called the Offered Company, in any manner, either wholly, or partly or on the basis of any equity related warrants attached to debt instruments. Issuance of FCEBs shall also conform to other applicable regulations.
10) *Foreign Equity Holder*: It means (a) direct foreign equity holder with minimum 25% direct equity holding in the borrowing entity, (b) indirect equity holder with minimum indirect equity holding of 51%, or (c) group company with common overseas parent.
11) *Infrastructure Sector*: It has the same meaning as given in the Harmonised Master List of Infrastructure sub-sectors, approved by Government of India vide Notification F. No. 13/06/2009-INF, as amended / updated. For the purpose of ECB, “Exploration, Mining and Refinery” sectors will be deemed as in the infrastructure sector.
12) *Infrastructure Space Companies:* Companies in the infrastructure sector, Non-Banking Finance Companies undertaking infrastructure financing, Holding Companies/ Core Investment Companies undertaking infrastructure financing, Housing Finance Companies regulated by National Housing Bank and Port Trusts (constituted under the Major Port Trusts Act, 1963 or Indian Ports Act, 1908).
13) *IOSCO Compliant Country*: A country whose securities market regulator is a signatory to the International Organisation of Securities Commission's (IOSCO’s) Multilateral Memorandum of Understanding or a signatory to bilateral Memorandum of Understanding with the SEBI for information sharing arrangements.
14) *Real Estate Activities*: Any real estate activity involving own or leased property, for buying, selling and renting of commercial and residential properties or land and also includes activities either on a fee or contract basis assigning real estate agents for intermediating in buying, selling, letting or managing real estate. However, this would

not include, (i) construction/development of industrial parks/integrated townships/SEZ (ii) purchase/long term leasing of industrial land as part of new project/modernisation of expansion of existing units and (iii) any activity under 'infrastructure sector' definition.

15) *Special Economic Zone & Free Trade Warehousing Zone*: They shall have the same meaning as assigned to them in Special Economic Zones Act 2005, as amended from time to time.

26.3.2 External Commercial Borrowings Framework

(a) Basic Approach:

External Commercial Borrowings are commercial loans raised by eligible resident entities from recognised non-resident entities and should conform to a set of parameters, prescribed by RBI. This framework is not applicable to investments in Non-Convertible Debentures in India made by Registered Foreign Portfolio Investors. Lending and borrowing by Indian banks and their branches/subsidiaries outside India is subject to prudential guidelines issued by the Department of Banking Regulation of the RBI. Further, other entities raising ECB are required to follow the sectoral/ prudential guidelines.

(b) Salient Features of the ECB Framework:

ECB can be raised as - (i) FCY denominated ECB and (ii) INR denominated ECB.

A. Common Parameters for FCY and INR denominated ECBs

i) Recognised lenders: Resident of FATF or IOSCO compliant country (even on transfer of ECB). Including -
   a) Multilateral and Regional Financial Institutions where India is a member country;
   b) Individuals - if they are foreign equity holders or if they subscribe to bonds/debentures listed abroad;
   c) Foreign branches/ subsidiaries of Indian banks - only for FCY ECB (except FCCBs and FCEBs). Subject to applicable prudential norms, they can participate as arrangers/ underwriters/ market-makers/ traders for INR Bonds issued overseas. Underwriting by foreign branches/subsidiaries of Indian banks for issuances by Indian banks is not allowed.

ii) Minimum Average Maturity Period (MAMP) –3 years (Call and put options cannot be exercised prior to this period.) MAMP for specific categories are as follows –
   a) By manufacturing companies (up to USD 50 mn or its equivalent per financial year) – 1 year (These can also be raised from foreign branches/ subsidiaries of Indian banks.)
   b) From foreign equity holder for working capital/ general corporate purposes or for repayment of Rupee loans – 5 years
   c) (i) For working capital/ general corporate purposes; (ii) For repayment of domestic Rupee loans for other than capital expenditure; and (ii) For on-lending by NBFCs for these purposes – 10 years
   d) (i) For repayment of domestic Rupee loans for capital expenditure; (ii) For on-lending by NBFCs for this purpose - 7 years

(ECB cannot be raised from foreign branches / subsidiaries of Indian banks, except where indicated.)

iii) Other costs - Prepayment charge/ Penal interest, if any, for default or breach of covenants, should not be more than 2 % over and above the contracted rate of interest on the outstanding principal amount and will be outside the all-in-cost ceiling.

iv) End-uses (Negative list) - The negative list, for which the ECB proceeds cannot be utilised, would include the following:
   a) Real estate activities.
   b) Investment in capital market.
   c) Equity investment.
   d) Working capital purposes, except in case of ECB mentioned at ii (b) and ii (c) above.
   e) General corporate purposes, except in case of ECB mentioned at ii (b) and ii (c) above.
   f) Repayment of Rupee loans, except in case of ECB mentioned at ii (c) and ii (d) above.
   g) On-lending to entities for the above activities, except in case of ECB raised by NBFCs as given at ii (c) and ii (d) above.

B. FCY denominated ECB

i) Currency of borrowing - Any freely convertible Foreign Currency

ii) Forms of ECB - Loans including bank loans; floating/ fixed rate notes/ bonds/ debentures (other than fully and compulsorily convertible instruments); Trade credits beyond 3 years; FCCBs; FCEBs and Financial Lease.

iii) Eligible borrowers - All entities eligible to receive FDI. Further, the following entities are also eligible to raise ECB: i. Port Trusts; ii. Units in SEZ; iii. SIDBI; and iv. EXIM Bank of India.

iv) All-in-cost ceiling per annum – (i) Benchmark Rate plus 550 bps spread: For existing ECBs linked to LIBOR whose benchmarks are changed to ARR. (ii) Benchmark rate plus 500 bps spread: For new ECBs.

v) Exchange rate - Change of FCY ECB into INR ECB can be at the exchange rate prevailing on the date of the agreement for such change or at a lower exchange rate if consented to by the ECB lender.

vi) Hedging provision - The entities should follow guidelines for hedging issued by the concerned sectoral or prudential regulator. Infrastructure space companies shall have a Board approved risk management policy; and must mandatorily hedge 70% of their ECB exposure in case the average maturity of the ECB is less than 5 years. Designated AD bank must monitor this aspect. An ECB may be considered naturally hedged only if the offsetting exposure has the maturity/cash flow within the same accounting year.

vii) Change of currency of borrowing - Change from one freely convertible foreign currency to any other freely convertible foreign currency as well as to INR is freely permitted.

C. INR denominated ECB

i) Currency of borrowing - Indian Rupee (INR)

ii) Forms of ECB - Loans including bank loans; floating/ fixed rate notes/bonds/ debentures/ preference shares (other than fully and compulsorily convertible instruments); Trade credits beyond 3 years; and Financial Lease. Also, plain vanilla Rupee denominated bonds issued overseas, which can be either placed privately or listed on exchanges as per host country regulations.

iii) Eligible borrowers - a) All entities eligible to raise FCY ECB; and b) Registered entities engaged in micro-finance activities, viz., registered Not for Profit companies, registered societies/trusts/ cooperatives and Non-Government Organisations.

iv) All-in-cost ceiling per annum - Benchmark rate plus 450 bps spread.

v) Exchange rate - For conversion to Rupee, the exchange rate shall be the rate prevailing on the date of settlement.

vi) Hedging provision - Overseas investors are eligible to hedge their exposure in Rupee through (i) permitted derivative products with AD banks in India; (ii) through branches / subsidiaries of Indian banks abroad; or (iii) branches of foreign banks with Indian presence on a back to back basis.

vii) Change of currency of borrowing - It is not permitted.

D. Exclusions

(i) The ECB framework is not applicable in respect of investments in Non-Convertible Debentures in India made by Registered Foreign Portfolio Investors.

(ii) Lending and borrowing under the ECB framework by Indian banks and their branches/subsidiaries outside India will be subject to prudential guidelines issued by the Department of Banking Regulation of the Reserve Bank. Further, other entities raising ECB are required to follow the guidelines issued, if any, by the concerned sectoral or prudential regulator.

(c) Limit and Leverage of ECB:

i) All eligible borrowers can raise ECB up to USD 750 million or equivalent per financial year under the automatic route.

ii) Under the automatic route, for FCY denominated ECB from direct foreign equity holder, ECB liability-equity ratio cannot exceed 7:1, if outstandings under all ECBs (including the proposed one) is USD 5 million or its equivalent. Guidelines on debt equity ratio by the sectoral or prudential regulator concerned also apply.

iii) Restrictions on issuance of Guarantee, etc. by Indian banks and Financial Institutions and NBFCs: Issuance of guarantee relating to ECB is not permitted. Investment in FCCBs/ FCEBs by them is not permitted.

(d) Parking of ECB Proceeds:

i) Entire ECB proceeds may not be required for deployment immediately, requiring parking of the disbursed funds. ECB proceeds can be parked abroad as well as domestically as specified:

ii) Parking abroad: ECB proceeds meant only for foreign currency expenditure can be parked abroad pending utilisation. Till utilisation, these funds can be invested in specified liquid assets.

iii) Parking domestically: ECB proceeds for Rupee expenditure should be repatriated immediately to India, and can be parked in unencumbered term deposits with AD bank maximum up to 12 months cumulatively.

(e) Procedure of raising ECB:

i) All ECBs conforming the prescribed framework fully can be raised under the Automatic Route.

ii) For approval route cases, the borrowers may approach the RBI through their AD bank. These are considered keeping in view the overall guidelines, macroeconomic situation and merits.

(f) Operational Aspects

1) *Loan Registration Number (LRN)*: To obtain LRN, borrowers are required to submit duly certified Form ECB, also containing terms and conditions of the ECB to the designated AD bank, which submits one copy to RBI. Any draw-down should happen only after obtaining the LRN.
2) *Changes in terms and conditions*: Changes in ECB parameters, including reduced repayment by mutual agreement should be reported to RBI.
3) *Monthly Reporting of actual transactions*: Actual transactions to be reported on monthly basis. Changes, in parameters should also be incorporated.
4) *Standard Operating Procedure (SOP) for Untraceable Entities*: The following SOP has to be followed by designated AD banks in case of untraceable entities -
   i) Definition: Any ECB borrower is treated as 'untraceable entity', if entity/auditor(s)/director(s)/ promoter(s) of entity are not reachable/responsive/reply in negative over email/letters/phone for a period of not less than two quarters with 6 or more documented communications/ reminders and if:
      a) Entity is not found to be operative at the available registered office address or not found to be operative during the visit by the officials of the AD Bank/ or its authorised agencies; and
      b) Entities have not submitted Statutory Auditor's Certificate for last two years or more;

   ii) Actions: The followings actions are to be taken:
      a) File Revised Form ECB, if required, and last Form ECB2 Return without certification from company, and with 'UNTRACEABLE ENTITY' written. The outstanding amount will be treated as written-off from external debt liability of the country but may be retained by the lender in its books for recovery through judicial/ non-judicial means;
      b) No fresh ECB application by the entity should be examined/ processed;
      c) Directorate of Enforcement should be informed whenever any entity is designated 'UNTRACEABLE ENTITY'; and
      d) No inward remittance or debt servicing will be permitted under automatic route.
5) *Powers delegated to AD Category I banks to deal with ECB cases*:
   To approve requests for changes in respect of ECB, except for FCCBs/ FCEBs. To ensure the changes comply with extant ECB norms and are with the consent of lender(s).
      a) Change of the AD bank: This is permitted subject to no objection certificate from the existing AD bank.

b) Cancellation of LRN: The designated AD banks may directly approach RBI for cancellation of LRN, if no draw down against the said LRN has taken place and the monthly ECB-2 returns have been submitted.

c) Refinancing of existing ECB:

   (1) Refinancing of existing ECB by fresh ECB is permitted provided –

      (a) the outstanding maturity of the original borrowing (weighted outstanding maturity in case of multiple borrowings) is not reduced, and

      (b) all-in-cost of fresh ECB is lower than the all-in-cost (weighted average cost in case of multiple borrowings) of existing ECB.

   (2) Refinancing of ECBs raised under the previous ECB frameworks is permitted, if the borrower is eligible to raise ECB under the extant framework.

   (3) Raising of fresh ECB to part refinance the existing ECB is also permitted subject to same conditions.

   (4) Indian banks are permitted to participate in refinancing of existing ECB, only for highly rated corporates (AAA) and for Maharatna/ Navratna public sector undertakings.

d) Conversion of ECB into equity: Conversion of ECB, including those which are matured but unpaid, into equity is permitted subject to prescribed conditions.

e) Security for raising ECB: AD banks are permitted to allow creation/ cancellation of charge on immovable assets, movable assets, financial securities and issue of corporate and/or personal guarantees in favour of overseas lender / security trustee.

f) Additional Requirements: AD banks should ensure the following requirements.

   (1) The changes permitted, if any, are in conformity with the applicable ceilings/ guidelines and the ECB continues to be in compliance with applicable guidelines.

   (2) If the borrower has availed of credit facilities from the Indian banking system (including foreign branches/ subsidiaries of Indian banks), any extension of tenure of ECB (whether matured or not) shall be subject to applicable prudential RBI guidelines including guidelines on restructuring.

   (3) The changes in the terms and conditions of ECB should be reported to the DSIM (RBI). These should also get reflected in the Form ECB 2 returns appropriately.

(g) Other Specific Provisions:

(1) Special dispensation has been prescribed for ECBs to be raised by (i) Oil Marketing Companies and (ii) Start-ups.

(2) All entities against which investigation / adjudication / appeal by the law enforcing agencies for violation of any of the provisions of the Regulations under FEMA pending, may raise ECB as per the applicable norms, if they are otherwise eligible. The borrowing entity shall inform about pendency of such investigation / adjudication / appeal to the AD bank / RBI. AD Banks / RBI while approving the proposal shall intimate the agencies concerned by endorsing a copy of the approval letter.

(3) An entity which is under a restructuring scheme/ corporate insolvency resolution process can raise ECB only if specifically permitted under the resolution plan.

(4) Eligible corporate borrowers who have availed domestic Rupee loans for capital expenditure in manufacturing and infrastructure sector classified as SMA-2 or NPA can avail ECB for repayment of these loans under any one time settlement with lenders.

(5) Eligible borrowers, participating in the Corporate Insolvency Resolution Process under Insolvency and Bankruptcy Code, 2016 as resolution applicants, can raise ECB from all recognised lenders, except foreign branches/subsidiaries of Indian banks, for repayment of Rupee term loans of the target company.

(h) Compliance Responsibility

The primary responsibility for ensuring that the borrowing is in compliance with the applicable guidelines is that of the borrower. Any contravention of the applicable provisions of ECB guidelines will invite penal action under the FEMA. The designated AD bank is also expected to ensure compliance with applicable ECB guidelines by their constituents.

26.3.3 Trade Credits Framework

(a) Basic Approach:

Trade Credits (TC) refer to the credits extended by the overseas supplier, bank, financial institution and other permitted recognised lenders for prescribed maturity, for imports of capital/non-capital goods. Depending on the source of finance, such TCs include suppliers' credit and buyers' credit.

(b) Salient Features of the Trade Credit Framework:

TC for imports into India can be raised in – (i) any freely convertible foreign currency (FCY denominated TC) or (ii) Indian Rupee (INR denominated TC).

A. Common Parameters for both FCY denominated TC and INR denominated TC

1) Forms of TC - Buyers' Credit and Suppliers' Credit
2) Eligible borrower - Person resident in India acting as an importer
3) Ceiling Amount per Import Transaction under automatic route - For oil/gas refining & marketing, airline and shipping companies - Up to USD 150 million or equivalent. For others - Up to USD 50 million or equivalent.
4) Recognised lenders –
   i) For suppliers' credit: Supplier of goods located outside India.
   ii) For buyers' credit: Banks, financial institutions, foreign equity holder(s) located outside India and financial institutions in IFSCs located in India.
   iii) Participation of Indian banks and NBFCs (operating from IFSCs) as lenders is subject to the RBI prudential guidelines. Foreign branches/ subsidiaries of Indian banks are permitted as recognised lenders only for FCY TC.

5) Period of TC - The period of TC, reckoned from the date of shipment, shall be - For capital goods – up to 3 years; For non-capital goods - up to one year or the operating cycle whichever is less. For shipyards / shipbuilders - up to 3 years.

B. FCY denominated TC

1) All-in-cost ceiling per annum - For existing TCs linked to LIBOR whose benchmarks are changed to ARR: Benchmark Rate plus 350 bps spread. For new TCs: Benchmark rate plus 300 bps spread.
2) Exchange rate - Change of FCY TC into INR TC can be at the exchange rate prevailing on the date of the agreement for such change or at a lower exchange rate, if consented to by the TC lender.
3) Hedging provision - To follow the sectoral/ prudential guidelines for hedging.
4) Change of currency of borrowing - Change from one freely convertible foreign currency to any other freely convertible foreign currency as well as to INR is freely permitted.

C. INR denominated TC

1) All-in-cost ceiling per annum - Benchmark rate plus 250 bps spread.
2) Exchange rate - For conversion to Rupee, exchange rate shall be the rate prevailing on the date of settlement.
3) Hedging provision - The overseas investors are eligible to hedge their exposure in Rupee through (a) permitted derivative products with AD banks in India; (b) branches/ subsidiaries of Indian banks abroad; or (c) branches of foreign banks with Indian presence on a back to back basis.
4) Change of currency of borrowing - Change of currency from INR to any freely convertible foreign currency is not permitted.

(c) Trade Credits in SEZ/FTWZ/DTA:

1) TC can be raised by a unit or a developer in a SEZ including FTWZ for purchase of non-capital and capital goods within an SEZ including FTWZ or from a different SEZ including FTWZ.
2) An entity in DTA is also allowed to raise TC for purchase of capital / non-capital goods from a unit or a developer of a SEZ including FTWZ.
3) Date of transfer of ownership of goods will be treated as TC date. The inter unit receipt generated through NSDL can be treated as an import document.

(d) Security for Trade Credit:

1) AD banks/ foreign banks/ overseas branches of Indian banks may give bank guarantees on behalf of the importer in favour of overseas lender.
2) The importer may offer security of movable assets (including financial assets)/ immovable assets (excluding land in SEZs)/ corporate or personal guarantee for raising trade credit.

(e) Reporting Requirement:

1) Monthly reporting: AD banks should report details of TCs like drawal, utilisation, and repayment of TC approved by all its branches, in a consolidated statement, during a month. Each TC may be given a unique identification number by the AD bank.

2) Quarterly reporting: AD banks are also required to furnish data on issuance of bank guarantees for TCs by all its branches, in a consolidated statement, at quarterly intervals on the XBRL platform.

(f) Role of AD bank:

1) While the primarily responsibility of ensuring adherence to the TC policy lies with the importer, the ADs are also expected to ensure compliance with applicable parameters of the trade credit policy / provisions of Foreign Exchange Management Act, 1999 by their constituents.
2) ADs should ensure that there is no double financing on account of these transactions between a unit or a developer in a SEZ including FTWZ for purchase of non-capital and capital goods within an SEZ including FTWZ or from a different SEZ including FTWZ.
3) ADs should ensure that for import of non-capital goods, the period of TC, as applicable, is lower of operating cycle or one year (three years for shipyards / shipbuilders).

26.4 Exports of Goods & Services

26.4.1 General

(a) General Aspects

i. Export trade is regulated by the Directorate General of Foreign Trade (DGFT). Policies and procedures for exports from India are announced by the DGFT.
ii. AD Category – I banks may conduct export transactions in conformity with the Foreign Trade Policy and the Rules framed by the Government of India and the Directions issued by RBI.
iii. AD banks are permitted to issue guarantees on account of exports subject to specified conditions.
iv. Export contracts and invoices may be denominated in freely convertible currency or Indian rupees but export proceeds shall be realized in freely convertible currency. Export proceeds against specific exports may also be realized in rupees, provided it is through a freely convertible Vostro account of a non-resident bank situated in any country other than a member country of Asian Clearing Union or Nepal or Bhutan. In July, 2022, Reserve Bank of India has suggested the AD Banks to develop a system of settlement of international trade transactions in INR.
v. "Financial Year" (April to March) is s the time base for all trade transactions related issues.

(b) Realization and repatriation of proceeds of export of goods/ software/ services

i. The exporter should realize and repatriate the full value of goods/ software/ services to India within 9 months from the date of export.
ii. For goods exported to a warehouse established outside India, the proceeds shall be realized within 15 months from the date of shipment.

(c) Manner of receipt and payment

i. The value of the goods exported shall be received through an AD Bank.
ii. For goods sold to overseas buyers during their visits EDF (duplicate) should be released by the AD banks – (a) on receipt of funds in their Nostro account, or (b) on

the exporter producing a certificate from the Credit Card servicing bank in India that it has received the equivalent amount in foreign exchange, or (c) AD bank has received payment by debit to the credit card of an importer where the reimbursement from the card issuing bank/ organization will be received in foreign exchange.

iii. Repatriation of proceeds of export of goods/ services of value up to USD 10,000 is permitted under arrangements with Online Payment Gateway Service Providers (OPGSPs) subject to specified conditions. A start-up can realise the receivables of its overseas subsidiary and repatriate them through OPGSPs.

iv. Settlement System under ACU Mechanism

a) Asian Monetary Unit (AMU) is denominated as 'ACU Dollar', 'ACU Euro' and 'ACU Yen' - equivalent in value to one US Dollar, one Euro and one Japanese Yen, respectively. In the Asian Clearing Union (ACU) participants can settle their transactions either in ACU Dollar or in ACU Euro or in ACU Japanese Yen.

b) AD banks can open and maintain ACU Dollar, ACU Euro and ACU Japanese Yen accounts with their correspondent banks in other participating countries. All eligible payments are required to be settled by the concerned banks through these accounts.

c) Relaxation from ACU Mechanism (Indo-Myanmar Trade) - Trade transactions with Myanmar can be settled in any freely convertible currency in addition to the ACU mechanism.

d) All eligible current account transactions including trade transactions with Iran should be settled in any permitted currency outside the ACU mechanism, until further notice.

e) Nostro accounts of the commercial banks of the ACU member countries, can be used for settling the payments of both exports and imports of goods and services among the ACU countries.

f) Operations in 'ACU Euro' have been temporarily suspended with effect from July 01, 2016.

v. Third party payments for export / import transactions

a) Third party payments for export / import transactions are allowed, subject to prescribed conditions.

b) Firm irrevocable order backed by a tripartite agreement should be in place, unless where documentary evidence for circumstances leading to third party payments/ name of the third party being mentioned in the irrevocable order/ invoice has been produced.

vi. Settlement of Export transactions in currencies not having a direct exchange rate

AD Category-I banks may permit settlement of those export transactions (except those put through the ACU mechanism) where the invoicing is in a freely convertible currency and the settlement takes place in the currency of the beneficiary, which though convertible, does not have a direct exchange rate, subject to prescribed conditions.

(d) Foreign Currency Accounts

1) Foreign Currency Account - Foreign currency accounts are permitted to be maintained in India or abroad in following cases:

a) Participants in international exhibition/trade fair – temporary foreign currency account abroad. The balance in the account is repatriated to India through normal banking channels within a period of one month from the date of closure of the exhibition/trade fair.

b) Exporters having good track record - FCA with AD banks in India and outside India.
c) Overseas office/branch of Indian entity - FCA with a bank outside India.
d) Unit located in a SEZ - FCA with an AD bank in India.
e) A project / service exporter (resident in India) foreign currency account with a bank outside or in India.

2) Diamond Dollar Account (DDA)
   a) Eligible persons: Firms and companies – (a) dealing in purchase/ sale of rough or cut and polished diamonds / precious metal jewellery plain, minakari and/ or studded with / without diamond and/ or other stones, (b) with a track record of at least 2 years in import / export of diamonds / colored gemstones / diamond and colored gemstones studded jewellery / plain gold jewellery and (c) having an average annual turnover of Rs. 3 crore or above during the preceding three licensing years (licensing year is from April to March)
   b) Not more than five Diamond Dollar Accounts are permitted per customer.
   c) Other conditions - As in case of EEFC Accounts.
3) Exchange Earners' Foreign Currency Account (EEFC Account)
   a) Eligible person: A person resident in India being a foreign exchange earner.
   b) Joint Holder: Resident close relative(s) (as per Companies Act 2013) permitted on former or survivor basis.
   c) Nature of Account: Non-interest bearing current account. No credit facilities, either fund-based or non-fund based, permitted against the security of balances held.
   d) Credits: 100% of foreign exchange earnings of the holder, subject to the condition that
      i) The sum total of the accruals in the account during a calendar month should be converted into Rupees on or before the last day of the succeeding calendar month after adjusting for utilization of the balances for approved purposes or forward commitments.
      ii) The facility is intended to enable exchange earners to save on conversion/transaction costs while undertaking forex transactions; and not to maintain assets in foreign currency.
   e) The eligible credits represent –
      i) inward remittance through normal banking channel, excluding the remittance – (i) received pursuant to any undertaking given to RBI, or (ii) which represents foreign currency loan raised or investment received from outside India, or (iii) those received for meeting specific obligations by the account holder.
      ii) payments received in foreign exchange by a 100% EOU or a unit in EPZ, STP or EHTP for supply of goods to similar such unit or to a unit in DTA, and also payments received in foreign exchange by a unit in DTA for supply of goods to a unit in SEZ;
   f) Exporter constituents can extend trade related loans/ advances to overseas importers out of their EEFC balances without any ceiling subject to prescribed conditions.
   g) Exporters can repay packing credit advances from balances in EEFC account and/ or Rupee resources to the extent exports have actually taken place.

h) If a part of the export proceeds is credited to an EEFC account, the export declaration (duplicate) form may be suitably certified.

(e) Special Arrangements:

1) Counter-Trade Arrangement - Counter trade proposals involving adjustment of value of goods imported into India against value of goods exported from India in terms of an arrangement voluntarily entered into between the Indian party and the overseas party through an Escrow Account opened in India in US Dollar is considered by the RBI subject to prescribed conditions.
2) Exports to neighboring countries by road, rail or river - Filing original copies of EDF by the exporter/ agent where exports are made to neighboring countries by road, rail or river transport:
    a. Exports by barges/country craft/road transport - The form should be presented at the Customs station at the border through which the vessel or vehicle has to pass before crossing over to the foreign territory.
    b. Exports by rail - Customs staff is posted at certain designated railway stations. They collect the EDF for goods loaded at these stations so that the goods may move straight on to the foreign country without further formalities at the border. For goods loaded at other stations, exporters must arrange to present EDF to the Customs Officer at the Border Land Customs Station.
3) Border trade with Myanmar - All trade transactions with Myanmar, including those at the Indo-Myanmar border shall be settled in any permitted currency in addition to the Asian Clearing Union mechanism.
4) Counter –Trade arrangements with Romania - RBI will consider counter trade proposals from Indian exporters with Romania involving adjustment of value of exports from India against value of imports made into India in terms of a voluntarily entered arrangement between the concerned parties, subject to the condition, among others that the Indian exporter should utilize the funds for import of goods from Romania into India within six months from the date of credit to Escrow Accounts allowed to be opened.
5) Repayment of State credits - Export of goods and services against repayment of state credits granted by erstwhile USSR continue to be governed by the extant directions issued by the RBI.
6) Forfaiting - EXIM Bank and AD banks have been permitted to undertake forfaiting, for financing of export receivables. Remittance of commitment fee / service charges, etc., payable by the exporter as approved by the EXIM Bank / AD banks concerned may be done through an AD bank. Such remittances may be made in advance in one lump sum or at monthly intervals as approved.
7) Export factoring on non-recourse basis - AD banks are permitted to factor the export receivables on non-recourse basis.
    a. The invoices purchased should represent genuine trade invoices.
    b. In case export financing has not been done by the Export Factor, the Export Factor may pass on the net value to the financing bank/ Institution after realising the export proceeds.

c. AD bank, being the Export Factor, should have an arrangement with the Import Factor for credit evaluation & collection of payment. In case of single factor, not involving Import Factor overseas, the Export Factor may obtain credit evaluation details from the correspondent bank abroad.
d. Notation should be made on the invoice that importer has to make payment to the Import Factor.
e. After factoring, the Export Factor may close the export bills and report the same in the EDPMS of RBI.
f. KYC and due diligence on the exporter shall be ensured by the Export Factor.

8) Project Exports and Service Exports
   a. Export of engineering goods on deferred payment terms and execution of turnkey projects and civil construction contracts abroad are collectively referred to as 'Project Exports'.
   b. Indian exporters are required to obtain the approval of the AD banks/ Exim Bank at post-award stage before undertaking execution of such contracts.
   c. AD banks/ Exim Bank may consider awarding post-award approvals without any monetary limit and permit subsequent changes in the terms of post award approval within the relevant FEMA guidelines / regulations.
   d. The respective AD bank / Exim Bank should monitor the projects for which post-award approval has been granted by them.
   e. Under mentioned facilities are provided to project & service exporters subject to certain specified conditions-
      i. Inter-Project transfer of machinery
      ii. Inter-Project transfer of funds.
      iii. Deployment of temporary cash surpluses
      iv. Repatriation of funds in case of On-site Software Contracts
9) Export of goods on lease, hire, etc. - Prior approval of the RBI is required for export of machinery, equipment, etc., on lease, hire basis under agreement with the overseas lessee against collection of lease rentals/hire charges and ultimate re-import.
10) Export on elongated credit terms - Exporters intending to export goods on elongated credit terms may submit their proposals through AD banks to the RBI.
11) Export of Currency - Permission of RBI is required for any export of Indian currency except as follows:
   a. Any resident in India may take currency notes outside India (other than to Nepal and Bhutan) - Not exceeding Rs. 25,000; and
   b. Any person resident outside India, (but not being a citizen of Pakistan and Bangladesh and also not a traveler coming from and going to Pakistan or Bangladesh) and visiting India may take currency notes outside India - Not exceeding Rs. 25,000 while exiting only through an airport.

26.4.2 EDF / SOFTEX Procedure

(a) Goods through Customs ports (Non-EDI):

Customs certify the value and give running serial number on the two copies of Export Declaration Form (EDF) at Non- Electronic Data Interchange (EDI) port. Customs transmit the original EDF to the RBI and return the duplicate to the exporter. At the time of shipment, after examining the goods, Customs certify the quantity on the duplicate copy of EDF and return it to the exporter. Within 21 days from the date of export, the exporter shall lodge with the AD the duplicate copy of EDF and the relative shipping documents and an extra copy of the invoice to the AD named in the EDF, for negotiation or collection of export bills. The AD shall report the transaction through Export Data Processing and Monitoring System (EDPMS) to the RBI and retain the documents. For exports under deferred credit arrangement or to joint ventures abroad against equity participation or under rupee credit agreement, the number and date of the RBI approval/ or reference of the relative RBI circular is recorded in the EDF. Copy of duplicate EDF duly certified by Customs may be accepted, if the duplicate copy is lost/ misplaced/

(b) Goods/ software through EDI Ports:
The shipping bill is submitted by the exporter, in duplicate, to the Commissioner of Customs or the SEZ, one copy of the shipping bill marked 'Exchange Control (EC) Copy' is returned after verification and authentication. for being submitted to the AD bank within 21 days from the date of export. The duplicate copy of the form together with a copy of invoice etc. shall be retained by ADs. Where data of shipping bill is integrated with EDPMS, requirement of submission of EC copy of shipping bill with the AD bank would not be there.

(c) Goods through Post:
EDF should be first presented by the exporter to an AD for countersignature. AD shall countersign EDF after ensuring that the parcel has been addressed to their branch or correspondent bank in the country of import. The exporter shall then submit the countersigned EDF to the post office with the parcel. The duplicate copy of EDF is retained by the AD to whom the exporter shall submit relevant documents together with an extra copy of invoice for negotiation/collection, within the prescribed period of 21 days. The concerned overseas branch or correspondent shall be instructed to deliver the parcel to consignee against payment or acceptance of relative bill. AD is permitted to countersign EDF covering parcels addressed direct to the consignees, provided: an irrevocable letter of credit for the full value of in favor of the exporter has been advised through the AD concerned; or full value has been received in advance; or AD is satisfied, on the basis of the standing and track record of the exporter and the arrangements made for realization of the export proceeds. The particulars of the related payments/ basis should be recorded on the EDF.

(d) Mid-sea trans-shipment of catch by deep sea fishing vessels:
For mid-sea trans-shipment of catches by Indian owned vessels, the exporters may submit the EDF, duly signed by the Master of the vessel in lieu of Custom certification, indicating the composition of the catch, quantity, export value, date of shipment (date of transfer of catch), etc. duly supported by a certificate from an international cargo surveyor. The EDF, both original and duplicate, should indicate the number and date of Letter of Permit issued by Ministry of Agriculture for operation of the vessel. The exporter will submit to the Customs the EDF in duplicate at the registered port of the vessel or any other port. EDF (Original) is retained by the Customs for capturing data in Customs' EDI. Customs will give their running

serial number on both the copies of EDF and will return the duplicate copy to the exporter as the value certification of the export has already been done.

(e) SOFTEX Forms:

The exporter should submit declaration in Form SOFTEX in quadruplicate in respect of export of computer software and audio / video / television software to the designated official concerned of the Government of India at STPI / EPZ /FTZ /SEZ for valuation / certification not later than 30 days from the date of invoice/ the date of last invoice raised in a month, as indicated above. The designated officials may also certify the SOFTEX Forms of EOUs, which are registered with them.

(f) Citing of specific identification numbers:

In all applications / correspondence with the RBI, the specific identification number as available on the EDF and SOFTEX forms should invariably be cited.

(g) Export of Services:

The exporter may export services (for which no forms have been specified) without furnishing any declaration, but shall be liable to realise the amount of foreign exchange which becomes due or accrues on account of such export, and to repatriate the same to India.

(h) Third party export proceeds:

Realization of export proceeds in respect of export of goods / software from third party should be duly declared by the exporter in the appropriate declaration form.

(i) Short Shipments and Shut out Shipments:

i. When part of a shipment covered by an EDF already filed with Customs is short-shipped, the exporter must give notice of short-shipment to the Customs and obtain certified copy.

ii. Where a shipment has been entirely shut out and there is delay in making arrangements to re-ship, the exporter will give notice in duplicate to the Customs, attaching thereto the unused duplicate copy of EDF and the shipping bill. The Customs will verify that the shipment was actually shut out, certify the copy of the notice as correct and forward it to the RBI together with unused duplicate copy of the EDF. In this case, the original EDF received earlier from Customs will be cancelled. If the shipment is made subsequently, a fresh set of EDF should be completed.

(j) Consolidation of air cargo/sea cargo:

i. Consolidation of air cargo - Where air cargo is shipped under consolidation, the airline company's Master Airway Bill will be issued to the Consolidating Cargo Agent. The Cargo agent in turn will issue his own House Airway Bills (HAWBs) to individual shippers. AD banks may negotiate HAWBs only if the relative letter of credit specifically provides for negotiation of these documents in lieu of Airway Bills issued by the airline company.

ii. Consolidation of sea cargo - AD banks may accept Forwarder's Cargo Receipts (FCR) issued by IATA approved agents, in lieu of bills of lading, in respect of export transactions backed by letters of credit, if the relative letter of credit specifically provides for negotiation of this document, in lieu of bill of lading. Similarly, ADs may, at their discretion, accept FCR where export transactions are not backed by letters of credit, provided the 'relative sale contract' with overseas buyer provides for acceptance of FCR. The bank should satisfy itself about the bona fides of the transaction and the track record of the overseas buyer and the Indian supplier.

26.4.3 Obligations of Authorised Dealers

(a) Grant of EDF waiver:

AD banks may consider requests for grant of EDF waiver - Status holders are entitled to export freely exportable items (excluding Gems and Jewellery, Articles of Gold and precious metals) on free of cost basis for export promotion subject to specified annual limits for different cases. These supplies are not entitled to Duty Drawback or any other export incentive. Exports of goods not involving any foreign exchange transaction directly or indirectly requires the waiver of EDF procedure.

(b) Receipt of advance against exports:

i. On receiving advance payment (with or without interest), from a buyer outside India, the exporter has to ensure that (a) the shipment of goods is made within one year from the date of receipt of advance payment; (b) the rate of interest, if any, payable on the advance payment does not exceed LIBOR + 100 basis points; and (c) the documents are routed through the AD bank through whom the advance payment is received. Any remittance towards refund of unutilized portion of advance payment or towards payment of interest, to be made after the expiry of the said period of one year, requires the prior approval of the RBI.

ii. AD banks have to report all the inward remittances including advance remittances, received for export of goods/ software in EDPMS. Also, AD banks need to report in EDPMS the electronic FIRCs issued against inward remittances.

iii. AD banks can allow exporters having a minimum of three years' satisfactory track record to receive long term export advance up to a maximum tenor of 10 years to be utilized for execution of long term supply contracts for export of goods subject to the prescribed conditions.

iv. AD banks may allow exporters to receive advance payment for export of goods which would take more than one year to manufacture and ship and where the 'export agreement' provides for shipment of goods extending beyond the period of one year from the date of receipt of advance payment subject to prescribed conditions.

v. Follow-up with exporters for making exports:

   a) AD banks need to follow up with the concerned exporters in order to ensure that export performance are completed within the stipulated time period.

   b) AD banks should exercise proper due diligence and ensure compliance with KYC and AML guidelines so that only bonafide export advances flow into India. Doubtful cases as also instances of chronic defaulters may be referred to

Directorate of Enforcement (DoE) for further investigation. A quarterly statement indicating details of such cases may be forwarded to the concerned Regional Offices of RBI within 21 days from the end of each quarter.

(c) EDF Approval for Trade Fair/Exhibitions abroad:
Firms/ Companies and other organizations participating in Trade Fair/Exhibition abroad can take/export goods for exhibition and sale outside India without the prior approval of the RBI. Unsold exhibit items may be sold outside the exhibition/ trade fair in the same country or in a third country. Such sales at discounted value are also permissible. It would also be permissible to 'gift' unsold goods up to the value of USD 5000 per exporter, per exhibition/ trade fair. AD banks may approve EDF of export items for display or display-cum-sale in trade fairs/exhibitions outside India subject to prescribed conditions.

(d) EDF approval for export of goods for re-imports:

i. AD banks may consider request from exporters for granting EDF approval in cases where goods are being exported for re-import after repairs/ maintenance/ testing/ calibration, etc., subject to the condition that the exporter shall produce relative Bill of Entry within one month of re-import of the exported item from India.
ii. Where the goods being exported for testing are destroyed during testing, AD banks may obtain a certificate issued by the testing agency that the goods have been destroyed during testing.

(e) Re-export of unsold rough diamonds from Special Notified Zone of Customs without Export Declaration Form (EDF) formality:
The unsold rough diamonds, when re-exported from the SNZ (being an area within the Customs) without entering the DTA, do not require any EDF formality. Entry of consignment containing different lots of rough diamonds into the SNZ should be accompanied by a declaration of notional value by way of an invoice and a packing list indicating the free cost nature of the consignment. Under no circumstance, entry of such rough diamonds is permitted into DTA.

For the lot/ lots cleared at the center/s Bill of Entry shall be filed by the buyer. AD bank may permit such import payments after being satisfied with the bona-fides of the transaction. Further, AD bank shall also maintain a record of such transactions.

(f) Setting up of Offices abroad and acquisition of immovable property for Overseas Offices:
At the time of setting up of the office, AD banks may allow remittances towards initial expenses up to 15% of the average annual sales/income or turnover during the last two financial years or up to 255 of the net worth, whichever is higher. For recurring expenses, remittances up to 10% of the average annual sales/income or turnover during the last two financial years may be sent for the purpose of normal business operations of the office (trading/non-trading)/branch or representative office outside India subject to the prescribed terms and conditions.

(g) Operational Aspects – Export Transactions:

1) Delay in submission of shipping documents by exporters
   AD banks may handle the export documents presented after the prescribed period of 21 days from date of export, without prior approval of the RBI, provided they are satisfied with the reasons for the delay.
2) Return of documents to exporters
   The duplicate copies of EDF and shipping documents, submitted to the AD banks should not ordinarily be returned to exporters, except for rectification of errors and resubmission.
3) Landlocked countries
   AD banks may deliver one negotiable copy of the Bill of Lading to the Master of the carrying vessel or trade representative for exports to certain landlocked countries if the shipment is covered by an irrevocable letter of credit and the documents conform strictly to the terms of the Letter of Credit which, inter alia, provides for such delivery.
4) Direct dispatch of documents by the exporter
   i) AD banks should normally dispatch shipping documents to their overseas branches/correspondents. However, these may be sent direct to the consignees or their agents resident in the country of final destination of goods, where either an advance payment or an LC for full value has been received, or the exporter is a regular customer with good standing and record.
   ii) AD banks may permit 'Status Holder Exporters', and units in SEZ to dispatch the export documents to the consignees outside India subject to the prescribed conditions.
5) Part Drawings/ Undrawn Balances
   In certain lines of export trade, it is the practice to leave a small part of the invoice value undrawn for payment after adjustment due to differences in weight, quality, etc., This is ascertained after inspection, weighment or analysis of the goods. AD banks may negotiate such bills, subject to certain conditions.
6) Consignment Exports
   i) For goods exported on consignment basis, the AD bank, while forwarding shipping documents to his overseas branch/ correspondent, should instruct the latter to deliver them only against trust receipt/undertaking to deliver sale proceeds by a specified date within the prescribed period for realization of proceeds of the export.
   ii) The agents/consignees may deduct from sale proceeds of the goods expenses normally incurred towards receipt, storage and sale of the goods, such as landing charges, warehouse rent, handling charges, etc. and remit the net proceeds to the exporter.
   iii) The account sales received from the Agent/Consignee should be verified by the AD banks. Deductions in Account Sales should be supported by bills/receipts in original except in case of petty items like postage/cable charges, stamp duty, etc.
   iv) In case the goods are exported on consignment basis, freight and marine insurance must be arranged in India.
   v) AD banks may allow the exporters to abandon the books, which remain unsold at the expiry of the period of the sale contract. Accordingly, the exporters may show

the value of the unsold books as deduction from the export proceeds in the Account Sales.

7) Opening / hiring of warehouses abroad
AD banks may consider applications from exporters and grant permission for opening/ hiring warehouses abroad subject to prescribed conditions.

8) Reduction in invoice value on account of prepayment of usance bills
Occasionally, exporters may approach AD banks for reduction in invoice value on account of cash discount to overseas buyers for prepayment of the usance bills. AD banks may allow cash discount to the extent of amount of proportionate interest on the unexpired period of usance, calculated at the rate of interest stipulated in the export contract or at the prime rate/LIBOR of the currency of invoice where rate of interest is not stipulated in the contract.

9) Reduction in invoice value in other cases
If, after a bill has been negotiated or sent for collection, its amount is to be reduced for any reason, AD banks may approve such reduction, if satisfied about genuineness of the request, subject to prescribed framework and conditions.

10) Change of buyer/consignee
Prior approval of the RBI is not required if, after goods have been shipped, they are to be transferred to a buyer other than the original buyer in the event of default by the latter, provided any reduction in value does not exceed 25% of the invoice value and any the realization of export proceeds is not beyond 9 months from the date of export. If reduction in value exceeds 25%, the conditions stipulated for such cases should be satisfied.

11) Export of goods by Special Economic Zones (SEZs)
Units in SEZs can undertake job work abroad and export goods from that country itself subject to prescribed conditions. AD banks may permit units in DTAs to purchase foreign exchange for payments for goods/ services supplied to them by units in SEZs. It must be ensured that the Letter of Approval (LoA) issued by the Development Commissioner (DC) of the SEZ, includes a provision for such transactions.

12) Extension of time
AD banks have been permitted to extend the period of realization of export proceeds beyond the stipulated period, for up to six months, at a time, irrespective of the value of the export, subject to prescribed conditions. Other cases would require RBI approval.

13) Export Bills Register
AD banks should maintain Export Bills Register, in physical or electronic form aligned with EDPMS. Bill number should be given to all export transactions on a financial year basis (i.e. April to March) and reported in EDPMS.

14) Follow-up of overdue bills
    i) AD banks should closely watch realization of bills and follow-up promptly with the concerned exporters where bills remain outstanding, beyond the due date for payment. If proceeds are not realised within the stipulated period. or the exporter seeks extension of time beyond the stipulated period, the matter should be reported to the RBI stating, where possible, the reason for the delay in realizing the proceeds.

ii) The duplicate copies of EDF/SOFTEX Forms should, continue to be held by AD banks until the full proceeds are realized, except in case of undrawn balances.

iii) AD banks should follow with exporters systematically and vigorously so that action against defaulting exporters does not get delayed. Any laxity in the follow up of realization of export proceeds by AD banks will be viewed seriously by the RBI.

iv) Realization of all export transactions should be reported in EDPMS.

15) Shipments lost in transit

i) When shipments for which payment has not been received are lost in transit, the AD banks must ensure that insurance claim is made as soon as the loss is known.

ii) If the claim is payable abroad, the AD banks must arrange to collect the full amount of claim due on the lost shipment, through their overseas branch/correspondent and release the duplicate copy of EDF only after the amount has been collected.

iii) A certificate for the claim amount received should be furnished on the reverse of the duplicate copy.

iv) AD banks should ensure that claim amounts partially settled abroad, directly by shipping companies/airlines under carrier's liability, are repatriated to India.

16) Export claims

AD banks may allow to remit export claims, provided the related export proceeds have already been realized and repatriated to India and the exporter is not on the caution list of the RBI. The exporter should be advised to surrender proportionate export incentives, if any, received by him.

17) "Write-off" of unrealized export bills

i) An exporter who has not been able to realize the outstanding export dues despite best efforts, may either self-write off or approach the AD banks, who had handled the relevant shipping documents, with appropriate supporting documentary evidence. Write-offs are permissible within prescribed limits and subject to meeting the prescribed conditions.

ii) The following cases do not qualify for the "write-off" facility:

(a) Exports to countries with externalization problem (i.e. where the overseas buyer has deposited the value of export in local currency but repatriation has not been permitted by the Central Bank/ authorities).

(b) EDF/Softex under investigation by agencies like, Enforcement Directorate, Directorate of Revenue Intelligence, Central Bureau of Investigation, etc. and the outstanding bills which are subject matter of civil / criminal suit.

iii) AD banks shall report write-off of export bills in EDPMS.

18) Write off – where claims have been paid by ECGC and private insurance companies regulated by IRDA

AD banks shall, on application from the exporter with documentary evidence of the claims settled by the ECGC/ insurance companies regulated by IRDA, write off the relative export bills in EDPMS. The claims settled in rupees by ECGC/ private insurance companies should not be construed as export realization in foreign exchange.

19) Set-off of export receivables against import payables

AD banks may deal with the following requests from their Exporter/Importer constituents for allowing set-off of outstanding export receivables against outstanding import payables, subject to the prescribe conditions.

i) Set-off of export receivables against import payables of the same overseas buyer/supplier.
ii) Set-off of export receivables against import payables with overseas group/associate companies (on net basis or gross basis) through an in-house or outsourced centralized settlement arrangement.

20) Netting-off of export receivables against import payments – Units in SEZs

AD banks may allow requests for 'netting off' of export receivables against import payments for units located in SEZ subject to prescribed conditions.

(h) Exporters' Caution List:

a) An exporter is caution-listed by the RBI based on the recommendations of the AD bank concerned, depending upon the exporters track record with the AD bank and investigative agencies.
b) AD Bank should refer to the RBI, if - the exporter has come to the adverse notice of the ED/ CBI/ DRI/any such other law enforcement agency, and/or the exporter is not traceable, and/or the exporter is not making sincere efforts to realise the export proceeds.
c) The AD bank may recommend to RBI for de-caution-listing an exporter.
d) AD banks should follow specified procedure and conditions while handling shipping documents for caution listed exporters. No shipping document should be handled for cases that do not meet the requirements.
e) AD banks should obtain prior approval of RBI for issuing guarantees for caution-listed exporters.

(i) Issue of Guarantees by an Authorised Dealer

a) An AD may give guarantee in respect of any debt, obligation or other liability incurred by an exporter resident in India, in respect of exports from India, and owed to a person resident outside India,
b) An AD may give a guarantee in respect of any debt, obligation or other liability incurred by a person resident outside India, in the following cases:
    (1) these are owed to a person resident in India in connection with a bonafide trade transaction, and if it is covered by a counter-guarantee of a bank of international repute resident broad;
    (2) as a counter-guarantee to cover guarantee issued by its branch/ correspondent outside India, on behalf of Indian exporter, where guarantees of only resident banks are acceptable to overseas buyers.

(j) Issuance of Electronic Bank Realisation Certificate (eBRC)

AD banks are required to update the EDPMS with data of export proceeds on "as and when realised basis" and, generate from it Electronic Bank Realisation Certificate (eBRC).

26.4.4 Remittances connected with Export

(a) Agency commission on exports:

(i) AD banks may allow payment of commission, either by remittance or by deduction from invoice value, on application by the exporter, subject to prescribed conditions.

(ii) AD banks may allow payment of commission by Indian exporters, for exports covered under counter trade arrangement through Escrow Accounts (designated in US Dollar), subject to prescribed conditions.

(b) *Refund of export proceeds*:

(i) AD banks, through whom the export proceeds were originally realized may consider requests for refund of export proceeds of goods exported from India and being re-imported into India on account of poor quality. While permitting such transactions, AD banks shall: (i) Exercise due diligence regarding the track record of the exporter; (ii) Verify the bona-fides of the transactions; (iii) Obtain from the exporter a certificate issued by DGFT / Custom authorities that no export incentive has been availed by the exporter against the relevant export or the proportionate incentives availed, if any, have been surrendered;

(ii) AD banks may not insist on the requirement of re-import of goods, where exported goods have been auctioned or destroyed by the Port / Customs / Health authorities/ any other accredited agency in the importing country subject to submission of satisfactory documentary evidence. In all other cases AD banks shall ensure that procedures as applicable to normal imports are adhered to and that an undertaking from the exporter, to re-import the goods within three months from the date of refund of export proceeds, shall be obtained.

26.5 Imports of Goods & Services

26.5.1 General

i. Import trade is regulated by the Directorate General of Foreign Trade (DGFT). AD banks should ensure that the imports into India are in conformity with the Foreign Trade Policy in force and Foreign Exchange Management (Current Account Transactions) Rules, 2000 and the Directions issued by Reserve Bank under FEMA.

ii. AD banks should follow normal banking procedures and adhere to the provisions of Uniform Customs and Practice for Documentary Credits (UCPDC), etc. while opening letters of credit for import into India on behalf of their constituents.

iii. Compliance with the provisions of Research & Development Cess Act, 1986 may be ensured for import of drawings and designs.

iv. AD banks may also advise importers to ensure compliance with the provisions of Income Tax Act, wherever applicable.

26.5.2 General Guidelines for Imports

(a) Remittances for Import Payments:

AD Banks may allow remittance for making payments for imports into India, after ensuring that all the requisite details are made available, and the remittance is for bona fide trade transactions as per applicable laws in force.

(b) Import Licences:

Except for goods included in the negative list which require licence under the Foreign Trade Policy in force, AD banks may freely open letters of credit and allow remittances for import. While opening letters of credit, the 'For Exchange Control purposes' copy of the licence should be called for and adherence to special conditions, if any, attached to such licences should be ensured. After effecting remittances under the licence, AD banks may preserve the copies of utilised licence /s till they are verified by the internal auditors or inspectors.

(c) Obligation of Purchaser of Foreign Exchange:

1) As per FEMA, any person acquiring foreign exchange is permitted to use it either for the purpose mentioned in the declaration made by him to an AD bank or for any other purpose for which acquisition of foreign exchange is permissible under the said Act or Rules or Regulations framed there under.
2) Where foreign exchange acquired has been utilised for import of goods into India, the AD bank should ensure that the importer furnishes evidence of import viz., as in IDPMS, Postal Appraisal Form or Customs Assessment Certificate, etc., and satisfy himself that goods equivalent to the value of remittance have been imported.
3) A person resident in India may make payment for import of goods in foreign exchange through an international card held by him/in rupees from international credit card/ debit card through the credit/debit card servicing bank in India or as prescribed by RBI.
4) Any person resident in India may also make payment as under:
    a) In rupees towards meeting expenses related to travel to India of a person resident outside India;
    b) By means of a crossed cheque or a draft for purchase of gold or silver in any form imported by such person in accordance with the related laws/ regulations, etc.;
    c) A company or resident in India may make payment in rupees (of the amounts due as sitting fees or commission or remuneration, and expenses related to travel to India) to its non-whole time director who is resident outside India and is on a visit to India for the company's work, subject to meeting the requirements of applicable laws/ regulations.
    d) Time Limit for Settlement of Import Payments:
        i) Time limit for Normal Imports
            (1) Remittances against imports should be completed no later than six months from the date of shipment, except in cases where amounts are withheld towards guarantee of performance, etc.
            (2) AD banks may permit settlement of import dues delayed due to disputes, financial difficulties, etc. However, interest payment can be permitted only for a period of up to three years from the date of shipment.
        ii) Time limit for Deferred Payment Arrangements
            Deferred payment arrangements (including suppliers' and buyers' credit) up to five years, are treated as trade credits, and hence to be dealt with accordingly.
        iii) Time Limit for Import of Books

Remittances against import of books may be allowed without restriction as to the time limit. Payment of any interest to be as per the provisions for the same.

iv) Extension of Time

(1) AD banks are permitted to grant extension of time for settlement of import dues up to a period of six months at a time (maximum up to the period of three years) for delays on account of disputes about quantity or quality or non-fulfillment of terms of contract; financial difficulties and where importer has filed suit against the seller. Sector specific guidelines of RBI for extension of time (i.e. rough, cut and polished diamonds) are applicable.

(2) While granting extension of time, AD banks are required to look into specified aspects and ensure that the prescribed requirements are met.

(3) Cases beyond the limits or not covered may be referred to the RBI.

(4) Extension of time should be noted in the IDPMS.

26.5.3 Import of Foreign exchange / Indian Rupees:

(a) Permission of RBI for Currency Import:

General or special permission of the RBI, is required to import or bring into India, any foreign currency. RBI may allow a person to bring into India, Indian currency notes, subject to prescribed conditions.

(b) Import of Foreign Exchange into India:

a) A person may send into India, without limit, foreign exchange in any form other than currency notes, bank notes and travellers cheques.

b) A person may bring into India from any place outside India, without limit, foreign exchange (other than unissued notes). On arrival in India, a declaration is to be given to the Custom Authorities at the Airport in the Currency Declaration Form (CDF), where the aggregate value of the foreign exchange in the form of currency notes, bank notes or travellers cheques at any one time exceeds USD 10,000 or its equivalent, and/or the aggregate value of foreign currency notes (cash portion) alone exceeds USD 5,000 or its equivalent.

c) Import of Indian Currency and Currency Notes:

i. A person resident in India returning from a temporary visit out of India, may bring (other than when returning from Nepal and Bhutan), Indian currency notes up to an amount not exceeding Rs. 25,000.

ii. A person may bring from Nepal or Bhutan, Indian currency notes for any amount in denominations up to Rs.100/-.

26.5.4 Import Transactions – Other Aspects

(a) Third Party Payment for Import Transactions:

AD banks are allowed to make payments to a third party for import of goods, subject to prescribed conditions.

(b) Issue of Guarantees by an Authorised Dealer:

An AD may give guarantees for the following types of transactions.

i. For any debt, obligation or other liability incurred, in respect of import on deferred payment terms (as per RBI approval for such terms), by an importer resident in India and owed to a person resident outside India.
ii. For any debt, obligation or other liability incurred by a person resident in India and owed to a person resident outside India (being an overseas supplier of goods, bank or a financial institution), for import of goods subject to conditions specified by RBI. It may be in the form of Letter of Undertaking of Letter of Comfort.
iii. On behalf of a resident service importer, in favour of a non-resident service provider, subject to prescribed conditions. A guarantee for an amount exceeding USD 500,000 or its equivalent cannot be issued, except on behalf of Public Sector Company or a Department / Undertaking of the Government of India / State Government. Where the service importer is a Public Sector Company or a Department / Undertaking of the Government of India / State Government, prior approval of the Ministry of Finance, Government of India is required for a guarantee of more than USD 100,000 or its equivalent.
iv. An AD may permit a person resident in India to issue corporate guarantee in favour of an overseas lessor for financing import through operating lease.

26.5.5 Operational Guidelines for Imports

(a) Advance Remittance:

1) Advance Remittance for Import of Goods
    a) AD bank may allow advance remittance for import of goods without any ceiling subject to the following conditions:
        i) Amount exceeds USD 200,000 or its equivalent: To obtain an unconditional, irrevocable standby Letter of Credit or a guarantee from an international bank of repute situated outside India or a guarantee of an AD bank in India, issued against the counter-guarantee of an international bank of repute situated outside India.
        ii) Amount up to USD 5,000,000 or its equivalent: May not insist upon a BG/ Standby LC, where the importer (other than a Public Sector Company or a Department/Undertaking of the Government of India/State Government/s) is unable to obtain bank guarantee from overseas suppliers and the AD bank is satisfied about the track record and bonafides of the importer.
        iii) A Public Sector Company or a Department/Undertaking of the Government of India / State Government/s not in a position to obtain a guarantee from an international bank of repute against an advance payment, is required to obtain a specific waiver for the bank guarantee from the Ministry of Finance, Government of India before making advance remittance exceeding USD 100,000.
    b) All payments towards advance remittance for imports are subject to the specified conditions and AD banks should create Outward Remittance Message (ORM) in IDPMS and follow other extant IDPMS guidelines.
2) Advance Remittance for Import of Rough Diamonds
    a) AD banks are permitted to take decision on overseas mining companies to whom an importer (other than Public Sector Company or Department / Undertaking of Government of India / State Government) can make advance payments, without any

limit / bank guarantee/ stand-by letter of Credit, subject to their ensuring the prescribed requirements and conditions.

b) For an importer entity in the Public Sector or a Department / Undertaking of the Government of India / State Government/s, AD banks may permit the advance remittance subject to the specified conditions and a specific waiver of bank guarantee from the Ministry of Finance, Government of India, if the advance payments is equivalent to or exceeds USD 100,000/-.

3) Entries to be made in IDPMS

Based on the AD code declared by the importer, the banks shall download the Bill of Entry (BOE) issued by EDI ports from "BOE Master" in IDPMS. For non-EDI ports, AD banks of the importer shall upload the BoE data in IDPMS as per message format "Manual BoE reporting" on daily basis on receipt of BoE from the customer/Customs Office. AD banks will enter BOE details and mark off ORMs as per the message format "BOE Settlement". In case of payment after receipt of BoE, the AD bank shall generate ORM for import payments made by the importer customer as per the message format "BOE Settlement". Multiple ORMs can be settled against single BoE and also multiple BoEs can be settled against one ORM.

4) Advance Remittance for Import of Aircrafts/Helicopters and other Aviation Related Purchases (Sector specific Relaxation)

a) Entities permitted to import aircrafts and helicopters (including used/second hand aircraft and helicopters) or person who has been granted permission to operate Scheduled or Non-Scheduled Air Transport Service (including Air Taxi Services) - AD banks may allow advance remittance, without obtaining a bank guarantee or an unconditional, irrevocable Standby Letter of Credit, up to USD 50 million, for direct import of each aircraft, helicopter and other aviation related purchases.

b) Advance remittances for aircraft, helicopter or other aviation related purchases, whether under specific measure or under general provision, are subject to certain prescribed conditions that AD banks should ensure.

5) Advance Remittance for the Import of Services

AD bank may allow advance remittance for import of services without any ceiling subject prescribed conditions. For amount exceeding USD 500,000 or its equivalent, a guarantee from a bank of international repute situated outside India, or a guarantee from an AD bank in India, issued against the counter-guarantee of a bank of international repute situated outside India, should be obtained from the overseas beneficiary. In the case of a Public Sector Company or a Department/ Undertaking of the Government of India/ State Governments, approval from the Ministry of Finance, Government of India is required for advance remittance for import of services without bank guarantee for an amount exceeding USD 100,000 or its equivalent. AD banks should also follow-up to ensure that the beneficiary of the advance remittance fulfils his obligation failing which, the amount should be repatriated to India. AD banks should ensure generation of ORMs and marking off in the IDPMS etc.

(b) *Interest on Import Bills*:

i. AD bank may allow payment of interest on usance bills or overdue interest on delayed payments for a period of less than three years from the date of shipment at the rate prescribed for trade credit from time to time.

ii. In case of pre-payment of usance import bills, remittances may be made only after reducing the proportionate interest for the unexpired portion of usance at the rate at which interest has been claimed or LIBOR of the currency in which the goods have been invoiced, whichever is applicable.

iii. In case of change in value due to interest effect the respective AD bank should ensure proper remark/indicator is entered for ORM mark off in IDPMS etc.

(c) *Remittances against Replacement Imports*:
Where goods are short-supplied, damaged, short-landed or lost in transit and the Exchange Control Copy of the import licence has already been utilised to cover the opening of a letter of credit against the original goods which have been lost, the original endorsement to the extent of the value of the lost goods may be cancelled by the AD bank and fresh remittance for replacement imports may be permitted without reference to RBI, provided, the insurance claim relating to the lost goods has been settled in favour of the importer. The consignment being replaced should be shipped within the validity period of the license. AD bank should ensure that proper remark/indicator is entered for ORM mark off/closure of Bills in IDPMS etc.

(d) Guarantee for Replacement Import:
If replacement goods for defective import are being sent by the overseas supplier before the defective goods imported earlier are reshipped out of India, AD banks may issue guarantees for dispatch/return of the defective goods.

(e) Import of Equipment by Business Process Outsourcing (BPO) Companies for their overseas sites:
AD banks may allow BPO companies in India to make remittances towards the cost of equipment to be imported and installed at their overseas sites in connection with the setting up of their International Call Centres (ICCs) subject to prescribed conditions.

(f) Receipt of Import Bills/ Documents:
Concerned AD banks should ensure generation of ORMs, BoE entries and BoE settlement with the respective ORMs.

1) Receipt of import documents by the importer directly from overseas suppliers
   Import bills and documents should be received from the banker of the supplier by the banker of the importer in India. AD bank should not, therefore, make remittances where import bills have been received directly by the importers from the overseas supplier, except in the following cases:
   a) Where the value of import bill does not exceed USD 300,000.
   b) Import bills received by wholly-owned Indian subsidiaries of foreign companies from their principals.
   c) Import bills received by Status Holder Exporters as defined in the Foreign Trade Policy, 100% Export Oriented Units / Units in Special Economic Zones, Public Sector Undertakings and Limited Companies.

   d) Import bills received by all limited companies viz. public limited, deemed public limited and private limited companies.
2) Receipt of import documents by the importer directly from overseas suppliers in case of specified sectors

   AD banks are permitted to allow remittance for imports by non-status holder importers up to USD 300,000 where the importer of rough diamonds, rough precious and semi-precious stones has received the import bills / documents directly from the overseas supplier and the documentary evidence for import is submitted by the importer at the time of remittance. Status holder importers dealing in the import of rough diamonds, rough precious and semi- precious stones can receive import bills directly from the suppliers without any ceiling. AD banks may undertake such transactions subject to the prescribed conditions.
3) Receipt of import documents by the AD bank directly from overseas suppliers

   At the request of importer clients, AD bank may receive bills directly from the overseas supplier, provided the AD bank is fully satisfied about the financial standing/status and track record of the importer customer. AD bank should obtain a report on each individual overseas supplier from the overseas banker or a reputed overseas credit agency.

(g) Evidence of Import:

(i) Physical Imports –

1) In case of all imports, irrespective of the value of foreign exchange remitted/ paid for import into India, it is obligatory on the part of the AD bank through which the relative remittance was made, to ensure that the importer submits:
   a) BoE number, port code and date for marking evidence of import under IDPMS.
   b) Customs Assessment Certificate or Postal Appraisal Form, or Courier Bill of Entry as evidence that the goods for which the payment was made have actually been imported into India, or
   c) For goods imported and stored in Free Trade Warehousing Zone (FTWZ) or SEZ Unit warehouses or Customs bonded warehouses, etc., - the Exchange Control Copy of the Ex-Bond Bill of Entry or Bill of Entry issued by Customs Authorities by any other name, the importer shall submit applicable BoE number, port code and date for marking evidence of import under IDPMS.
2) For imports on Delivery against acceptance basis - AD bank shall verify the evidence of import from IDPMS when effecting remittance. If importers do not produce documentary evidence due to genuine reasons (non- arrival of consignment, delay in delivery/ customs clearance of consignment, etc.,), if satisfied with the genuineness of request, AD bank may allow reasonable time, not exceeding three months from the date of remittance, to submit the evidence of import.
3) AD banks are required to create Outward Remittance Message (ORM) for all such outward remittances irrespective of value and shall perform the subsequent activity viz document submission, outward remittance data, matching with ORM, closing of transactions etc..

(ii) Evidence of Import in Lieu of Bill of Entry

1) AD bank may accept, in lieu of Exchange Control Copy of Bill of Entry for home consumption, a certificate from the Chief Executive Officer (CEO) or auditor of the company that the goods for which remittance was made have actually been imported into India for remittances of less than USD 1,000,000 or its equivalent by importing entities satisfying certain specified criterion.
2) Outward Remittance Message has to be created and BoE downloaded from "BoE Master "in IDPMS (in case of EDI ports). In case of Non-EDI ports duplicate copy/customs certified copy have to be submitted or BoE waiver obtained from RBI.

(iii) Non-physical Imports

1) For imports in non-physical form, i.e., software or data through internet / dotcom channels and drawings and designs through e-mail / fax – To obtain a certificate from a Chartered Accountant that the software / data / drawing/ design has been received.

26.5.6 Import Data Processing and Monitoring System:

(a) Outward Remittance Message:

To create Outward Remittance Message (ORM) for all outward remittance/s for import payments for which the prescribed documents for evidence of import have not been submitted.

(b) Settlement of ORM with BoE:

i. To download the Bill of Entry (BoE) issued by EDI ports from "BOE Master" in IDPMS, based on the AD Code (declared by the importer). For non-EDI ports, AD bank of the importer shall upload the BoE data in IDPMS as per message format "Manual BOE reporting" on daily basis on receipt of BoE from the customer/ Customs office.
ii. Submission of hardcopy of evidence of import documents i.e., BoE Exchange Control copy has been discontinued with effect from December 1, 2016. The revised procedure is as under:
iii. AD banks shall enter BoE details (BoE number, port code and date) for ORM associated with the advance payments for import transactions as per the message format "BOE settlement".
iv. In case of payment after receipt of BoE, the AD bank shall generate ORM for import payments as per the message format "BOE settlement".
v. Multiple ORMs can be settled against single BoE and also multiple BoE can be settled against one ORM.
vi. On settlement of ORM with evidence of import in all cases issue an acknowledgement slip to the importer containing – a) importer's full name and address with code number; b) number and date of BoE and the amount of import ; and c) a recap advice on number and amount of BoE and ORM not settled for the importer.
vii. The importer needs to preserve the printed 'Importer copy' of BoE as evidence of import and acknowledgement slip for future use.

(c) Extension and Write Off:

i. Extension for submission of BoE, given by AD banks, will be reported in IDPMS as per the message "Bill of Entry Extension" along with the date up to which extension is granted.

ii. AD banks can consider closure of BoE/ORM in IDPMS that involves write off to the extent of 5% of invoice value in cases where the amount declared in BoE varies from the actual remittance due to operational reasons and AD bank is satisfied with the reason/s submitted by the importer.

iii. AD banks may close the BoE for such import transactions where write off is on account of - quality issues; short shipment or destruction of goods by the port / Customs / health authorities subject to submission of satisfactory documentation irrespective of the amount involved. AD Bank shall settle and close ORM/BoE with appropriate "Adjustment Indicator" in IDPMS.

iv. While allowing write off, AD banks must ensure that: the case is not the subject matter of any pending civil or criminal suit; the importer has not come to the adverse notice of the ED or the CBI or any such other law enforcement agency; and there is a system in place under which internal inspectors or auditors of the AD banks (including external auditors) should carry out random sample check/ percentage check of write-off of import bills;

v. Extension and write off cases not covered by the guidelines should be referred to the RBI.

vi. The extant instructions and guidelines for Evidence of Import in Lieu of Bill of Entry will apply mutatis mutandis. The evidence of import in lieu of BoE in permitted/approved conditions will be created and uploaded in the form of BoE data as per message format "Manual BOE reporting" in IDPMS.

(d) Follow-up for Evidence of Import:

AD banks should follow up for outward remittance made for import (i.e. unsettled ORM). Where relevant evidence of import data is not available on due dates should follow up for submission of documentary evidence of import. Similarly, if BoE data is not settled against ORM within the prescribed period should follow up with the importer.

26.5.7 Verification and Follow-up

(a) Verification and Preservation:

Internal inspectors and IS auditors (including external auditors) should carry out verification of following aspects of the bank -

i. Verification and IS audit and assurance of the "BOE Settlement" process. Data and process followed should be preserved as per Cyber Security Framework in the bank.

ii. Verification of the documents evidencing import other than which are available in IDPMS, e.g. Exchange Control copies of Postal Appraisal Forms, or Customs Assessment Certificates, etc. These should be preserved for a period of one year from the date of their verification. For cases under investigation, documents, and/or data, process may be destroyed only after obtaining clearance from the investigating agency concerned.

(b) Follow up for Import Evidence:

i. In case an importer does not furnish any documentary evidence of import, within 3 months from the date of remittance the bank should rigorously follow-up for the next 3 months, using various modes of communications. At least one communication with the importer in this regard is by registered letter.

ii. In IDPMS, all outstanding import remittances, should be reported.

26.5.8 Imports of Specific Commodities

(a) Import of Gold:

Nominated banks and nominated agencies, as notified by DGFT, are permitted to import gold on consignment basis. In addition to the above, qualified jewellers as notified by International Financial Services Centres Authority (IFSCA) will be permitted to import gold under specific ITC (HS) Codes through India International Bullion Exchange IFSC Limited (IIBX). All sale of gold domestically will, however, be against upfront payment. Nominated banks are free to grant gold metal loans. The import of gold coins and medallions is permitted. However, prohibition on sale of gold coins and medallions by banks continues pending further review. The Status Holder Exporters shall adhere to the guidelines contained in extant Foreign Trade Policy.

(b) Import of Other Precious Metals:

i. Import of Platinum/ Palladium/ Rhodium/ Silver/ Rough, Cut & Polished Diamonds/ Precious and Semi-precious Stones.

   Suppliers' and Buyers' Credit, including the usance period of Letters of Credit opened for import should not exceed 90 days from the date of shipment. However Clean Credit given by a foreign supplier to its Indian customer/ buyer, for import of rough, cut and polished diamonds, precious and semi-precious stones, may be permitted for a period not exceeding 180 days from the date of shipment. AD banks may allow extension of time in respect of such clean credit for import of rough, cut and polished diamonds, to a maximum period of 180 days beyond the prescribed period/ due date; beyond which they may refer the cases to the RBI. Such extension by AD banks is subject to the prescribed conditions.

ii. Import of Platinum / Silver on Unfixed Price Basis

   The nominated agency/bank may allow import of platinum and silver, on outright purchase basis subject to the condition that although ownership of the same shall be passed on to the importers at the time of import itself, the price shall be fixed later as and when the importer sells to the user.

26.5.9 Other Import Transaction Modalities

(a) Import Factoring:

AD bank may enter into arrangements with international factoring companies of repute, preferably members of Factors Chain International, without the approval of RBI.

(b) Merchanting Trade:

AD banks may handle the Merchanting Trade Transactions (MTT) subject to RBI guidelines.

1) Basics of Merchanting Trade:
   a) Goods acquired shall not enter the Domestic Tariff Area.
   b) The state of goods acquired may be allowed some transformation subject to the AD bank being satisfied with the documentary evidence and bonafides of the transaction.
   c) c). Permitted for the goods that are permitted for exports / imports under the prevailing Foreign Trade Policy (FTP). All rules, regulations and directions applicable to exports (except Export Declaration Form) and imports (except Bill of Entry) shall be complied with for the export leg and import leg respectively.
   d) The entire merchanting trade is to be routed through the same AD bank. The AD bank shall verify the documents like invoice, packing list, transport documents and insurance documents (if originals are not available, non-negotiable copies duly authenticated by the bank handling documents may be taken) and satisfy itself about the genuineness of the trade. The AD bank may, if satisfied, rely on online verification of Bill of Lading/ Airway Bill on the website of International Maritime Bureau or Airline web check facilities. However, the AD bank shall ensure that the requisite details are made available /retrievable at the time of Inspection/Audit/investigation of the transactions.
   e) The entire MTT shall be completed within an overall period of nine months and there shall not be any outlay of foreign exchange beyond four months.
   f) The commencement date of merchanting trade shall be the date of shipment/ export leg receipt or import leg payment, whichever is first. The completion date shall be the date of shipment/ export leg receipt or import leg payment, whichever is the last.
2) Funding of Merchanting Trade
   a) Short-term credit (suppliers' credit or buyers' credit) may be extended to the extent not backed by advance remittance for the export leg, including the discounting of export leg LC by the AD bank, as in the case of import transactions. Letter of Undertaking (LoU)/ Letter of Comfort (LoC) shall not be issued for supplier's/ buyer's credit.
   b) Any receipts for the export leg, prior to the payment for import leg, may be parked either in Exchange Earners Foreign Currency (EEFC) account or in an interest-bearing INR account till the import leg liability arises. It shall be strictly earmarked/ lien-marked for the payment of import leg. No fund/non-fund-based facilities shall be extended against these balances. The liability of the import leg, as soon as it arises, shall be extinguished out of these funds without any delay.
   c) Payment for import leg may also be allowed to be made out of the balances in EEFC account of the merchant trader.
   d) Merchanting traders may be allowed to make advance payment for the import leg on demand made by the overseas supplier. Any such advance payment for an import leg beyond USD 500,000/- per transaction, shall be made against Bank Guarantee/ an unconditional, irrevocable standby Letter of Credit from an international bank of repute.
   e) Letter of Credit to the supplier for the import leg is permitted against confirmed export order, subject to other regulatory aspects.

3) Monitoring MTT Transactions:
   a) AD bank shall ensure one-to-one matching in case of each MTT and report defaults in any leg by the traders to the RBI.
   b) The merchanting traders shall be genuine traders of goods and not mere financial intermediaries. Confirmed orders must be received by them from the overseas buyers. AD banks shall satisfy themselves about the capabilities of the merchanting trader to perform the obligations under the order. The merchanting trade shall result in profit which shall be determined by subtracting import payments and related expenses from export proceeds for the specific MTT.
   c) Write-off of unrealized amount of export leg: AD bank may write-off the unrealized amount of export leg, without any ceiling, on the request made by the Merchanting trader, in the following circumstances, subject to prescribed conditions.
      i) MTT buyer is declared insolvent.
      ii) The goods exported have been auctioned or destroyed by the Port/ Customs Health authorities in the importing country.
      iii) The unrealized amount represents the balance due in a case settled through the intervention of the Indian Embassy, Foreign Chamber of Commerce or similar Organization.
4) MTT - Other Aspects
   i. Third Party payments
   Third party payments for export and import legs of the MTT are not allowed.
   ii. Payment of Agency Commission
   Agency commission is not allowed in MTTs. AD banks may allow payment of agency commission up to a reasonable extent under exceptional circumstances, subject to prescribed conditions.
   iii. AD bank may approach RBI for regularization of the MTT for deviation, if any, from the prescribed guidelines, and the MTT shall be closed only after receiving approval.
5) Merchanting trade to Nepal and Bhutan
   a) As Nepal and Bhutan are landlocked countries, there is a facility of transit trade whereby goods are imported from third countries by Nepal and Bhutan through India under the cover of Customs Transit Declarations in terms of the Government of India Treaty of Transit with these two countries.
   b) Goods consigned to the importers of Nepal and Bhutan from third countries under merchanting trade from India would qualify as traffic-in-transit.

(c) Processing of import related payments through Online Payment Gateway Service Providers (OPGSPs)

AD banks can offer facility of payment for imports of goods and software of value not exceeding USD 2,000 by entering into standing arrangements with the OPGSPs subject to prescribed conditions.

(d) *Settlement of Import transactions in currencies not having a direct exchange rate:*

Settlement of import transactions where the invoicing is in a freely convertible currency and the settlement takes place in the currency of the beneficiary, which though convertible, does not have a direct exchange rate, can be permitted by AD banks subject to prescribed conditions.

26.6 FOREX FACILITIES FOR INDIVIDUALS

26.6.1 Liberalised Remittance Scheme (LRS)

(a) Basic Features of LRS:

i. AD may freely allow remittances by resident individuals up to USD 2,50,000 per Financial Year (April-March) for any permitted current or capital account transaction or a combination of both.
ii. The Scheme is available to all resident individuals including minors. For a minor, the natural guardian will complete the Form A2.
iii. The Scheme is not available to corporates, partnership firms, HUF, Trusts, etc.
iv. Remittances can be consolidated in respect of family members subject to individual family members complying with its terms and conditions.
v. Clubbing is not permitted by other family members for capital account transactions, if they are not the co-owners/co-partners of the overseas bank account/investment/property.
vi. A resident cannot gift to another resident, in foreign currency, for the credit of the latter's foreign currency account held abroad under LRS.
vii. All other transactions which are otherwise not permissible under FEMA and those in the nature of remittance for margins or margin calls to overseas exchanges/ overseas counterparty are not allowed.
viii. Release of foreign exchange exceeding USD 2,50,000 requires prior permission from the RBI.

(b) Capital Account Transactions:

Permissible capital account transactions under LRS are:

i. Opening of foreign currency account abroad with a bank
ii. Purchase of property abroad
iii. Making investments abroad
iv. (Acquisition and holding shares or debt instruments of listed and unlisted overseas company; Acquisition of qualification shares of an overseas company for holding the post of Director; Acquisition of shares of a foreign company towards professional services rendered or in lieu of Director's remuneration; Investment in units of Mutual Funds, Venture Capital Funds, Unrated debt securities, Promissory notes)
v. Setting up Wholly Owned Subsidiaries and Joint Ventures outside India for bonafide business subject to applicable conditions.
vi. Extending loans including loans in Indian Rupees to NRIs who are relatives (as per Companies Act, 2013)

(c) Current Account Transactions:

Within the prescribed limit per FY current account transactions as (specified under Para 1 of Schedule III of the FEMA Rules) are also included.

(d) Limit on Remittances:

The limit of USD 2,50,000 applies to the aggregate value of all the remittances made for different eligible purposes (both current account and capital account transactions) during a given financial year. Specific provisions in respect of different current account purposes for which foreign exchange can be availed by the resident individuals under LRS are stated below. Except where stated otherwise, the permissible amount for any specific purpose is USD 2,50,000 in a FY less the amount utilized for any other eligible purposes during the FY.

(e) Current Account Transactions - Eligible Purposes:

i. Private visits - The aggregate amount of foreign exchange for all the private visits during a financial year abroad should be within the ceiling. Visits to Nepal and Bhutan are not included for this purpose. All tour related expenses (including cost of rail/road/water transportation; cost of Euro Rail; passes/tickets, etc. outside India; and overseas hotel/lodging expenses) shall be subsumed under the LRS limit. The tour operator may collect this amount either in Indian rupees or in foreign currency from the resident traveller.

ii. Gift/donation – Gifts to persona residing outside India or donations to organizations outside India are covered in the Scheme.

iii. Going abroad on employment – Foreign exchange can be drawn when going abroad for employment.

iv. Emigration -
Foreign exchange up to the amount prescribed by the country of emigration but not exceeding the ceiling under the Scheme is permitted. Remittance outside India in excess of this limit may be allowed only towards meeting incidental expenses in the country of immigration, and not for earning points or credits to become eligible for immigration, by way of overseas investments in government bonds; land; commercial enterprise; etc.

v. Maintenance of close relatives abroad – Remittances towards maintenance of close relatives [‘relative’ as defined in Section 2(77) of the Companies Act, 2013] living abroad are covered.

vi. Business trip - Visits by individuals in connection with attending of an international conference, seminar, specialised training, apprentice training, etc., are treated as business visits. Remittances for such purposes are covered within the ceiling in a FY irrespective of the number of visits. If an employee is being deputed by an entity for any of the above and the expenses are borne by the latter, such expenses shall be treated as residual current account transactions outside LRS and may be permitted without any limit, subject to verifying the bonafides of the transaction.

vii. Medical treatment abroad – These expenses are covered under the Scheme, and foreign exchange can be released without insisting on any estimate from a hospital/doctor within the ceiling. For amount exceeding the limit, foreign exchange may be released under general permission based on the estimate from the doctor in India or hospital/ doctor abroad. For a person who has fallen sick after proceeding release of foreign exchange is permitted (without seeking prior approval of the RBI) for medical treatment outside India. In addition, an amount up to USD 250,000 per financial year is allowed to a person for accompanying as attendant to a patient going abroad for medical treatment/check-up.

viii. Facilities available to students for pursuing their studies abroad - Foreign exchange may be released under the Scheme for studies abroad without insisting on any estimate from the foreign University. However, remittances exceeding USD 2,50,000 may be allowed (without seeking prior approval of the RBI) based on the estimate received from the institution abroad.

(f) Remittances for Other Purposes:

i. Remittances under the Scheme can be used for purchasing objects of art subject to the provisions of other applicable laws such as the extant Foreign Trade Policy of the Government of India.

ii. The Scheme can be used for outward remittance in the form of a DD either in the resident individual’s own name or in the name of beneficiary with whom he intends putting through the permissible transactions at the time of private visit abroad, against self-declaration of the remitter in the prescribed format.

iii. Individuals can also open, maintain and hold foreign currency accounts with a bank outside India for making remittances under the Scheme without prior approval of the RBI. The foreign currency accounts may be used for putting through all transactions connected with or arising from remittances eligible under this Scheme.

(g) Restrictions/ Prohibitions:

i. Banks should not extend any kind of credit facilities to resident individuals to facilitate capital account remittances under the Scheme.

ii. The Scheme is not available for remittances for any purpose specifically prohibited under Schedule I or any item restricted under Schedule II of Foreign Exchange Management (Current Account Transaction) Rules.

iii. The Scheme is not available for capital account remittances to countries identified by Financial Action Task Force (FATF) as non-co-operative countries and territories as available on FATF website www.fatf-gafi.org or as notified by the RBI.

iv. Remittances directly or indirectly to those individuals and entities identified as posing significant risk of committing acts of terrorism as advised separately by the RBI to the banks is also not permitted.

(h) Documentation by the remitter:

i. The individual has to designate a branch of an AD through which all the remittances under the Scheme will be made.

ii. The individual has to furnish Form A2 for purchase of foreign exchange under LRS.

iii. Permanent Account Number (PAN) of the remitter is mandatory to be furnished.

(i) Accretions/ Repatriation:

Investor can retain, and reinvest the income earned on the investments made under LRS. The individual is not required to repatriate the funds or income generated out of investments made under the Scheme. An individual who has made overseas direct investment in the equity shares; compulsorily convertible preference shares of a JV/ WoS outside India, within the LRS limit, shall have to comply with the terms and conditions prescribed by the overseas investment guidelines.

(j) Loans/ Gifts to NRI/ PIO – Close Relatives:

1) Facility to grant loan in rupees to NRI/ PIO close relative
   Resident individual is permitted to lend to a Non-resident Indian (NRI)/ Person of Indian Origin (PIO) close relative ['relative' as defined in Section 2(77) of the Companies Act, 201311] by way of crossed cheque/ electronic transfer subject to the following conditions:
   i) the loan is free of interest and the minimum maturity of the loan is one year;
   ii) the loan amount should be within the overall limit under the LRS.
   iii) the loan shall be utilized for meeting the borrower's personal requirements or for his own business purposes in India.
   iv) the loan shall not be utilized, either singly or in association with other person for any of the activities in which investment by persons resident outside India is prohibited, namely: (a) The business of chit fund, or (b) Nidhi Company, or (c) Agricultural or plantation activities or in real estate business, or construction of farm houses, or (d) Trading in Transferable Development Rights (TDRs). [Here real estate business shall not include development of townships, construction of residential/ commercial premises, roads or bridges.]
   v) the loan amount should be credited to the NRO a/c of the NRI / PIO. Credit of such loan amount may be treated as an eligible credit to NRO a/c;
   vi) the loan amount shall not be remitted outside India; and
   vii) repayment of loan shall be made by way of inward remittances through normal banking channels or by debit to the Non-resident Ordinary (NRO)/ Non-resident External (NRE)/ Foreign Currency Non-resident (FCNR) account of the borrower or out of the sale proceeds of the shares or securities or immovable property against which such loan was granted.
2) Facility to give rupee gift to NRI/ PIO close relative
   A resident individual can make a rupee gift to a NRI/PIO who is a relative of the resident individual ['relative' as defined in Section 2(77) of the Companies Act, 201312] by way of crossed cheque /electronic transfer. The amount should be credited to the Non-Resident (Ordinary) Rupee Account (NRO) a/c of the NRI/ PIO and credit of such gift amount may be treated as an eligible credit to NRO a/c.

26.6.2 Operational instructions to Authorised Persons (LRS)

i. The RBI does not, generally, prescribe the documents which should be verified by the Authorised Persons while releasing foreign exchange for current account transactions.
ii. Sub-section (5) of Section 10 of the FEMA, 1999 provides that an authorised person shall obtain from a person transacting in foreign exchange a declaration and to required information to be reasonably satisfied that the transaction will not involve and is not designed for the purpose of any contravention or evasion of the provisions of the FEMA or any rule, regulation, notification, direction or order issued there under.

iii. AD should keep on record any information/ documentation, on the basis of which the transaction was undertaken for verification by the RBI.
iv. If the applicant refuses to comply with any requirement or makes unsatisfactory compliance therewith, the AD shall refuse, in writing, to undertake the transaction and shall, if he has reasons to believe that any contravention / evasion is contemplated by the person, report the matter to the RBI.
v. It is mandatory for ADs to comply with the requirement of the tax laws for deduction of tax at source while allowing remittances to the non-residents, as applicable.
vi. Capital account transactions under the Scheme should be permitted to the customers who have maintained the bank account with the bank for a minimum period of one year prior to the remittances. If the applicant is a new customer of the bank, AD in addition to due diligence on the opening, operation and maintenance of the account, should obtain bank statement (of the account with other bank) for the previous year to satisfy themselves regarding the source of funds. If such a bank statement is not available, copies of the latest Income Tax Assessment Order or Return filed by the applicant may be obtained.
vii. The AD should ensure that the payment is received out of funds belonging to the person seeking to make the remittances, by a cheque drawn on the applicant's bank account or by debit to his account or by Demand Draft / Pay Order. AD may also accept the payment through credit /debit/prepaid card of the card holder.
viii. The AD should certify that the remittance is not being made directly or indirectly by /or to ineligible entities and that the remittances are made in accordance with the instructions contained herein.

Marketing in India of schemes soliciting foreign currency deposits by foreign entities, not having operational presence in India, raises supervisory concerns. Therefore, banks, including those not having an operational presence in India, should seek prior approval from RBI for the schemes to be marketed by them in India to residents either for soliciting foreign currency deposits for their foreign/overseas branches or for acting as agents for overseas mutual funds or any other foreign financial services company.

26.6.3 Accounts for Non-Residents/ NRIs in India

(a) Definitions:

i. *'Authorised Bank'* is a bank including a co-operative bank authorised by the Reserve Bank to maintain an account of a person resident outside India.
ii. '*Deposit*' includes deposit of money with a bank, company, proprietary concern, partnership firm, corporate body, trust or any other person.
iii. *A 'Non-resident Indian'* (NRI) is a person resident outside India who is a citizen of India.
iv. A '*Person of Indian Origin (PIO)*' is a person resident outside India who is a citizen of any country other than Bangladesh or Pakistan or such other country as may be specified by the Central Government, satisfying the following conditions:
    a. Who was a citizen of India by virtue of the Constitution of India or the Citizenship Act,1955 (57 of 1955); or

b. Who belonged to a territory that became part of India after the 15th day of August, 1947; or
c. Who is a child or a grandchild or a great grandchild of a citizen of India or of a person referred to in clause (a) or (b); or
d. Who is a spouse of foreign origin of a citizen of India or spouse of foreign origin of a person referred to in clause (a) or (b) or (c)

Explanation: PIO will include an 'Overseas Citizen of India' cardholder within the meaning of Section 7(A) of the Citizenship Act, 1955.

v. '*Permissible currency*' is a foreign currency which is freely convertible.
vi. '*Relative*' means relative as defined in section 2(77) of the Companies Act, 2013.

(b) Non-Resident (External) Rupee Account Scheme – (NRE Account):

i. Non-resident Indians (NRIs) and Person of Indian Origin (PIOs) are permitted to open and maintain these accounts (in any form, e.g. savings, current, recurring or fixed deposit account etc.) with ADs and with banks (including cooperative banks) authorised by the Reserve Bank to maintain such accounts.
ii. Joint accounts can be opened by two or more NRIs and/or PIOs or by an NRI/PIO with a resident relative(s) on 'former or survivor' basis.
iii. Credits permitted: Interest accruing on the account, Inward remittance of Interest on investment, transfer from other NRE/ FCNR(B) accounts, Maturity proceeds if such investments were made from this account or through inward remittance.
iv. Debits allowed: Local disbursements, Transfer to other NRE/ FCNR(B) accounts and investments in India, Outward remittance.
v. Current income like rent, dividend, pension, interest etc. is a permissible credit to the NRE account provided the credit represents current income of the NRI/PIO account holder and income tax thereon has been deducted/ paid/ provided for, as the case may be.
vi. Loans against the security of the funds held in NRE accounts: Permitted for the account holder, For third party in India, subject to the usual margin requirements. The loan cannot be repatriated outside India. "Loan" includes all types of fund based/ non-fund based facilities. It shall be used for the following purposes:
   a) Personal purposes or for carrying on business activities except for the purpose of relending or carrying on agricultural/ plantation activities or for investment in real estate business;
   b) Making direct investment in India on non-repatriation basis by way of contribution to the capital of Indian firms/ companies;
   c) Acquiring flat/ house in India for his own residential use.
vii. Loans to a third party - there should be no direct or indirect foreign exchange consideration for the non-resident depositor agreeing to pledge his deposits to enable the resident individual/ firm/ company to obtain such facilities.
viii. Loan to the account holder - it can be repaid either by adjusting the deposits or through inward remittances from outside India through banking channels or out of balances held in the NRO account of the account holder.

ix. AD may allow their branches/ correspondents outside India to grant loans to or in favour of non-resident depositor or to third parties at the request of depositor for bona fide purpose against the security of funds held in the NRE accounts in India and also agree for remittance of the funds from India, if necessary, for liquidation of the outstanding.

x. Facility for premature withdrawal of deposits will not be available where loans against such deposits are availed of.

xi. NRE accounts should be designated as resident accounts or the funds held in these accounts may be transferred to the RFC accounts, at the option of the account holder, immediately upon the return of the account holder to India for taking up employment or on change in the residential status.

xii. In the event of the demise of an account holder, balances in the account can be transferred to the non-resident nominee of the deceased account holder. However, request from a resident nominee for remittance of funds outside India for meeting the liabilities, if any, of the deceased account holder or for similar other purposes, should be forwarded to the Reserve Bank for consideration.

xiii. Operations on an NRE account may be allowed in terms of Power of Attorney or other authority granted in favour of a resident by the non-resident account holder. The power of attorney can be given to the resident the joint account holder.

xiv. The operations permitted by the PoA holder - Withdrawals for local payments or Remittance to the account holder himself through banking channels. If the non-resident is eligible to make investments in India, the PoA holder may be permitted to operate the account to facilitate such investment.

xv. The resident PoA holder is not allowed to (a) Open a NRE account; (b) Repatriate outside India funds held in the account other than to the account holder himself; (c) Make payment by way of gift to a resident on behalf of the account holder; (d) Transfer funds from the account to another NRE account.

xvi. Income from interest on balances standing to the credit of NRE Accounts is exempt from Income Tax. Likewise, balances held in such accounts are exempt from wealth tax.

xvii. The rate of interest and tenor applicable to these accounts will be in accordance with the directions/ instructions.

(c) Foreign Currency (Non-resident) Account (Banks) Scheme – FCNR (B) Account:

i. Non-resident Indians (NRIs) and Persons of Indian Origin (PIOs) are permitted to open and maintain these accounts with AD and banks authorised by the RBI to maintain such accounts. Deposits may be accepted in the form of fixed deposit and in any permissible currency.

ii. Other conditions such as credits/debits, joint accounts, loans / overdrafts, operation by power of attorney etc., as applicable to an NRE account are applicable to FCNR (B) account as well.

iii. The rate of interest and tenor forthese accounts are in accordance with the directions/ instructions.

(d) Non-Resident (Ordinary) Account Scheme – NRO account:

i. Any person resident outside India, may open and maintain NRO account with an AD or an Authorised Bank or a Post Office for the purpose of putting through bona fide transactions denominated in Indian Rupees.
ii. NRO accounts may be maintained in any form, e.g. savings, current, recurring or fixed deposit account. NRIs and PIOs may hold an NRO account jointly with other NRIs and PIOs. They may be held jointly with residents on 'former of survivor' basis.
iii. Permissible credits: Inward remittances from outside India, legitimate dues in India and transfers from other NRO accounts. Rupee gift/ loan made by a resident to a NRI/ PIO relative within the limits prescribed under the Liberalised Remittance Scheme may be credited to the latter's NRO account.
iv. Permissible debits: Local payments, transfers to other NRO accounts or remittance of current income abroad. Apart from these, balances in the NRO account cannot be repatriated abroad except by NRIs and PIOs up to USD 1 million, subject to conditions specified. Funds can be transferred to NRE account within this USD 1 Million facility.
v. Loans against the deposits can be granted in India to the account holder or third party subject to usual norms and margin requirement. The loan amount shall not be used for relending, carrying on agricultural/plantation activities or investment in real estate.
vi. NRO accounts may be designated as resident accounts on the return of the account holder to India for any purpose indicating his intention to stay in India for an uncertain period. Likewise, when a resident Indian becomes a person resident outside India, his existing resident account should be designated as NRO account.
vii. Power of Attorney may be granted in favour of a resident by the non-resident individual account holder for operations on the account restricted to local payments and remittances to non-residents.

(e) Conversion of Resident Account of Foreign Nationals:

i. To facilitate the foreign nationals to collect their pending dues in India, AD Category-I banks may permit such foreign nationals to re-designate their resident account maintained in India as NRO account on leaving the country after their employment.
ii. The bank should satisfy itself that the credit of amounts are bonafide dues of the account holder when she/ he was a resident in India.
iii. The funds credited to the NRO account should be repatriated abroad immediately, subject to payment of the applicable income tax and other taxes in India. The amount repatriated abroad should not exceed USD one million per financial year. The debit to the account should be only for the purpose of repatriation to the account holder's account maintained abroad.
iv. The account should be closed immediately after all the dues have been received and repatriated as per the declaration made by the account holder when the account was designated as an NRO account.

(f) Foreign National (Non-Indian Origin) Visiting India:

i. NRO (current/ savings) account can be opened by a foreign national of non-Indian origin visiting India, with funds remitted from outside India through banking channel or by sale of foreign exchange brought by him to India.
ii. The balance in the NRO account may be paid to the account holder at the time of his departure from India provided the account has been maintained for a period not exceeding six months and the account has not been credited with any local funds, other than interest accrued thereon.

(g) Opening of accounts by individuals/ entities of certain countries:
Opening of accounts by individuals/ entities of Pakistan nationality/ ownership and entities of Bangladesh ownership requires prior approval of the Reserve Bank. However, individuals of Bangladesh nationality may be allowed to open these accounts subject to the individual/s holding a valid visa and valid residential permit issued by Foreigner Registration Office (FRO)/ Foreigner Regional Registration Office (FRRO) concerned.

(h) Opening of accounts for Citizens of Pakistan/ Bangladesh belonging to the Minority Communities there

i. AD may open only one Non-Resident Ordinary (NRO) Account for a citizen of Bangladesh or Pakistan, belonging to minority communities in those countries, namely Hindus, Sikhs, Buddhists, Jains, Parsis and Christians, residing in India and who has been granted a Long Term Visa (LTV) by the Central Government.
ii. The account will be converted to a resident account once such a person becomes a citizen of India.
iii. This account can also be opened if such person has applied for LTV which is under consideration of the Central Government, in which case the account will be opened for a period of six months and may be renewed at six monthly intervals subject to the condition that the individual holds a valid visa and valid residential permit issued by Foreigner Registration Office (FRO)/ Foreigner Regional Registration Office (FRRO) concerned.
iv. The opening of such NRO accounts will be subject to reporting of the details of accounts opened by the concerned Authorised bank to the Ministry of Home Affairs (MHA) on a quarterly basis. The report shall contain details of name/s of the individual/s; date of arrival in India; Passport No. and place/country of issue; Residential Permit/Long Term Visa reference and date & place of issue; name of the FRO/ FRRO concerned; (vi) complete address and contact number of the branch where the bank account is being maintained.

26.6.4 Non Residents - Other Aspects

(a) International Credit Cards:
AD banks have been permitted to issue International Credit Cards to NRIs/ PIOs, without prior approval of RBI. Such transactions may be settled by inward remittance or out of balances held in the cardholder’s FCNR (B) / NRE / NRO Accounts.

(b) Income-Tax:

The remittances (net of applicable taxes) will be allowed to be made by the AD banks on production of requisite information in the formats prescribed by the Central Board of Direct Taxes, Ministry of Finance, Government of India from time to time.

26.7 LET US SUM UP

Foreign Direct Investment: A person resident outside India may hold foreign investment either as Foreign Direct Investment or as Foreign Portfolio Investment in any particular Indian company. Automatic Route is one in which the prior approval from the Central Government is not required. Government Route requires prior Government approval. Foreign investment in the sectors/ activities given in Schedule I of the NDI Rules is permitted up to the limit indicated against each sector/ activity, subject to various conditions.

Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad: These can be made through - Automatic Route or Approval Route. An Indian Party can make investment/ undertake financial commitment in overseas Joint Ventures (JV) / Wholly Owned Subsidiaries (WOS), as per the ceiling prescribed by the RBI (currently 400% of the net worth as per the last audited balance sheet).

External Commercial Borrowing (ECB): ECB can be raised as - (i) FCY denominated ECB and (ii) INR denominated ECB. Minimum average maturity period is 3 years, with some exceptions. ECB is permitted for specified purposes including General corporate purpose and working capital purpose.

Trade Credits: Trade Credits (TC) refer to the credits extended by the overseas supplier, bank, financial institution and other permitted recognised lenders for prescribed maturity, for imports of capital/non-capital goods. Per import transaction the ceiling amount is USD 150 million or equivalent (for oil/gas refining & marketing, airline and shipping companies) and USD 50 million (for others). For capital goods the term is up to 3 years; and for non-capital goods - up to one year or the operating cycle whichever is less.

Exports of Goods & Services: The exporter should realize and repatriate the full value of goods/ software/ services to India within 9 months from the date of export. Certain special arrangements in place are - Counter-Trade Arrangement; Border trade with Myanmar; Counter –Trade arrangements with Romania; Repayment of State credits, etc.

Imports of Goods & Services: AD Banks may allow remittance for making payments for imports into India, after ensuring that all the requisite details are made available, and the remittance is for bona fide trade transactions as per applicable laws in force. Where foreign exchange acquired has been utilised for import of goods into India, the AD bank should ensure that the importer furnishes evidence of import. Remittances against imports should be completed no later than six months from the date of shipment, except in cases where amounts are withheld towards guarantee of performance, etc.

Forex Facilities for Individuals: (i) Liberalised Remittance Scheme (LRS) - AD may freely allow remittances by resident individuals up to USD 2,50,000 per FY, for any permitted current or capital account transaction or a combination of both. Within the prescribed limit per FY current account transactions as (specified under Para 1 of Schedule III of the FEMA Rules) are also included. (ii) Accounts for Non-Residents/ NRIs in India – (a) Non-Resident (External) Rupee Account Scheme (NRE Account) (b) Foreign Currency (Non-resident) Account (Banks) Scheme (FCNR (B) Account) - (c) Non-Resident (Ordinary) Account Scheme (NRO account)

26.8 KEY WORDS

Equity Instruments; Convertible Note; E-commerce entity; Foreign Portfolio Investor (FPI); Foreign Institutional Investor (FII); Fully diluted basis; Indian entity; Automatic Route; Government Route; Transferable Development Rights; Non-Repatriation basis; Alternative Investment Fund; American Depository Receipt; Sponsor contribution; Financial Commitment; Foreign Currency Convertible Bond; Host country; Indian Depository Receipts; Foreign Currency Exchangeable Bond; Compulsorily Convertible Preference Shares (CCPS);; ECB liability-Equity ratio; IOSCO Compliant Country; Loan Registration Number (LRN); Untraceable Entities; Suppliers' credit; Buyers' credit; Diamond Dollar Account; Exchange Earners' Foreign Currency Account (EEFC Account); Forfaiting; Export Data Processing and Monitoring System (EDPMS); SOFTEX Forms; Shut out Shipments; Customs Assessment Certificate; Capital Account Transactions; Current Account Transactions.

26.9 CHECK YOUR PROGRESS

1) Foreign investment is not reckoned as FDI if the investment is made in ----.
   a) equity shares,
   b) fully and mandatorily convertible preference shares
   c) fully and mandatorily convertible debentures with the pricing being decided upfront as a figure or based on the formula that is decided upfront.
   d) Rated debentures

2) The normal prescribed Aggregate limit for investment by all FPIs in an Indian company is ______ %
   a) 10
   b) 49
   c) 51
   d) 24

3) Authorised Dealer Category - I (AD Category - I) banks have been allowed to offer the facility of repatriation of export related remittances by entering into standing arrangements with Online Payment Gateway Service Providers (OPGSPs) subject to export of goods and services of value not exceeding USD ____.
   a) 3000
   b) 5000
   c) 10000
   d) 4000

4) The general permission for raising ECB under the Automatic Route by an eligible entity in a financial year is USD ___ million.
   a) 500
   b) 750
   c) 100
   d) 200

5) Under Liberalised Remittance Scheme for Resident Individuals permitted investment is ___________.
   a) Funding margin calls
   b) Funding active foreign exchange trading
   c) Purchasing real estate
   d) None of the above

26.10 KEY TO 'CHECK YOUR PROGRESS'

1 (d); 2 (d); 3 (c); 4 (b); 5 (c)

References:

1) RBI Circular No. FED Master Direction No.11/2017-18 dated January 4, 2018 (Updated up to March 17, 2022) - Master Direction – Foreign Investment in India (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11200)
2) RBI Circular No. FED Master Direction No. 15/2015-16 dated January 1, 2016 (Updated as on June 24, 2021) - Master Direction – Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10637)
3) RBI Circular No. FED Master Direction No.5/2018-19 dated March 26, 2019 (Updated up to December 10, 2021) - Master Direction - External Commercial Borrowings, Trade Credits and Structured Obligations (https://rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510)
4) RBI Circular No. FED Master Direction No. 16/2015-16 dated January 1, 2016 (Updated up to January 08, 2021) - Master Direction – Export of Goods and Services (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10395)
5) RBI Circular No. FED Master Direction No. 17/2016-17 dated January 1, 2016 (Updated up to January 06, 2022) - Master Direction – Import of Goods and Services (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10201)
6) RBI Circular No. FED Master Direction No. 7/2015-16 dated January 1, 2016 (Updated up to June 20, 2018) - Master Direction – Liberalised Remittance Scheme (LRS) (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10192)
7) RBI Circular No. FED Master Direction No. 14/2015-16 dated January 1, 2016 (Updated up to January 9, 2020) - Master Direction – Deposits and Accounts (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10198)

CHAPTER 27

CUSTOMER SERVICE – OPERATIONAL ASPECTS OF BANKING

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Know about operations related to savings and time deposits
- Learn about the nomination facility for deposit accounts
- Know about handling of Demand Drafts/ Cheques
- Understand the obligations of confidentiality and guidance to customers
- Know the Grievance Redressal Mechanism
- Learn about government business

27.1 CUSTOMER CONFIDENTIALITY OBLIGATIONS

The scope of the secrecy law in India has generally followed the common law principles based on implied contract. The bankers' obligation to maintain secrecy arises out of the contractual relationship between the banker and customer, and as such no information should be divulged to third parties except under circumstances which are well defined. The following exceptions to the said rule are normally accepted:

i. Where disclosure is under compulsion of law
ii. Where there is duty to the public to disclose
iii. Where interest of bank requires disclosure and
iv. Where the disclosure is made with the express or implied consent of the customer.

27.1.1 Collecting Information for Cross-selling Purposes

The information provided by the customer for KYC compliance while opening an account is confidential and divulging any details thereof for cross selling or any other purpose would be in breach of customer confidentiality obligations. Banks may, therefore, ensure that information sought from the customer is relevant to the perceived risk, is not intrusive, and is in conformity with the guidelines issued in this regard. Any information collected about the customer for a purpose other than KYC requirements should not form part of the account opening form. Such information may be collected separately, purely on a voluntary basis for the customer, after explaining the objectives to the customer and taking his express approval for the specific uses to which such information could be put.

27.2 OPERATIONS IN SAVINGS & TIME DEPOSIT ACCOUNTS

Comprehensive Deposit Policy

Banks should have a transparent policy setting out the rights of the depositors in general and small depositors in particular. The policy should cover all aspects of operations of deposit accounts, charges leviable and other related issues, including the policy of secrecy and confidentiality of the customers.

Intra-bank Deposit Accounts Portability

Banks should be guided by instructions on KYC / AML for identification procedure for opening of accounts for individuals. Full KYC once done by one branch should be valid for transfer of the account within the bank for the concerned account. The customer should be allowed to transfer his account from one branch to another branch on the basis of a self-declaration from the account holder about his / her current address, subject to submitting proof of address within a period of six months. Periodical updation of KYC data would continue to be done by bank as per prescribed periodicity.

27.2.1 Savings Bank Rules

The Savings Bank Rules must be annexed as a tear-off portion to the account opening form so that the account holder can retain the rules.

Photographs of depositors

Banks should obtain and keep on record photographs of all depositors' / account holders, subject to the following clarifications:

i. Two copies of photographs should be obtained. Photocopies of driving licence/ passport containing photographs will not suffice.

ii. Photographs are required for all types of deposits including fixed, recurring, cumulative, etc. Only one set of photographs need be obtained for a customer and separate photographs should not be obtained for each category of deposit. The applications for different types of deposit accounts should be properly referenced. Fresh photographs need not be obtained when an additional account is opened.

iii. Banks, Local Authorities and Government Departments (excluding public sector undertakings or quasi-Government bodies) are exempt from the requirement of photographs.

iv. Photographs may not be insisted upon in case of accounts of staff members only (Single/Joint).

v. Photographs of the 'Pardanishin' women also should be obtained.

vi. Photographs of all persons authorised to operate the accounts should be obtained. For operative accounts, viz. Savings Bank and Current accounts, photographs of all the persons authorised to operate should be obtained. For other deposits, viz., Fixed, Recurring, Cumulative, etc., photographs of all depositors in whose names the deposit receipt stands are required. In the case of deposits in the name of minors only guardians' photographs may be obtained.

vii. Photographs cannot be a substitute for specimen signatures. The banks should not ordinarily insist on the presence of account holder for making cash withdrawals in case of 'self' or 'bearer' cheques unless the circumstances so warrant. The banks should pay 'self' or 'bearer' cheques taking usual precautions.

Opening of Bank Accounts in the Names of Minors

With a view to promote the objective of financial inclusion and also to bring uniformity among banks in opening and operating minors' accounts, following provisions have been made:

i. A savings /fixed / recurring bank deposit account can be opened for a minor of any age through his/her natural or legally appointed guardian.

ii. Minors above the age of 10 years may be allowed to open and operate savings bank accounts independently, if they so desire. A bank need to fix for itself limits for age and amount up to which minors may be allowed to operate the deposit accounts independently. It has also to decide for itself what minimum documents are required for this purpose.

iii. On attaining majority, the erstwhile minor should confirm the balance in his/her account. If the account is operated by the natural guardian/ legal guardian, fresh operating instructions and specimen signature of erstwhile minor should be obtained.

iv. Banks may also offer additional banking facilities like internet banking, ATM/ debit card, cheque book facility etc., subject to the safeguards that minor accounts are not allowed to be overdrawn.

Opening accounts in the name of minors with Mothers as guardians

A minor cannot enter into a contract; hence a minor's bank account is permitted to be opened by her/ his guardian. Section 6 of the Hindu Minority and Guardianship Act, 1956, stipulates that the father alone, when he is alive, should be deemed to be the guardian of a minor. Similar legal provisions exist in respect of other communities. So women were not in a position to open accounts in the name of their minor children.

The legal and practical aspects of the above problem were examined by RBI, in consultation with the Government of India. It was considered that if mothers are treated as guardians only for opening of fixed and savings bank accounts in the name of minors, there would seem to be no difficulty. Banks would need to take adequate safeguards in allowing operations in the accounts by ensuring that such accounts are not allowed to be overdrawn and they always remain in credit. Thus, the minors' capacity to enter into contract would not be a subject matter of dispute, and the banks' interests would be adequately protected. Banks are now allowed to open minors' accounts (fixed, savings, and recurring deposit account only) with mothers as guardians, subject to this safeguard.

Minimum balance in savings bank accounts

At the time of opening the accounts, banks should inform their customers in a transparent manner the requirement of maintaining minimum balance and levying of charges, etc., if the minimum balance is not maintained. Any charge levied subsequently should be transparently made known to all depositors in advance with one month's notice. The banks should inform, at least one month in advance, the existing account holders of any change in the prescribed minimum balance and the charges that may be levied if the prescribed minimum balance is not maintained. The guidelines for levy of such charges are as follows:

i. Penal charges for non-maintenance of minimum balances are not permitted in any inoperative account.

ii. In the event of a default in f minimum balance / average minimum balance as agreed to, the bank should notify the customer clearly by SMS / email / letter etc. that if the minimum balance is not restored within a month from the date of notice, penal charges will be applicable.

iii. In case the minimum balance is not restored within a reasonable period (to be at least one month from the date of notice of shortfall), penal charges may be recovered under intimation.

iv. The policy on penal charges to be so levied should be decided with the approval of Board.
v. The penal charges should be directly proportionate to the extent of shortfall observed. The charges should be in terms of a fixed percentage of the difference between the actual balance and the minimum balance required. A suitable slab structure for such charges may be finalised.
vi. The penal charges should reasonable and not out of line with the average cost of providing the services.
vii. The balance in the savings account does not turn into negative balance solely on account of levy of charges for non-maintenance of minimum balance.
viii. These guidelines should be brought to the notice of all customers apart from being disclosed on the bank's website.

27.2.2 Statement of accounts / Pass Books

(a) Passbooks to Savings Bank Account holders (Individuals):

A passbook is a ready reckoner of transactions and is handy and compact. It is far more convenient to the small customer than a statement of account. Following are some difficulties inherent to a statement of account –

i. These need to be filed regularly,
ii. The opening balance needs to be tallied with closing balance of last statement,
iii. Loss of statements in postal transit is not uncommon and obtaining duplicates thereof involves expense and inconvenience,
iv. ATM slips during the interregnum between two statements does not provide a satisfactory solution as full record of transactions is not available, and
v. There are a large number of small customers who do not have access to computers / internet, etc.

As such, non-issuance of pass-books to such small customers would indirectly lead to their financial exclusion. Banks must invariably offer pass book facility to all its savings bank account holders (individuals).

(b) Updating passbooks

i. Customers may be made conscious of the need on their part to get the pass-books updated regularly and employees may be exhorted to attach importance to this area.
ii. Wherever pass-books are held back for updating, because of large number of entries, paper tokens indicating the date of its receipt and also the date when it is to be collected should be issued.
iii. In addition to the instructions printed in the passbook, whenever a passbook is tendered for posting after a long interval of time or after very large number of transactions, a printed slip requesting the depositor to tender it periodically should be given.

(c) Statements of Savings Bank Account:

In case a bank offers the facility of statement of account and the customer chooses to get a statement of account, the bank must issue monthly statement of accounts.

(d) Charges for Passbook or Statement of Account:

The cost of providing such Pass Book or Statements should not be charged to the customer.

(e) Entries in passbooks / Statements of account

i. Ensure that the entries made in pass books/ statements of accounts are correct and legible with required particulars.
ii. The entries in depositors' passbooks / statements of accounts, are stated as "by clearing" or "by cheque". In the case of Electronic Clearing System (ECS) and RBI Electronic Fund Transfer (RBIEFT), banks generally do not provide any details though brief particulars are provided to the receiving bank. In some cases, codes of computerized entries just cannot be deciphered. Banks should avoid such inscrutable entries in passbooks / statement of accounts and ensure that brief, intelligible particulars are invariably entered in passbooks / statements of account.

(f) Precautions for holding savings bank pass books:

Negligence in taking adequate care in the custody of savings bank pass books facilitates fraudulent withdrawals from the relative accounts. A few precautions in this regard are given below:

i. Branches should accept the pass books and return them against tokens.
ii. Pass books should be in the custody of named officials.
iii. Pass books should be held under lock and key overnight.

(g) Providing monthly statement of accounts

i. Banks must ensure that monthly periodicity of sending statement of accounts.
ii. For current accounts these may be sent in a staggered manner instead of a single date. The customers may be informed about staggering of the statements.
iii. Inspecting Officers should carry out sample check at the time of internal inspection to verify whether the statements are being despatched in time.

(h) Address / Telephone Number of the Branch in Pass Books / Statements of Account

It would be useful to customers if the address / telephone number of the branch is mentioned on the passbooks / statement of accounts. Full address / telephone number of the branch should invariably be mentioned in the passbooks / statements of account issued to account holders.

(i) Printing of MICR code and IFSC code on Passbook / Statement of account

The Magnetic Ink Character Recognition (MICR) code is necessary for all Electronic Clearing Service (ECS – Credit and Debit) transactions and the Indian Financial System Code (IFSC) is a pre-requisite for National Electronic Funds Transfer (NEFT) and Real Time Gross Settlement (RTGS) transactions. At present, this information is made available on the cheque leaf along with the IFSC code of the branch. However, on a review, banks are advised to take necessary steps to provide this information in all passbook / statement of account of their account holders.

27.2.3 Issue of Cheque Books

(a) Issuing large number of cheque books (issued to Public Sector Banks)

Banks may issue cheque books with larger number of leaves (20/25) if a customer demands the same and also ensure that adequate stocks of such cheque books are maintained to meet the requirements of the customers. Banks should take appropriate care while issuing large number of cheque books.

(b) Writing the cheques in any language

All cheque forms should be printed in Hindi and English. The customer may, however, write cheques in Hindi, English or in the concerned regional language.

(c) Dispatching the cheque book by courier

Banks should refrain from obtaining such undertakings from depositors and ensure that cheque books are delivered over the counters on request to the depositors or his authorized representative.

(d) Acceptance of cheques bearing a date as per National Calendar (Saka Samvat) for payment

An instrument written in Hindi having date as per Saka Samvat calendar is a valid instrument.

(e) Issue of Multicity / Payable at All Branches Cheques by CBS enabled Banks:

All CBS enabled banks have to issue only "payable at par" / "multi-city" CTS 2010 Standard cheques to all eligible customers without extra charges.

27.2.4 Term Deposit Account

Bank should issue term deposit receipt indicating therein full details, such as, date of issue, period of deposit, due date, applicable rate of interest, etc. Term deposits should be freely transferable from one office of bank to another.

(a) Disposal of deposits

Advance instructions from depositors for disposal of deposits on maturity may be obtained in the application form itself. Where such instructions are not obtained, banks must send intimation of impending due date of maturity well in advance to their depositors.

(b) Notifying the change in interest rates

Change in interest rate on deposits should be intimated to customers as well as bank branches expeditiously.

(c) Calculation of interest on fixed deposit

For the purpose of interest on domestic term deposit, IBA has prescribed that on deposits repayable in less than three months or where the terminal quarter is incomplete, interest should be paid proportionately for the actual number of days reckoning the year at 365 days. Some banks are adopting the method of reckoning the year at 366 days in a Leap year and 365 days in other years. Banks may adopt their methodology, they should inform their depositors about the manner of calculation of interest appropriately while accepting the deposits and display the same at their branches.

(d) Premature withdrawal of term deposit

i. Penalty on premature withdrawal: A bank, on request from the depositor, must allow withdrawal of a term deposit of less than ₹1 crore before completion of the period of the deposit agreed upon at the time of making the deposit. For deposits of larger amounts, a bank has the option of permitting premature withdrawal. A bank can determine its own penal interest rate of premature withdrawal of term deposits. The depositors should be informed about the penal rate along with the deposit rate.
ii. Interest Rate on premature withdrawal: On pre-matured payment, interest on the deposit for the period that it has remained with the bank is paid at the rate applicable to the period for which the deposit remained with the bank and not at the contracted rate. No interest is payable, where premature withdrawal of deposits takes place before the minimum period prescribed, currently seven days.
iii. Premature withdrawal of large deposits: Banks have the discretion to disallow premature withdrawal of a term deposit in respect of bulk deposits of ₹1 crore and above. Bank should notify depositors of this policy in advance, i.e., at the time of accepting such deposits.

(e) Repayment of Term/Fixed Deposits in Joint Names:

Signatures of both the depositors should not be insisted upon for repayment of money in fixed/term deposits, where the deposit account is opened with operating instructions, 'Either or Survivor' or 'Former or Survivor'. Such insistence makes the mandate given by the depositors redundant.

i. For term deposits with operating instructions 'Either or Survivor', the signatures of both the depositors need not be obtained for payment on maturity. For payment before maturity, the signatures of both the depositors may be obtained. If one of the depositors expires, pre-payment may be allowed only with the concurrence of the legal heirs of the deceased joint holder. On maturity, the payment can be made to the survivor.
ii. For 'Former or Survivor' mandate, the 'Former' alone can operate/withdraw the matured amount of the fixed/term deposit, when both the depositors are alive. Signature of both the depositors should be obtained for payment before maturity. Premature withdrawal would require the consent of the surviving depositor, and the legal heirs of the deceased in case of death of one of the depositors. If the former holder expires before the maturity the 'Survivor' can withdraw the deposit on maturity.
iii. If the joint depositors prefer to allow premature withdrawals of fixed/term deposits also in accordance with the mandate of 'Either or Survivor' or 'Former or Survivor', banks may on their choice provide the facility. For this a specific joint mandate should be taken from the depositors to this effect. Banks should incorporate a clause in the account opening form and make the customers aware of the facility of such mandate,

to avoid putting the "surviving" deposit account holder(s) to unnecessary inconvenience. The joint deposit holders may give the mandate either at the time of placing fixed deposit or anytime subsequently during the term/ tenure of the deposit. With such a mandate, banks can allow premature withdrawal of term/ fixed deposits by the surviving depositor without seeking the concurrence of the legal heirs of the deceased joint deposit holder. Such premature withdrawal would not attract any penal charge.

iv. Proceeds of 'Either or Survivor' Fixed Deposits: When a fixed deposit account is opened in the joint names of two depositors on 'Either or Survivor' basis and they already have a savings bank account in their names jointly on 'Either or Survivor' instructions, the proceeds of the matured fixed deposit can be credited to this savings account. There is no need for opening a separate savings bank account in the name of the first depositor for crediting the proceeds of the fixed deposit.

v. Renewal of Overdue Fixed deposits: All aspects concerning renewal of overdue deposits may be decided by a bank, subject to its Board laying down a transparent policy in this regard. . The policy should be non-discretionary and non-discriminatory. The customers should be informed of the terms and conditions of renewal including interest rates, at the time of acceptance of deposit.

   In case, if a Term Deposit (TD) matures and proceeds are unpaid, the amount left unclaimed with the bank shall attract rate of interest as applicable to savings account or the contracted rate of interest on the matured TD, whichever is lower.

   (Ref:RBI/2021-22/66 DoR.SPE.REC.29/13.03.00/2021-2022 July 02, 2021

vi. Addition or deletion of the name/s of joint account holders: A bank may, at the request of all the joint account holders, allow the addition or deletion of name/s of joint account holder/s; or allow an individual depositor to add the name of another person as a joint account holder. The amount or duration of the original deposit undergo a change in case the deposit is a term deposit.

vii. Splitting of Joint Deposit Receipt: A bank may, at its discretion, at the request of all the joint account holders of a deposit receipt, allow the splitting up of the joint deposit, in the name of each of the joint account holders only, provided the period and the aggregate amount of the split deposits do not undergo any change.

(f) Payment of interest on accounts frozen by banks:

Banks are at times required to freeze the accounts of customers based on the orders of the enforcement authorities. RBI has, in consultation with Indian Banks' Association, advised to follow the procedure detailed below for Term Deposits frozen by the enforcement authorities:

i. On maturity, to obtain from the depositor a request letter for renewal indicating the term for which the deposit is to be renewed. In case the depositor does not indicate the term for renewal, the bank renews the same for a term equal to the original term.

ii. No new receipt should be issued. Suitable note may be made regarding renewal in the deposit ledger.

iii. Renewal of deposit may be advised by registered letter / speed post / courier service to the concerned Government department under advice to the depositor. In the advice to the depositor, the rate of interest at which the deposit is renewed should also be mentioned.

iv. If overdue period does not exceed 14 days on the date of receipt of the request letter, renewal may be done from the date of maturity. If it exceeds 14 days, the bank may pay interest for the overdue period as per its policy adopted by them, and keep it in a separate interest free sub-account which should be released when the original fixed deposit is released.

v. For the savings bank accounts frozen by the Enforcement authorities, banks may continue to credit the interest to the account on a regular basis.

Cheque Drop Box Facility

i. Both the drop box facility and the facility for acknowledgement of the cheques at regular collection counters should be available to the customers. Branch should not refuse to give an acknowledgement.

ii. Customers should not be compelled to drop the cheques in the drop-box. Banks should display on the cheque drop-box "Customers can also tender the cheques at the counter and obtain acknowledgment on the pay-in-slips", in English, Hindi and the concerned regional language.

iii. Banks should make fool proof arrangements accounting for the number of instruments each time the box is opened so that there are no disputes and the customer's interests are not compromised.

27.3 NOMINATION FACILITY IN ACCOUNTS

Legal Provisions:

The Banking Regulation Act, 1949 was amended by adding new Sections 45ZA to 45ZF providing for a banking company -

a) To make payment to the nominee of a deceased depositor, the amount standing to the credit of the depositor.
b) To return the articles left by a deceased person in its safe custody to his nominee.
c) To release the contents of a safety locker to the nominee of the hirer of such locker, in the event of the death of the hirer.

The Banking Companies (Nomination) Rules, 1985 provide for:

i. Nomination Forms for deposit accounts, articles kept in safe custody and contents of safety lockers.
ii. Forms for cancellation and variation of the nominations.
iii. Registration of Nominations and cancellation and variation of nominations, and
iv. Matters related to the above.

Banks should be guided by the provisions of Sections 45 ZC to 45 ZF of the Banking Regulation Act, 1949 and the Banking Companies (Nomination) Rules, 1985 and the relevant provisions of Indian Contract Act and Indian Succession Act.

Nomination facility can be made available for the following in the name of individuals or sole proprietary concern:

i. Current accounts/ savings accounts
ii. Fixed deposits
iii. Safe custody articles
iv. Safe deposit lockers

For this purpose, the customer has to make the nomination as per the formats specified for the purpose.

Single Deposit Accounts: In a case which came up before the Allahabad High Court, the Honourable Court has observed that "it will be most appropriate that the RBI issues guidelines to the effect that no Savings Account or Fixed Deposit in single name be accepted unless name of the nominee is given by the depositors. It will go a long way to serve the purpose of the innocent widows and children, who are dragged on long drawn proceedings in the Court for claiming the amount, which lawfully belongs to them".

Banks should explain the benefits of nomination to the customer and prevail upon him to make a nomination. If the customer is insistent of not making any nomination, this fact should be obtained in writing. If the customer, refuses even to give the denial in writing, this fact should be recorded on the account opening form, before opening the account. Under no circumstances, a bank should refuse to open an account solely on the ground that the person opening the account refused to nominate.

Acknowledgement of Nomination/ Cancellation/ Variation: In terms of Rules 2 (9), 3 (8) and 4 (9) of the Banking Companies Nomination (Rules), 1985, banks are required to acknowledge in writing to the depositor(s) / locker hirers (s) the filing of the relevant duly completed Form of nomination, cancellation and / or variation of the nomination. Banks should strictly comply with these provisions. Such acknowledgement should be given to all the customers irrespective of whether the same is demanded by the customers.

Registering the nomination: In terms of Rules 2 (10), 3 (9) and 4 (10) of the Banking Companies (Nomination) Rules, 1985 banks are required to register in its books the nomination, cancellation and/ or variation of the nomination. The banks should register nominations or changes therein, made by their depositor(s)/ hirers.

Nomination legend: When a bank account holder has availed himself of nomination facility, the same may be indicated on the passbooks/ fixed deposit receipts “Nomination Registered” so that, in case of death of the account holder, his relatives can know from the pass book that the nomination facility has been availed of by the deceased depositor and take suitable action. The name of the Nominee also may be indicated in the Pass Books / Statement of Accounts / FDRs; in case the customer is agreeable to the same.

Separate nomination for savings bank account and pension account: Nomination facility is available for Savings Bank Account opened for credit of pension. Banking Companies

(Nomination) Rules, 1985 are distinct from the Arrears of Pension (Nomination) Rules, 1983. So nomination exercised by the pensioner under the latter rules for receipt of arrears of pension will not be valid for the purpose of deposit accounts maintained for credit of pension amount.

Nomination facility in respect of deposits – Salient Aspects:

i. Nomination shall be made only in favour of individuals. A nominee cannot be an Association, Trust, Society, etc. or any office-bearer n his official capacity.
ii. There cannot be more than one nominee in respect of a joint deposit account.
iii. Banks may allow variation/cancellation of a subsisting nomination by all the surviving depositor(s) acting together, even in case of deposits with "either or survivor" instructions.
iv. For a joint deposit account, the nominee's right arises only after the death of all the depositors.
v. Witness in Nomination Forms: Only Thumb-impression(s) of the depositor or the customer shall be attested by two witnesses. Signatures of the customers need not be attested by witnesses.
vi. Nomination in case of Joint Deposit Accounts: Nomination facility is available for joint deposit accounts also.

Publicity Educating Customers:

i. Banks should take all necessary measures for popularising the nomination facility among their constituents.
ii. Banks should give wide publicity and provide guidance to deposit account holders on the benefits of the nomination facility and the survivorship clause. Especially, stressing the aspect that in the event of the death of one of the joint account holders, the right to the deposit proceeds does not automatically devolve on the surviving joint deposit account holder, unless there is a survivorship clause.
iii. Account opening form should contain space for nomination also.
iv. Publicity may be launched, including printing compatible message on cheque books, pass-book and any other literature reaching the customers as well as launching periodical drives.

27.4 INCOME TAX RELATED PROVISIONS - CASH OPERATIONS

Acknowledgement by banks at the time of submission of Form 15-G / 15-H:

Banks are not required to deduct TDS from depositors who submit declaration in Form 15-G/15-H under Income Tax Rules, 1962. RBI in consultation with Indian Banks' Association (IBA), has advised to give an acknowledgment at the time of receipt of Form 15-G/15-H. This helps in a system of accountability and customers will not be put to inconvenience due to any omission on part of the banks.

Timely Issue of TDS Certificate to Customers

Banks should have in place systems that will enable them to provide Form 16A to the customers well within the time-frame prescribed under the Income Tax Rules.

Acceptance of cash over the counter
Some banks have introduced certain products whereby the customers are not allowed to deposit cash over the counters and also have incorporated a clause in the terms and conditions that cash deposits, if any, are required to be done through ATMs.

Banks cannot design any product which is not in tune with the basic tenets of banking. Further, incorporating such clauses in the terms and conditions which restrict deposit of cash over the counters also amounts to an unfair practice.

Branches should invariably accept cash over the counters from all their customers who desire to deposit cash at the counters. Further, they are also advised to refrain from incorporating clauses in the terms and conditions which restrict deposit of cash over the counters. The provisions of Income Tax Act for accepting amounts in cash should be followed.

As per the provisions of Income Tax Act there are certain requirements of quoting PAN for certain transactions in cash with banks. These are as follows -

i. Cash deposits with a banking company or a co-operative bank exceeding fifty thousand rupees during any one day.
ii. Purchase of bank drafts or pay orders or banker's cheques from a banking company or a co-operative bank in cash for an amount exceeding fifty thousand rupees during any one day.
iii. A time deposit with a banking company or a co-operative bank amount exceeding fifty thousand rupees or aggregating to more than five lakh rupees during a financial year.
iv. Payment for one or more pre-paid payment instruments to a banking company or a co-operative bank in cash or by way of a bank draft or pay order or banker's cheque of an amount aggregating to more than fifty thousand rupees in a financial year.

Co-ordination with officers of Central Board of Direct Taxes
There is a need for greater co-ordination between the income-tax department and the banking system. As such banks should extend necessary help/co-ordination to tax officials whenever required. Further, banks will have to view with serious concern cases where their staff connive/assist in any manner with offences punishable under the Income Tax Act. In such cases in addition to the normal criminal action, such staff member should also be proceeded against departmentally.

27.5 ATTACHMENT ORDERS

Garnishee Order:
Garnishee order is an attachment order issued by a Court under order 21, Rule 46 of Civil procedure code. It is an order of the Court obtained by the judgment creditor attaching the funds belonging to a judgment debtor in the hands of his debtors, including a bank. Here the bank is the Garnishee. It is a process of law in favour of judgment-creditor for a debt due from the judgment- debtor (bank customer) upon a third party for attachment. A garnishee order served on a bank attaches the credit balance in the account of the customer named, to the

extent specified in the order. If no amount is specified, the order attaches all sums owing and accruing to the customer as on the date and time it is served and received by the bank. Cheques presented after service of the garnishee order should be returned with the remark 'Refer to Drawer'. The service of the garnishee order nisi is the preliminary proceedings of a Court. This is to be followed by subsequent proceedings of a Court to make it absolute, when it is called garnishee absolute. The order can only relate to the present balance in the account of the customer, i.e. amount due and accruing due or payable to the customer at the time of receipt of the order.

(a) *Joint accounts*: When a garnishee order is in a single name and the customer/s account is in joint names (husband and wife, two brothers, mother and daughter or two friends) with the operation clause 'either or survivor', the monies lying in such account cannot be attached. Such a Garnishee order specifying only one of the joint account holders does not bind other joint holders and the Court must be approached for withdrawal of such order. However, if the amount is payable to former or survivor, it can be attached even though the garnishee order is in the former's name only. This is because; the money is a debt due and accruing to the former in his lifetime and to the survivor only after the death of the former. However, if the order specifies all the joint account holders, such order will attach not only the balance in the joint account but also the balances in the individual accounts of the joint account holders.
(b) *Partnership accounts*: The personal account of a partner can be attached for the firm's debt because partners are jointly and severally liable for the firm's debts. Nevertheless, the firm's account cannot be attached for individual debts of the partners.
(c) *Multiple Accounts*: In case where the customer is having more than one account in the bank's branch, one is in debit and the other is in credit balances, the net result if in credit can be attached. The order will not attach only the credit balance account. But if the debit balance is in a loan account, which has not been recalled by the bank on the date of service of order, credit into another account cannot be adjusted.

Other Attachment Orders: Other attachment orders are normally issued by competent authorities like Income Tax Dept./ GST authorities, Enforcement Directorate, National Investigation Agency, PF/ Employees State Insurance authorities, etc. On receipt of such attachment orders, the fact should be noted in the System with date & time of receipt of such order duly attested by the Manager. There are certain distinctions in respect of attachment orders issued by the Income Tax officers.

Attachment orders issued by income tax officers under The Income Tax Act, 1961. The attachment order under this Act lays down certain procedures regarding recovery of tax from the assesse in default. Under Section 226(I) of the Act, the Income Tax Officer may, by a notice in writing, call upon any person (including a banking company), from whom money is due or may become due to the assesse or any person who holds or may subsequently hold money for, or on account of the assesse to pay to the Income Tax Officer either immediately or upon the money becoming due, so much of the money as is sufficient to satisfy the tax due from the assesse.

The order of the ITO may attach:

a) Any debt due and payable;
b) Debts due but not payable on the date of receipt of the notice; and
c) Any amount received subsequently.

Account holder must be informed through Registered post (and other modes) about receipt of such attachment order, and that the attached amount has been set aside by the bank. It should also be advised that the same could be released to the account holder only if she is able to get orders from the concerned authority withdrawing the attachment order and produce to the bank.

If the attached amount is lying in a Current/ Savings bank account, the amount must be transferred to suspense account. If the attached amount is in Term Deposit, a noting in the System should be made - “Under Attachment by IT/Commercial Tax Authorities” duly attested by the Manager. No foreclosure of such attached Term Deposit should be allowed, similarly, no loan against such attached term deposit should be sanctioned.

27.6 REMITTANCE – DEMAND DRAFTS

Remittance of Funds for Value Rs.50,000/- and above

Remittances by way of demand drafts/mail transfers / telegraphic transfers or any other mode and issue of travellers cheques for value of ₹50,000/- and above is effected only by debit to the customer’s account or against cheques or other instruments tendered by the purchaser and not against cash payment. These instructions also apply to retail sale of gold/silver/platinum.

Demand Drafts

(a) *Issue of Demand Drafts*: Measures for reducing the incidence of frauds perpetrated through bank drafts should be built into the draft form itself. Necessary changes in system and procedures to speed up issue and payment of drafts should be taken.

i. Demand drafts of ₹20,000/- and above should be issued invariably with account payee crossing.
ii. All superscriptions about validity of the demand draft should be provided at the top of the draft form.
iii. A draft should be uniformly valid for a period of three months and procedure for revalidation after three months should be simplified.
iv. Drafts of small amounts should be issued by their branches against cash to all customers whether they are having accounts with the banks or not.
v. Bank's counter staff should not refuse to accept small denomination notes from the customers (or non-customers for issuance of the drafts).

(b) *Encashment of drafts*: Drafts drawn on the bank’s branches should be paid immediately. Payment of draft should not be refused for the only reason that relative advice has not been received.

(c) *Issue of Duplicate Demand Draft*:

i. Duplicate draft, in lieu of lost draft, up to and including ₹5,000/- may be issued to the purchaser on the basis of adequate indemnity and without insistence on seeking non-payment advice from drawee office.

ii. Banks should issue duplicate Demand Draft to the customer within a fortnight from the receipt of such request made by the purchaser or the beneficiary. For the delay beyond this period, banks have to pay interest at the rate applicable for fixed deposit of corresponding maturity in order to compensate the customer for such delay. The time limit is not applicable in the case of third party endorsements.

27.7 COLLECTION OF INSTRUMENTS

Cheque Collection Policy

Banks should formulate a transparent Cheque Collection Policy taking into account their technological capabilities, systems and processes adopted for clearing arrangements and other internal arrangements for collection through correspondents. The policy should cover the following three aspects:

- Immediate Credit for Local / Outstation cheques
- Time frame for Collection of Local / Outstation Instruments
- Interest payment for delayed collection

The policy should include compensation payable for the delay in the collection of local cheques as well. In case, no rate is specified in the CCP for delay in realisation of local cheques, compensation at savings bank interest rate should be paid for the corresponding period of delay.

The policy framed in this regard should be integrated with the deposit policy formulated by the bank in line with the IBA's model deposit policy. The policy should clearly lay down the liability of the banks by way of interest payments due to delays for non-compliance with the standards set by the banks themselves. Compensation as interest payment, should be made without any claim from the customer.

Purchase of Local Cheques, Drafts, etc., during suspension of Clearing: When Clearing House operations are temporarily suspended the constituents of the banks face hardships due to inability of banks to realize promptly the proceeds of cheques, drafts, etc., drawn on the local banks other than those with whom they maintain accounts. To minimize the inconvenience and hardship to constituents, where it is apprehended that the suspension may be prolonged, banks may temporarily accommodate both borrowers and depositors, to the extent possible by purchasing the local cheques, drafts, etc., deposited in their accounts for collection. In this, special consideration may be shown in respect of cheques drawn by Government departments/companies of good standing and repute, as also demand drafts drawn on local banks. Banks would take into consideration such factors as creditworthiness, integrity, past dealings and occupation of the constituents, so as to guard themselves against any possibility of such instruments being dishonoured subsequently.

Delays in Cheque Clearing - Case No. 82 of 2006 before National Consumer Disputes Redressal Commission

Banks have to comply with the final order on 'timeframe for collection of outstation cheques passed by the National Consumer Disputes Redressal Commission in case no. 82 of 2006.

i. Banks shall frame their Cheque Collection Policies (CCPs) covering local and outstation cheque collection as per the timeframe prescribed by the Commission.
ii. For local cheques, credit and debit shall be given on the same day or at the most the next day of their presentation in clearing. For local clearing, the usage of the shadow credit in the customer accounts may be permitted immediately after closure of relative return clearing. In any case withdrawal shall be allowed on the same day or maximum within an hour of commencement of business on the next working day.
iii. Timeframe for collection of cheques drawn on State Capitals / major cities / other locations should be 7/10/14 days respectively. For any delay in collection beyond this period, interest at the rate specified in the CCP of the bank, shall be paid. In case the rate is not specified in the CCP, the applicable rate shall be the interest rate on Fixed Deposits for the corresponding maturity. The timeframe for collection specified by the Commission is the outer limit, and credit shall be afforded if the process gets completed earlier.
iv. Banks shall not decline to accept outstation cheques deposited by its customers for collection.
v. Banks shall give wide publicity to the CCP by prominently displaying salient features thereof in bold and visible letters on the notice board at their branches.
vi. A copy of the complete CCP shall be made available by the branch manager, if the customers require so.

Collection of Account Payee Cheque - Prohibition on Crediting Proceeds to Third Party Account:

i. RBI has prohibited the banks from crediting 'account payee' cheque to the account of any person other than the payee named therein. This decision is based on the legal requirements and in particular, the intent of the Negotiable Instruments Act, 1881; with a view to protect the banks being burdened with liabilities arising out of unauthorized collections, and in the interest of the integrity and soundness of the payment and banking systems, and in order to prevent recurrence of deviations observed in the past.
ii. Where the drawer/ payee instructs the bank to credit the proceeds of collection to any account other than that of the payee, the bank should ask the drawer / payee to have the cheque or the account payee mandate thereon withdrawn by the drawer. This also applies to a cheque drawn by a bank payable to another bank.
iii. Account payee cheques deposited with a sub-member for credit to their customers' account can be collected by the member bank (i.e. the sponsor member) of the Clearing House. There should be clear undertaking to the effect that the proceeds of the account payee cheque will be credited to the payee's account only, upon realization.

iv. For the members of co-operative credit societies, collecting banks may consider collecting account payee cheques drawn for an amount not exceeding ₹50,000/- to the account of co-operative credit societies, if the payees of such cheques are the constituents of such co-operative credit societies. While collecting these cheques, banks should have a clear representation in writing given by the co-operative credit societies that, upon realization, the proceeds of the cheques will be credited only to the account of the member of the co-operative credit society who is the payee named in the cheque. This shall, however, be subject to the fulfillment of the requirements of the provisions of Negotiable Instruments Act, 1881, including Section 131 thereof.
v. These instructions also extend to drafts, pay orders and bankers' cheque.

Payment of Cheques/Drafts/Pay Orders/Banker's Cheques

RBI has advised that banks should not make payment of cheques/drafts/pay orders/banker's cheques bearing, if they are presented beyond the period of three months from the date of such instrument.

Cheques / Instruments lost in transit / in clearing process / at paying bank's branch:

i. In respect of cheques lost in transit or in the clearing process or at the paying bank's branch, the bank should immediately inform the account holder so that account holder can intimate to the drawer to record stop payment and can also take care that other cheques issued by him are not dishonoured due to non-credit of the amount of the lost cheques / instruments.
ii. The onus of such loss lies with the collecting banker and not the account holder.
iii. The banks should reimburse the account holder related expenses for obtaining duplicate instruments and also interest for reasonable delays occurred in obtaining the same.
iv. If the cheque / instrument has been lost at the paying bank's branch, the collecting banker should have a right to recover the amount reimbursed to the customer for the loss of the cheque / instrument from the paying banker.

Bills for collection

Bills for collection including bills discounted required to be collected through another bank at the realising centre should be forwarded directly by the forwarding office to the realising office.

i. Payment of interest for Delays in collection of bills: The lodger's bank should pay interest to the lodger for the delayed period in respect of collection of bills at the rate of 2% p.a. above the rate of interest payable on balances of Savings Bank accounts. The delayed period should be reckoned after making allowance for normal transit period based upon a time frame of 2 days each for (i) Despatch of bills; (ii) Presentation of bills of drawees (iii) Remittance of proceeds to the lodger's bank (iv) Crediting the proceeds to drawer's account.
ii. To the extent the delay is attributing to the drawee's bank, the lodger's bank may recover interest for such delay from that bank. The banks may suitably revise the format of their payment advices to incorporate the above information.

Delay in Re-presentation of Technical Return Cheques and Levy of Charges for such Returns: Cheque return charges should be levied only in cases where the customer is at fault and is responsible for such returns. In cases where the cheques need to be re-presented without any recourse to the payee, such re-presentation should be made in the immediate next presentation clearing not later than 24 hours (excluding holidays) with due notification to the customers of such representation through SMS alert, email etc.

Dishonour of Cheques

Various norms related to key aspects connected with dishonor of cheques are as mentioned below.

1) *Returning dishonoured cheques*:
    a) The paying bank should return dishonoured cheques presented through clearing houses strictly as per the return discipline prescribed for respective clearing house in terms of Uniform Regulations and Rules for Bankers' Clearing Houses. The collecting bank on receipt of such dishonoured cheques should despatch it immediately to the payees / holders, in any case within 24 hours.
    b) In relation to cheques presented direct to the paying bank for settlement of transaction by way of transfer between two accounts with that bank, it should return such dishonoured cheques to payees/ holders immediately.
    c) In case of dishonor / return of cheques, the paying banks should clearly indicate the return reason code on the return memo / objection slip which should also bear the signature / initial of the bank officials as prescribed in Rule 6 of the Uniform Regulations and Rules for Bankers’ Clearing Houses (URRBCH).
2) Information on dishonoured cheques
    a) Data in respect of each dishonoured cheque for amount of ₹1 crore and above should be made part of bank's MIS on constituents and concerned branches should report such data to their respective controlling office / Head Office.
    b) Data in respect of cheques drawn in favour of stock exchanges and dishonoured should be consolidated separately by banks irrespective of the value of such cheques as a part of their MIS relating to broker entities, and be reported to their respective Head Offices / Central Offices.
3) Dealing with incidents of frequent dishonour of cheques of value ₹1 crore and above:
    a) With a view to enforce financial discipline among the customers, banks should introduce a condition for operation of accounts with cheque facility that in the event of dishonour of a cheque valuing ₹1 crore and above drawn on a particular account of the drawer on four occasions during the financial year for want of sufficient funds in the account, no fresh cheque book would be issued.
    b) Also, the bank may consider closing current account at its discretion.
    c) In respect of advances accounts such as cash credit account, overdraft account, the need for continuance or otherwise of these credit facilities and the cheque facility relating to these accounts should be reviewed by appropriate authority higher than the sanctioning authority.

d) Banks may, at the time of issuing new cheque book, issue a letter advising the constituents of the new conditions.
e) If a cheque is dishonoured for a third time on a particular account of the drawer during the financial year, banks should issue a cautionary advice to the concerned constituent drawing his attention to the condition and consequential stoppage of cheque facility in the event of cheque being dishonoured on fourth occasion on the same account during the financial year. Similar cautionary advice may be issued if a bank intends to close the account.

4) Dealing with frequent dishonour of cheques of value of less than ₹1 crore
   a) Since frequent dishonour of cheques of value of less than ₹1 crore is also a matter of concern, it is felt that banks need to take appropriate action in those accounts where such dishonour of cheques occur. Banks should have their own approach to deal with recalcitrant customers.
   b) Banks should have a Board approved policy for dealing with frequent dishonour of cheques of value of less than ₹1 crore. The policy should also deal with matters relating to frequent dishonour of ECS mandates.
5) General
   a) For the purpose of adducing evidence to prove the fact of dishonour of cheque on behalf of a complainant (i.e., payee / holder of a dishonoured cheque) in any proceeding relating to dishonoured cheque before a court, consumer forum or any other competent authority, banks should extend full co-operation, and should furnish him/her documentary proof of fact of dishonour of cheques.
   b) Banks should place before their Audit/ Management Committee, every quarter, consolidated data in respect of the matters referred to above.
6) Framing appropriate procedure for dealing with dishonoured cheques
   Banks have to adopt, appropriate procedure (approved by the Board) for dealing with dishonoured cheques with inherent preventive measures and checks to prevent any scope for collusion of the staff of the bank or any other person, with the drawer of the cheque for causing delay in or withholding the communication of the fact of dishonour of the cheque to the payee/ holder or the return of such dishonoured cheque to him.

27.8 CLEAN NOTE POLICY

Basic Responsibilities of Bank Branches

All branches of banks are mandated to provide following customer services, actively and vigorously so that there is no need for public to approach RBI Regional Offices for this purpose:

i. Issuing fresh / good quality notes and coins of all denominations,
ii. Exchanging soiled / mutilated / defective notes, and
iii. Accepting coins and notes either for transactions or exchange.

Practices against Clean Note Policy of RBI

RBI issues guidelines / instructions for realising the objectives of Clean Note Policy as part of currency management. Following are certain practices against the RBI's Clean Note Policy:

i. Stapling of notes in a packet

ii. Writing number of note pieces in loose packets on watermark window of notes
iii. Disfiguring the watermark impression
iv. Rendering the watermark impression difficult for easy recognition
v. Writing/scribbling on the body of the banknotes.
vi. Bank branches do not sort notes into re-issuables and non-issuables
vii. Issue soiled notes to public.

RBI Guidelines/ Norms for Clean Notes Policy

a) The banks should increase dispensation of Rs. 100 bank notes through ATMs which are widely used for distribution of banknotes for retail use.
b) The tolerance level of re-issuable notes in the soiled banknote remittance to RBI is 5%,
c) Note Sorting Machines at the currency chest branches should be used to sort the banknotes and only the non-issuables are sent to RBI.
d) Banks are advised to desist from writing anything whatsoever on the banknotes.
e) Banks should also endeavour to educate their staff, customers and members of public, in this regard.
f) To do away with stapling of any note packet and instead secure note packets with polymer or paper bands, All the currency transactions in note packets are in unstapled condition. The cash held at Branches/Chests is in unstapled condition only. Rubber bands should not be used as they get melted and cause problems in processing of soiled note remittances under CVPS at RBI. Chests should not issue/accept note packets in stapled condition.
g) Sort notes into re-issuables and non-issuables, and issue only clean notes to public. Soiled/mutilated/Ashoka Pillar series notes should not be issued to the public.
h) Stop writing of any kind on watermark window of bank notes.
i) Notes with slogans, political or religious messages, scribbling, stain (including colour stain) etc. are unfit for usage and circulation.
j) Under mechanized processing of banknotes, inscription or scribbling on any part of the banknote would render it to be classified as unfit for reissue. Accordingly, such banknotes get treated as soiled banknotes and cannot be recirculated.
k) Banks should stop writing/ scribbling of any kind on any part of the banknote. Such notes received from public shall not be reissued and shall be remitted to currency chest for remittance to RBI offices.
l) Any note with slogans and message of a political or religious nature written across it ceases to be a legal tender and the claim on such a note will be rejected under Rule 6(3) (iii) of Note Refund Rules (NRR), 2009. Similarly, notes which are disfigured may also be rejected under Rule 6(3) (ii) of NRR, 2009.
m) All Bank notes with scribbling/ stain (including colour stain) on them continue to be legal tender. Such notes can be deposited or exchanged in any bank branch.
n) Uncurrent coins: The coins of 25 paise and below, issued from time to time have ceased to be legal tender with effect from June 30, 201.

Currency Chests

a) All the Currency chests are provided with Note counting machines, and Note sorting machines. The chest officials have to ensure the following: (i) Process all the currency notes received through note sorting machine. (ii) To ensure segregation of issuable, non-issuable, counterfeit notes. (iii) To ensure that all note packets shall be invariably signed by the concerned staff of currency chest.
b) If the unsorted currency is held in the currency chest, RBI imposes penalty and in such circumstances the amount of penalty imposed by RBI shall be recovered from the concerned chest officials. If any note packet is found unsigned by the concerned staff suitable action shall be initiated against concerned chest officials.
c) Currency chests to ensure the soiled note remittances made to RBI do not contain fresh/re-issuable notes, unsorted notes and improper de-stapled packets.
d) The Currency chest officials have to confirm that all the Currency notes remitted to RBI are properly verified and found in order at the time of remittance itself and a certificate to this effect has to be kept on record under joint signatures.
e) Currency Chests issue only good quality notes to branches.

Facility for Exchange of Soiled/Mutilated/Imperfect Notes

(a) General Norms

All branches shall provide the facilities of exchanging soiled / mutilated / defective notes and coins to members of public without any discrimination on all working days.

i. The availability of the above-mentioned facilities at the bank branches shall be given wide publicity.
ii. None of the bank branches shall refuse to accept small denomination notes and / or coins tendered at their counters.

(b) Exchange of soiled notes:

i. Soiled Note – Definition: A ‘soiled note’ means a note which has become dirty due to normal wear and tear and also includes a two-piece note pasted together wherein both the pieces presented belong to the same note and form the entire note with no essential feature missing.
ii. These shall be accepted over bank counters in payment of Government dues and for credit to accounts of the public maintained with banks. These notes must not be issued to the public. These shall be deposited in currency chests for transmission to RBI as soiled note remittances.
iii. Following norms apply for exchanging soiled notes by branches -
    a) Where the number of notes presented by a person is up to 20 pieces with a maximum value of ₹5000 per day, should be exchanged over the counter, free of charge.
    b) Not Where the number of notes presented exceeds 20 pieces or ₹5000 in value per day, banks may accept them, against receipt, for value to be credited later. Banks may levy service charges as per RBI guidelines. If tendered value is above ₹50000, banks should take the usual precautions.

c) RBI has formulated a framework of incentives titled Currency Distribution and Exchange Scheme (CDES) to encourage all bank branches to provide better customer services to the members of public.

(c) Exchange of mutilated and imperfect notes

i. A mutilated note is a note of which a portion is missing or which is composed of more than two pieces. Mutilated notes shall be presented at any of the bank branches. The notes so presented shall be accepted, exchanged and adjudicated in accordance with NRR, 2009.
ii. RBI has authorized all the branches of the banks to accept, exchange and pay the admissible exchange value of mutilated notes in accordance with the RBI (Note Refund) Rules, 2009 or reject such mutilated notes as are not payable under these Rules.
iii. The branches shall accept notes in all denominations that are current for exchange under the Rules.
iv. Notes which have turned extremely brittle or are badly burnt, charred, inseparably stuck together and therefore cannot withstand further handling or which may lose their original identity with the passage of time shall not be accepted by the branches for exchange. The holder/s may be advised to tender them to RBI.
v. The branches shall freely accept the notes from anyone who wishes to get his/her mutilated notes exchanged from the branch.
vi. Large quantity of notes may be accepted from the Government Departments and banks by mutual arrangements. The exchange facilities should not be cornered by private money changers or professional dealers of defective notes.
vii. The procedure laid down in NRR 2009 must be followed for processing and payment of the mutilated notes received for adjudication.

(d) Scheme of Penalties for bank branches including currency chests – RBI has stipulated penalties for various types of deficiencies in respect of exchange of notes facility.

27.9 SAFE DEPOSIT LOCKERS

The Committee on Procedures and Performance Audit on Public Services (CPPAPS) had made some recommendations for easy operation of lockers. Accordingly, banks may adhere to the following guidelines:

(a) Allotment of Lockers

i. Banks should not link the provisions of lockers facility with placement of fixed or any other deposit beyond what is specifically permitted. Banks may obtain a Fixed Deposit which would cover 3 year’s rent and the charges for breaking open the locker in case of an eventuality. Banks should not insist on such Fixed Deposit from the existing locker hirers.
ii. Branches should maintain a wait list, duly numbered, for the purpose of allotment of lockers and ensure transparency in allotment of lockers.
iii. Banks should give a copy of the agreement to the locker-hirer at the time of allotment.

(b) Operations of Safe Deposit Vaults/Lockers

Banks should exercise due care and necessary precaution for the protection of the lockers.

i. Customer due diligence for allotment of lockers

Banks should carry out customer due diligence for both new and existing customers at least to the levels prescribed for customers classified as medium risk. If the customer is classified in a higher risk category, customer due diligence as per KYC norms applicable to such higher risk category should be carried out.

ii. Un-operated Lockers

a) Where the lockers have not been operated for more than three years for medium risk category or one year for a higher risk category, banks should immediately contact the locker hirer and advise him to either operate the locker or surrender it, even if the locker hirer is paying the rent regularly. Further, the bank should ask the locker hirer to give in writing, the reasons why he/she did not operate the locker. In case the locker hirer has some genuine reasons as in the case of NRIs or persons who are out of town due to a transferable job etc., banks may allow the locker hirer to continue with the locker. In case the locker hirer does not respond nor operate the locker, banks should consider opening the lockers after giving due notice to him. A clause to this effect should be included in the locker agreement.

b) Banks need to draw up a procedure for breaking open the lockers and taking stock of inventory.

c) In order to facilitate identifying the ownership of the locker keys, banks should have the locker keys embossed with the Identification Code of the bank/branch.

(c) Nomination in Safe Deposit Lockers / Safe Custody Articles – Salient Aspects:

i. Joint Safe Custody: Nomination facilities are available only in the case of individual depositors and not in respect of persons jointly depositing articles for safe custody.

ii. Minor as Nominee: Section 45ZE of the Banking Regulation Act, 1949 does not preclude a minor from being a nominee for obtaining delivery of the contents of a locker. However, the responsibility of the banks in such cases is to ensure that when the contents of a locker are sought to be removed on behalf of the minor nominee, the articles were handed over to a person who, in law, is competent to receive the articles on behalf of the minor.

iii. Jointly Hired Lockers: As regards lockers hired jointly, on the death of any one of the joint hirers, the contents of the locker are only allowed to be removed jointly by the nominees and the survivor(s) after an inventory is taken in the prescribed manner.

iv. Access to the safe deposit lockers / return of safe custody articles (with survivor/nominee clause) -

a) If the sole locker hirer nominates a person, banks should give to such nominee access of the locker and liberty to remove the contents of the locker in the event of the death of the sole locker hirer.

b) For lockers hired jointly with the instructions to operate it under joint signatures, and the locker hirer(s) have nominated person(s), in the event of death of any of the locker hirers, the bank should give access of the locker and the liberty to remove the contents jointly to the survivor(s) and the nominee(s). In case the locker was hired jointly with survivorship clause and the hirers instructed that the access of the locker should be given over to 'either or survivor', 'anyone or survivor' or 'former or survivor' or according to any other survivorship clause, banks should follow the mandate in the event of the death of one or more of the locker hirers. Following precautions should be taken:

i. Due care and caution should be exercised in establishing the identity of the survivor(s)/nominee(s) and the fact of death of the locker hirer by obtaining appropriate documentary evidence.
ii. Diligent efforts should be made to find out if there is any order from a competent court restraining the bank from giving access to the locker of the deceased.
iii. Banks should make it clear to the survivor(s)/nominee(s) that access to locker/safe custody articles is given to them only as a trustee of the legal heirs of the deceased locker hirer; such access given to them shall not affect the right or claim which any person may have against the survivor(s)/nominee(s) to whom the access is given.

v. Access to the safe deposit lockers/return of safe custody articles (without survivor/nominee clause)
In case where the deceased locker hirer had not made any nomination or where the joint hirers had not given any mandate that the access may be given to one or more of the survivors by a clear survivorship clause, banks should adopt a customer-friendly procedure drawn up in consultation with their legal advisers for giving access to legal heir(s)/legal representative of the deceased locker hirer. Similar procedure should be followed for the articles under safe custody of the bank.

vi. Preparing an Inventory -
   i. Banks should prepare an inventory before returning articles left in safe custody/before permitting removal of the contents of a safe deposit locker in terms of Notification DBOD.NO.Leg.BC.38/ C.233A-85 dated March 29, 1985.
   ii. Banks are not required to open sealed/closed packets left with them for safe custody or found in locker while releasing them to the nominee(s) and surviving locker hirers / depositor of safe custody article.
   iii. In case the nominee(s) / survivor(s) / legal heir(s) wishes to continue with the locker, banks may enter into a fresh contract with nominee(s) / survivor(s) / legal heir(s) and also adhere to KYC norms in respect of the nominee(s) / legal heir(s).

27.10 GUIDANCE TO CUSTOMERS AND DISCLOSURE OF INFORMATION

Assistance/guidance to customers:

All branches, except very small branches should have "Enquiry" or "May I Help You" counters either exclusively or combined with other duties, located near the entry point of the banking hall.

Display of time norms:
Time norms for business transactions should be displayed predominantly in the banking hall.

Display of information by banks - Comprehensive Notice Board:
The display of information by banks in their branches is a mode of imparting financial education. It enables customers to take informed decision, be aware of their rights as also the obligations of the banks. It disseminates information on public grievance redressal mechanism and enhances the quality of customer service.

i. Notice Boards - The instructions are clubbed on certain categories such as 'customer service information', 'service charges', 'grievance redressal' and 'others'. Also, on the Notice Board only the important aspects or 'indicators' to the information is to be placed. These are given in a Comprehensive Notice Board at least 2 feet by 2 feet for comfortable viewing from a distance of 3 to 5 meters.
    a. The notice board may be updated on a periodical basis, indicating the date of updation.
    b. The display must be simple and readable.
    c. The language requirements should be taken into account.
    d. The notice board shall specifically indicate wherever recent changes have been done. For instance, to displayed as 'We offer SSI loans/products (changed on ……….)'.
    e. It should also indicate a list of items on which detailed information is available in booklet form.
    f. Branches should also display details such as 'Name of the bank/branch, Working Days, Working Hours and Weekly Off-days' outside the branch premises.

ii. Booklets/ Brochures - The booklets/ brochures may be kept in a separate file/folder in the form of 'replaceable pages' so as to facilitate copying and updation.
    a. The file/folder may be kept in the customer lobby in the branch or at the 'May I Help You' counter.
    b. The language requirements may be taken into account.
    c. The font size is minimum Arial 10 so that the customers are able to easily read the same.
    d. Copies of booklets may be made available to the customers on request.

iii. Other modes of display - Banks may also display all the information to be given in the booklet form in the touch screen by placing them in the information kiosks. Scroll Bars, Tag Boards are other options available.

iv. Other issues - Banks are free to decide on their promotional and product information displays, without obstructing the mandatory displays, and giving them priority. Information relating to Government sponsored schemes location-wise may be displayed according to their applicability.

v. Display of information relating to interest rates and service charges - Rates at a quick glance - These should be displayed as per RBI format which would enable the customer to obtain the desired information at a quick glance. It may be modified without impairing the basic structure or curtailing the scope of disclosures.

The latest information should be displayed including the information on the websites.

27.11 DISCLOSURE OF INFORMATION BY BANKS IN THE PUBLIC DOMAIN

Website:

The detailed information given on the Notice Board may also be made available on the bank's website. Banks should adhere to the broad guidelines relating to dating of material, legibility, etc., while placing the same on their websites. The customers should be able to easily access the relevant information from the Home Page of the bank's websites.

Further, there are certain information relating to service charges and fee and grievance redressal that are to be posted compulsorily on the websites of the bank. RBI is providing a link to the websites of banks so that customers can also have access to the information through RBI's website.

i. Banks should display on website - the interest rate range, and the mean interest rtaes of contracted loans for the past quarter for different categories of advances to individual borrowers.

ii. The total fees and charges applicable on loans to individual borrower should be disclosed at the time of processing of loan as well as displayed on the website of banks for transparency and comparability.

iii. Banks should publish Annual Percentage Rate (APR) or such similar other arrangement of representing the total cost of credit on a loan to an individual borrower on their websites.

iv. Besides banks should provide a clear, concise, one-page key fact statement/ fact sheet, as per prescribed format, to all individual borrowers at every stage of the loan processing as well as in case of any change in any terms and conditions. The same may also be included as a summary box to be displayed in the credit agreement.

Disclosures result in increased transparency in operations and also help to create awareness among customers about the products and services offered by banks. An indicative list of the details, which could be at the minimum, be made available for public viewing through websites of banks has been given in the RBI Circular.

Display of Timelines for Credit Decisions:

Banks should make suitable disclosures on the timelines for conveying credit decisions through their websites, notice-boards, product literature, etc.

27.12 DEALING WITH COMPLAINTS AND IMPROVING CUSTOMER RELATIONS

Complaints/suggestions box:

Complaints/suggestions box should be provided at each office of the bank. At every office of the bank a notice requesting the customers to meet the branch manager may be displayed regarding grievances, if the grievances remain unredressed.

Complaint Book/Register:

i. Complaint book with perforated copies in each set may be introduced, so designed as to instantly provide an acknowledgement to the customers and an intimation to the Controlling Office.

ii. All bank's branches should maintain a separate complaints register in the prescribed format given for entering all the complaints/grievances received by them directly or through their Head Office/Govt. These registers should be maintained irrespective of the fact whether a complaint is received or not in the past. The complaints registers maintained by branches should be scrutinised by the concerned Regional Manager during his periodical visit to the branches and his observations/comments recorded in the relative visit reports.

iii. Banks having computerized operations may adopt the aforesaid format and generate copies electronically.

Complaint Form:

A complaint form, along with the name of the Nodal Officer for complaint redressal, may be provided in the homepage itself to facilitate complaint submission by customers. The complaint form should also indicate that the first point for redressal of complaints is the bank itself and that complainants may approach the Banking Ombudsman only if the complaint is not resolved at the bank level within a month. Similar information may be displayed in the boards put up in the branches to indicate the name and address of the Banking Ombudsman. In addition, the name, address and telephone numbers of the Controlling Authority of the bank to whom complaints can be addressed may also be given prominently.

Analysis and Disclosure of complaints:

Banks should place a statement of complaints before their Boards/Customer Service Committees along with an analysis of the complaints received. The complaints should be analyzed (i) to identify customer service areas in which the complaints are frequently received; (ii) to identify frequent sources of complaint; (iii) to identify systemic deficiencies; and (v) for initiating appropriate action to make the grievance redressal mechanism more effective.

Banks are also required to disclose brief details of complaints received and redressed, etc. along with their financial results. The detailed statement of complaints and its analysis are required to be placed on their website for information of the general public at the end of each financial year. Those complaints redressed within the next working day, need not be included in the statement of complaints.

27.13 GRIEVANCE REDRESSAL MECHANISM

A suitable mechanism should exist for receiving and addressing complaints from its customers/constituents with specific emphasis on resolving such complaints fairly and expeditiously.

Banks are also advised to:

i. Ensure that the complaint registers are kept at prominent place in their branches.
ii. Have a system of acknowledging the complaints, where received through letters/forms.
iii. Fix a time frame for resolving the complaints received at different levels.
iv. Ensure that redressal of complaints emanating from rural areas and those relating to financial assistance to Priority Sector and Government's Poverty Alleviation Programmes also form part of the above process.
v. Prominently display at the branches, the names and contact details of the officials who can be contacted for redressal of complaints,
vi. Also display at their branches, the name and contact details (Telephone/mobile number and E-mail ID) of the Principal Nodal Officer along with the details of the complaint lodging portal of the Ombudsman (https://cms.rbi.org.in) as per the integrated Ombudsman Scheme 2021.
vii. A copy of the Scheme should be available in all its branches, to be provided to the customer for reference upon request.
viii. Salient features of the Scheme, its copy, the contact details of the Principal Nodal Officer shall be displayed and updated on the website.
ix. Banks should also display on their web-sites - the names and other details of officials at their Head Office/Regional Offices/Zonal Offices; CMD/CEO; Line Functioning Heads for various operations who can be contacted for redressal of complaints.

For complaints not redressed within one month, the concerned branch/ Controlling Office should forward a copy of the same to the concerned Nodal Officer under the Banking Ombudsman Scheme and keep him updated regarding the status of the complaint. The customer should be made aware of his rights to approach the concerned Banking Ombudsman in case he is not satisfied with the bank's response. In the final letter sent to the customer regarding redressal of the complaint, banks should indicate that the complainant can also approach the concerned Banking Ombudsman.

27.14 REVIEW OF GRIEVANCES REDRESSAL MACHINERY IN PUBLIC SECTOR BANKS

Certain guidelines provided based on the review are as follows:

i. Banks should critically examine how Grievances Redressal Machinery is working.
ii. Banks should identify areas in which the number of complaints is large or on the increase. Should have special squads to look into complaints on the spot, where there are frequent complaints.
iii. Should shift the managers/officers of branches having large number of complaints to other branches/regional offices/departments at Head Offices where contacts with public is infrequent.
iv. At larger branches and at branches with a large number of complaints, the banks may appoint Public Relations Officers/Liaison Officers for looking into the complaints expeditiously.

v. Training programmes should include one or two sessions on customer service, public relations etc.
vi. Where the contention of the complainant is not accepted, a complete reply should be given.
vii. Grievances/complaints relating to congestions in the banking premises should be examined by the bank's internal inspectors/auditors on a continuing basis and action taken for augmentation of space, whenever necessary.

Chief Customer Service Officer

All public sector banks, and some private sector and foreign banks were advised to appoint an internal ombudsman designated as Chief Customer Service Officer (CCSO). The CCSO should not have worked in the bank in which he/she is appointed as CCSO. The bank's internal ombudsman will be a forum available for grievance redressal before the customers even approach the Ombudsman.

27.15 RECONCILIATION OF TRANSACTIONS AT ATMs FAILURE - TIME LIMIT

Banks took considerable time in reimbursing the amounts involved in such failed transactions to card holders. In many cases, the time taken was as much as 50 days.

a) The time limit for resolution of customer complaints by the issuing banks is fixed as t+5 days (t is referred as calendar date) from the date of failed transaction. Failure to do so, shall entail payment of compensation to the customer @ ₹ 100/- per day by the issuing bank.
   i. RBI has directed vide notification dated 20.09.2019 about "Harmonisation of Turn Around Time (TAT) and customer compensation for failed transactions using authorized Payment Systems" for resolution of customer complaints and compensation frame work across all authorised payment systems. Majority of complaints emanate on account of unsuccessful or "failed transactions"
   ii. the framework for TAT for failed transactions and compensation therefor has been finalsied to improve customer confidence.
   iii. Salient aspect of this notification is given as under:

   * the prescribed TAT is the outer limit for resolution of failed transactions; and
   * the banks and other operators' / system participants shall endeavour towards quicker resolution of such failed transactions
   * Wherever financial compensation is involved, the same shall be effected to the customer's account suo moto, without waiting for a complaint or claim from the customer.
   * Customers who do not get the benefit of redress of the failure as defined in the TAT, can register a complaint with the Reserve Bank - Integrated Ombudsman Scheme, 2021 (as amended from time to time).

The RBI – notification dated 20.09.2019 has advised details of incidents and framework for auto-reversal and compensation.
(RBI- https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12125)

b) All disputes regarding ATM failed transactions shall be settled by the issuing bank and the acquiring bank through the ATM System Provider only. No bilateral settlement arrangement outside the dispute resolution mechanism available with the system provider is permissible. This measure is to bring down the instances of disputes in payment of compensation between the issuing and acquiring banks.

Lodging of ATM Related Complaints

The following information should be displayed prominently at the ATM locations:

i. Complaints should be lodged at the branches where customers maintain accounts to which ATM card is linked;
ii. Telephone numbers of help desk/contact persons of the ATM owning bank to lodge complaint/seek assistance.
iii. Uniform Template for lodging of complaints relating to ATM transactions.

To improve the customer service through enhancement of efficiency in ATM operations, banks are advised to initiate following action:

i. Message about non-availability of cash should be displayed before the transaction is initiated.
ii. Make available sufficient toll-free phone numbers for lodging complaints / reporting and blocking lost cards and also attend the requests on priority
iii. Mobile numbers / e-mail IDs of the customers may be registered to send alerts

In case of complaints pertaining to a failed ATM transaction at other bank ATMs, the customer should lodge a complaint with the card issuing bank even if the transaction was carried out at another bank's ATM.

Transactions at ATM Procedural Amendment - PIN Validation for Every Successive Transaction

The type of card readers installed by each ATM vendor also contributes to the variation in the process flow. Security concerns arise in the case of certain type of card readers which facilitate multiple transactions without the need for pin validation for every successive transaction. The possibility of frauds/misuse of cards is very high in a scenario where the card is inserted in such reader slots, the card holder fails to collect the card after the transaction is completed and the card is misused. To mitigate this risk, the process flow demands pin validation. Hence each bank may ensure that the process flow is modified to provide for the pin validation for every transaction, including balance enquiry facilitated through ATM.

27.16 GOVERNMENT BUSINESS

The Reserve Bank of India carries out the general banking business of the Central and State Governments through its own offices and through the offices of the agency banks appointed under Section 45 of the RBI Act, 1934, by mutual agreement. RBI pays agency commission (also called turnover commission) to the agency banks for the government business handled by them. Government business and transaction such as payment of taxes, payment of pension is much sought after by banks. Apart from more CASA business there is an element of commission which is lucrative. Revenue receipts and payments on behalf of the Central/State Governments, Pension payments in respect of Central/State Governments, Special Deposit Scheme (SDS) 1975, Public Provident Fund (PPF) Scheme, Senior Citizen Savings Scheme (SCSS), are eligible for agency commission.

Some of the specific government related businesses handled by banks are enumerated below: Central Government Taxes/ Payments: Goods and Service Tax; CRIS Payments (e-freight); Government E-Market Place; E-Procurement/E-auction services to Indian Railways; ICEGATE (Indian Customs EDI Gateway); IIT-Gate; MCA (Ministry of Corporate Affairs); MHA (PSARA); National Permit; OLTAS (Income Tax Department); AIIMS INDIA (New Delhi); Staff Selection Commission; UPSC (Union Public Service Commission) State Government Taxes / Payments: Depending on the preparedness of various state governments their taxes and payments.

Payment of Taxes

With a view to improving customer service to direct taxpayers, special attention was drawn to the certain provisions of 'Accounting System for Direct Taxes': For challans tendered physically at the branches the important aspects are:

i. Issue of Token: In the case of challans deposited with cheque or draft, the receipted challans will be issued on realisation of the amount of cheque or draft and hence the paper token should indicate the date on which the receipted copies of the challans would be kept ready so that the assesse makes an arrangement to collect the receipted challan on the date given in the token.
ii. Receipted Challan: The receipted challan should be made available to the assesse within 4-5 days, based on the local Clearing arrangements.
iii. Double Date Stamp on Receipted Challan: The challan should bear two dates i.e. the 'Date of tender' of challans and instruments and the 'Date of realisation' of proceeds of the instruments.
iv. Acceptance of Clearing Cheques: The banks should accept cheques drawn on other banks while receiving taxes.

Online Tax Accounting System (OLTAS)

1) It is a system launched in June 2004 to collect, account, and report Direct Tax payments from different taxpayers, with the objectives:
   a) Collection of online direct taxes
   b) Accounting of online direct taxes
   c) Reporting of payments as well as receipts of online direct taxes

   All these objectives are carried out through banks and their respective network of branches. OLTAS transactions are completed online via one of the network bank branches.
2) The salient features are the introduction of a single copy challan with tear-off taxpayer's counterfoil, branding of acknowledgement stamp with unique serial number known as Challan Identification Number (CIN) on the single copy challan and on taxpayer's

counterfoil. Tax payers are now able to view the tax paid by them by logging on to http://tin-nsdl.com. Further, the new file structure required by Income Tax Department was also forwarded to Agency banks for developing suitable software for the OLTAS.

3) Under the new procedure, banks issue acknowledgement in respect of challans tendered with clearing cheques/drafts (i.e. other than cash and transfer cheques/drafts) only after the realization of such cheques/drafts. Banks issue paper token in respect of such challans indicating the date of tender and the date on which the counterfoil will be kept for delivery. The receiving banker return the tear-off portion of taxpayers' counterfoil on realization of such cheques/drafts after branding with the rubber stamp acknowledging the payment with Challan Identification Number (CIN) comprising the following:
   a) BSR Code number of the bank branch (7 digits)
   b) Date of presentation of the challan (DD/MM/YY)
   c) Serial number of the challan in that branch on that day (5 digits)
4) The tear off portion of the challans accompanied with cash or cheques drawn on the same receiving branch may be returned to the taxpayer on the same day with necessary acknowledgement by branding with the rubber stamp prescribed above.
5) All the non-networked branches need to ensure that data pertaining to those branches be transmitted from its nearest computerized/networked branch to the Nodal branch and from Nodal branch to Link Cell electronically so that complete data pertaining to all the authorized branches of a bank throughout India are seamlessly transmitted to the Tax Information Network (TIN) hosted by NSDL.
6) OLTAS has replaced the procedure insofar as the sending of scrolls and challans to the Income Tax Department was concerned.
7) RBI in December 2019 advised that 31 out of the 35 RBI circulars issued on Collection of Direct Taxes were withdrawn, in consultation with the Office of Principal Chief Controller of Accounts, Central Board of Direct Taxes. The instructions issued by the office of Principal Chief Controller of Accounts, Central Board of Direct Taxes remain in force wherever applicable. The salient points covered by the four circulars that are not withdrawn are:
   a) Agency banks need to ensure that there is no mismatch in figures uploaded to CAS and TIN for a given uploading date.
   b) Quoting of PAN/TAN on Challans made compulsory from 1/1/2005
   c) The cut-off time of 8.00 p.m. fixed for e-payment transactions would be applicable for all Government transactions including EASIEST and OLTAS.
   d) Instructions to introduce computer generated receipts for challan payment of OLTAS transactions,

Payment of Pension

1) A pensioner is entitled to receive his/her pension by getting it credited to a saving/current bank account either operated singly or operated jointly with their spouse in whose favour an authorization for family pension exists in the Pension Payment Order (PPO).
2) The joint account of the pensioner with the spouse could be operated either by 'Former or Survivor' or 'Either or survivor subject to following terms:

a) Once pension has been credited to a pensioner's bank account, the liability of the Government/Bank ceases. No further liability arises, even if the spouse wrongly draws the amount.
b) As pension is payable only during the life of a pensioner, his/ her death shall be intimated to the bank at the earliest and in any case within one month of the demise, so that the bank does not continue crediting monthly pension to the joint account with the spouse, after the death of the pensioner.
c) If any amount has been wrongly credited to the joint account, it shall be recoverable from the joint account and/or any other account held by the pensioner/spouse either individually or jointly. The legal heirs, successors, executors etc. shall also be liable to refund any amount, which has been wrongly credited to the joint account.
d) Payment of Arrears of Pension (Nomination) Rules 1983 would continue to be applicable to a Joint Account with the pensioner's spouse. This implies that if there is an 'accepted nomination' in accordance with Rules 5 and 6 of these Rules, arrears mentioned in the Rules shall be payable to the nominee.

3) The scheme of some states/ministries add that opening of joint account with any other person for credit of pension, except the spouse in whose favour family pension is authorised in the PPO, shall not be permissible. Family pensioners are also not covered under the revised scheme. For specific details, the scheme of each individual Ministry/State Government may be examined.
4) Digital Life Certificate: Pensioners are required to furnish a life certificate to the pension disbursing bank every year in November. The Government of India has launched "Jeevan Pramaan", a digital life certificate based on Aadhaar Biometric Authentication through a web portal (jeevanpramaan.gov.in) on November 10, 2014. All agency banks disbursing government pension were advised to take necessary steps to implement the scheme.
5) There have been complaints that life certificates submitted over the counter of pension paying branches are misplaced causing delay in payment of monthly pensions. Agency banks were instructed to mandatorily issue duly signed acknowledgements, and also to consider entering the receipt of life certificates in their CBS and issue a system generated acknowledgement which would serve the twin purpose of acknowledgement as well as real time updation of records.

27.17 LET US SUM UP

The bankers' obligation to maintain secrecy arises out of the contractual relationship between the banker and customer. Banks should have a transparent and comprehensive policy setting out the rights of the depositors in general and small depositors in particular. Banks should be generally guided by RBI instructions on KYC / AML for identification procedure for opening of accounts for individuals. Banks should open and conduct savings accounts of customers following due procedure. Bank should issue term deposit receipt indicating therein full details, such as, date of issue, period of deposit, due date, applicable rate of interest, etc. Term deposits should be freely transferable from one office of bank to another. Nomination facility should be provided on the deposit accounts.

Several provisions of the Income Tax Act are required to be observed in respect of certain products/ transactions. Banks receive attachment/ garnishee orders in respect of the deposits of the customer held by them. These should be meticulously acted upon. Various aspects related to collection of instruments tendered by a customer should be adhered to for customer service to the bank and avoiding any risks to the bank.

Clean Note Policy of the RBI should be meticulously followed. Safe deposit lockers related norms include allotment procedure, monitoring of locker operations, linking f fixed deposits with locker facility, etc. Several measures connected with customer service are time norms for various services, display/ dissemination of information on aspects like charges, contact particulars of key executives, significant policies relevant to the customer, grievance redressal mechanism; etc.; prompt resolution of failed ATM transactions.

Government business is a source of fee income, and at the same time it serves an important function by making it convenient for the public in conduct of their financial transactions with the government departments or bodies e.g. payment of taxes, payment for services availed, receipt of pension, receipt of incentives, subsidies or refunds, etc.

27.18 KEY WORDS

Deposit Accounts Portability; Electronic Clearing System (ECS); Indian Financial System Code (IFSC); National Calendar; CTS 2010 Standard; Garnishee Order; Attachment Orders; Clean Note Policy; Soiled/Mutilated/Imperfect Notes; CRIS Payments; ICEGATE; Online Tax Accounting System (OLTAS); Challan Identification Number (CIN).

27.19 CHECK YOUR PROGRESS

1) The bankers' obligation to maintain secrecy arises out of the contractual relation- ship between the banker and customer, and as such no information should be divulged to third parties except in following cases. One of them is incorrect. Identify
   a) Where disclosure is under compulsion of law
   b) Where there is duty to the public to disclose
   c) Where interest of bank requires disclosure and
   d) Where the disclosure is made to his spouse who is however not a joint holder

2) Time limit for compensation of failed transaction / reconciliation at ATMs failure is _____ days
   a) t-+7
   b) t+5
   c) t+12
   d) 15

3) The challans presented by the customer for payment of government taxes through cheques when returned to the customers after receipt of funds should bear ----- date stamps.
   a) 1
   b) 2
   c) 3
   d) None of the above

27.20 KEY TO 'CHECK YOUR PROGRESS'

1 (d); 2 (b) ; 3 (b)

References:

1) RBI Circular DBR No.Leg.BC.21/09.07.006/2015-16 - Master Circular on Customer Service in Banks dated July 1, 2015
(https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9862)
2) RBI Circular DCM (CC) No. G-3/03.41.01/2022-23 - Master Direction on Framework of Incentives for Currency Distribution & Exchange Scheme for bank branches including currency chests based on performance in rendering customer service to the members of public dated April 1, 2022
(https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12269)
3) RBI Circular DCM (NE) No. G-5/08.07.18/2022-23 - Master Circular – Facility for Exchange of Notes and Coins – dated April 01, 2022
(https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=12265)
4) RBI Circular DCM (CC) No.1170/03.41.01/2016-17 - Dispensation of Rs.100 denomination banknotes through exclusive ATMs - November 02, 2016
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=10674)
5) RBI Circular DCM (NPD) No. 5673/09.39.00/2006-07 - Clean Note Policy – Sorting of banknotes - February 12, 2007
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=3280)
6) RBI Circular UBD.CO. BPD. (PCB). No.20 /12.05.001/2007-08 - Misuse of banknotes - November 12, 2007
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=3928)
7) RBI Circular DCM (NPD) No.5133/ 09.39.000/2012-13 - Clean Note Policy - May 10, 2013
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=7983)
8) RBI Circular DCM (NPD) No. G-11 /09.39.000 /2013-14 - Clean Note Policy - August 14, 2013
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=8308)
9) Reserve Bank of India (Note Refund) Rules, 2009 [As amended by Reserve Bank of India (Note Refund) Amendment Rules, 2018]
(https://rbi.org.in/scripts/PublicationsView.aspx?id=6450
10) RBI Circular DCM (CC) No. G-5/03.44.01/2022-23 - Master Circular – Scheme of Penalties for bank branches including Currency Chests for deficiency in rendering customer service to the members of public - April 01, 2022
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12268)

11) RBI Press Release dated Nov 12, 2021 - The Reserve Bank - Integrated Ombudsman Scheme, 2021 and The Scheme.
(https://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=52549)
12) RBI Circular DGBA. GBD.No.1141/42.01.034/2019-20 dated December 12, 2019 RBI Master Circular on Collection of Direct Tax – OLTAS
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11754)

CHAPTER 28

INTEREST RATES ON DEPOSITS

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Understand the fundamental framework for interest rates on deposits
- Learn about the norms for determining interest rates on domestic deposits
- Know about the distinctions for interest rates on rupee deposits of non-residents
- Learn about the basis for interest rates on foreign currency deposits
- Know about the prohibitions in respect of any payments for deposits

28.1 DEFINITIONS

i. "*Bulk Deposit*" means: Single Rupee term deposits of - ₹ 2 crore and above for Scheduled Commercial Banks (excluding RRBs) and Small Finance Banks; and Single Rupee term deposits of ₹ 15 lakh and above for RRBs..

ii. "*Composite Cash Credit*" means a type of loan product having a cash credit limit with a fully savings module designed to take care of farmer's interest.

iii. "*Current Account*" means a form of non-interest bearing demand deposit where from withdrawals are allowed any number of times depending upon the balance in the account or up to a particular agreed amount, and shall also be deemed to include other deposit accounts which are neither Savings Deposit nor Term Deposit.

iv. "*Daily product*" means the interest applied on the end of day balance.

v. "*Demand deposit*" means a deposit received by the bank, which is withdrawable on demand;

vi. "*Domestic Rupee Deposits*" mean rupee deposits maintained in India in the form of current account, savings deposits or term deposit.

vii. "*Family*" includes members as mentioned in the bank's Service/Staff Regulations.

viii. "*FCNR (B) account*" means a Foreign Currency Non-Resident (Bank) account referred to in Foreign Exchange Management (Deposit) Regulations, 2000, as amended from time to time.

ix. "*Member of the bank's staff*" means a person employed on a regular basis, whether full-time or part-time, and includes a person recruited on probation or employed on a contract of a specified duration or on deputation and an employee taken over in pursuance of any scheme of amalgamation, but does not include a person employed on casual basis.

x. "*Notice deposit*" means term deposit for specific period but withdrawable on giving at least one complete banking days' notice.

xi. "*RFC account*" means a Resident Foreign Currency account referred to in Foreign Exchange Management (Foreign currency accounts by a person resident in India) Regulations, 2000, as amended from time to time.

xii. "*Savings deposit*" means a form of interest bearing demand deposit which is a deposit account whether designated as "Savings Account", "Savings Bank Account", "Savings Deposit Account", "Basic Savings Bank Deposit Account (BSBDA)" or other account by whatever name called which is subject to the restrictions as to the number of withdrawals as also the amounts of withdrawals permitted by the bank during any specified period;

xiii. "*Term deposit*" means an interest bearing deposit received by the bank for a fixed period and shall also include deposits such as Recurring / Cumulative / Annuity / Reinvestment deposits and Cash Certificates;

28.2 INTEREST RATE FRAMEWORK

a) Banks will have a policy on interest rates on deposits approved by the Board/ its Committee.
b) Banks shall pay interest on deposits of money (other than current account deposits) accepted by them or renewed in their Domestic, Ordinary Non-Resident (NRO), Non-Resident (External) Accounts (NRE) and Foreign Currency (Non-resident) Accounts (Banks) Scheme {FCNR(B)} deposit account.
c) The interest rates shall be uniform across all branches and for all customers. There shall be no discrimination between one deposit and another - similar amount, accepted on same date, at any of its offices.
d) The rates shall be strictly as per the schedule of interest rates disclosed in advance. The interest rate card for bulk deposits must be maintained in the Core Banking System.
e) The rates shall not be subject to negotiation between the depositors and the bank.
f) The rates shall be reasonable, consistent, and transparent. These should be available for supervisory review/scrutiny as and when required.
g) All transactions, involving payment of interest on deposits shall be rounded off to the nearest rupee for rupee deposits, and to two decimal places for FCNR (B) deposits.
h) Deposits maturing on non-business working day:
    a. Term deposit: To pay interest at the originally contracted rate on the original principal deposit amount for the non-business working day, intervening between the date of the maturity and the date of payment on the succeeding working day.
    b. Reinvestment deposits and recurring deposits: To pay interest for the intervening non-business working day on the maturity value.
i) Transfer of branch of one bank to another bank:
   For deposits transferred on account of takeover of bank branches in rural and semi-urban centres:
    a. Deposit shall be deemed to be transferred to the new bank and will continue to be governed by the terms of contract agreed to between the customer and the bank branch that is being taken over.
    b. The same rate of interest shall be payable till maturity, as was payable at the time of takeover.

28.3 INTEREST RATE ON DOMESTIC RUPEE DEPOSITS

A. Current Account

No interest shall be paid on deposits held in current accounts. Balances in current account in the name of a deceased individual depositor or sole proprietorship concern shall attract interest from the date of death of the depositor till the date of repayment at the rate of interest for savings deposit as on the date of payment.

B. Savings Deposits

Interest on domestic rupee savings deposits shall be subject to the following:

To be calculated on a daily product basis as under:

a. A uniform interest rate on balance up to ₹ 1 lakh, irrespective of the balance within this limit.
b. Differential rates may be provided for any end-of-day savings bank balance exceeding ₹ 1 lakh.

C. Term Deposits

a) Interest rates on term deposits shall vary only on account of one or more of the following reasons:
   i) Tenor of Deposits: Can determine the tenor freely, minimum tenor to be seven days.
   ii) Size of Deposits: Differential interest rate may be paid only on bulk deposits.

   No differential interest rate is permitted on deposit schemes on the basis of the Bank Term Deposit Scheme, 2006 or the deposits received under the Capital Gains Accounts Scheme, 1988.
b) Non-availability of Premature withdrawal option: Can offer term deposits without premature withdrawal option. But all term deposits of individuals (held singly or jointly) for amount of ₹15 lakh and below shall have premature withdrawal facility.
c) Payment of Interest on pre-mature withdrawal: The interest rates on term deposits withdrawn before the maturity date shall be as under:

2) At the rate applicable to the amount and period for which the deposit remained with the bank.
3) No interest shall be paid, where premature withdrawal takes place before the minimum period specified by RBI (currently 7 days).

D. Additional Interest

1) Can allow additional interest of 1% per annum, on savings or term deposits of bank's staff and their exclusive associations as well as on deposits of Chairman, Chairman & Managing Director, Executive Director or such other Executives appointed for a fixed tenure, subject to the following conditions:
   a) The additional interest is payable till the person continues to be eligible for the same and in case of his ceasing to be so eligible, till the maturity of a term deposit account.
   b) In case of employees taken over pursuant to the scheme of amalgamation, the additional interest is allowed only if the interest at the contractual rate together with the additional interest does not exceed the rate, which could have been allowed if such employees were originally employed by the bank.
   c) In the case of employees taken on deputation from another bank, the bank from which they are deputed may allow additional interest in respect of the savings or term deposit account opened with it during the period of deputation.
   d) In the case of persons taken on deputation for a fixed tenure or on a contract of a fixed tenure, the benefit will cease to accrue on the expiry of the term of deputation or contract, as the case may be.

e) Bank Employees' Federations, in which bank employees are not direct members, shall not be eligible for additional interest.
f) The additional interest may be paid on the following deposits after obtaining a declaration that the monies deposited or which may be deposited from time to time belong to the depositor:
    i) member or a retired member of the bank's staff, either singly or jointly with any member or members of his/her family; or
    ii) the spouse of a deceased member or a deceased retired member of the bank's staff; and
    iii) an Association or a fund, members of which are members of the bank's staff;

2) Can formulate term deposit schemes specifically for resident Indian senior citizens, offering higher and fixed rates of interest as compared to normal deposits of any size. This is not permitted for the term deposit of an HUF or the Karta of HUF, even if the Karta is a resident Indian senior citizen.
3) Can give their resident Indian retired staffs, who are senior citizens, the benefit of additional interest rates for senior citizens over and above the additional interest for being retired members of the banks' staff.

E. Overdue Term Deposits

a. The rate of interest on renewal of overdue term deposits shall be subject to the general stipulations given in paragraph C.
b. If a Term Deposit matures and proceeds are unpaid, the amount left unclaimed with the bank shall attract rate of interest as applicable to savings deposits or as per contract whichever is less

F. Floating Rate Term Deposits

Floating rate domestic term deposits shall be linked to a directly observable and transparent market determined external benchmark.

G. Periodicity of Payment - Savings Deposits

a. Interest on savings deposit shall be credited at half yearly or shorter intervals.
b. Interest on savings bank accounts, including those frozen by the enforcement authorities, shall be credited on regular basis irrespective of the operational status of the account.

H. Deposit account of deceased depositor:

The rate of interest on matured deposits in the case of death of an individual depositor, or one of the two or more joint depositors, shall be subject to the general conditions given above.

I. Discretion to pay interest on the minimum credit balance in the composite cash credit account of a farmer:

Interest on the minimum credit balance in the composite cash credit account of a farmer during the period from the 10th to the last day of each calendar month shall be paid, subject to the general conditions given in paragraph 3.

J. Penalty on premature withdrawal of domestic term deposit:

a) To have a comprehensive policy on penalties for premature withdrawal of term deposits approved by the Board/ its committee.
b) The components of penalty shall be clearly brought to the notice of the depositors at the time of acceptance of deposits. If not, no penalty shall be levied.
c) In case of splitting of the amount of term deposit at the request from the claimant/s of deceased depositors or Joint account holders, no penalty for premature withdrawal of the term deposit shall be levied if the period and aggregate amount of the deposit do not undergo any change.
d) No penalty for premature withdrawal shall be levied, where depositors desire premature withdrawal of deposit consequent to the transfer of business to another bank.

28.4 RUPEE DEPOSITS OF NON-RESIDENTS

A. Interest Rates on NRE/NRO Deposits

These will be within the general framework stipulated given in paragraph 2.

1) Savings Deposits: These will be as stated for domestic savings deposits.
2) Term Deposits: The interest rate will vary only on account of one or more of the following reasons:
   a) Tenor of Deposits: Can determine the tenor of the deposit freely. Minimum tenor of NRE term deposits shall be one year and that of NRO term deposits shall be seven days.
   b) Size of Deposits: Differential interest rate only on bulk deposits
   c) Shall not be higher than those on comparable domestic rupee term deposits.
3) Additional interest rate for bank's own staff/ senior citizens not paid on NRE and NRO deposits.
4) Interest on savings deposits: Shall be credited at quarterly or shorter intervals.
5) If an NRE account holder, immediately on return to India, requests for conversion of the NRE term deposit into Resident Foreign Currency Account (RFC), interest shall be paid as under:
   a) if the NRE deposit has not run for a minimum period of one year, interest shall be paid at a rate not exceeding the rate payable on savings deposits held in RFC accounts.
   b) In all other cases, interest shall be paid at the contracted rate.
6) Prohibition on marking lien: Cannot mark any type of lien, direct or indirect, against NRE saving deposits.
7) Penalty on premature withdrawal: To have a policy on penalties for premature withdrawal of NRE term deposits approved by the Board/ its committee.
   a) The components of penalty shall be clearly brought to the notice of the depositors at the time of acceptance of the deposits.
   b) No penalty shall be levied for premature withdrawal of NRE term deposits for conversion into Resident Foreign Currency (RFC) Account.
   c) Penalties for premature withdrawal shall be levied for conversion of NRE deposit into FCNR (B) deposit and vice versa.

d) No penalty for premature withdrawal shall be levied, where depositor desires premature withdrawal of deposit consequent to the transfer of business to another bank.

8) Interest payable on the NRE term deposit account of deceased depositor: In case the claimants of an NRE term deposit account of a deceased depositor are residents, the deposit on maturity shall be treated as a domestic rupee term deposit and interest shall be paid for the subsequent period at a rate applicable to a domestic term deposit of similar maturity.

28.5 FOREIGN CURRENCY DEPOSITS

A. Foreign Currency (Non-resident) Accounts (Banks) Scheme

1) The interest rates shall be subject to the general conditions laid down.
2) Interest rates on term deposits under the FCNR (B) scheme shall vary only on account of one or more of the following reasons:
   a) Tenor of deposits: The maturity period shall be as under:
      (1) 1 year and above but less than 2 years;
      (2) 2 years and above but less than 3 years;
      (3) 3 years and above but less than 4 years;
      (4) 4 years and above but less than 5 years;
      (5) 5 years only

   Cannot accept or renew FCNR (B) deposits over 5 years, and no recurring deposits can be accepted.
   b) Size of deposits: Can decide the currency-wise minimum quantum on which differential rates of interest may be offered.
   c) The interest rates on all deposits, including where differential rates of interest are offered, shall be subject to the overall ceiling prescribed.
   d) Interest on floating rate deposits shall be paid within the ceiling of swap rates for the respective currency/ maturity and in case of fixed rate deposits, interest shall be paid within the ceiling of Overnight Alternative Reference Rate for the respective currency/maturity.
   e) The interest reset period shall be six months for all floating rate deposits.
   f) The Overnight Alternative Reference Rate for the respective currency /SWAP rates as on the last working day of the preceding month shall form the base for fixing ceiling rates for the interest rates offered effective in the following month.
   g) The interest rates ceiling on FCNR (B) deposits shall be as under:

Period of Deposit	Ceiling Rate
1 year to less than 3 years	Overnight Alternative Reference Rate2 for the respective currency/ Swap plus 250 basis points
3 years and above up to and including 5 years	Overnight Alternative Reference Rate2 for the respective currency / Swap plus 350 basis points

h) The Overnight Alternative Reference Rate for the respective currency/ Swap rates quoted/ displayed by Foreign Exchange Dealers Association of India (FEDAI) shall be used as the reference for arriving at the interest rates on FCNR (B) deposits.

i) Manner of calculation of interest on FCNR (B) deposits

   (1) Interest on the deposits accepted under the scheme shall be calculated on the basis of 360 days to a year.

   (2) The interest on FCNR (B) deposits shall be calculated and paid at intervals of 180 days each and thereafter for the remaining actual number of days.

   The depositor will have the option to receive the interest on maturity with compounding effect.

j) Calculation of interest on renewal of FCNR (B) deposits: It shall be as under -

   i) If the period from the date of maturity till the date of renewal (both days inclusive) does not exceed 14 days, the rate of interest payable on the amount of the deposit so renewed shall be the appropriate rate of interest for the period of renewal as prevailing on the date of maturity or on the date when the depositor seeks renewal, whichever is lower.

   ii) In all other cases of renewal, interest rates for the overdue period on the renewed amount shall be determined by treating it as a fresh term deposit.

   iii) If, after renewal, the deposit is withdrawn before completion of the minimum period, bank can recover the interest paid for the overdue period i.e. period beyond the original date of maturity.

k) On the deposit of a deceased FCNR (B) depositor: To pay interest on the term deposits standing in the name(s) of a deceased FCNR(B) individual depositor or two or more joint depositors where one of the depositors has died, as under:

   i) If paid on the maturity of the deposit, interest shall be paid at the contracted rate;

   ii) If the deposit is claimed before the maturity date, interest shall be paid not at the contracted rate but at the rate applicable to the period for which the deposit remained with the bank and without charging penalty for pre-payment;

   iii) In case the depositor dies before the date of maturity of the deposit but the amount of the deposit is claimed after the date of maturity, interest shall be paid at the contracted rate till the date of maturity and simple interest at the applicable rate operative on the date of maturity for the period for which the deposit remained with the bank beyond the date of maturity.

   iv) In case of death of the depositor after the date of maturity of the deposit, the interest rate operative on the date of maturity in respect of savings deposits held under Resident Foreign Currency (RFC) Account Scheme shall be paid from the date of maturity till the date of payment.

   v) In case the claimants are residents, the maturity proceeds shall be converted into Indian Rupees on the date of maturity and interest shall be paid for the subsequent period at the rate applicable to a domestic term deposit of similar maturity.

l) Payment of interest on FCNR (B) deposits of NRIs on return to India: At the request of the depositor, can allow FCNR (B) deposits of persons of Indian nationality/origin who return to India for permanent settlement to continue till maturity at the contracted rate of interest. This is subject to the following conditions –

i) The rate of interest as applicable to FCNR (B) deposits shall continue.
ii) Deposits shall be treated as resident deposits from the date of return of the account holder to India.
iii) On maturity it shall be converted into Resident Rupee Deposit Account or RFC Account (if eligible) at the option of the account holder.
iv) The rate of interest on the new deposit (Rupee account or RFC Account) shall be the relevant rate applicable for such deposit account.

m) Conversion of FCNR (B) Accounts of Returning Indians into RFC Accounts/Resident Rupee Accounts- Payment of interest - Can pay interest, subject to general conditions given in paragraph 2, at the time of conversion of FCNR (B) Account into RFC/Resident Rupee Account even if the deposit has not completed the minimum maturity period. The rate of interest shall not exceed the rate payable on savings bank deposits held under RFC Account Scheme.
n) Premature withdrawal of deposits: It is permitted. If the premature withdrawal takes place before the minimum stipulated period, no interest shall be paid.
o) Penalty on Premature Withdrawal of deposits: To have a comprehensive policy on penalties for premature withdrawal of FCNR (B) term deposits approved by the Board of Directors or a committee of the Board.
   i) The components of penalty shall be informed to the depositors at the time of acceptance of the deposits. If not, the exchange loss arising out of premature withdrawal shall be borne by the bank.
   ii) Penalty shall be levied on premature withdrawal of FCNR (B) deposits
      (1) when the depositors return to India for permanent settlement.
      (2) for conversion of FCNR (B) deposits into NRE deposits or vice-versa.

3) In case of splitting of the amount of term deposit at the request from the claimant/s, no penalty for premature withdrawal of the term deposit shall be levied if the period and aggregate amount of the deposit do not undergo any change.
4) Banks may at their discretion levy penalty to recover the swap cost in the case of premature withdrawal of FCNR (B) deposits.
5) No penalties shall be levied in the case of premature conversion of balances held in FCNR (B) deposits into RFC Accounts by Non-Resident Indians on their return to India.
6) No penalty shall be levied, where depositors desire premature withdrawal of deposit consequent to the transfer of business to another bank.

B. Resident Foreign Currency Accounts Scheme

Banks have the freedom to determine interest on deposits of money accepted by it or renewed by it under the Resident Foreign Currency Account Scheme, in accordance to the comprehensive policy on interest rates on deposits duly approved by the Board of Directors.

28.6 PROHIBITIONS

Banks are not permitted to:

a) Pay any remuneration or fees or commission or brokerage or incentives on deposits in any form or manner to any individual, firm, company, association, institution or any other person except:

i. commission paid to agents employed to collect door-to-door deposits under a special scheme.
ii. commission paid to Direct Selling Agents/ Direct Marketing Agents as part of the outsourcing arrangements.
iii. remuneration paid to Business facilitators or Business Correspondents.

b) Offer prize/lottery/free trips (in India and/or abroad), etc. or any other initiative having element of chance for mobilizing deposits. However, inexpensive gifts costing not more than ₹ 250/- which is the amount prescribed by the Indian Banks' Association (IBA) as part of the Ground Rules and Code of Ethics framed by them may, at the bank's discretion, be given to depositors at the time of accepting deposits.
c) Resort to unethical practices of raising of resources through agents/third parties to meet the credit needs of the existing/prospective borrowers or to grant loans to the intermediaries based on the consideration of deposit mobilisation.
d) Issue any advertisement/ literature soliciting deposits from public highlighting only the compounded yield on term deposits without indicating the actual rate of simple interest offered by the bank for the particular period. Simple rate of interest per annum for the period of deposit should be indicated invariably.
e) Accept interest-free deposit other than in current account or pay compensation indirectly.
f) Accept deposits from/at the instance of private financiers or unincorporated bodies under any arrangement which provides for either issue of deposit receipt/s favouring client/s of private financiers or giving of an authority by power of attorney, nomination or other-wise, for such clients receiving such deposits on maturity.
g) Grant advances against term deposits maintained with other banks.
h) Open a savings deposit account in the name of entities other than individuals, Karta of HUF and organisations/agencies as specified by RBI.
i) Create any fund to be utilized for charitable purposes in consultation with the depositors.

28.7 EXEMPTIONS

The provisions in the above paragraphs shall not be applicable to:

1) A deposit received by the bank:
   a) from the institutions permitted to participate in the Call/Notice/Term Money Market both as lenders and borrowers.
   b) for which it has issued a participation certificate;
   c) under the Capital Gains Accounts Scheme, 1988, framed by the Government of India in pursuance of sub-section (2) of Section 54, sub-section (2) of Section 54B, sub-section (2) of Section 54D, sub-section (4) of Section 54F and sub-section (2) of Section 54G of the Income-Tax Act, 1961; and
   d) under the Certificate of Deposit Scheme.
2) Payment of interest on delayed collection of outstation instruments like cheques, drafts, bills, telegraphic/mail transfers, etc.

28.8 LET US SUM UP

The interest rates shall be uniform across all branches and for all customers. The rates shall be reasonable, consistent, and transparent. No interest shall be paid on deposits held in current accounts. Interest on domestic rupee savings deposits calculated on a daily product basis. Differential rates may be provided for any end-of-day savings bank balance exceeding ₹1 lakh Floating rate domestic term deposits shall be linked to a directly observable and transparent market determined external benchmark.

28.9 KEY WORDS

Composite Cash Credit; Daily product; Notice deposit; RFC account; Direct Selling Agents; Direct Marketing Agents; Capital Gains Accounts Scheme, 1988; Certificate of Deposit; Bank Term Deposit Scheme, 2006.

28.10 CHECK YOUR PROGRESS

1) Banks can pay interest in case of __________.
   a) Current account of a NGO
   b) Savings bank account of Agricultural Produce Market Committee
   c) Demand draft cancelled after 4 months
   d) Amount placed as term deposit that was lying in current account for 6 months, by value dating it six months prior.

2) Banks cannot vary the interest rates on Term deposits based on _____.
   a) Tenor
   b) Amount
   c) Place
   d) No premature withdrawal facility

3) FCNR (B) deposits can be in the form of ____________.
   a) Current Account
   b) Savings Account
   c) Recurring Account
   d) Term Deposit.

28.11 KEY TO 'CHECK YOUR PROGRESS':

1 (b); 2 (c); 3 (d)

References:

(1) RBI Circular DBR. Dir. No.84/13.03.00/2015-16 dated March 03, 2016 (Updated as on November 11, 2021) - Master Direction - Reserve Bank of India (Interest Rate on Deposits) Directions, 2016 (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10296)

CHAPTER 29

ALTERNATIVE DELIVERY CHANNELS

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Learn about various card based payment products
- Know about various electronic transfer channels
- Learn about ATMs related provisions
- Understand various aspects of Online banking, Digital banking and Neobanking

29.1 CARDS PRODUCTS - SMART/ DEBIT/ CREDIT CARDS/ PREPAID PAYMENT INSTRUMENTS (CARDS)

Banks issue several card products like debit cards, credit cards, and prepaid cards. These are smart cards both chip types and RFID (Radio Frequency Identification) types.

29.1.1 Definitions:

It is useful to know certain terms in connection with various card products:

A. Credit/ Debit Cards Related Terms:

i. *Add-on Credit Card* means a supplementary credit card to the principal or primary credit card, issued to person/s with predefined relationship with the primary cardholder, within her liability.

ii. *Annual Percentage Rate* is the annual cost of credit to the cardholder which includes interest rate and all other charges associated with the credit card.

iii. *Billing Cycle/Billing Period* is the regular length of time between closing dates of two consecutive bills raised by the card-issuer.

iv. *Business Credit Cards* are issued to business entities/ individuals for the purpose of business expenses with specified terms and conditions and not for personal use.

v. *Cardholders* – A person to whom a card is issued or one who is authorized to use an issued card.

vi. *Card-issuers* - Banks which issue debit or credit cards and NBFCs which have been permitted by RBI to issue credit cards in India.

vii. *Card Loyalty /Reward Programme/s* are schemes linked to a credit card or debit card whereby the card-issuer or associated merchant establishments, upon use of the card/s, offer digital coupons, points, discounts, cash backs or other benefits having monetary value that can be used/redeemed for the same transactions or other future transactions after accumulation.

viii. *Charge Card* is where the user has to pay the billed amount in full on due date after the billing cycle, and no rolling over of credit to the next billing cycle is permitted.

ix. *Co-branded Card* is a card issued jointly by a card-issuer and a co-branding entity bearing the names of both the partnering entities.

x. *Convenience Fee* is a fixed or pro-rata charge on use of credit/debit cards as one of the alternative forms of payment which is not ordinarily accepted vis-à-vis other forms of payment.

xi. *Corporate Credit Card* is a credit card that is issued to specific employee/s of a corporate employer wherein the liability could rest with the corporate entity or the employee or jointly on both, as per the product design features.

xii. *Credit Card* is a physical or virtual payment instrument containing a means of identification, issued with a pre-approved revolving credit limit that can be used to purchase goods and services or draw cash advances, subject to prescribed terms and conditions.

xiii. *Credit Limit* is the maximum amount of revolving credit determined and notified to the cardholder to transact in the credit card account.

xiv. *Debit Card* is a physical or virtual payment instrument containing a means of identification, linked to a Saving Bank/Current Account which can be used to withdraw cash, make online payments, do PoS terminal/ Quick Response (QR) code transactions, fund transfer, etc. subject to prescribed terms and conditions.

xv. *Form Factor* is the physical or virtual instrument that can be used in place of a card to undertake a payment/banking transaction.

xvi. *Interest-Free Credit Period* is the time period from the date of transaction to the due date of payment, wherein interest free payment can be made, subject to the payment of entire outstanding on or before the payment due date by the cardholder.

xvii. *Minimum Amount Due* is the minimum amount of money, as a part of the total bill amount, that a cardholder has to pay to not be treated as an overdue bill.

xviii. *Most Important Terms and Conditions (MITC)* are the standard set of conditions for the issuance and usage of credit cards, thereby defining the responsibilities and liabilities of the card-issuer and the cardholder.

xix. *Principal Cardholder* means the customer who has been issued credit card by a card-issuer and on whose name the card account has been opened.

xx. *Unsolicited Credit Card* is a credit card issued without a specific written/digital request or an application therefor.

B. Prepaid Instruments/ Cards Related Terms:

i. *Closed System PPIs*: These PPIs are issued by an entity for facilitating the purchase of goods and services from that entity only and do not permit cash withdrawal. These instruments cannot be used for payment or settlement for third party services. The issuance or operation of such instruments is not classified as a payment system requiring approval / authorisation by RBI and are, therefore, not regulated or supervised by RBI.

ii. *Entities/ Entity*: The term ‘entities / entity’ refer/s to banks / non-banks who have approval / authorisation from RBI to issue PPIs as well as those who are proposing to issue PPIs.

iii. *Holder*: Individuals / Organisations who obtain / purchase PPIs from the issuer and use them for purchase of goods and services, financial services, remittance facilities, etc.

iv. *Issuer*: Entities issuing PPIs to individuals / organisations.

v. *Limits*: All limits in the value of instruments stated in this MD indicate the maximum value of such instruments denominated in INR that shall be issued.

vi. *Merchants*: Establishments who have a specific contract to accept the PPIs of the PPI issuer (or contract through a payment aggregator / payment gateway) against the sale of goods and services, financial services, etc.

vii. *Net-worth*: Shall consist of 'paid up equity capital, preference shares which are compulsorily convertible into equity capital, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of assets but not reserves created by revaluation of assets' adjusted for 'accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any'. While compulsorily convertible preference shares reckoned for computation of net-worth can be either non-cumulative or cumulative, these shall be compulsorily convertible into equity shares and the shareholder agreements shall specifically prohibit any withdrawal of this preference share capital at any time.

viii. *Prepaid Card*: is a Prepaid Payment Instrument.

ix. *Prepaid Payment Instruments (PPIs):* Instruments that facilitate purchase of goods and services, financial services, remittance facilities, etc., against the value stored therein. PPIs that require RBI approval / authorisation prior to issuance are classified under two types viz. (a) Small PPIs, and (b) Full-KYC PPIs.

   a. Small PPIs: Issued by banks and non-banks after obtaining minimum details of the PPI holder. They shall be used only for purchase of goods and services. Funds transfer or cash withdrawal from such PPIs shall not be permitted. Small PPIs can be used at a group of clearly identified merchant locations / establishments which have a specific contract with the issuer (or contract through a payment aggregator / payment gateway) to accept the PPIs as payment instruments.

   b. Full-KYC PPIs: Issued by banks and non-banks after completing Know Your Customer (KYC) of the PPI holder. These PPIs shall be used for purchase of goods and services; funds transfer or cash withdrawal.

29.1.2 Conduct of Credit Card Business

(a) Eligibility:

Scheduled Commercial Banks (SCBs) other than Regional Rural Banks (RRBs) with net worth of ₹100 crore and above are permitted to undertake credit card business either independently or in tie-up arrangement with other card issuing banks/NBFCs with the approval of their Boards. SCBs (excluding Small Finance Banks and RRBs) desirous of setting up separate subsidiaries for undertaking credit card business shall require prior approval of the RBI. Besides, certain other entities may issue credit cards under general permission subject to certain conditions or with prior RBI permission.

(b) Governance Framework:

Banks shall have a Board approved policy. It shall be placed on the website. They should have a mechanism for review of their credit card operations on half-yearly basis by the Audit

Committee. The review should also include customer service, frauds, complaints and grievance redressal, card usage analysis including cards not used for long durations and the attendant risks.

(c) Issue of Credit Cards:

1) *Customer Acquisition*:
   Card-issuer shall provide a one-page Key Fact Statement along with the credit card application form containing the important aspects (rate of interest, quantum of charges, etc.). In case of rejection, the shall convey in writing the specific reason/s. The MITC (as prescribed) shall be highlighted and published/ sent separately to the customers, at the acceptance stage (welcome kit) and in important subsequent communications (at the time of onboarding, each time a condition is modified). The MITC and copy of the agreement signed shall be sent to the registered email address/ postal address as per the choice of the customer. Issuer should obtain explicit consent in writing or in digital mode for any insurance cover offered. The issue of unsolicited cards/ upgradation is strictly prohibited. In case, an unsolicited card is issued/existing card upgraded and activated without the explicit consent of the recipient and the latter is billed for the same, the card-issuer shall not only reverse the charges forthwith, but also pay a penalty without demur to the recipient amounting to twice the value of the charges reversed. The person can also approach the RBI Ombudsman who would determine the amount of compensation payable by the card-issuer. Any loss arising out of misuse of such unsolicited cards shall be the responsibility of the card-issuer only. Card-issuers shall seek, within 30 days, OTP based consent from the cardholder for activating a credit card. If no consent is received for activating the card, card-issuers shall close the credit card account without any cost to the customer within 7 working days from date of seeking confirmation. In case of a renewed or replaced card, the closure of an inactivated card shall be subject to payment of all dues by the cardholder. The issuer shall not report any credit information relating to a new credit card account to Credit Information Companies prior to activation of the card.
2) *Underwriting Standards*:
   While issuing cards to persons ensure prudence and independently assess the credit risk, taking into account independent financial means of applicants. As holding several credit cards enhances the total credit available to any consumer, assess the credit limit for a credit card customer taking into consideration all the limits enjoyed from other entities on the basis of self-declaration/credit information obtained from a Credit Information Company, as appropriate.
3) *Types of credit cards:*
   a) Credit cards/charge cards may be issued to individuals for personal use together with add-on cards wherever required.
   b) Cards linked to overdraft accounts that are in the nature of personal loans may be issued without any end-use restrictions subject to the conditions as stipulated in the overdraft account.
   c) Business credit cards may be issued to business entities/individuals for business expenses. These may also be issued as charge cards, corporate credit cards or by

linking a credit facility such as overdraft/cash credit provided for business purpose as per the terms and conditions stipulated for the facility concerned. Corporate credit cards can be issued together with add-on cards wherever required.

d) The liability of the corporate/business entity on account of business cards shall form part of their total assessed credits for compliance to RBI's Exposure Norms as well as IRACP norms for advances.

e) The add-on cards shall be issued only to the persons specifically identified by the principal cardholder under both personal and business credit card categories, and with the clear understanding that the liability will be that of the principal cardholder. Similarly, for corporate credit cards, the responsibilities and liabilities of the corporate and its employees shall be clearly specified. The liability of the corporate/business entity shall form part of its assessed credits.

4) *Closure of Credit Card*:

a) Any request for closure of a credit card shall be honoured within 7 working days, subject to payment of all dues by the cardholder. Subsequent to the closure, the cardholder shall be immediately notified through email, SMS, etc. Options are provided to submit request for closure through multiple channels - helpline, dedicated e-mail-id, IVR, prominently visible link on the website, internet banking, mobile-app or any other mode. Failure to complete the process of closure within 7 working days shall result in a penalty of ₹500 per day of delay payable to the customer, till the closure of the account provided there is no outstanding in the account.

b) If a credit card has not been used for a period of more than one year, the process to close the card shall be initiated after intimating the cardholder. If no reply is received from the cardholder within a period of 30 days, the card account shall be closed by the card-issuer, subject to payment of all dues by the cardholder, including updating the Credit Information Company/ies.

c) Subsequent to closure of credit card account, any credit balance available in credit card accounts shall be transferred to the cardholder's bank account.

5) *Interest rates and other charges*:

a) The instructions on interest rate on advances should be applied, while determining the interest rate on credit card dues. Interest charged shall be justifiable basis the cost incurred and the extent of return that could be reasonably expected. An interest rate ceiling in line with other unsecured loans, including processing and other charges shall be prescribed as part of the Board approved policy. In case interest rates are varied based on the payment/default history of the cardholder, there shall be transparency in levying such differential interest rates. The interest rates for various categories of customers shall be publicised through website and other means. The card holder should be advised upfront - the methodology of calculation of finance charges with illustrative examples, particularly in situations where only a part of the amount outstanding is paid.

b) The following directions relating to interest rates and other charges should be followed:

i) Annualized Percentage Rates (APR) should be quoted for different situations - retail purchases, balance transfer, cash advances, non-payment of minimum amount due, late payment etc., if these are different. The method of calculation of APR shall be given with clear examples for better comprehension. The APR charged, and the annual fee shall be shown with equal prominence. The late payment charges, including the method of calculation of such charges and the number of days, shall be prominently indicated. The manner in which the outstanding unpaid amount has been arrived at for calculation of interest shall also be specifically shown with prominence in all the billing statements. In addition, these aspects shall also be shown in the Welcome Kit.

ii) The terms and conditions for payment of credit card dues, including the minimum amount due, shall be stipulated so as to ensure there is no negative amortization. The unpaid charges/levies/taxes shall not be capitalized for charging/compounding of interest.

iii) Card-issuers shall inform the cardholders of the implications of paying only 'the minimum amount due'. A legend/warning to the effect that "Making only the minimum payment every month would result in the repayment stretching over months/years with consequential compounded interest payment on your outstanding balance" shall be prominently displayed in all the billing statements to caution the cardholders about the pitfalls in paying only the minimum amount due. The MITC shall specifically explain that the 'interest-free credit period' is suspended if any balance of the previous month's bill is outstanding. The card-issuers shall specify in the billing statement, the level of unpaid amount of the bill i.e., part payment beyond 'minimum amount due', at which the interest-free credit period benefits would not be available to cardholders.

iv) For this purpose, card-issuers shall work out illustrative examples and include the same in the Welcome Kit sent to the cardholders and also place it on their website.

v) Card-issuers shall report a credit card account as 'past due' to credit information companies (CICs) or levy penal charges, viz. late payment charges and other related charges, if any, only when a credit card account remains 'past due' for more than three days. The number of 'days past due' and late payment charges shall, however, be computed from the payment due date mentioned in the credit card statement, as specified under the IRACP norms for Advances. Penal interest, late payment charges and other related charges shall be levied only on the outstanding amount after the due date and not on the total amount.

vi) Changes in charges shall be made only with prospective effect giving prior notice of at least one month. If a cardholder desires to surrender his/her card on account of any change in charges to his/her disadvantage, he/she shall be permitted to do so without levying any extra charge, subject to payment of all dues by the cardholder.

vii) There shall not be any hidden charges while issuing credit cards free of charge.

6) *Billing*:
   a) There should be no delay in sending/dispatching/emailing bills/statements and the customer should have sufficient number of days (at least one fortnight) for making payment before the interest starts getting charged. Bills and statements of accounts may be provided through internet/mobile banking with the explicit consent of the cardholder.
   b) Care should be taken to ensure that wrong bills are not raised and issued to cardholders. In case, a cardholder protests any bill, the card-issuer shall provide explanation and, wherever applicable, documentary evidence within a maximum period of 30 days from the date of complaint.
   c) No charges shall be levied on transactions disputed as 'fraud' by the cardholder until the dispute is resolved.
   d) Cardholders shall be provided a one-time option to modify the billing cycle of the credit card as per their convenience.
   e) Any credit amount arising out of refund/failed/reversed transactions or similar transactions before the due date of payment for which payment has not been made by the cardholder, shall be immediately adjusted against the 'payment due' and notified to the cardholder.
   f) Explicit consent of the cardholder should be taken to adjust credit amount (beyond a cut-off, one percent of the credit limit or ₹5000, whichever is lower, arising out of refund/failed/reversed transactions or similar transactions) against the credit limit for which payment has already been made by the cardholder. The consent shall be obtained through e-mail or SMS within 7 days of the credit transaction. The credit transaction should be reversed to the cardholder's bank account, if no consent/ response is received from the cardholder. Notwithstanding the cut-off, if a cardholder makes a request for reversal of the credit amount in the card account into his/her bank account, the card-issuer shall do it within 3 working days from the receipt of such request.
7) *Issue of unsolicited facilities*:
   a) Unsolicited loans or other credit facilities shall not be offered to the credit cardholders without seeking explicit consent. In case an unsolicited credit facility is extended without the written/explicit consent of the cardholder and the latter objects to the same, the card-issuer shall not only withdraw the facility, but also be liable to pay such penalty as may be considered appropriate by the RBI Ombudsman, if approached.
   b) Card-issuers shall not unilaterally upgrade credit cards and enhance credit limits. Explicit consent of the cardholder shall invariably be taken whenever there is/are any change/s in terms and conditions. In case of reduction in the credit limit, the card-issuer shall intimate the same to the cardholder.
8) *Reporting to Credit Information Companies (CIC):*
   a) For providing information relating to credit history/ repayment record of the cardholder to a CIC (registered with RBI), the card-issuer shall explicitly bring to the notice of the customer that such information is being provided in terms of the Credit Information Companies (Regulation) Act, 2005.

b) Before reporting default status of a credit cardholder to a CIC, the procedure approved by their Board should be followed, including issuing of a 7-day notice to the cardholder regarding this. If the customer settles his/her dues after being reported, the card-issuer shall update the status within 30 days from the date of settlement. Card-issuers shall be particularly careful in the case of cards where there are pending disputes. The disclosure/release of information, particularly about the default, shall be made only after the dispute is settled. In all cases, a well laid down procedure shall be transparently followed and be made a part of MITC.

9) *Customer Conduct:*

a) In the matter of recovery of dues, card-issuers and their agents must adhere to the Fair Practices Code for lenders.

b) In respect of third-party agencies for debt collection, the card-issuers shall ensure that their agents refrain from actions that could damage their integrity and reputation and observe strict customer confidentiality. All communications issued by recovery agents must contain the name, and contact particulars of the concerned senior officer of the card-issuer whom the customer can contact. Card-issuers shall provide the name and contact details of the recovery agent to the cardholder immediately upon assigning the agent to the cardholder.

c) Card-issuers/their agents shall not resort to intimidation or harassment of any kind, either verbal or physical, against any person in their debt collection efforts, including acts intended to humiliate publicly or intrude upon the privacy of the credit cardholders' family members, referees and friends, making threatening and anonymous calls or making false and misleading representations.

d) Card-issuers shall ensure to comply with the extant guidelines in respect of engagement of recovery agents issued by the RBI.

e) The disclosure of customers' information to the DSAs/DMAs/recovery agents shall also be limited to the extent that will enable them to discharge their duties. Personal information provided by the cardholder but not required for recovery purposes shall not be released by the card-issuer. The card-issuer shall ensure that the DSAs/DMAs/recovery agents do not transfer or misuse any customer information during marketing of credit card products.

f) In outsourcing various credit card related operations should take care that it does not compromise the quality of the customer service and the card-issuers' ability to manage credit, liquidity and operational risks. In the choice of the service provider - shall be guided by the need to ensure confidentiality of the customer's records, respect customer privacy and adhere to fair practices in debt collection.

g) Card-issuers shall have a system of random checks and mystery shopping to ensure that their agents have been properly briefed and trained as to how to handle customers and are also aware of their responsibilities, particularly with regard to soliciting customers, hours for calling, privacy of customer information, conveying the correct terms and conditions of the product on offer.

h) Card-issuers shall ensure that their employees/agents do not indulge in mis-selling of credit cards by providing incomplete or incorrect information to the customers, prior to the issuance of a credit card. The card-issuers shall also be liable for the acts of their agents. Repetitive complaints received in this regard against any employee/agent shall be taken on record by the card-issuer and appropriate action shall be initiated against them including blacklisting of such agents. A dedicated helpline and email-id shall be available for the cardholders to raise complaints against any act of mis-selling or harassment by the representative of the card-issuer.

29.1.3 Guidelines for Issue of Debit Cards by Banks

(a) Issue of Debit Cards:

Banks should have a comprehensive debit cards issuance policy with the approval of their Boards and issue debit cards to their customers in accordance with this policy. Debit cards should be issued to customers having Saving Bank/Current Accounts but not to cash credit/loan account holders. This does not preclude the banks from linking the overdraft facility provided along with Pradhan Mantri Jan Dhan Yojana accounts with a debit card. Banks should not compel a customer to avail a debit card, nor link the issuance of debit card to availment of any other facility.

(b) Other Form Factors:

Scheduled Commercial Banks (other than RRBs) may issue other form factors in place of a plastic debit card such as wearables after obtaining explicit consent from the customer. Banks shall submit a detailed report to the Department of Regulation, Reserve Bank of India, prior to the issuance of any such form factors. Banks shall provide options for disabling or blocking the form factor through mobile banking, internet banking, SMS, IVR or any other mode.

(c) Review of operations:

The banks shall undertake review of their operations/issue of debit cards on half-yearly basis that shall also include analysis of cards not used for long periods and the attendant risks.

29.1.4 Co-Branding Arrangement

(a) Issue of Co-branded Cards:

i. Prior approval of the Reserve Bank is not necessary for the issuance of co-branded debit cards/co-branded prepaid cards by banks and co-branded credit cards by card-issuers. However, UCBs shall not issue debit/credit cards in tie-up with other non-bank entities. The co-branding arrangement for credit cards, debit cards and prepaid cards shall also be subject to the specific conditions applicable to such cards.
ii. The co-branded credit/debit card shall explicitly indicate that the card has been issued under a co-branding arrangement. The co-branding partner shall not advertise/market the co-branded card as its own product. In all marketing/ advertising material, the name of the card-issuer shall be clearly shown.
iii. The co-branded card shall prominently bear the branding of the card-issuer.

(b) Board approved policy:

The co-branding arrangement should be as per the Board approved policy of the bank.

(c) Due diligence:
Banks should carry out due diligence in respect of the co-branding partner entity with which they intend to enter into tie-up for issue of such cards to protect themselves against the reputation risk they are exposed to in such an arrangement. Banks may ensure that in cases where the proposed co-branding partner is a financial entity, it has obtained necessary approvals from its regulator for entering into the co-branding arrangement.

(d) Outsourcing of activities:
The card issuing bank would be liable for all acts of the co-branding partner. The bank may ensure adherence to the guidelines on "Managing Risks and Code of Conduct in outsourcing of financial services by banks". Banks shall ensure that cash backs, discounts and other offers advertised by a co-branding partner are delivered to the cardholder on time. Banks shall be liable for any delay or non-delivery of the same to the cardholders.

(e) Role of co-branding partner entity:
The role of the co-branding partner entity under the tie-up arrangement should be limited to marketing/distribution of the cards or providing access to the cardholder for the goods/services that are offered. The co-branding partner shall not have access to information relating to transactions undertaken through the co-branded card. Post issuance of the card, the co-branding partner shall not be involved in any of the processes or the controls relating to the co-branded card except for being the initial point of contact in case of grievances.

(f) Co-branding arrangement between banks and NBFCs for Credit Cards:
NBFCs, which desire to enter into a co-branding arrangement for issue of credit cards with a card-issuer, shall also be guided by the Guidelines on issue of Co-Branded Credit Cards contained in the respective Master Directions applicable to NBFCs, as amended from time to time.

29.1.5 General Guidelines for Credit and Debit Cards
(a) General Conditions:

a) Card-issuers shall keep internal records to enable operations to be traced and errors to be rectified (taking into account the law of limitation for the time barred cases) as prescribed under 'Master Direction on Know Your Customer', as amended from time to time.
b) The cardholder shall be provided with a record of the transactions after he/she has completed it, immediately in the form of receipt or another form such as the bank statement/email/SMS.
c) Card-issuers may consider issuing card with advanced security features that may evolve from time to time.
d) Card-issuers shall block a lost card immediately on being informed by the cardholder and formalities, if any, can follow within a reasonable period.
e) Card-issuers shall provide to the cardholder the detailed procedure to report the loss, theft or unauthorised use of card or PIN. They shall provide multiple channels - dedicated helpline, dedicated number for SMS, dedicated e-mail-id, Interactive Voice

Response, clearly visible link on the website, internet banking and mobile-app or any other mode - for reporting an unauthorized transaction on 24 x 7 basis, and allow the customer to initiate the blocking of the card. These facilities shall be adequately publicized and included in the billing statements.

f) Card-issuers shall immediately send a confirmation to the cardholder on blocking of a card.
g) No card-issuer shall dispatch a card to a customer unsolicited, except in the case where the card is a replacement/renewal of a card already held by the customer. In case a card is blocked at the request of the customer, replacement card in lieu of the blocked card shall be issued with the explicit consent of the customer. Further, card-issuer shall obtain explicit consent of the cardholder prior to the renewal of an existing card.
h) Any discounts, cash backs, reward points, loyalty points or any other benefits offered by the card-issuer shall be provided in a transparent manner including source of such benefits. The accounting process for the same shall be verifiable in the books of the card-issuer. Detailed information regarding these benefits shall be displayed on the website of the card-issuer and a copy of the same shall also be provided to the cardholder.
i) In case of an insurance cover provided with a card, card-issuers shall ensure that the relevant nomination details are recorded by the Insurance Company and the availability of insurance is included, along with other information, in every statement. The information shall also include the details regarding the insurance cover, name/address and telephone number of the Insurance Company which will handle the claims relating to the insurance cover.

(b) Terms and conditions for issue of cards to customers:

a) The relationship between the card-issuer and the cardholder shall be contractual. Card-issuers shall make available to the cardholders in writing, a set of contractual terms and conditions governing the issue and use of such cards. These terms shall be expressed clearly and also maintain a fair balance between the interests of the parties concerned.
b) The terms and conditions for the issue and usage of a card shall be mentioned in clear and simple language (preferably in English, Hindi and the local language) comprehensible to the cardholder.
c) Card-issuers shall not levy any charge that was not explicitly indicated to the cardholder at the time of issue of the card and without getting his/her explicit consent. However, this shall not be applicable to charges like service taxes which may subsequently be levied by the Government or any other statutory authority. The details of all the charges associated with cards shall be displayed on the card-issuer's website.
d) The convenience fee, if any charged on specific transactions, shall be indicated to the cardholder in a transparent manner, prior to the transaction.
e) The terms shall clearly specify the time-period for reversal of unsuccessful/failed transactions and the compensation payable for failure to meet the specified timeline.
f) The terms may be altered by the card-issuer, but 30 days' notice of the change shall be given to the cardholder to enable him/her to withdraw if he/she so chooses. After the

notice period of 30 days, the cardholder would be deemed to have accepted the terms if he/she had not withdrawn during the specified period. The change in terms shall be notified to the cardholder through all the communication channels available.

g) The terms shall put the cardholder under an obligation to take all appropriate steps to keep the card safe and not to record the PIN or code, in any form that would be intelligible or otherwise accessible to any third party if access is gained to such a record, either honestly or dishonestly.
h) The terms shall specify that the card-issuer shall exercise care when issuing PINs or codes and shall be under an obligation not to disclose the cardholder's PIN or code to anyone, except to the cardholder.

(c) Compliance with Other instructions:
The issue of cards as a payment mechanism shall also be subject to relevant instructions on cash withdrawal, issue of international card, security issues and risk mitigation measures, card-to-card fund transfers, merchant discount rates structure, failed ATM transactions, etc., issued by the Department of Payment and Settlement Systems, Reserve Bank of India under the Payment and Settlement Systems Act, 2007, and the Foreign Exchange Department, Reserve Bank of India under Foreign Exchange Management Act, 1999, as amended from time to time. Cash drawals against debit cards at the POS Terminals will be limited to ₹2000/- per day (Tier I and II centres), and ₹1000/- per day (Tier III to VI centres).

(d) Redressal of grievances:

a) Card-issuers shall put in place a Grievance Redressal Mechanism within the card issuing entity and give wide publicity about it through electronic and print media. The name, and contact particulars of the designated grievance redressal officer shall be mentioned on the credit card bills and account statements.
b) Card-issuers shall ensure that their call centre staff is trained adequately to competently handle and escalate, a complaint, if necessary.
c) Card-issuers shall be liable to compensate the complainant for the loss of his/her time, expenses, financial loss as well as for the harassment and mental anguish suffered by him/her for the fault of the card-issuer and where the grievance has not been redressed in time.

(e) Confidentiality of customer information:

a) Card-issuers shall not reveal any information relating to customers obtained at the time of opening the account or issuing the card to any other person or organization without obtaining their explicit consent, with regard to the purpose/s for which the information will be used and the organizations with whom the information will be shared. Card-issuers shall ensure strict compliance to the extant legal framework on data protection. Further, in case where the customers give explicit consent for sharing the information with other agencies, card-issuers shall explicitly state and explain clearly to the customer the full meaning/implications of the disclosure clause.
b) Under a co-branding arrangement, the co-branding entity shall not be permitted to access any details of customer's accounts that may violate the card-issuer's secrecy obligations.

c) In case, the co-branding arrangement is between two banks, the card issuing bank shall ensure compliance with the relevant instructions.

(f) Outsourcing of various services:
Card-issuers shall ensure adherence to the guidelines on "Managing Risks and Code of Conduct in Outsourcing of Financial Services" as amended from time to time.

(g) Compliance with KYC Norms/ AML Standards/ CFT Obligation under the PMLA, 2002
The instructions/ Directions on KYC/AML/CFT issued by RBI from time to time shall be strictly adhered to in respect of all cards issued, including co-branded cards.

29.1.6 Guidelines for Prepaid Payment Instruments

(a) Eligibility requirements for issuance of PPIs by banks:
Banks that comply with the eligibility criteria, including those stipulated by the respective regulatory department of RBI, shall be permitted to issue PPIs after obtaining approval from RBI.

(b) Safeguards against money laundering provisions:
The KYC/ AML/ CFT guidelines in "Master Direction – Know Your Customer Direction, 2016" apply mutatis mutandis to all the entities (bank or non-bank) issuing PPIs. Provisions of Prevention of Money Laundering Act, 2002 (PMLA) and Rules framed thereunder are also applicable to PPI issuer. PPI issuer shall maintain a log of all the transactions undertaken using the PPIs for at least ten years. This data shall be made available for scrutiny to RBI or any other agency / agencies as may be advised by RBI. The PPI issuer shall also file Suspicious Transaction Reports (STRs) to Financial Intelligence Unit-India (FIU-IND).

(c) Issuance, loading and reloading of PPIs:
All entities approved/ authorised to issue PPIs by RBI are permitted to issue reloadable or non-reloadable PPIs depending upon the permissible type/ category of PPIs. PPI issuer shall have a clear laid down policy for this activity, duly approved by its Board. The name of the authorised PPI issuer entity should be prominently displayed along with the PPI brand name. RBI must be informed the brand names of its various products.

(d) Loading/ Reloading Amounts:
PPIs shall be denominated in INR only and can be loaded/ reloaded through cash or payment through any bank account/ payment instrument. Cash loading is limited to Rs.50,000/- per month subject to overall limit. No interest can be paid on the amount loaded/ held in PPI. Loading/ reloading can be done at branches, BC outlets, through agents, as per the Board approved policy.

(e) PPI Forms:
PPIs may be issued as cards, wallets, and in any such form/ instrument which can be used to access the PPI and to use the amount therein. No PPI shall be issued in the form of paper vouchers.

(f) Co-branding arrangements:

The co-branding arrangement shall be as per the Board approved policy of the PPI issuer, clearly laying down the roles, responsibilities and obligations of each co-branding partner. The co-branding partner shall be a company incorporated in India under the Companies Act, 1956/ 2013 or a Government department/ ministry. In case the co-branding partner is a bank, the same shall be licensed by RBI. In case of tie up with a financial entity, it may ensure that approval of co-branding partner's regulator for entering into such arrangement is available. PPI issuer shall carry out due diligence of the co-branding partner. PPI issuer shall be liable for all acts of the co-branding partner. PPI issuer shall be permitted to co-brand such instruments with the name/ logo of the company for whose customers/ beneficiaries such co-branded instruments are to be issued. The name of PPI issuer shall be prominently visible on the payment instrument. In case of co-branding arrangements between a bank and non-bank entity, the bank shall be the PPI issuer. Role of the non-bank entity shall be limited to marketing/ distribution of the PPIs or providing access to the PPI holder to services that are offered. In case of co-branding arrangement between two banks, the PPI issuing bank shall ensure compliance to various norms.

(g) Restrictions on PPI Transactions:

There shall be no remittance without compliance to KYC requirements. New PPIs should not be created every time for facilitating cash-based remittances to other PPIs/ bank accounts. PPI of the same person created for previous remittance shall be used.

(h) Cross-Border Transactions:

INR denominated PPIs can be used for cross-border transactions only as provided below:

A. Outward Transactions

i. Full-KYC PPIs issued by AD-I banks can be used for permissible current account transactions under FEMA viz. purchase of goods and services.
ii. PPIs shall not be used for any cross-border outward fund transfer and / or for making payments under Liberalised Remittances Scheme (LRS).
iii. Prefunding of online merchant's account is not permitted.
iv. Facility of cross-border outward transactions should be activated only on explicit request of the PPI holders and with per transaction limit of up to Rs.10,000/-, and monthly limit of up to Rs.50,000/-.
v. All PPIs in card form should be with EMV Chip and PIN compliant.

B. Credit through Inward Remittances:

i. Full-KYC PPIs can be issued to a beneficiary of inward remittances under the Money (ii) Transfer Services Scheme (MTSS), adhering to the prescribed norms.
ii. Only up to Rs.50,000/- from individual inward MTSS remittances can be loaded/ reloaded in full-KYC PPIs issued to beneficiaries. Any excess amount shall be paid by credit to a bank account of the beneficiary. Full details of the transactions shall be maintained on record for scrutiny;

iii. Roles and responsibilities of PPI issuer shall be distinct from the roles and responsibilities as Indian Agents under MTSS;

C. Types of PPIs:

PPIs have been categorised as follows:

1) Small PPIs (or Minimum-detail PPIs):
   a) PPIs up to ₹10,000/- (with cash loading facility): Issued with mobile number verified with OTP and a self-declaration of name and unique identity / identification number of any 'mandatory document' or 'Officially Valid Document (OVD)'. They can be reloadable with monthly and annual ceilings of ₹10,000/ and ₹120000/- respectively. The maximum balance cannot exceed ₹10,000/-. These shall be used only for purchase of goods and services. Cash withdrawal or funds transfer is not be permitted. Only one such PPI can be issued to any person. These shall be converted into full-KYC PPIs within 24 months from the date of issue, failing which no further credit shall be allowed and the PPI holder shall be allowed to use the balance available. The PPI can be closed any time at the customer's request. The closure proceeds can be transferred to the payment source from where it was loaded; else these can be transferred to a bank account after complying with KYC requirements of PPI holder
   b) PPIs up to ₹10,000/- (with no cash loading facility): These have similar restrictions as in case of PPIs up to ₹10,000/- (with cash loading facility), except that these can be continued for any period of time at the choice of the customer. The PPI can be closed any time at the customer's request. The closure proceeds can be transferred to the payment source from where it was loaded; else these can be transferred to a bank account after complying with KYC requirements of PPI holder.

2) Full-KYC PPIs:
   These can be issued after completing KYC of the PPI holder. Video-based Customer Identification Process (V-CIP) as per RBI MD on KYC can be used for this purpose, even for converting Small PPIs to Full-KYC PPI's. Ceiling on balance at any time is. ₹ 2,00,000/- at any point of time. The PPI can be closed any time at the customer's request. The closure proceeds can be transferred to the payment source from where it was loaded; else these can be transferred to a bank account (to be verified by the PPI issuer). PPI issuer shall set the limits considering the risk profile of the PPI holders, other operational risks, etc. Funds transferred to pre-registered beneficiaries shall not exceed ₹2,00,000/- per month per beneficiary; and to all other cases it shall be restricted to ₹10,000/- per month. Funds transfer from such PPIs shall also be permitted to other PPIs, debit cards and credit cards as per these limits. There is no separate limit on purchase of goods and services using PPIs. Banks can allow cash withdrawals on their issued PPIs. Cash withdrawal from such PPIs at PoS devices is permitted up to ₹2,000/- per transaction, and monthly limit of ₹10,000/- across all locations (Tier 1 to 6 centres).

3) Specific categories of PPIs: Only following specific categories of PPIs are permitted to be issued.

a) Gift PPIs - Prepaid gift instrument of maximum ₹10,000/- are permitted. These are not reloadable. Cash-out or funds transfer are not permitted. Funds may be transferred to the account from where it was loaded, after receiving consent of the PPI holder. KYC details of the purchaser shall be maintained. Separate KYC is not required for issuing the instrument against debit bank accounts and/ or credit cards in India. Number of such instruments to be issued to a customer, transaction limits, etc. should be decided on risk based approach. These can be revalidated on request of the PPI holder.
b) PPIs for Mass Transit Systems (PPI-MTS) – These are issued by authorised MTS operators. These shall contain the Automated Fare Collection application related to transit service to qualify as such. These shall be used, apart from for MTS, at those merchant outlets whose activities are allied / related to or are carried on within premises of the MTS. The issuer may decide about customer details, if any, required to be obtained for issuance of such PPIs. These shall be reloadable and maximum value in such PPIs shall not exceed ₹3,000/-. Cash-out or refund or funds transfer shall not be permitted. These PPIs shall be revalidated (including through issuance of new instrument) as and when requested by the PPI holder.

4) Interoperability:
Interoperability is the technical compatibility that enables a payment system to be used in conjunction with other payment systems.
a) NPCI and card networks shall facilitate participation by PPI issuer in UPI and card networks. Where PPIs are issued in the form of wallets, interoperability across PPIs shall be enabled through UPI. Where PPIs are issued in the form of cards (physical or virtual), the cards shall be affiliated to the authorised card networks. PPI-MTS shall remain exempted from interoperability, while Gift PPI issuer (both banks and non-banks) have the option to offer interoperability. PPI issuer must give the holders of full-KYC PPIs (KYC-compliant PPIs) interoperability through authorised card networks and UPI, as applicable. Interoperability shall be mandatory on the acceptance side as well, with QR Codes in all modes were to be so by end-March 2022.
b) All new PPIs issued in the form of cards should be EMV Chip and PIN compliant. Gift PPIs may continue to be issued with or without EMV Chip and PIN enablement.

5) Deployment of money collected:
a) For the schemes operated by banks, the outstanding balance shall be part of the ‘net demand and time liabilities’ for the purpose of maintenance of reserve requirements.
b) To ensure timely settlement, the non-bank PPI issuer is required to maintain the outstanding balance in an escrow account with any scheduled commercial bank. An additional escrow account may be maintained with a different scheduled commercial bank at the discretion of the PPI issuer. The same auditor shall be employed to audit both escrow accounts. Non-bank PPI issuer that is member of Centralised Payment Systems operated by RBI shall maintain a Current Account with RBI.

6) Validity and redemption:
   a) All PPIs shall have a minimum validity period of one year from the date of last loading / reloading in the PPI. PPIs can be issued with a longer validity as well. The PPI Issuer shall clearly indicate the expiry period of the PPI to the customer at the time of issuance of PPIs. In case of PPIs issued in the form of card (with validity period mentioned on the card), the customer shall have the option to seek replacement of the card. The holders of PPIs shall be permitted to redeem the outstanding balance in the PPI, if for any reason the scheme is being wound-up or is directed by RBI to be discontinued.
   b) PPI holder should be intimated during the 45 days' period prior to expiry of the validity period of the PPI. In case the PPI holder approaches the PPI issuer for refund of such amount, at any time after the expiry date of PPI, then the same shall be paid to the PPI holder in a bank account. PPIs with no financial transaction for a consecutive period of one year shall be made inactive by the PPI issuer after sending a notice to the PPI holder/s. These can be reactivated only after validation and applicable due diligence. These PPIs shall be reported to RBI separately.

7) Transactions limits:
   The PPI holder is allowed to use the PPI for purposes within the overall PPI limit applicable.

8) Handling refunds:
   a) Refunds in case of failed / returned / rejected / cancelled transactions shall be applied to the respective PPI immediately, to the extent that payment was made initially by debit to the PPI, even if such application of funds results in exceeding the limits prescribed for that type/ category of PPI.
   b) Refunds in case of failed / returned / rejected / cancelled transactions using any other payment instrument shall not be credited to PPI.

9) Security, fraud prevention and risk management framework:
   a) Adequate information and data security infrastructure and systems for prevention and detection of frauds should be in place.
   b) There should be Board approved Information Security policy for the safety and security of the payment systems operated by it, and implement security measures in accordance with this policy to mitigate identified risks. Various measures specified by RBI should be put in place. These may include restricting multiple invalid attempts, two-factor authentication for debits, customer induced options for restricting number of transactions, value for each type of transactions, etc.
   c) There should be systems to prevent multiple purchases of PPIs at different locations, leading to circumvention of limits. In case of full-KYC PPIs issued by scheduled commercial banks for government departments, the limit of Rs.2,00,000/- shall be for each PPI, provided the PPIs are issued for expenses of the concerned government department and the loading is from the bank account of the government department.

10) Customer protection and grievance redressal framework:
   a) All-important terms and conditions in clear and simple language should be disclosed to the holders while issuing the instruments.
   b) A formal, publicly disclosed customer grievance redressal framework should be in place. This should have at the minimum the prescribed elements.
   c) PPI issuer shall create sufficient awareness and educate customers in the secure use of the PPIs, including the need for keeping passwords confidential, procedure to be followed in case of loss or theft of card or authentication data or if any fraud/ abuse is detected, etc.
   d) Option should be provided to the PPI holders to generate/ receive account statements for at least past 6 months. Additionally, the PPI issuer shall provide transaction history for at least 10 transactions.
   e) In case of PPIs issued by banks and non-banks, customers shall have recourse to the Reserve Bank - Integrated Ombudsman Scheme, 2021 for grievance redressal.
   f) PPI issuer shall ensure transparency in pricing and the charge structure as prescribed by RBI.

11) Limiting liability of customers in unauthorised electronic payment transactions in PPIs issued by banks and non-banks:
   a) For banks, the norms related to liability of customers as per RBI circulars DBR.No.Leg.BC.78/09.07.005/2017-18 dated July 6, 2017 or DCBR.BPD.(PCB/RCB). Cir.No.06/12.05.001/2017-18 dated December 14, 2017, on Customer Protection – Limiting Liability of Customers in Unauthorised Electronic Banking Transactions will be applicable.
   b) For PPI related norms, electronic payment transactions have been divided into two categories:
      i) Remote / Online payment transactions: Transactions that do not require physical PPIs to be presented at the point of transactions e.g. wallets, card not present (CNP) transactions, etc.; and
      ii) Face-to-face / Proximity payment transactions: Transactions that require physical PPIs to be present at the point of transactions e.g. transactions at ATMs, PoS devices, etc.

12) Foreign Exchange PPIs:
   Entities authorised under FEMA to issue foreign exchange denominated PPIs shall be outside the purview of these norms.

29.1.7 Certain Common Aspects Related to Card Products

1) At the time of issue / re-issue, all cards (physical and virtual) shall be enabled for use only at contact based points of usage [viz. ATMs and Point of Sale (PoS) devices] within India. Issuers shall provide cardholders a facility for enabling card not present (domestic and international) transactions, card present (international) transactions and contactless transactions,

2) Existing cards which have never been used for online (card not present) / international / contactless transactions shall be mandatorily disabled for this purpose.
3) The issuers shall provide to all cardholders:
   a) Facility to switch on / off and set / modify transaction limits (within the overall card limit, if any, set by the issuer) for all types of transactions – domestic and international, at PoS / ATMs / online transactions / contactless transactions, etc.
   b) This may be provided on a 24x7 basis through multiple channels - mobile application / internet banking / ATMs / Interactive Voice Response (IVR); this may also be offered at branches / offices.
   c) Alerts / information / status, etc., should be sent through SMS / e-mail, as and when there is any change in status of the card.
   d) Contactless mode transaction at Points of Sale (PoS) terminals – require additional factor authentication (AFA) for value above ₹ 5,000/-.
   e) The customer at his option may use contactless or contact mode of transaction.
   f) Banks may, based on the approval of their Board, provide cash withdrawal facility at PoS terminals, without obtaining RBI approval.
   g) Banks may extend the facility of withdrawal of cash at any merchant establishment designated by them after a due diligence process.
   h) The designated merchant establishments should clearly display the availability of this facility along with the charges, if any.
   i) Cash withdrawal to be available irrespective of whether the card holder makes a purchase or not.
   j) Limits for cash withdrawal at PoS devices enabled for all debit cards/open loop prepaid cards issued by banks: ₹ 1000/- per day in Tier I and II centres and ₹ 2,000/- per day in Tier III to VI centres.
   k) Customer charges, if any, on such cash withdrawals should not be more than 1% of the transaction amount.

29.2 ELECTRONIC REMITTANCES – NEFT, RTGS, IMPS, UPI

Over last few decades there have been significant developments in domestic remittances of funds. Four major remittance systems in India are:

i. National Electronic Funds Transfer (NEFT) System
ii. Real Time Gross Settlement System (RTGS)
iii. Immediate Payment Services
iv. United Payment Interface

29.2.1 National Electronic Funds Transfer (NEFT) System

National Electronic Funds Transfer (NEFT) is a nation-wide centralised payment system owned and operated by the Reserve Bank of India (RBI).

1) *Definitions:*
   a) "NEFT Clearing Centre" means any office designated by the Nodal Department for receiving, processing and sending the NEFT SFMS message and the debiting and crediting of accounts of the participating banks and institutions for settlement of payment obligations.

b) "NEFT Service Centre" means an office or branch of a bank in a centre designated by that bank to be responsible for processing, sending or receiving NEFT SFMS message on behalf of that bank in that Centre.

c) "Funds Transfer" means the series of transactions beginning with the issue of originator's payment instruction to the sending bank and completed by acceptance of payment instruction by the beneficiary's bank for the purpose of making payment to the beneficiary of the instruction.

d) "Notified" means communicated electronically or in writing.

e) "Payment Instruction" means an unconditional instruction issued by an originator in writing or transmitted electronically to a sending bank to effect a funds transfer for a certain sum of money expressed in Indian Rupees, to the designated account of a designated beneficiary by debiting correspondingly an account of the originator or through remittance of cash.

f) "Settlement Account" means an account maintained by a participating bank or institution for the purpose of settlement of payment obligations under the NEFT System.

g) "Valid Reasons of Non-payment" are the reasons due to which the beneficiary bank fails to or cannot make payment to the beneficiary. Some illustrative reasons are:

   i) Beneficiary not having an account with the beneficiary bank

   ii) Account number indicated in the payment instruction not matching with the number as recorded at the beneficiary bank.

   iii) Dislocation of work due to circumstances beyond the control of the beneficiary bank such as earthquake, fire, etc., at the place where the beneficiary's account details are maintained, etc.

   iv) Any other valid reason preventing passage of the credit – such as a court order restraining operations on the beneficiary’s account. The reason shall be explicitly indicated.

h) "SFMS Message" means an electronic Structured Financial Messaging Solution (SFMS) message containing a batch of payment instructions for funds transfer, processed and consolidated in the manner specified for transmission of payment instructions and communication related thereto.

i) "IFSC" means Indian Financial System Code used to identify a participating bank branch in the NEFT SFMS message.

2) *Procedure for Participation*:

A participating organization may be a bank, and non- banks like PPI Issuers, Card Networks and White Label ATM Operators. The participant should be a member of the Real Time Gross Settlement (RTGS) System, should have installed SFMS, and meet other eligibility criteria. RBI issues a letter of admission to every bank/ non-bank participant, on an application being made by it.

3) *Request for NEFT by Customer*:

a) The payment instruction given by the sender/ originator shall be in compliance with the provisions contained in Rights and Obligations of customer.

b) On the sending bank accepting a payment instruction issued by the sender the transaction is initiated.

c) Remittances to multiple beneficiaries are treated as separate instructions.
d) The essential elements of beneficiary's identification in the instruction are: Beneficiary's Name; Beneficiary's Branch Name; Beneficiary's Bank Name; Beneficiary's Account Type; Beneficiary's Account No.; Beneficiary's Branch IFSC.
e) The cut-off timings up to which it shall receive the NEFT application forms from its customers for different settlements and the likely timings of the settlements by the NEFT Clearing Centre should be displayed.
f) In order to facilitate cash remittances through NEFT up to ₹50,000/- for persons who are not having account with the originating bank, the originating banks are required to collect the full details of remitters, including complete address and telephone number, etc., in order to comply with the Wire Transfer Guidelines. These details should be filled in the sender's details fields.
g) In order to facilitate workers' remittances from India to Nepal for bank customers and persons not having bank accounts in India, Indo Nepal Remittance Facility Scheme has been introduced.
h) In case of payments towards Credit Card dues, customers would be required to furnish the 16-digit Credit Card Number as the beneficiary's account number, the beneficiary's account type as 52 and the beneficiary bank's IFSC will be the IFSC of the branch responsible for handing these card bill payments.

4) *Rights and Obligations of Sender Bank*:
a) The Bank shall execute a payment instruction issued by the customer, only after due verification with reference to the security procedure for its authenticity.
b) The sending bank shall therefore ensure that such remittances are eligible to be credited to NRE accounts in India under the said Act and guidelines. In such cases, the account type number 40 is to be used to enable the beneficiary bank to identify that the funds proposed to be credited to the beneficiaries" account represent foreign inward remittance / eligible to be remitted abroad.
c) If the funds transfer is not complete before end of the particular NEFT batch timing as specified by the customer, the bank shall advise the customer.
d) The sending bank shall, upon completion of funds transfer of a payment instruction, furnish to the originator on request by him, a duly authenticated record of the transaction.
e) The participating banks shall reconcile the transactions on a daily basis with reference to the settlements / settlement details made available by the NEFT centre and the bank account details by RBI, DAD, Mumbai.

5) *Rights and Obligation of Beneficiary Bank:*
a) The beneficiary bank shall execute the payment instruction within two hours of batch settlement (B+2) on the NEFT working day unless it notices one or more of the following deficiencies – The beneficiary bank has no such account number as mentioned in the payment instructions; The beneficiary bank is bound by instructions of the beneficiary not to give or receive any credit to the account; No credit could be afforded to the beneficiary's account for any other reasons.
b) The beneficiary bank shall return the funds and the reasons for the return as per the NEFT procedure, where credit cannot be afforded.

c) For any delay, beneficiary bank is liable to pay penalty (at the rate RBI LAF Repo rate plus two percent). Payment of penal interest shall be made to customer even if no claim is lodged by the customer to that effect.

6) *Other Norms of RBI*:

a) Banks shall not levy any charges from their savings bank account holders for funds transfers done through NEFT system which are initiated online (viz. internet banking and/or mobile apps of the banks).

b) Where the customer has provided both the IFS Code as well as branch details of the beneficiary branch, the bank should ensure that these details match. In case of any mismatch, the same may be brought to the notice of the customer for rectification before originating the transaction.

c) NEFT has been made available for 24 x 7 with 48 half-hourly batches every day. The settlement of first batch commences after 00:30 hours and the last batch ends at 00:00 hours. The system is available on all days of the year, including holidays.

d) NEFT transactions after usual banking hours of banks are expected to be automated transactions initiated using 'Straight Through Processing (STP)' modes by the banks.

e) The discipline for crediting beneficiary's account or returning the transaction (within 2 hours of settlement of the respective batch) to originating bank continues.

f) Banks to include remitter and beneficiary LEI information in RTGS and NEFT payment messages system for all payment transactions of value ₹50 crore and above undertaken by entities (non-individuals) using Reserve Bank-run Centralised Payment Systems viz.Real Time Gross Settlement (RTGS) and National Electronic Funds Transfer (NEFT). The Legal Entity Identifier (LEI) is a 20-digit number used to uniquely identify parties to financial transactions worldwide. It was conceived as a key measure to improve the quality and accuracy of financial data systems for better risk management post the Global Financial Crisis. Entities can obtain LEI from any of the Local Operating Units (LOUs) accredited by the Global Legal Entity Identifier Foundation (GLEIF). In India, LEI can be obtained from Legal Entity Identifier India Ltd. (LEIL) (https://www.ccilindia-lei.co.in).

g) Banks should have system to ensure positive confirmation is sent to the originator. Such confirmation messages should be sent as soon as the beneficiary account is credited, but it should not exceed beyond end-of-the-day under any circumstance.

h) Responsibility to provide correct inputs in the payment instructions, particularly the beneficiary account number information, rests with the remitter/ originator. The beneficiary's name shall be compulsorily mentioned in the instruction request, and carried as part of the funds transfer message, reliance will be only on the account number for the purpose of affording credit. This is applicable both for transaction requests emanating at branches and those originated through the online/ internet delivery channel. The name field in the message formats will, however, be a parameter to be used by the destination bank based on risk perception and/ or use for post-credit checking or otherwise. Originating banks may put in place an appropriate maker-checker system to ensure that the account number information furnished by their customers is correct and free from errors.

29.2.2 Real Time Gross Settlement System (RTGS):

Real Time Gross Settlement, which can be explained as a system where there is continuous and real-time settlement of fund-transfers, individually on a transaction by transaction basis (without netting). The RTGS System set up, operated and maintained by the RBI comprises the RTGS application, the Inter-Bank Funds Transfer Processor (IFTP) application and the RTGS Member (RTGS Participant) Interface application. The RTGS and the IFTP applications will, for the purposes of this document, be referred to as the Central System jointly.

1) *Definitions*:
   a) 'Central System' means the hardware and software installed in a central location hosting RTGS application to process and to settle the funds transfer requests received from the members. The Central System will be operated and managed by the Bank.
   b) ‘E-Kuber’ means Core Banking Solution of the Bank maintaining current accounts of the banks, Governments and other institutions / entities.
   c) 'Host system' means members own system like Core Banking Solution (CBS) system or similar kind of application.
   d) ‘INFINET’ means the Indian Financial Network, the communication backbone.
   e) 'Inter-institutional transaction' means a funds transfer between two RTGS System members / participants.
   f) 'Interface' means the utility (software application) which helps to interact between member’s host system and Member Interface of the RTGS System, 2013.
   g) 'Member' means an entity admitted by the Bank to access the RTGS System.
   h) 'Member Interface (MI)' means the hardware and software component installed at the member’s/participant's end connecting with the Central System.
   i) 'Multilateral Net Settlement Batch (MNSB)' means a settlement file containing the net funds positions (receivable / payable) of clearing members emanating from various payment systems having current account / settlement account with RBI.
   j) 'Own Account Transfer' means transfer of funds between member's current account and settlement account maintained with the Bank.
   k) ‘RTGS’ system means system which facilitates on-line real time settlement of payments either on gross basis or through Multilateral Settlement Batches, received from the members.
   l) 'Settlement Account' means an account opened with the Bank by members of RTGS to facilitate settlement of transactions.
   m) ‘SFMS’ means the Structured Financial Messaging Solution provided by IDRBT.
   n) ‘SWIFT’ means the messaging system provided by the Society for Worldwide Interbank Financial Telecommunication.
   o) ‘System Operator’ means the Bank which will operate and manage the CenCentral System.
   p) ‘UTR Number/ Transaction Identification’ means Unique Transaction Reference Number that identifies a transaction uniquely.
2) *Procedure for Participation*:
   The access to the RTGS System will be decided on the basis of Access Criteria guidelines issued by the Bank. These mainly include - Membership of the Indian Financial Network

(INFINET) / SFMS / domestic SWIFT network; Maintaining a current account with RBI with sufficient liquidity; and Maintaining Subsidiary General Ledger (SGL) account with RBI. A participating organization may be a bank, and non- banks like PPI Issuers, Card Networks and White Label ATM Operators. RTGS has four types of membership categories, of which, banks fall under Type A i.e. Regular Participant.

3) *Types of Transactions*:

   The RTGS System processes following types of transactions:

   a) Inter-institutional/ inter-bank transaction – Funds transfer purely between two RTGS members.
   b) Customer transaction – Funds transfer / receipt on behalf of the customer.
   c) Government transaction – Funds transfer/receipt on behalf of Government Accounts.
   d) Multilateral Net Settlement Batch (MNSB) – The file containing net settlement position of clearing participants of an ancillary payment system managed by a clearing house.
   e) Delivery versus Payment (DvP) – A transaction involving funds in one leg against delivery of securities on the other leg. (A securities settlement mechanism that links a securities transfer and a funds transfer so as to ensure that delivery occurs if and only if the corresponding payment occurs.)
   f) Own Account Transfer (OAT) – Transfer of funds by a member between RTGS settlement account and the current account maintained with the Bank.
   g) Return Payment Transaction – Credit transfer received by a participant through RTGS that could not be credited to an account specified in the message to be returned to sending member.

4) *Information in RTGS Transaction*:

   a) In RTGS Message: In R41 message format, banks should capture the details of sender and receiver information as per wire transfer guidelines. In a STP environment, standardization is necessary and uniformity in message format is a pre requisite for the success. Information in field tag no. 5500 and 5561 should be provided uniformly by all banks.
   b) In Passbook/ Statement of Accounts: A bank customer receiving RTGS credit shall be provided with the name of the remitter in his account statements / pass book. A bank customer sending a RTGS remittance shall be provided with the name of the beneficiary in his account statements / pass book.
   c) Information on ‘Return’ Transactions: To provide the description – “RTGS – Return” in the passbook/ statement of account. This also applies to NEFT transactions.

5) *Hybrid feature*:

   From the priority point of view, the RTGS system can handle two types of payments: Urgent Payments and Normal Payments. This is indicated in the field ‘InstrPrty’ The urgent payments are processed as soon as they are received by the RTGS and using as much liquidity as required from the settlement account of the sending Participant. The normal payments are processed differently, following certain strict rules, and settle only at periodic time intervals.

6) *Future Value Transactions*:

It allows Participants to send RTGS payments which are not submitted for settlement immediately, but at a later date. The value date must be within a certain time period which is controlled by system parameter of the application (3 working days). If the value date is set on a non-working date, the payment will be rejected immediately. A future value dated transaction can be manually canceled at any time, as long as the status is 'FUTURE'.

7) *Positive Payment Confirmation*:
   The positive confirmation feature in RTGS is available for member banks wherein both remitter and beneficiary banks access RTGS, in a new message format (camt.059) to communicate an acknowledgement to the remitting bank containing the date and time of credit to beneficiary account. After receiving the positive confirmation from the beneficiary bank, the remitter bank shall initiate an SMS and / or generate an e-mail to the remitter. All banks should to put in place systems to ensure STP based confirmation processing.
8) *Availability for 24x7:*
   RTGS is available for customer and inter-bank transactions round the clock, except for the interval between 'end-of-day' and 'start-of-day' processes, whose timings are broadcasted through the RTGS system. Banks need to provide RTGS round the clock to their customers. RTGS transactions undertaken after normal banking hours are expected to be automated using STP modes.
9) *Obligations of RTGS Members:*
   a) Install and operationalise the PI on its Payment Systems Gateway and the Disaster Recovery System therefor;
   b) Comply with the RTGS Regulations and RTGS (Membership) Business Operating Guidelines, 2004 and also with circular, order, notification, press release, instructions as may be issued by RBI;
   c) Not provide access to the PI to any other institution, including its own subsidiary;
   d) Maintain secrecy of information about other members, received by it in the course of the use of the RTGS System;
   e) Not misuse any information or document, which it may receive in the course of its participation in the RTGS system;
   f) Track continuously whether the payment transactions, submitted by it, have settled or not and if not settled, take necessary action for immediate settlement thereof;
   g) Be bound in all respects for all the transactions made by it with other members through the RTGS system;
   h) Ensure the use of the digital certificates in connection with the RTGS operations; and
   i) Furnish such information and documents as may be called for by the RBI from time to time.

29.2.3 Unified Payments Interface (UPI)

Unified Payments Interface (UPI) is a system that powers multiple bank accounts into a single mobile application (of any participating bank), merging several banking features, seamless fund routing and merchant payments into one hood. It also caters to the "Peer to Peer" collect request which can be scheduled and paid as per requirement and convenience. During April 2022, 5.58 Bn transactions of the aggregate value of ₹ 9.83 Tn were executed It was an all-time high as digital payments platforms are rising on month-on-month basis. If we look at the Y-O-Y data, in year 2021-22, UPI saw a 111% jump in volume of transactions and nearly 100% increase in transactional value as compared to previous year.

(a) Features of UPI:
Facilitates immediate money transfer through mobile device round the clock 24*7 and 365 days. Single mobile application for accessing different bank accounts. Single Click 2 Factor Authentication, yet provides seamless single click payment. Virtual address of the customer for Pull & Push provides additional security - since the customer is not required to enter the details such as Card no, Account number; IFSC etc. QR Code based payments facilitated. Best alternative to Cash on Delivery hassle, running to an ATM or rendering exact amount. Merchant Payment with Single Application or In-App Payments. Utility Bill Payments - Over the Counter Payments, QR Code (Scan and Pay) based payments. Facilitates Donations, Collections, and Disbursements Scalable. Enables raising Complaint from Mobile App directly.

(b) Participants in UPI:
UPI system comprises following players – Payment Service Providers; Banks of the users (i.e. account holders) availing the services; Merchants who receive payments through UPI; NPCI – the agency managing the UPI platform and system. Typically, in any transaction the PSPs of the payer and the payee may be different, as also the banks in which they have their accounts.

(c) Product Functionalities:
A. Financial Transactions: UPI supports the following financial transactions viz.

i. Pay Request: A Pay Request is a transaction where the initiating customer is pushing funds to the intended beneficiary. Payment Addresses include Mobile Number & MMID, Account Number & IFSC and Virtual ID
ii. Collect Request: A Collect Request is a transaction where the customer is pulling funds from the intended remitter by using Virtual ID.

B. Non-Financial Transactions: UPI supports following types of non-financial transactions on any PSP App viz.

i. Mobile Banking Registration (if the mobile number is registered with the Issuer bank for SMS alerts.)
ii. Generate One Time Password (OTP)
iii. Set/Change PIN
iv. Check Transaction Status
v. Raise Dispute/Raise query

UPI can be accessed on all platforms viz. Android / iOS – The Apps have been developed by members on Android 4.2.2 and above/ iOS 8.1 and above platforms.

(d) Using UPI Application Functioning:

i. For a user to be able to use UPI facility it requires one-time registration on the UPI App to be downloaded from the bank’s website or the App Store.

ii. User creates his/her profile in the UPI App by entering details like name, virtual id (payment address), password etc. and links his bank and account number with the virtual id.
iii. User generates a UPI – PIN using the credentials of the Debit card issued to him.

(e) Roles & Responsibilities of the System Players:

A. Roles & responsibilities of NPCI

i. NPCI owns and operates the Unified Payments Interface (UPI) platform
ii. NPCI prescribes rules, regulations, guidelines, and the respective roles, responsibilities and liabilities of the participants, with respect to UPI, also covering transaction processing and settlement, dispute management and clearing cut-offs for settlement.
iii. NPCI approves the participation of Issuer Banks, PSP Banks, Third Party Application Providers (TPAP) and Prepaid Payment Instrument issuers (PPIs) in UPI.
iv. NPCI provides a safe, secure and efficient UPI system and network facilitating online transaction routing, processing and settlement services to members participating in UPI.
v. NPCI can, either directly or through a third party, conduct audit on UPI participants and call for data, information and records, in relation to their participation in UPI.
vi. NPCI provides the banks participating in UPI access to system where they can download reports, raise chargebacks, update the status of UPI transactions etc.

B. Roles & responsibilities of PSP Bank

i. PSP Bank is a member of UPI and connects to the UPI platform for availing UPI payment facility and providing the same to the TPAP which in turn enables the end-user customers / merchants to make and accept UPI payments.
ii. PSP Bank, either through its own app or TPAP's app, on-boards and registers the end-user customers on UPI and links their bank accounts to their respective UPI ID.
iii. PSP Bank is responsible for authentication of the end-user customer at the time of registration of such customer, either through its own app or TPAP's app.
iv. PSP Bank engages and on-boards the TPAPs to make the TPAP's UPI app available to the end-user customers.
v. PSP Bank has to ensure that TPAP and its systems are adequately secure to function on UPI platform.
vi. PSP Bank is responsible to ensure that UPI app and systems of TPAP are audited to safeguard security and integrity of the data and information of the end-user customer including UPI transaction data as well as UPI app security
vii. PSP Bank has to store all the payments data including UPI Transaction Data collected for the purpose of facilitating UPI transactions, only in India.
viii. PSP Bank is responsible to give all UPI customers an option to choose any bank account from the list of Banks available on UPI platform for linking with the customer's UPI ID.
ix. PSP Bank is responsible to put in place a grievance redressal mechanism for resolving complaints and disputes raised by the end-user customer.

C. Roles & responsibilities of TPAP

i. TPAP is a service provider and participates in UPI through PSP Bank.
ii. TPAP is responsible to comply with all the requirements prescribed by PSP Bank and NPCI in relation to TPAP's participation in UPI.
iii. TPAP is responsible to ensure that its systems are adequately secure to function on the UPI platform.
iv. TPAP is responsible to comply with all applicable laws, rules, regulations and guidelines etc. prescribed by any statutory or regulatory authority in relation to UPI and TPAP's participation on the UPI platform including all circulars and guidelines issued by NPCI in this regard.
v. TPAP has to store all the payments data including UPI Transaction Data collected by TPAP for the purpose of facilitating UPI transactions, only in India
vi. TPAP is responsible to facilitate RBI, NPCI and other agencies nominated by RBI/ NPCI, to access the data, information, systems of TPAP related to UPI and carry out audits of TPAP, as and when required by RBI and NPCI
vii. TPAP shall facilitate the end-user customer with an option to raise grievance through the TPAP's grievance redressal facility made available through TPAP's UPI app or website and such other channels as may be deemed appropriate by the TPAP like email, messaging platform, IVR etc.

29.2.4 Immediate Payment Service (IMPS)

Immediate Payment Service (IMPS) was launched on 22nd November 2010. During April 2022, 471.620 mn transactions of the aggregate value of ₹444,669.88 crore were executed by the reporting entities.

(a) Basic Aspects:

i. IMPS provides robust and real time fund transfer which offers an instant, 24X7, interbank electronic fund transfer service that could be accessed on multiple channels like Mobile, Internet, ATM, SMS. Currently, on IMPS, 647 members are live which includes banks and PPIs.
ii. The eligible criteria for the Banks who can participate in IMPS is that the entity should have valid banking or prepaid payment instrument license from Reserve Bank of India to participate in IMPS.

(b) Objectives of IMPS:

i. To enable bank customers to use mobile instruments as a channel for accessing their banks accounts and remit funds.
ii. Making payment simpler just with the mobile number of the beneficiary.
iii. To sub-serve the goal of RBI in digitalisation of retail payments.
iv. To facilitate mobile payment systems earlier introduced to be inter-operable across banks and mobile operators in a safe and secured manner
v. To build the foundation for a full range of mobile based banking services.

(c) Participants in IMPS:

The participants in IMPS are as follows - Remitter (Sender); Beneficiary (Receiver); Banks; National Financial Switch - NPCI

(d) Product Features:

i. IMPS is an instant, 24*7 interbank electronic fund transfer service capable of processing - person to person, person to account and person to merchant remittances via mobile, internet and ATMs.

ii. It is a multichannel and multidimensional platform that makes the payments possible within fraction of seconds with all the standards and integrity maintained for security required for even high worth transactions.

iii. The per transaction limit on IMPS is maximum ₹ 5 lakh (for all channels except SMS and IVR).

iv. IMPS facilitates following types of transactions - Sending money; Receiving money; Beneficiary Account check functionality; Transaction status check functionality; and Foreign Inward Remittance

v. The charges for remittance through IMPS are decided by the individual member banks and PPIs.

(e) Pre-Requisites for Mobile Banking through IMPS:

i. Customer has to register with the mobile banking service of the bank, and obtain Mobile Money Identifier (MMID) (7-digit code) and MPIN from the bank. Generation of MMID is a One-time process. Each MMID is linked to a unique Mobile Number. Different MMIDs can be linked to same Mobile Number

ii. The App for mobile banking is required to be downloaded or the SMS facility may be used if the bank provides IMPS on SMS.

(f) Fund transfer/ Remittance:

i. It provides two modes of funds transfer -

   a. Using Mobile number & MMID (P2P) - The IMPS service Person-to-Person (P2P) funds transfer requires the Remitter customer to make funds transfer using Beneficiary Mobile Number and MMID. Both Remitter as well as Beneficiary need to register their mobile number with their respective bank account and get MMID, in order to send or receive funds using IMPS with this modality.

   b. Using Account number & IFS Code (P2A) - There may be cases where Remitter is enabled on Mobile Banking, but Beneficiary mobile number is not registered with any bank account. In such cases, Remitter shall not be able to send money to the Beneficiary using Mobile Number & MMID. Hence on the merit of the feedback received from the banking community as well as to cater the above mentioned need, the IMPS funds transfer has been made possible using Beneficiary account number and IFS code as well.

ii. IMPS transactions can also be initiated from ATMs and Internet banking channels. Authentication of the remitter while using the ATM channel is done through the ATM

Card + ATM PIN. In case of the Internet banking channel, the remitter is identified through User ID + Internet Banking Password/ Transaction Password.

iii. The limit as prescribed by the bank for these channels would apply while transferring money using either of these channels.

iv. While initiating an IMPS transaction using either ATM or Internet channel, mobile banking registration of the remitter is not mandatory. Similarly, for customers receiving money using account number/ IFSC, or AADHAAR number, mobile banking registration is not mandatory.

29.3 AUTOMATED TELLER MACHINE (ATM)

29.3.1 Basic Aspects of ATM Channel

1) An ATM provides customers of banks the facility of accessing their accounts for dispensing cash and to carry out other financial and non-financial transactions without the need to visit the bank branch.
2) In addition to dispensing cash, ATMs/ WLAs may offer many other services/ facilities to customers. Some of such services include: Account Information; Cash Deposit; Regular Bill Payment; Purchase of Re-load Vouchers for Mobiles; Mini / Short Statement Generation; PIN Change; and Request for Cheque Book.
3) The ATM/ ATM cum debit cards, credit cards and prepaid cards, as permitted by the issuer, can be used at ATMs for various transactions. The cards issued by banks in India can be used at any ATM / WLA in the country. For transacting at an ATM / WLA, the customer should traditionally have a valid card and Personal Identification Number (PIN). RBI has also allowed card-less withdrawals at ATMs.
4) A transaction carried out at an ATM of the card issuing bank is called an On-Us transaction. A transaction carried out at any other ATM is called an Off-Us transaction. For instance, if a card issued by bank A is used at an ATM of bank A then it is an On-Us transaction; if the card is used at a WLA or at an ATM of any other bank, the transaction is Off-Us.
5) A bank must offer to its savings bank account holders a minimum number of free transactions at ATMs as under:
    a) Transactions at a bank's own ATM (On-Us transactions) at any location: Minimum of five free financial transactions in a month, irrespective of the location of ATMs. All non-cash withdrawal transactions will be provided free.
    b) Transactions at any other banks' ATM (Off-Us transactions) at Metro locations (Bengaluru, Chennai, Hyderabad, Kolkata, Mumbai, and New Delhi): Minimum of three free transactions (including financial and non-financial transactions) in a month.
    c) Transactions at any other banks' ATM (Off-Us transactions) at non-Metro locations: Minimum of five free transactions (including financial and non-financial transactions) at other bank ATMs in a month.
    d) Transactions which fail on account of technical reasons like hardware, software, communication issues; non-availability of currency notes in the ATM; and other declines ascribable directly/ wholly to the bank/ service provider; invalid PIN/ validations; etc., shall not be counted as valid ATM transactions for the customer. Consequently, no charges therefor shall be levied.

e) Non-cash withdrawal transactions (such as balance enquiry, cheque book request, payment of taxes, funds transfer, etc.), which constitute 'on-us' transactions (i.e., when a card is used at an ATM of the bank which has issued the card) shall also not be part of the number of free ATM transactions.
f) Banks are permitted to charge to the customer ₹21 per transaction beyond the minimum number of free transactions permitted. Banks are allowed to charge other banks interchange fee of ₹17 for financial transactions and ₹6 for non-financial transactions.
g) The service charges for the following types of cash withdrawal transactions are to be determined by the banks themselves: cash withdrawal with the use of credit cards; cash withdrawal in an ATM located abroad.

6) All cards are now required to be EMV Chip and PIN cards.

29.3.2 ATM Cash-Bank Guidelines:

a) Cash should be loaded into ATM strictly under dual custody. Admin function should be properly done and the cash loaded should be correctly entered. Before and after cash loading, print cash scroll should be obtained from the ATM showing the number of notes.
b) Reconciliation of Cash at ATM account should be regularly done and the excess/shortage of physical should be recorded with detailed break up.
c) All ATMs shall be operated for cash replenishment only with digital One Time Combination (OTC) locks. Combination lock should be operated by two Officers with 4 digits each. Strict secrecy of the 4-digit code should be maintained and should not be divulged to any one including the other Officer/ATM Engineer. Hood key for the ATM should be kept in branch safe always.
d) While verifying the JP log if any entry for opening of cassettes is found, the same should be thoroughly investigated particularly if such entry relates to opening at odd hours.
e) Strict control on the activities of the ATM service Engineer should be kept. He should not be allowed access to the Cash cassettes. If such access is to be provided, the branch officials should open the ATM safe in his absence and only then the Engineer may be allowed access strictly in the presence of the branch official.
f) Banks should use lockable cassettes (in lieu of in open cash replenishment/ top-up cassettes) in their ATMs which shall be swapped at the time of cash replenishment. All the existing cassettes are required to be swapped by the lockable cassettes by end-March 2023.
g) Multiple points of cash withdrawal may be avoided and shall be restricted to one in each centre. However, metropolitan centres may have two points of cash withdrawal. Reconciliation of transactions shall be done between the bank, the service provider and its sub-contractors at least on a T+3 basis.
h) In the event of a dispute or the reporting of alleged / attempted breach of security / laid down procedures, access to video footage of the ATM may be provided to the service provider and its sub-contractors on request.

i) Banks should put in place an efficient digital records management system for data retrieval and reconciliation pertaining to cash activities at their ATMs.
j) Cash-out at any ATM of more than ten hours in a month will attract a flat penalty of ₹ 10,000/- per ATM. When the customer is not able to withdraw cash due to non-availability of cash in a particular ATM, it is reckoned as ‘cash-out’.
k) Failed transaction (for cash Withdrawal) - A ‘failed transaction’ is a transaction which has not been fully completed due to any reason not attributable to the customer such as failure in communication links, non-availability of cash in an ATM, time-out of sessions, etc. Where customer’s account debited but cash not dispensed - pro-active reversal (R) of failed transaction should be within a maximum of T + 5 days. For any delay compensation of ₹ 100/- per day of delay beyond T + 5 days, is paid to the credit of the account holder.

29.3.3 ATM – Safety Measures

a) All ATMs shall be grouted to a structure (wall, pillar, floor, etc.), except for ATMs installed in highly secured premises such as airports, etc. which have adequate CCTV coverage and are guarded by state / central security personnel.
b) Banks may have an e-surveillance mechanism at the ATMs to ensure timely alerts.
c) Implement security measures such as BIOS password, disabling USB ports, disabling auto-run facility, applying the latest patches of operating system and other softwares, terminal security solution, time-based admin access, etc.
d) Upgrading all the ATMs with supported versions of operating system.
e) The process flow should provide for the pin validation for every transaction, including balance enquiry facilitated through ATM.
f) As an additional safety measure, the time-out of sessions should be enabled for all screens/ stages of ATM transaction.

29.4 ONLINE BANKING, DIGITAL BANKING UNIT AND NEOBANKING

29.4.1 Online Banking

(a) General Aspects:

i. Online banking (or Internet banking or E-banking) allows customers of a financial institution to conduct financial transactions on a secure website operated by a banking institution.
ii. Online banking is now available through various channels viz. the Internet, Smartphones through Apps, through Social Media, or at the Kiosks of banks.
iii. Access to online banking is available on specific request of the customer to the bank. Customer is allotted a User ID and a password. Additional security is added by requiring another access factor like OTP sent through SMS on the registered mobile number.
iv. Banks offer wide range of services online - opening a new account, payment transactions for various purposes, Government payments (for taxes, fees, etc.), investments (in mutual funds, stock markets, commodity markets, etc.), or transfer to fixed deposits, etc. Also, transactions in foreign exchange can be conducted. Several

loan related transactions can also be done. Non-financial requests for cards, cheque books, etc. can also be made.

(b) RBI Guidelines – Technology Security:

RBI had issued fundamental guidelines on Internet Banking in 2001, these form the basic framework. There has since been certain enhancement in technological safety measures. Salient aspects of the guidelines are as mentioned below.

i. Bank should have a board approved Internet Banking Policy, fitting into the Information Technology and Information Security policy.
ii. There should be a network and database administrator.
iii. Information Security Division and the Information Technology Division to be separate.
iv. Logical access controls to data, systems, application software, utilities, telecommunication lines, libraries, system software, etc. should be in place.
v. The bank should use the proxy server type of firewall so that there is no direct connection between the Internet and the bank's system.
vi. All applications of banks should have proper record keeping facilities for legal purposes. It may be necessary to keep all received and sent messages both in encrypted and decrypted form.
vii. The Information Technology Act, 2000, in Section 3(2) provides for a particular technology (viz., the asymmetric crypto system and hash function) as a means of authenticating electronic record. Any other method used by banks for authentication is a source of legal risk.
viii. In Internet banking scenario there is very little scope for the banks to act on stop-payment instructions from the customers. Hence, banks should clearly notify to the customers the timeframe and the circumstances in which any stop-payment instructions could be accepted.
ix. Only such banks which are licensed and supervised in India and have a physical presence in India will be permitted to offer Internet banking products to residents of India.
x. Thus, both banks and virtual banks incorporated outside the country and having no physical presence in India will not, for the present, be permitted to offer Internet banking services to Indian residents.
xi. Overseas branches of Indian banks are permitted to offer Internet banking services to their overseas customers' subject to their satisfying, in addition to the host supervisor, the home supervisor.
xii. Hyperlinks from a bank's website should be confined to only those portals with which they have a payment arrangement or sites of their subsidiaries or principals.
xiii. Hyperlinks to bank's website from other portals are normally meant for passing on information relating to purchases made by bank's customers in those portals. Banks must follow the minimum recommended security precautions while dealing with request received from other websites, relating to customers' purchases.

(c) Security Measures – Online Banking:

i. Web applications should not store sensitive information in HTML hidden fields, cookies, or any other client-side storage.
ii. Re-establishment of any session after interruption should require normal user identification, authentication, and authorization.
iii. Strong server side validation should be enabled.
iv. Authentication practices for internet banking involve three basic "factors": Something the user knows (e.g., password, PIN); Something the user has (e.g., ATM card, smart card); and Something the user is (e.g., biometric characteristic, such as a fingerprint).
v. Based on mutual authentication protocols, customers could also authenticate the bank's web site through security mechanisms such as personal assurance messages/images, exchange of challenge response security codes and/or the Secure Sockets Layer (SSL) server certificate verification.
vi. Virtual keyboard should be implemented.
vii. Risk based transaction monitoring or surveillance process needs to be considered as an adjunct.
viii. An online session would need to be automatically terminated after a fixed period of time unless the customer is re-authenticated for the existing session to be maintained.
ix. Use of OTPs for various purposes like login, adding new payees, carrying out every transaction, should be adopted for added security. OTP timing out approach should be adopted.

(d) Internet Banking – Forex Transactions:

i. Banks can offer Internet based foreign exchange services, for permitted underlying transactions.
ii. Banks will remain responsible for secrecy, confidentiality and integrity of data.
iii. The data relating to Indian operations will be kept segregated.
iv. The data will be made available to RBI inspection/ audit as and when called for.
v. The services offered through Internet, for banks' customers on an Internet based platform for dealing in foreign exchange, should allow only reporting and initiation of foreign exchange related transactions, with the actual trade transactions being permitted only after verification of physical documents.
vi. Banks should comply with FEMA regulations for cross-border transactions.
vii. Use of internet banking for transactions not permitted under FEMA should be prevented.

29.4.2 Digital Banking

(a) Definitions:

i. Digital Banking: Digital Banking refers to present and future electronic banking services provided by a licensed bank for the execution of financial, banking and other transactions and/or orders/instruments through electronic devices/ equipment over web sites (i.e. online banking), mobile phones (i.e. mobile banking) or other digital channels as determined by the bank, which involve significant level of process automation and cross-institutional service capabilities running under enhanced technical architecture and differentiated business model / strategy.

ii. Digital Banking Segment: A Digital Banking Segment, for the purpose of disclosure under Accounting Standard 17 (AS-17), is a sub-segment of the existing 'Retail Banking' Segment which will now be sub-divided in to (i) Digital Banking and (ii) Other Retail Banking. The business involving digital banking products acquired by DBUs or existing digital banking products would qualify to be clubbed under this segment.

iii. Digital Banking Products: Digital banking products and services would generally mean those financial products/services whose designs and fulfillments have nearly end-to-end digital life cycle with the initial customer acquisition/ product delivery necessarily taking place digitally through self-service or assisted self-service.

iv. Digital Banking Unit (DBU): A specialised fixed point business unit/ hub housing certain minimum digital infrastructure for delivering digital banking products & services as well as servicing existing financial products & services digitally, in both self-service and assisted mode, to enable customers to have cost effective/ convenient access and enhanced digital experience to/ of such products and services in an efficient, paperless, secured and connected environment with most services being available in self-service mode at any time, all year round.

(b) General Permission:

i. Scheduled Commercial Banks (other than RRBs, PBs and LABs) with past digital banking experience are permitted to open DBUs in Tier 1 to Tier 6 centres.

ii. DBUs of the banks will be treated as Banking Outlets (BOs). The DBUs will be treated as opened in a centre from where the significant parts of its new business are proposed to be sourced, regardless of its physical location.

(c) Infrastructure and Resources:

i. Each DBU shall be housed distinctly, with the separate entry and exit provisions. They will be separate from an existing Banking Outlet.

ii. For front-end or distribution layer of digital banking, each bank would choose suitable smart equipment, such as Interactive Teller Machines, Interactive Bankers, Service Terminals, Teller and Cash Recyclers, Interactive Digital Walls, Document uploading, self -service card issuance devices, Video KYC Apparatus, secured and connected environment for use of own device for digital banking, Video Call / Conferencing facilities, to set up an DBU. These facilities can be insourced or outsourced while complying with relevant regulatory guidelines.

iii. The back-end including the Core Banking System and other back office related information systems for the digital banking products and services can be shared with that of the incumbent systems with logical separation.

iv. As the purpose of DBUs is to optimally blend digital infrastructure with 'human touch', remote or in situ assisted mode arrangements in right proportion should be planned and put in place by the banks.

(d) Products and Services:

i. Each DBU must offer certain minimum digital banking products and services, on both liabilities and assets side. The DBUs are expected to migrate to more structured and custom made products, by use of its hybrid and high quality interactive capabilities.

ii. Any product or service that can be provided digitally through internet banking or mobile banking can be provided in the DBU. Any product or service which a bank is not permitted to offer as per the provisions of Banking Regulation Act 1949, shall not be offered by the DBU.

iii. Digital Banking Customer Education: In addition to onboarding of customers in a fully digital environment, various tools and methods shall be used by DBUs to offer hands-on customer education on safe digital banking products and practices.

iv. This effort has to be clearly translated to incremental digital penetration of the financial services. The district where the DBU is located will be the catchment area for the purpose.

v. Digital Business Facilitator/ Business Correspondent: The banks will have the options to engage digital business facilitator/ business correspondents.

(e) Minimum Products and Services to be offered by DBUs:

i. Liability Products and services: (i) Account Opening: Saving Bank account under various schemes, Current account, Fixed deposit and Recurring deposit account; (ii) Digital Kit for customers: Mobile Banking, Internet Banking, Debit Card, Credit card and mass transit system cards; (iii) Digital Kit for Merchants: UPI QR code, BHIM Aadhaar, POS, etc.

ii. Asset Products and services: (i) Making applications for and onboarding of customer for identified retail, MSME or schematic loans. This may also include end to end digital processing of such loans, starting from online application to disbursal; (ii) Identified Government sponsored schemes which are covered under the National Portal.

iii. Digital Services: (i) Cash withdrawal and Cash Deposit only through ATM and Cash Deposit Machines respectively- no physical cash acceptance/disbursal across counters; (ii) Passbook printing / Statement Generation; (iii) Internet Banking Kiosk which may also include facilities to provide all/majority of services available on internet banking including indent and issuance/processing of Cheque Book request, receipt and online processing of various standing instructions of clients;(iv) transfer of funds (NEFT/IMPS support); (v) updation of KYC / other personal details, etc.; (iv) Lodging of grievance digitally and acknowledgement thereof and also tracking of resolution status; (v) Account Opening Kiosk; (vi) Kiosk with e-KYC/ Video KYC; (vii) Digital onboarding of customers for schemes such as Atal Pension Yojana (APY); Insurance onboarding for Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY) and Pradhan Mantri Suraksha Bima Yojana (PMSBY).

29.4.3 Neobanking

Neobanks - also known as online banks, digital banks, internet-only banks, virtual banks, or even “challenger banks” - are changing the financial services landscape.

A neobank (also known as an online bank, internet-only bank, virtual bank or digital bank) is a type of direct bank that operates exclusively online without traditional physical branch networks. There are two main types of companies that provided services digitally: - (i) companies that have their own banking license and (ii) companies in a relationship with a traditional bank to provide those financial services. The former were called challenger banks and the latter were called neobanks.

This more open landscape has meant new fintech firms have been able to securely access customer account data that was previously the sole preserve of traditional banks. This has allowed neobanks to thrive. These are institutions without physical branches, where customers organise their finances entirely via digital channels. Their lower overheads mean they frequently out-compete traditional banks regarding the fees they charge customers and in terms of their agility.

Certain neobanks like Atom Bank, Tandem Bank and Starling Bank have acquired banking licence though they offer mobile-only services. They are therefore in a position to offer wider service range. There are on the other hand firms like N26 that partnered with another bank to offer their financial services and later graduated to obtaining a banking licence itself.

In India several fintech companies are offering certain financial services in digital mode though they have not entered the banking sector. Fintech that provides digital financial services is transforming the provision and delivery of financial services. Taken together, digital technology is changing the way financial services are organised and financial products are delivered. Because FinTech can improve the efficiency of intermediation by driving down costs, sachetising of products and services, improving customer service and expanding the reach of financial services, it poses a challenge to the incumbents and forces them to adapt or change the way financial intermediation takes place.

To foster innovation, the Reserve Bank has come out with enabling framework for Regulatory Sandbox with the objective of fostering orderly and responsible innovation in financial services, promoting efficiency and bringing benefit to consumers. A Reserve Bank Innovation Hub (RBIH) has been set up to promote innovation across the financial sector by creating an enabling ecosystem where academics, technology, finance and regulators are brought together.

29.5 LET US SUM UP

Card Payment Products: Banks issue several card products like debit cards, credit cards, and prepaid cards. These are smart cards both chip types and RFID types. Scheduled Commercial Banks (SCBs) other than Regional Rural Banks (RRBs) with net worth of ₹100 crore and above are permitted to undertake credit card business either independently or in tie-up arrangement with other card issuing banks/NBFCs with the approval of their Boards. The issue of unsolicited cards/ upgradation is strictly prohibited.

Prior approval of RBI is not necessary for banks desirous of issuing debit cards to their customers. The co-branded card shall prominently bear the branding of the card-issuer. Card-issuers may consider issuing card with advanced security features. Banks can issue PPIs after obtaining approval from RBI. Issuers are permitted to issue reloadable or non-reloadable PPIs depending upon the permissible type/ category of PPIs.

Electronic Remittance Systems: Four major remittance systems in India are: NEFT, RTGS, IMPS, and UPI.

NEFT is owned and operated by RBI. Banks, and non- banks like PPI Issuers, Card Networks and White Label ATM Operators can participate. The beneficiary bank shall execute the payment instruction within two hours of batch settlement (B+2) on the NEFT working day, if it is in order. RTGS System has been set up, operated and maintained by the RBI. RTGS handles Urgent Payments and Normal Payments. differently.

Unified Payments Interface (UPI) is a system that powers multiple bank accounts into a single mobile application (of any participating bank). It facilitates immediate money transfer through mobile device round the clock. Immediate Payment Service (IMPS) provides robust and real time fund transfer on multiple channels like Mobile, Internet, ATM, SMS.

Automated Teller Machine (ATM): A bank must offer to its savings bank account holders a minimum number of free transactions at ATMs. All cards are now required to be EMV Chip and PIN cards. Banks should henceforth use lockable cassettes (in lieu of in open cash replenishment/ top-up cassettes) in their ATMs which shall be swapped at the time of cash replenishment.

Online Banking/ Digital Banking/ Neobanking: Online banking is now available through various channels viz. the Internet, Smartphones through Apps, through Social Media, or at the Kiosks of banks. Banks are permitted to offer Internet based foreign exchange services, for permitted underlying transactions.

Digital Banking refers to present and future electronic banking services provided by a licensed bank for the execution of financial, banking and other transactions and/or orders/instruments through electronic devices/ equipment over web sites (i.e. online banking), mobile phones (i.e. mobile banking) or other digital channels as determined by the bank. A specialised fixed point business unit/ hub housing certain minimum digital infrastructure for delivering digital banking products and services as well as servicing existing financial products and services digitally, in both self-service and assisted mode. Scheduled Commercial Banks (other than RRBs, PBs and LABs) with past digital banking experience are permitted to open DBUs in Tier 1 to Tier 6 centres.

Neobanks are changing the financial services landscape. It is a type of direct bank that operates exclusively online without traditional physical branch networks. These are institutions without physical branches, where customers organise their finances entirely via digital channels.

29.6 KEY WORDS

Chip Type cards; RFID cards; Add-on cards; On-line Cards; Off-line Cards; Charge Card; Co-branded Card; Convenience Fee; Corporate Credit Card; Prepaid Payment Instruments (PPI); Closed System PPIs; Small PPIs; Annualized Percentage Rates (APR); Key Fact Statement; Credit Information Companies; Balance transfer; NEFT Clearing Centre; NEFT Service Centre; Payment Instruction; Settlement Account; Structured Financial Messaging Solution (SFMS) message; Straight Through Processing (STP); Legal Entity Identifier (LEI); Central System; E-Kuber; Host system; INFINET; Multilateral Net Settlement Batch (MNSB); Member Interface (MI); SWIFT; Positive Payment Confirmation; Virtual address; Pull transaction; Push transaction; National Financial Switch; Off-Us transactions; On-Us transactions; Lockable cassettes; Digital Banking; Neobanking; Digital Banking Unit (DBU); Interactive Teller Machines; Cash Recyclers; Interactive Digital Walls; Digital Services; Challenger banks; Virtual bank; Internet-only bank; Regulatory Sandbox;

29.7 CHECK YOUR PROGRESS

1) In debit cards the cash withdrawals permitted per day at PoS terminals in Tier III center is ------.
   a) ₹50,000
   b) ₹25,000
   c) ₹2,000
   d) Cash not allowed to be drawn

2) The beneficiary branches would make payment of NEFT remittance to the beneficiaries within two hours of batch settlement time by crediting the specified account of the beneficiary failing which the bank would be liable for penal interest at -----.
   a) RBI LAF Repo rate plus two per cent
   b) RBI LAF Repo rate plus five per cent
   c) Base rate plus two per cent
   d) Base rate plus five per cent

29.8 KEY TO 'CHECK YOUR PROGRESS'

1 (c); 2 (a)

References:

1. RBI Circular No. DoR.AUT.REC.No.27/24.01.041/2022-23 dated April 21, 2022 - Master Direction – Credit Card and Debit Card – Issuance and Conduct Directions, 2022 (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12300)
2. RBI Circular No. DPSS.CO.PD No.1343/02.14.003/2019-20 dated January 15, 2020 - Enhancing Security of Card Transactions (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11788)

3. RBI Circular No. DPSS.CO.PD.No. 147/02.14.003/ 2009-10 dated 22nd July 2009 - Cash Withdrawal at Point-of-Sale (POS)
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11802)
4. RBI Circular No. DPSS.CO.PD.No.501/02.14.003/2019-20 dated August 29, 2019 - Cash Withdrawal at Points-of-Sale (PoS) Devices
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11672)
5. RBI Circular No. DPSS.CO.PD No.1465/02.14.003/2019-20 dated January 31, 2020 - Cash withdrawal using Point of Sale (PoS) Terminals
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11802)
6. RBI Circular No. CO.DPSS.POLC.No.S-479/02.14.006/2021-22 dated August 27, 2021 (Updated as on November 12, 2021) - Master Directions on Prepaid Payment Instruments (PPIs)
(https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12156)
7. RBI FAQs - NEFT System - (Updated as on November 17, 2021)
(https://rbi.org.in/scripts/FAQView.aspx?Id=60)
8. RBI Circular No. DPSS (CO) RPPD No.1097/04.03.01/2019-20 dated December 6, 2019 - Availability of National Electronic Funds Transfer (NEFT) System on 24x7 basis
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11750)
9. RBI Circular No. DPSS.CO.OD No.901/06.24.001/2020-21 dated January 05, 2021 - Introduction of Legal Entity Identifier for Large Value Transactions in Centralised Payment Systems
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12010)
10. RBI Circular No. DPSS.CO.LVPD No.S290/04.04.009/2021-22 dated July 28, 2021 - Access for Non-banks to Centralised Payment Systems
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12133)
11. RBI Circular No. DPSS (CO) EPPD No.1199/04.03.01/2011-12 dated January 05, 2012 - Providing Positive Confirmation to the Originator – Non-adherence to RBI Instructions
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=6926)
12. RBI Circular No. DPSS (CO) EPPD No. / 863 / 04.03.01 / 2010-11 dated October 14, 2010 - Electronic payment products - Processing inward transactions based solely on account number information
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=6043)
13. RBI FAQs - RTGS System - (Updated as on January 7, 2021)
(https://rbi.org.in/scripts/FAQView.aspx?Id=65)
14. RBI Circular No. DPSS (CO) RTGS No. 1776 / 04.04.002 / 2008 – 2009 dated April 8, 2009 - RTGS Transactions
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=4918)
15. RBI Circular No. DPSS (CO) RTGS No. 341 / 04.04.002 / 2010-2011 dated August 13, 2010 - RTGS / NEFT Return Transactions – Information for Account Statement
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=5945)
16. RBI Circular No. DPSS (CO) RTGS No.2589/04.04.017/2013-14 dated June 20, 2014 - New features in RTGS System
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=8953)

17. RBI Circular No. DPSS (CO) RTGS No.1049/04.04.016/2018-19 dated November 15, 2018 - Real Time Gross Settlement (RTGS) System - Implementation of Positive Confirmation
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11414)
18. RBI Circular No. DPSS (CO) RTGS No.750/04.04.016/2020-21 dated December 04, 2020 24x7 - Availability of Real Time Gross Settlement (RTGS) System
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11998)
19. NPCI Website: UPI
(https://www.npci.org.in/what-we-do/upi/product-overview)
20. NPCI Website: IMPS
(https://www.npci.org.in/what-we-do/imps/product-overview)
21. RBI Circular No. DCM (RMMT) No.S153/11.01.01/2021-22 dated August 10, 2021 - Monitoring of Availability of Cash in ATMs
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12144)
22. RBI Circular No. DPSS.CO.PD No.629/02.01.014/2019-20 dated September 20, 2019 - Harmonisation of Turn Around Time (TAT) and customer compensation for failed transactions
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11693)
23. RBI Circular No. DPSS.CO.PD No. 377/02.10.002/2019-20 dated August 14, 2019 - Usage of ATMs – Free ATM transactions – Clarifications
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11661)
24. RBI Circular No. DPSS.CO.PD.No. 316/02.10.002/2014-2015 dated August 14, 2014 - Usage of ATMs – Rationalisation of number of free transactions
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=9170)
25. RBI Circular No. DPSS.CO.PD.No.659/02.10.002/2014-2015 dated October 10, 2014 Usage of ATMs – Rationalisation of number of free transactions– Clarifications
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=9276)
26. RBI Circular No. DPSS.CO.OD.No.S-182/06.07.011/2021-22 dated June 10, 2021 - Usage of Automated Teller Machines / Cash Recycler Machines – Review of Interchange Fee and Customer Charges
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12111)
27. RBI Circular No. DCM (Plg.)No.2968/10.25.007/2018-19 dated June 14, 2019 - Security Measures for ATMs
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11592)
28. RBI Circular No. DCM (Plg) No.2746/10.25.07/2018-19 dated May 14, 2019 - Outsourcing of Cash Management – Reconciliation of Transactions
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11556)
29. RBI Circular No. DBS(CO).CSITE/BC.5/31.01.015/2017-18 dated June 21, 2018 - Control measures for ATMs – Timeline for compliance
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11311)
30. RBI Circular No. DBOD.COMP.BC.No.130/ 07.03.23/ 2000-01 dated June 14, 2001 - Internet Banking in India -– Guidelines
(https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=414)

31. RBI Circular No. DBOD No. Comp.BC.14/07.03.29/2005-06 dated July 20, 2005 - Internet Banking in India – Guidelines (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=2379)
32. RBI Circular No. DGBA. GAD. No.H 3095/41.07.001/2005-06 dated October 06, 2005 - Providing E-payment Facilities to Tax Payers (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=2529)
33. RBI Circular No. DBOD No. Comp. BC. 1658 /07.23.29/2006-07 dated August 22, 2006 - Internet Banking - Internet based platforms for dealing in Forex (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=3070)
34. RBI Circular No. UBD.BPD.(SCB)Cir No. 1/09.18.300/2011-12 dated September 26, 2011 - Internet Banking for Customers of UCBs (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=6734)
35. RBI Circular No. A.P. (DIR Series) Circular No. 46 dated September 17, 2013 - Overseas forex trading through electronic / internet trading portals (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=8427)
36. RBI Circular No. DOR.AUT.REC.12/22.01.001/2022-23 dated April 7, 2022 - Establishment of Digital Banking Units (DBUs) (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=12285)
37. https://en.wikipedia.org/wiki/Neobank
38. https://www.worldfinance.com/banking/the-unstoppable-rise-of-neobanks
39. Responsible Digital Innovation – Dated Sep 28, 2021 (Speech by Shri T Rabi Sankar, Deputy Governor, Reserve Bank of India – Address to the Global Fintech Festival) (https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=1129)
40. Regulatory Sandbox – Announcement of Theme for Fourth Cohort and Review of Enabling Framework dated Oct 08, 2021 (RBI Press Release) (https://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=52371)
41. RBI Circular No. DPSS.CO.PD.No.449/02.14.003/2015-16 dated August 27, 2015 Cash Withdrawal at Point-of-Sale (POS) - Enhanced limit at Tier III to VI Centres (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=10004)

CHAPTER 30

FINANCIAL SERVICES

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Learn about various business activities of financial services
- Understand the prudential regulations regarding bank's investments
- Know about conditions for undertaking various financial services

30.1 FORMS OF BUSINESS

(a) Business of Financial Services:

The 'business of financial services' shall mean the following forms of business –

1) enumerated in clauses (a), (c), (d), (e) and notified under clause (o) of section 6(1) of the Banking Regulation Act, 1949;
2) enumerated in clause (c) and clause (f) of Section 45-I of Reserve Bank of India Act, 1934;
3) credit information under the Credit Information Companies (Regulation) Act, 2005;
4) operation of a payment system under the Payment and Settlement Systems Act, 2007;
5) operation of a stock exchange, commodity exchange, derivatives exchange or other exchange of similar nature;
6) operation of a depository under the Depositories Act, 1996;
7) securitisation or reconstruction company under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
8) merchant banker, portfolio manager, stock broker, sub-broker, share transfer agent, trustee of trust deeds, registrar to an issue, underwriter, debenture trustee, investment adviser and such other intermediary in the Securities and Exchange Board of India Act, 1992 and related regulations;
9) credit rating agency under the Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999;
10) collective investment scheme under the Securities and Exchange Board of India Act, 1992;
11) managing a pension fund;
12) an authorised person as defined under the Foreign Exchange Management Act, 1999; and
13) as may be specified by Reserve Bank from time to time.

(b) General Permission:

Unless specified otherwise by RBI, a bank may undertake the businesses permitted under Section 6(1) of the BR Act, 1949 either departmentally or through a separate subsidiary set up for the purpose.

(c) Activities undertaken Departmentally:

An activity undertaken departmentally shall be subject to the following conditions:

i. To have a comprehensive Board approved policy for the activity.
ii. The instructions/guidelines on KYC/AML/CFT shall be complied with.
iii. The general principles of the Charter of Customer Rights shall be adhered to.

iv. The specific conditions prescribed by RBI for the respective businesses shall be complied with in addition to the instructions of respective regulators.

(d) Other Definitions:

i. Assignee: means an assignee as defined in the Factoring Regulation Act, 2011.
ii. Assignor: means an assignor as defined in the Factoring Regulation Act, 2011.
iii. Associate: means an associate as defined in terms of the Accounting Standards of the Institute of Chartered Accounts of India.
iv. Debtor: means a debtor as defined in the Factoring Regulation Act, 2011.
v. Factoring: means factoring as defined in the Factoring Regulation Act, 2011.
vi. Financial Services Company: means a company engaged in the 'business of financial services'.
vii. Government Securities: means securities as defined in the Government Securities Act, 2006.
viii. Hire Purchase: means hire purchase as defined in the Hire Purchase Act, 1972.
ix. Infrastructure Debt Fund: means an infrastructure debt fund as defined in the Notification no. DNBS.233/CGM (US)-2011 dated November 21, 2011, as amended from time to time.
x. Investment Advisory Service: means the service offered by a investment adviser as defined in the SEBI (Investment Advisers) Regulations, 2013.
xi. Joint Venture: means a joint venture as defined in terms of the Accounting Standards of the Institute of Chartered Accountants of India.
xii. Mutual Fund: means a fund as defined in SEBI (Mutual Funds) Regulations, 1996.
xiii. Non-Financial Services Company: means a company not engaged in any of the business mentioned in Section 3(vi) of these Directions.
xiv. Pension Fund Management: means management of a pension fund as defined in the Pension Fund Regulatory Development Authority (Exit and Withdrawals under National Pension System) Regulations, 2014.
xv. Portfolio Management Services: means the service offered by a portfolio manager as defined in the SEBI (Portfolio Managers) Regulations, 1993.
xvi. Referral Services: means the arrangement between a bank and a third party financial product provider, for referring the customers of the bank to the third party financial product provider.
xvii. Significant Influence: means significant influence as defined in terms of the Accounting Standards of the Institute of Chartered Accountants of India.
xviii. Sponsor Bank: means any bank that sets up a separate entity for conduct of certain financial activity.
xix. Subsidiary: means a subsidiary as defined in terms of the Accounting Standards of the Institute of Chartered Accountants of India.

30.2 PRUDENTIAL REGULATION FOR BANKS' INVESTMENTS

Investment by a bank in a subsidiary or in a financial services company not being a subsidiary or a non-financial services company is subject to several conditions. Within the statutory ceilings and restrictions on the investments as per the BR Act, 1949, the RBI has stipulated prudential ceilings on investments in various financial-services and non-financial services providing entities. The banks need to adhere to these regulatory/ statutory ceilings.

Prior approval of RBI is required for following purposes:

1) Investment in a subsidiary and a financial services company that is not a subsidiary; except if -
    a) Investment is in a company engaged in financial services; and
    b) The bank has the minimum prescribed capital (including Capital Conservation Buffer) and has also made a net profit in the immediate preceding financial year; and
    c) The shareholding of the bank including the proposed investment is less than 10% of the investee company's paid up capital; and
    d) The aggregate shareholding of the bank along with shareholdings, if any, by its subsidiaries or joint ventures or other entities, directly or indirectly controlled by the bank, is less than 20% of the investee company's paid up capital.
2) Investment in a non-financial services company in excess of 10% of such investee company's paid up share capital.
3) Investment of more than 10% of the paid up capital/ unit capital in a Category I/ Category II Alternative Investment Fund.

    Banks shall ascertain the risks arising on account of equity investments in Alternative Investment Funds/ Infrastructure Debt Funds directly or through their subsidiaries, within the ICAAP framework and determine the additional capital required.

Relationship with Subsidiaries:

A parent/sponsor bank shall maintain an "arm's length" relationship with the subsidiary sponsored by it and evolve the following supervisory strategies:

a) The Board of Directors of the parent/sponsor bank shall review the working at periodical intervals.
b) The parent/sponsor bank shall undertake inspection/audit at periodical intervals.
c) The subsidiary shall not set up another subsidiary, or promote a new company which is not a subsidiary thereof, or undertake any new line of business without prior approval of RBI.
d) The subsidiary shall not make any portfolio investment in another existing company with an intention of acquiring controlling interest, without prior approval of the Reserve Bank. This shall not apply to the investments made by a VCF/AIF-I set up by a subsidiary.
e) A subsidiary shall not have any on-line access to customers' accounts maintained with the bank. The information between a bank and its subsidiary may be shared subject to maintaining arm's length relationship.
f) The bank shall not grant any unsecured advances to the subsidiary without prior approval of the RBI.
g) Transactions between a bank and its subsidiary shall be at arm's length.

30.3 CONDITIONS FOR SPECIFIC FINANCIAL SERVICES

1) Sponsoring of an Infrastructure Debt Fund (IDF):
   IDFs can be set up either as a IDF-MF or a IDF-NBFC, within Board approved limit for the overall infrastructure exposure including as sponsor of IDF.
2) Equipment Leasing and Hire Purchase Business:
   Can undertake this either departmentally or through a subsidiary, at its option and subject to the conditions applicable to each option.
3) Factoring Services:
   Can undertake this either departmentally or through a subsidiary, at its option and subject to the conditions applicable to each option.
4) Primary Dealership Business:
   Can undertake this either departmentally (with authorization from RBI-IDMD) or through a subsidiary (to be registered as NBFC), at its option and subject to the conditions applicable to each option.
5) Underwriting Activities:
   Can undertake underwriting of issues of shares, debentures and bonds either departmentally (with SEBI Registration as Merchant Banker) or through a subsidiary (as Merchant Banking subsidiary) at its option and subject to the conditions applicable to each option.
6) Mutual Fund Business:
   A bank shall undertake mutual fund business with risk participation only through a subsidiary/ joint venture set up for the purpose. If its name is lent to the bank sponsored mutual fund, a suitable disclaimer clause shall be inserted while publicising new schemes that the bank is not liable or responsible for any loss or shortfall.
7) Insurance Business:
   Insurance business with risk participation through a subsidiary/joint venture: A bank shall undertake insurance business with risk participation only through a subsidiary/joint venture set up for the purpose, and on fulfillment of the eligible criteria.
   a) Undertaking of insurance broking/ corporate agency by a subsidiary/joint venture: A bank shall set up a subsidiary/joint venture company for undertaking insurance broking and corporate agency only if it fulfils the prescribed eligibility criteria.
   b) Insurance broking services departmentally: A bank may, at its option, act as an insurance broker departmentally subject to the prescribed conditions for insurance agency business.
8) Pension Fund Management by Banks:
   A bank shall undertake business of pension fund management only through a subsidiary set up for the purpose, and on fulfillment of the eligible criteria, and subject to the prescribed conditions.
9) Investment Advisory Services:
   A bank shall undertake the business of investment advisory services (IAS) only through a separate subsidiary set up for the purpose or one of its existing subsidiaries. Specific prior approval shall be obtained before offering IAS. It shall be provided only for products and services in which banks are permitted to deal in as per the BR Act, 1949.
10) Portfolio Management Services:

A bank shall start or introduce any new portfolio management service (PMS) or similar scheme or set up a subsidiary for the purpose only with the approval of RBI. This activity is subject to certain regulatory norms.

11) Agency Business by Banks:

Agency business shall be undertaken only for the products and services in which a bank is permitted to deal in as per BR Act, 1949. The service shall be provided on fee basis, without any risk participation.

12) Referral Services:

Banks can offer referral services only for financial products other than insurance, on a non-risk participation basis.

13) Retailing of Government Securities:

Banks can undertake the business of retailing of Government Securities with non-bank clients subject to the Directions issued by RBI on the subject.

14) Membership of SEBI approved Stock Exchanges

AD Category I scheduled commercial bank shall become a trading/clearing member of the currency derivatives segment of the SEBI recognised stock exchanges on fulfilling prescribed criteria.

A bank shall become a Professional Clearing Member of the commodity derivatives segment of SEBI recognised exchanges only if it satisfies the prescribed prudential criteria and shall be subject to the prescribed conditions. These include having in place effective risk control measures, prudential norms on risk exposure, not undertake trading in the derivative segment of the commodity exchange on its own account, strict compliance with various margin requirements as stipulated.

15) Broking services for Commodity Derivatives Segment:

A bank shall offer broking services for the commodity derivatives segment of SEBI recognised stock exchanges only through a separate subsidiary set up for the purpose or one of its existing subsidiaries and shall do so subject to the prescribed conditions. The subsidiary shall not undertake proprietary positions in the commodity derivatives segments.

30.4 LET US SUM UP

Banks are permitted to undertake directly or indirectly several types of businesses under financial services. For the services that can be undertaken departmentally, prior permission of RBI is not required. Bank must have a Board approved policy for this purpose. The RBI regulations in addition to the concerned sectoral regulator viz. SEBI, PFRDA and IRDA will need to be followed.

Certain activities can be undertaken through a subsidiary. The investment in subsidiary is governed by certain prudential regulations. A parent/sponsor bank shall maintain an “arm’s length” relationship with the subsidiary sponsored by it. The bank shall not grant any unsecured advances to the subsidiary without prior approval of the Reserve Bank.

There specific conditions for following activities:

Sponsoring of an Infrastructure Debt Fund; Equipment Leasing and Hire Purchase Business; Factoring Services; Primary Dealership; Underwriting Activities; Mutual Fund; Insurance; Pension Fund Management; Investment Advisory; Portfolio Management; Agency Business; Referral Services; Retailing of Government Securities; Broking services for Commodity Derivatives Segment.

30.5 KEY WORDS

Payment system; Depository; Merchant banker; Portfolio manager; Underwriter; Debenture trustee; Investment adviser; Credit rating agency; Infrastructure Debt Fund; Investment Advisory Service; Pension Fund Management; Portfolio Management; Referral Services.

30.6 CHECK YOUR PROGRESS

1) A bank cannot undertake agency of ----.
   a) General Insurance Policy;
   b) Residential Properties
   c) Health Insurance Policy;
   d) Mutual Funds;

2) A bank cannot undertake ----- departmentally.
   a) Factoring,
   b) Stock broking,
   c) Equipment Leasing;
   d) Insurance Agency.

30.7 KEY TO 'CHECK YOUR PROGRESS'

1 (b); 2 (b)

References:

RBI Master Direction/DBR.FSD.No.101/24.01.041/2015-16 dated May 26, 2016 (Updated as on August 10, 2021) Master Direction- Reserve Bank of India (Financial Services provided by Banks) Directions, 2016

CHAPTER 31

FRAUD AND VIGILANCE FRAMEWORKS IN BANKS

STRUCTURE

OBJECTIVES

In this Chapter the learner will

- Know about the framework for frauds classification and reporting
- Learn about framework for loan frauds
- Understand about sale of financial assets of doubtful standard/ fraudulent origin
- Know about requirements for reporting cases of theft, burglary, dacoity
- Internal vigilance in banks

31.1 INTRODUCTION

The objectives of RBI directions on frauds classification are: enabling banks to detect and report frauds early; taking timely consequent actions; examining staff accountability; to manage fraud risk effectively; and faster dissemination of information by RBI to banks. A framework for loans related frauds has also been put in place.

Closely linked with frauds is the vigilance angle. The banks need to have a proactive vigilance function so that it has effective preventive vigilance measures.

31.2 FRAUDS - CLASSIFICATION AND REPORTING

General Management Norms

i. Chairmen and Managing Directors/Chief Executive Officers (CMD/CEOs) to provide focus on the Fraud Prevention and Management Function.
ii. CEO, Audit Committee of the Board and the Special Committee of the Board responsible for fraud risk management, fraud monitoring and fraud investigation function.
iii. Board should approve the policy for fraud risk management and fraud investigation function.
iv. FMR Returns should be promptly submitted. An officer of General Manager Grade to be responsible for ensuring submission.

Classification of frauds

For uniformity frauds are classified based mainly on the provisions of the Indian Penal Code:

a) Misappropriation and criminal breach of trust.
b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
c) Unauthorised credit facilities extended for reward or for illegal gratification.
d) Negligence and cash shortages (if intention to cheat/ defraud). But to report all cases of cash shortage of (i) more than ₹10,000/-, (including at ATMs)), and (ii) more than ₹5,000/- if detected by bank and not reported on the day of occurrence by the persons.
e) Cheating and forgery.
f) Irregularities in foreign exchange transactions (involving irregularities/ violations and if intention to cheat/ defraud is suspected).
g) Any other type of fraud not coming under the specific heads as above.

Reporting of Frauds to RBI on FMR

a) To furnish Fraud Monitoring Return (FMR) in individual fraud cases of any amount.
b) To report within three weeks of detection in XBRL System.
c) To send monthly certificate of submitting all the FMRs to CFMC, and SSM.
d) Fraud reports to be submitted for cases: (i) Where central investigating agencies have initiated criminal proceedings suo moto; (ii) Where the RBI has directed that such cases be reported as frauds.
e) Frauds at overseas branches/ offices of Indian banks are also to be reported.
f) Frauds in the subsidiaries/ affiliates/ joint ventures are reported in FMR format in hard copy only.
g) Any development in a fraud case is reported through the FMR Update Application.
h) Complete particulars are vital for monitoring and supervisory purposes and dissemination of information through Caution Advice/ Central Fraud Registry (CFR).
i) Failure to observe the prescribed timelines is penalized. Staff accountability for delays should be fixed.

Reports to the Board:
All frauds of ₹1.00 lakh and above should be reported to the Board promptly. The report should include the failure of the branch officials and controlling authorities, and action initiated against them. Periodical reports are also submitted to the Board/ Audit Committee of the Board (ACB).

1) Reports to the ACB:
   a) Quarterly Review of Frauds: A review containing details of frauds for the quarters ending June, September and December in the month following the quarter, with analytical statistical information.
   b) Copy of the circular on modus-operandi of fraud issued for alerting branches/ controlling offices etc., on specific frauds.
   c) Report on individual cases of attempted fraud involving ₹10 million and above covering - modus operandi; how the attempt failed/ was foiled; strengthening measures for systems/ controls; new systems and controls.
   d) Annual Review of Attempted Frauds: A review of the attempted frauds involving ₹10 million and above for the year-ended March is submitted before the June 30th. It should contain - area of operations affected, effectiveness of new processes/ procedures; trend during last three years, need for further changes, etc.
2) Annual Review of Frauds to the Board: An annual review of the frauds is submitted for the year-ended March before June 30th. The review should cover following aspects: (i) Systems capable of prompt detection of frauds; (ii) Staff angle examined and reported to Vigilance function; (iii) Deterrent punishment to the guilty person; (iv) Is laxity in systems/ procedure a cause? Action taken to ensure scrupulous adherence; (v) Reported to the local police/ CBI. The review contains data on frauds; analysis of frauds; and status of major frauds.

Special committee of the Board
Banks should constitute a Special Committee of the Board on Frauds (SCBF) for monitoring and follow up of cases involving amounts of ₹10 million and above.

a) Composition: Five Directors - consisting of MD & CEO/ MD, two members from ACB and two other members from the Board.
b) Periodicity of the meetings: Depending on the number of cases, and as and when a fraud involving an amount of ₹10 million and above comes to light.
c) (c) Major functions: To identify systemic lacunae and suggest measures to plug the same; To identify the reasons for delay in detection and reporting; To monitor progress of CBI/Police investigation and recovery position; To ensure prompt staff accountability examination and action; and to review efficacy of the remedial action/ internal controls.

Closure of Fraud cases

1) Report to RBI: Banks shall report to CFMC, RBI and the SSM (Senior Supervisory Manager) of RBI, the details of fraud cases of ₹0.1 million and above closed along with reasons for the closure.
2) Procedure for Closure: Only the cases where following steps are completed and SSM approval for closures is obtained should be closed.
   a) Cases filed with CBI/Police/Court are finally disposed of. Banks should vigorously pursue with these authorities.
   b) Staff accountability examination is completed.
   c) Amount has been recovered or written off.
   d) Insurance claim has been settled.
   e) Systems/ procedures have been reviewed; identified causative factors; plugged the lacunae and it is certified by the Board/ ACB.
3) Procedure for closure of cases upto ₹2.5 million: Closure permitted only for limited statistical/ reporting purposes – if the investigation is on or a challan/ charge sheet has not been filed for more than three years from filing of FIR by the CBI/Police or if the trial in the courts, after charge sheet/ challan by CBI/ Police, has not started or is in progress.
4) A bank should have policy for closure of fraud cases, incorporating various RBI norms.

Guidelines for Reporting Frauds to Police/ CBI:

a) In dealing with cases of fraud/embezzlement, banks should be motivated by the necessity of recovering the amount, by public interest, and ensuring that guilty persons do not go unpunished.
b) The following cases should be referred to the State Police or to the CBI as detailed below:

Category of bank	**Amount involved in the fraud**	**Agency to whom complaint should be lodged**	**Remarks**
Private Sector/	₹10000 and above	State Police	If committed by staff

Category of bank	**Amount involved in the fraud**	**Agency to whom complaint should be lodged**	**Remarks**
Foreign Banks	₹0.1 million and above	State Police	If committed by outsiders on their own and/or with the connivance of bank staff/officers
	₹10 million and above	In addition to State Police, SFIO, Ministry of Corporate Affairs, Government of India.	Details of the fraud are to be reported to SFIO in FMR Format.
Public Sector Banks	1. Above ₹10,000/- but below ₹0.1 million	State Police	If committed by staff
	2. ₹0.1 million and above	To the State CID/ Economic Offences Wing of the State concerned	To be lodged by the Regional Head of the bank concerned
	₹30 million and above and up to ₹250 million	CBI	To be lodged with Anti-Corruption Branch of CBI (where staff involvement is prima facie evident) Economic Offences Wing of CBI (where staff involvement is prima facie not evident)
	More than ₹250 million and up to ₹500 million	CBI	To be lodged with Banking Security and Fraud Cell (BSFC) of CBI (irrespective of the involvement of a public servant)
	More than ₹500 million	CBI	To be lodged with the Joint Director (Policy) CBI, HQ New Delhi

For fraud cases of below ₹10000, the Regional Head of the Bank would decide whether it should be reported to the local police station for further legal action.

Cheque Related Frauds, Precautions to be taken and Reporting to RBI and the Police:

1) Banks were advised to strengthen the controls in processing cheques, including following:

a) Ensuring the use of 100% CTS - 2010 compliant cheques.
b) Strengthening the facilities and persons at the cheque handling Service Branches.
c) Ensuring that the beneficiary is KYC compliant.
d) Examination under UV lamp for all cheques of say, ₹0.2 million or more.
e) Checking at multiple levels of cheques of say, ₹0.5 million or above.
f) Close monitoring of credits/ debits in newly opened transaction accounts.
g) Sending SMS alert to payer/drawer for cheques in clearing.

2) Preventive measures for suspicious or large value cheques (vis-a-vis normal operations):
   a) Alerting the customer by a phone call and obtaining confirmation from the payer/drawer.
   b) Contacting base branch for non-home cheques.
3) Precautionary measures are required to ensure that confidential information viz., customer name/account number/signature, cheque serial numbers and other related information are neither compromised nor misused either from the bank or from the vendors' (printers, couriers etc.) side. Movement of cheques is to be handled in secured manner with due care, from the time they are tendered over the counters or dropped in the collection boxes.
4) Frauds involving forged instruments (including truncated instruments) will be reported by the paying banker and not by the collecting banker. The paying banker has to file the police complaint. The presenting bank should hand over the underlying instrument to drawee/ paying bank as and when demanded.
5) An instrument which is genuine but the amount is collected fraudulently by a person who is not the true owner, or where the amount has been credited before realisation and subsequently the instrument is found to be fake/forged and returned by the paying bank, the collecting bank, which is defrauded or is at loss by paying the amount before realisation of the instrument, will have to file both the fraud report with the RBI and complaint with the police.
6) In case of collection of altered/fake cheque involving two or more branches of the same bank, the branch where the altered/fake cheque has been encashed, should report the fraud to its Head Office. Similarly, in the event of an altered/fake cheque having been paid/ encashed involving two or more branches of a bank under Core Banking Solution (CBS), the branch which has released the payment should report the fraud to the Head Office. Thereafter, Head Office of the bank will file the fraud report with RBI and also file the Police complaint.

31.3 LOAN FRAUDS - NEW FRAMEWORK

Objective of the framework: To direct the focus of banks on the following aspects - relating to prevention, early detection, prompt reporting to – (i) RBI (for system level aggregation, monitoring & dissemination), and (ii) Investigative agencies (for instituting criminal proceedings against the fraudulent borrowers), and timely initiation of the staff accountability proceedings (for determining negligence or connivance, if any). It also seeks to ensure that the normal conduct of business of the banks and their risk taking ability is not adversely impacted. Early detection and corrective actions are important to reduce the quantum of loss.

Early Warning Signals (EWS) and Red Flagged Accounts (RFA)

A Red Flagged Account (RFA) is one where a suspicion of fraudulent activity is thrown up by the presence of one or more Early Warning Signals (EWS). These signals put the bank on alert regarding a weakness or wrong doing which may turn out to be fraudulent, and hence a trigger to launch a detailed investigation.

a) Banks should compile their list of EWS based on RBI list, own experience, client profile and business models, for classifying an account as a RFA.
b) The threshold for EWS and RFA is an exposure of ₹500 million or more at the level of a bank. All accounts beyond ₹500 million classified as RFA or 'Frauds' must be reported on the CRILC data platform together with the dates on which the accounts were classified as such.
c) The modalities for monitoring of loan frauds below ₹500 million threshold is decided by the banks.
d) Tracking of EWS must be integrated with the credit monitoring process.
e) The Fraud Monitoring Group (FMG) should report the loan accounts in which EWS are observed, and classification as RFAs or otherwise to the CMD/CEO every month. A report on the RFA accounts is put up to the Special Committee of the Board on Frauds (SCBF) providing a synopsis of the remedial action and their current status.

Early Detection and reporting:

Banks were reporting an account as fraud only when they exhausted the chances of further recovery. This resulted in delaying alerting of other banks through caution advices, in similar frauds being perpetrated elsewhere, delayed action against the unscrupulous borrowers, which impact the recoverability aspects and also increase the loss. Following checks/investigations during the different stages of the loan life-cycle may be carried out:

a) Pre-sanction: The Risk Management Group (RMG) or any other group should be collecting independent information and market intelligence on the potential borrowers (from the public domain) on their track record. It should cover governance, legal and fiduciary responsibilities. This information could be used by the sanctioning authority. This should be part of the sanction documentation.
b) Disbursement: Checks by RMG may focus on adherence to the terms and conditions of sanction, rationale for dilution of these, level at which dilutions were allowed, etc. The sanctioning authority may specify certain terms and conditions as 'core' which should not be diluted. The RMG may immediately flag the non-adherence of core stipulations.
c) Annual review: Banks need to be vigilant from fraud perspective at the time of annual review. The aspects of diversion of funds, adequacy of stock vis-a-vis stock statements, stress in group accounts, etc., must also be commented upon. The RMG should have capability to track market developments relating to the major clients of the bank and provide inputs to the credit officers. This would involve collecting information from the grapevine, following up stock market movements, subscribing to a press clipping service, monitoring databases on a continuous basis and for the borrowing entity and also the group as a whole.

Staff empowerment:
Employees should be encouraged to report fraudulent activity in an account, along with the reasons in support of their views, to the appropriately constituted authority, under the Whistle Blower Policy of the bank.

Role of Auditors:
During the course of the audit, auditors may come across instances where the transactions in the account or the documents point to the possibility of fraudulent transactions in the account. The auditor may immediately bring it to the notice of the top management/ ACB for appropriate action.

Incentive for Prompt Reporting:
In case of accounts classified as 'fraud', banks should make provisions to the full extent immediately, irrespective of the value of security. It may spread it over four quarters provided there is no delay in reporting. In case of delays banks need to make the provision in one go. Delay means not flashed to CFMC, RBI or reported on the CRILC platform, RBI within a period of one week from its (i) classification as a fraud through the RFA route (has a maximum time line of six months), or (ii) detection/ declaration as a fraud ab initio by the bank.

Bank as a Sole Lender
The FMG will decide, within one month, whether or not an account in which EWS are observed be classified as a RFA. If classified as a RFA, it will stipulate the nature and level of further investigations or remedial measures necessary to protect the bank's interest within a period not exceeding six months. The bank may use external auditors, forensic experts or an internal team for investigations before taking a final view on the RFA. At the end of six months, banks would either lift the RFA status or classify the account as a fraud. A report on these accounts is put up to the SCBF.

Lending under Consortium or Multiple Banking Arrangements
All the banks which have financed a borrower under 'multiple banking' arrangement should take co-ordinated action, based on commonly agreed strategy, for legal/criminal actions, follow up for recovery, exchange of details on modus operandi, achieving consistency in data/ information on frauds reported to RBI. The bank which detects a fraud should immediately share the details with all other banks. Any major concerns from the fraud perspective noticed at the time of annual reviews or through the tracking of early warning signals should be shared with other lenders immediately. The initial decision to classify any standard or NPA account as RFA or Fraud will be at the individual bank level. This bank should report the RFA or Fraud status of the account on the CRILC platform so that other banks are alerted. Within 15 days, the bank which has red flagged the account or detected the fraud would ask the consortium leader or the largest lender under MBA to convene a meeting of the JLF, within 15 days, to discuss the issue. Banks with at least 60% share in the total lending, so deciding, the account would be red flagged by all the banks and subjected to a forensic audit commissioned or initiated by the consortium leader or the largest lender under MBA. The

forensic audit must be completed within three months from the date of the JLF meeting authorizing the audit. Within 15 days of the completion of the forensic audit, the JLF will reconvene and decide on the status of the account, either by consensus or the majority rule. Within 15 days of the RBI reporting, the bank commissioning/ initiating the forensic audit would lodge a complaint with the CBI on behalf of all banks in the consortium/MBA. Overall time for the entire exercise should be within six months from the date when the first member bank reported the account as RFA or Fraud on the CRILC platform.

Staff Accountability:

a) Banks must initiate and complete staff accountability exercise within six months from the date of classification as a Fraud. The role of sanctioning official(s) may also be covered under this exercise. The completion of the staff accountability exercise for frauds and the action taken should be placed before the SCBF and intimated to the RBI at quarterly intervals.
b) All fraud cases are grouped into vigilance and non-vigilance. Only vigilance cases should be referred to the investigative authorities. Non-vigilance cases may be investigated and dealt with at the bank level within a period of six months. In cases involving very senior executives of the bank, the Board/ ACB/ SCBF may initiate staff accountability process. Staff accountability process should not be held up for the case being filed with law enforcement agencies. Both the criminal action and domestic enquiry should be conducted simultaneously.

Filing Complaints with Law Enforcement Agencies

Banks should lodge complaint with the law enforcement agencies immediately on detection of fraud. Banks should have a nodal point/ officer for filing all complaints with the CBI on behalf of the bank and serve as the single point for coordination and redressal of infirmities in the complaints. The complaint lodged by the bank should be vetted by a legal officer. For complaints of cheating, misappropriation of funds, diversion of funds etc., by borrowers, the account should be classified as frauds and reported to RBI.

Penal measures for fraudulent borrowers

The penal provisions as applicable to wilful defaulters would apply to the fraudulent borrower including the promoter director(s) and other whole time directors of the company in so far as raising of funds from the banking system or from the capital markets. Borrowers who have defaulted and have also committed a fraud in the account would be debarred from availing bank finance from Scheduled Commercial Banks, Development Financial Institutions, Government owned NBFCs, Investment Institutions, etc., for a period of five years from the date of full payment of the defrauded amount. After this period, it is for individual institutions to take a call on whether to lend to such a borrower. The penal provisions would apply to non-whole time directors (like nominee directors and independent directors) only in rarest of cases based on conclusive proof of their complicity. No restructuring or grant of additional facilities may be made in the case of RFA or fraud accounts. No compromise settlement involving a fraudulent borrower is allowed unless the conditions stipulate that the criminal complaint will be continued. Third parties such as builders, warehouse/cold storage owners, motor vehicle/tractor dealers, travel agents, etc. and professionals such as architects, valuers, chartered accountants, advocates, etc. are also to be held accountable if they have played a vital role in credit sanction/disbursement or facilitated the perpetration of frauds. The details of such third parties involved in frauds, should be reported to Indian Banks Association (IBA). In this regard the normal procedures and the processes of notice and personal hearing be adopted. IBA would prepare caution lists of such third parties for circulation among the banks.

Legal Audit of Title Documents in respect of Large Value Loan Accounts

The title deeds and other documents in respect of all credit exposures of ₹5 crore and above should be subject to periodic legal audit; and re-verification of title deeds with relevant authorities as part of regular audit exercise till the loan stands fully repaid. A review note should be submitted to their Board/Audit Committee of the Board at quarterly intervals in respect of such legal audits.

31.4 SALE OF FINANCIAL ASSETS OF DOUBTFUL STANDARD/ FRAUDULENT ORIGIN TO ASSET RECONSTRUCTION COMPANY (ARC)

Banks should ensure that while packaging and selling performing or non-performing assets, it is properly ascertained that the pool of assets being sold does not contain any loan originated fraudulently or has been classified as fraud as on the date of sale.

31.5 REPORTING CASES OF THEFT, BURGLARY, DACOITY AND BANK ROBBERIES

Banks should arrange to report by fax/e-mail instances of bank robberies, dacoities, thefts and burglaries to the following authorities immediately on their occurrence.

- ❖ Centralised Fraud Monitoring Cell (CFMC), RBI; Regional Office of DBS/ Senior Supervisory Manager (SSM)/ Small Bank Monitoring Division (SBMD); RO of DBS; The Security Adviser, Central Security Cell, RBI; Ministry of Finance, Department of Financial Services Government of India.

The report should include relevant particulars and details of such events.

Banks should also submit a quarterly Return on such events to RBI electronically in XBRL system covering all cases during the quarter, within 15 days of the end of the quarter.

31.6 INTERNAL VIGILANCE IN BANKS (PRIVATE SECTOR/ FOREIGN BANKS)

For public sector banks the guidelines issued by the Central Vigilance Commission require them to appoint a Chief Vigilance Officer. This is aimed at the internal vigilance functions in the public sector banks are addressed through a set of predetermined and structured procedures to ensure comprehensive treatment and transparency. A set of guidelines have been prescribed by RBI for having broadly common approach in all banks.

Vigilance promotes clean business transactions, professionalism, productivity, promptness and transparent practices. It includes putting in place systems and procedures to curb opportunities for corruption. The guidelines aim at structuring efficient and effective vigilance system in banks in the larger interest of all concerned stakeholders.

Anti-corruption Agencies:
The disciplinary authority of the bank has the overall responsibility of looking into the acts of misconduct alleged against, or committed by, the employees, and to take appropriate punitive action. It is also required to take appropriate preventive measures so as to prevent commission of misconducts/ malpractices by the employees. The designated Officer, designated as Chief of Internal Vigilance (CIV), [similar to CVO in case of Public Sector Banks] acts as a Special Assistant/Advisor to the CEO in the discharge of these functions. He also acts as a liaison officer between the bank and the Police/ SFIO/ other law enforcement authorities.

Chief of Internal Vigilance will head the Internal Vigilance Division. Vigilance functions are wide ranging and include – Collecting intelligence about the corrupt practices committed by the employees; investigating into verifiable allegations reported to him; processing investigation reports for further consideration of the disciplinary authority concerned; referring the matters to the CEO; taking steps to prevent commission of improper practices/misconducts, etc.
CIVs' functions can broadly be divided into three parts – (i) Preventive vigilance; (ii) Punitive vigilance; and (iii) Surveillance and detection.

Acts with Vigilance Angle
1) Vigilance angle is obvious in the following acts
    a) Demanding and/or accepting gratification other than legal remuneration in respect of an official act or for using his influence with any other official.
    b) Obtaining valuable thing, without consideration or with inadequate consideration from a person with whom he has or is likely to have official dealings or his subordinates have official dealings or where he can exert influence.
    c) Obtaining for himself or for any other person any valuable thing or pecuniary advantage by corrupt or illegal means or by abusing his position as an employee.
    d) Possession of assets disproportionate to his known sources of income.
    e) Cases of misappropriation, forgery or cheating or other similar criminal offences.
2) For certain other acts like those stated below, the disciplinary authority and the CIV need to weigh the circumstances and conclude whether it is reasonable to doubt the integrity of the officer concerned - (i) Gross or wilful negligence; (ii) Recklessness in decision making; (iii) Blatant violations of systems and procedures; (iv) Exercise of discretion in excess, where no ostensible organizational interest is evident; (v) Failure to keep the controlling authority/ superiors informed in time.

Preventive Vigilance Measures:
(i) Study of existing procedure and practices with a view to modifying those which provide a scope for corruption.
(ii) Review the regulatory functions to see whether these are strictly necessary, and whether the manner of discharge and exercise of powers are capable of improvement.

(iii) Devise adequate methods of control over exercise of discretion so that these are not exercised arbitrarily but in a transparent and fair manner;
(iv) Identify the areas prone to corruption and that the officers of proven integrity are posted in those.

Staff rotation and mandatory leave: The banks should identify sensitive positions and frame Board approved internal policy for rotation of staff in general and in respect of sensitive desks in particular. The policy should also include the minimum period for staff rotation and mandatory leave for the staff at all levels, including the CEO.

Complaints: Information about corruption, malpractice or misconduct on the part of employees, from any source, is termed as a complaint. These may flow to the administrative authority/ the Police/ SFIO/ RBI from any of the following sources: (a) From employees or the public; (b) Inspection reports and stock verification surveys; (c) Annual property statements; (d) Transactions reported under the Conduct Rules; (e) Irregularities detected in the routine audit of accounts; e.g. tampering with records, over-payments, misappropriation of money or materials etc.; (f) Audit reports; (i) Complaints and allegations in the press etc.; and (j) Intelligence gathered by agencies like CBI, local bodies etc. Anonymous/ pseudonymous complaints received by the CIV may be dealt with on merit.

Investigation agency for conducting investigations: It will be necessary to decide whether the allegations should be inquired into departmentally or whether a police investigation is necessary. This will also be determined based on the norms stipulated for fraud cases.

Review of cases entrusted to Police/ SFIO: A case registered by the Police should normally not be reviewed administratively. If reviewed for specific reasons, the police should be associated.

Action against persons making false complaints: If a complaint against an employee is found to be malicious, vexatious or unfounded, action against the complainant should be examined.

31.7 LET US SUM UP

CEO, Audit Committee of the Board and the Special Committee of the Board responsible for fraud risk management, fraud monitoring and fraud investigation function. Frauds have been classified based mainly on the provisions of the Indian Penal Code. Fraud Monitoring Return (FMR) is submitted for individual fraud cases. All frauds of ₹1.00 lakh and above should be reported to the Board promptly on detection. Frauds are required to be reported to Police. CBI as per the norms of RBI based on the amount involved (of ₹10000 and above).

Framework for loan related frauds has been laid down to direct the focus of banks on the following aspects - relating to prevention, early detection, and prompt reporting to RBI and investigating agencies, and timely initiation of staff accountability proceedings. Risk Management Group should scrutinize at pre-sanction stage itself. Employees should be encouraged to report fraudulent activity in an account. Banks must initiate and complete staff accountability exercise within six months from the date of classification as a Fraud.

Banks should subject the title deeds and other documents in respect of all credit exposures of ₹5 crore and above to periodic legal audit and re-verification of title deeds with relevant authorities as part of regular audit exercise till the loan stands fully repaid.

Banks should arrange to report by fax/e-mail instances of bank robberies, dacoities, thefts and burglaries to the following authorities immediately on their occurrence.

An officer of suitable seniority to be designated as Chief of Internal Vigilance (CIV). CIV's functions can broadly be divided into three parts – (i) Preventive vigilance; (ii) Punitive vigilance; and (iii) Surveillance and detection. Vigilance angle is obvious in certain acts, while in certain other acts one has to weigh the circumstances to arrive at a conclusion.

31.8 KEYWORDS

Monitoring Return (FMR) Returns; Central Fraud Registry (CFR); Early Warning Signals (EWS); Red Flagged Accounts (RFA); Fraud Monitoring Group (FMG) Risk Management Group (RMG); Chief Vigilance Officer; Vigilance Angle; Preventive Vigilance;

31.9 CHECK YOUR PROGRESS

1) Quarterly Review of Frauds is submitted to the -----.
   a) Board of Directors
   b) Risk management Committee of the Board
   c) Special Committee of the Board on Frauds
   d) Audit Committee of the Board

2) Banks should submit a copy each of the Quarterly Report on Frauds Outstanding in the format given in ___ to the Regional Office of Urban Banks Department of the Reserve Bank of India under whose jurisdiction the Head Office of the bank falls within 15 days of the end of the quarter to which it relates.
   a) FMR
   b) FMR 1
   c) FMR 2
   d) FMR 4

3) The threshold value for application of early warning signals and red flagged accounts is exposure of ----- or more.
   a) ₹ 500 million
   b) ₹ 100 million
   c) ₹ 250 million
   d) ₹ 50 million

4) The tenure of Chief of Internal Vigilance is ----- years.
   a) 5
   b) 6
   c) 3
   d) 1

31.10 KEY TO 'CHECK YOUR PROGRESS'

1 (d); 2 (a); 3 (a); 4 (c)

References:

1) RBI Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs dated July 1, 2016 (https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10477)
2) RBI Circular DBS .CO.FrMC .BC.No.9/23.04.001/2010-11 dated May 26, 2011 on Internal Vigilance in Private Sector/foreign Banks. (https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=6448)

About IIBF

Established in 1928 as a Company under Section 25 of the Indian Companies Act, 1913, Indian Institute of Banking & Finance (IIBF), formerly known as The Indian Institute of Bankers (IIB), is a professional body of Banks, Financial Institutions, and their Employees in India. With a total membership of over 9.6 lakhs, IIBF is the largest institution of its kind in the world and is working with a Mission "to develop professionally qualified and competent bankers and finance professionals primarily through a process of education, training, examination, consultancy / counselling and continuing professional development programs."

During its 94 years of service, IIBF has emerged as a premier institute in banking and finance education for those employed as well as seeking employment in the sector, aiming for professional excellence. Since inception, the Institute has educated numerous members and awarded several banking and finance qualifications, viz., JAIIB, CAIIB, Diploma and Certificates covering diverse and contemporary subjects in the banking & finance domains, which have helped the banking & finance professionals to sustain their professionalism through continuing professional development programs.

Indian Institute of Banking & Finance

Kohinoor City, Commercial-II, Tower-I, 2nd Floor, Kirol Road, Off L. B. S. Marg, Kurla West, Mumbai - 400 070.

Tel. : 022 68507000

Website : www.iibf.org.in