SIB Students' Economic Forum

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The South Indian Bank Ltd.
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The South Indian Bank Ltd.

SIB STUDENTS' ECONOMIC FORUM

Head Office :
'S.I.B. House', Thrissur, Kerala
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JUNE 2004

Theme No. 151 : SWIFT

A well-informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "SIB Students' Economic Forum". This month we discuss the theme "SWIFT".

What is meant by the acronym "SWIFT"?
SWIFT stands for SOCIETY FOR WORLDWIDE INTERBANK FINANCIAL TELECOMMUNICATIONS. It is a cooperative society under Belgian law and is owned and controlled by its member-shareholders. SWIFT is based in Brussels (Belgium). It is a reliable, safe, instantaneous and economical means of communication amongst member banks.

What is the mission of SWIFT?
SWIFT is a worldwide community of financial institutions whose purpose is to be the leader in communications solutions with lowest risk and highest resilience. It provides low-cost competitive financial processing and communications services of the highest security and reliability. It contributes significantly to the commercial success of its members through greater automation based on its leading expertise in message processing and financial standards setting.

When did the inception of SWIFT take place?
SWIFT was formed in 1973. At the time of inception, there were 239 members from Europe and America. Presently Swift has almost 7600 members and participants in 200 countries. Daily messages regularly exceed 9 million and the average transit time is less than 20 seconds.

What was the rationale behind formation of SWIFT?
SWIFT was formed in response to the communications problems faced by the international banking community. The system provides a standard technique for fund transfer among the member banks.

How does the system work?

The financial institutions can do business with one another using computerised systems over an international data network. The member banks are provided with a Swift Interface Device (SDI) which enables them to format messages according to SWIFT rules or to accept messages in SWIFT format from another computer system. Thus it handles the communication between the computer and the network. Each member bank is given a Bank Identification Code (BIC). Normally there are 8 to 11 characters. The first 4 digits represent Bank, followed by 2 digits Country and 2 digits Region. The last 3 digits represent branch.

How are the messages transmitted and received?

Messages are sent in test key which can be decoded. Message is sent in encrypted form which is decrypted at the receiving end. Charges are levied not based on distance but based on the block of characters.In India the SWIFT Regional Processor (RGP) is located at World Trade Centre, Mumbai.

What is meant by encryption & decryption?

Encryption means translation of data into a secret code. It is the most effective way to achieve data security. To read an encrypted file,you must have access to a secret key or password that enables you to decrypt it. Unencrypted data is called "plain text" and encrypted data is referred to as "cipher text".

What are the various types of SWIFT messages?

SWIFT messages are in standardised format. Each message type is denoted by a three digit number. The first digit denotes the series to which message belongs and the next two digits denote the format.

Series	**Message Type**
0xx	messages to SWIFT head quarters.
1xx	Customer transfer
2xx	Bank transfer
3xx	Inter bank deal/confirmations
4xx	cash/cheque/collection/advice/fate
5xx	Securities- processing/confirmation
6xx	precious metal deals
7xx	documentary credits
8xx	Travellers cheques
9xx	Account statements

Formats	**Type**
x95	queries
x96	answers
x99	free format

Eg: Message in 199 denotes customer transfer in free format. Message in 795 denotes documentary credit queries. All messages, except in 3 series (3xx) and 9 series (9xx), are tested messages and put through between banks having Bilateral Key Exchange(BKE).

What is the present status of the system?

When SWIFT commenced its operation, the average daily message traffic was a modest 50000. Now it has increased to almost 9 million. By now SWIFT has evolved into a global system spread over 200 countries, with 2,296 live members and 7,539 live users. India was the 73rd country to join the network. Reserve Bank of India and most of the commercial Banks in the country are members of SWIFT.

How does the system enable banks to provide better service to customers?

A member of SWIFT transmits a message to the main switch in Brussels which in turn forwards the message to the switch serving the receiving bank. The most important point is that the messages are in the standard SWIFT format. The member banks world over can understand the content of each message. These messages can be read on the computer of the users, thus enabling faster processing. The system enables banks to provide fast and better customer services at low costs.

What are the advantages of SWIFT?

The major advantages of SWIFT are

1. REACH: SWIFT provides one point contact to almost 1,20000 offices of the members at the touch of a computer key.
2. SECURITY: The SWIFT systems ensure security at all levels right from the entry point to delivery of the messages. It guards against mutilation, wrong delivery, delays, fradulent actions and errors in storage.
3. AUTHENTICATION: SWIFT Authentication Keys (SAK) are exchanged among member banks to ensure automatic authentication of the messages.
4. RELIABILITY: The system assures safe delivery of SWIFT messages.
5. ACCESSIBILTY: The system is accessible to all members 24 hours a day, 7 days a week and 365 days a year.
6. STANDARDISATION: The messages passing through the SWIFT are on standardised message formats. This facilitates a lot in automatic processing and elimination of interpretation problems.
7. COST EFFECTIVENESS: The average length of a SWIFT message is 325 characters. The cost of transmitting an average message will be only Rs. 17/- whereas the cost over other media will of course be more.
8. RISK MANAGEMENT: Through the system,head offices of banks can perform the risk management more effectively for their entire global network of branches.

What are the facilities offered by SWIFT?

1. Transfer of funds from one bank to another across various countries: The system acts as a fast and safe medium for huge fund transfer among banks.
2. Transfer of funds betweem customers: SWIFT provides a reliable solution to customers all over the world to transfer funds through the banking channel most economically.
3. Statement of accounts: The system generates the account statements
4. Credit or Debit advices: The system can generate both credit and debit advices for each transaction.
5. Confirmations: SWIFT provides confirmations in respect of Forex and money market.
6. Security trading among banks.: The trading in securities by banks can be undertaken through the SWIFT medium. It ensures prompt and early settlement of these transactions among banks.
7. Reporting: SWIFT enables reporting of balances.

The important element in the above applications offered, is that the messages can be directly read on the monitors of the users. The bank personnel in all member countries can understand the message because they are transmitted in the standard format.

Discuss on some of the major US payment systems?

In the United States, there are two principal electronic interbank payment systems. They are

1. CHIPS 2. FEDWIRE

What is meant by CHIPS?

CHIPS means Clearing House Interbank Payment System. It is a net settlement payment system through which majority of US dollar payments are settled. CHIPS is a large value system that has the capability of carrying extensive remittance information for commercial payments. CHIPS processes over 2,67000 payments a day with a gross value of $ 1.37trillion.It is a premier payments platform serving the largest banks from around the world, representing 22 countries world wide.

What is FEDWIRE?

Fedwire is also an electronic payment system operated by the Federal Reserve Bank. It is an automated, computer based message system with gross settlement. Unlike CHIPS, whose members are only banks, Fedwire is open to all depository institutions. Majority of the domestic US interbank payments are settled through Fedwire.

How do CHIPS and FEDWIRE differ from SWIFT?

Under CHIPS and FEDWIRE, only US dollars are allowed in the transfers. But SWIFT handles multiple currencies for transfer. ❑

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SIB STUDENTS' ECONOMIC FORUM

JULY 2004

Theme No. 152 : CALL MONEY MARKET

A well-informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs.This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "SIB Students' Economic Forum". This month we discuss the theme "Call Money Market".

What is a call money market?

The call money market is the most visible segment of the money market where surplus funds, mostly of banks, are traded. The major portion of money market turnover is accounted by call money market. Since its inception in 1955-56, the call money market has registered tremendous growth in volume of activity.

How does a call money market operate?

It is a market for short term funds repayable on demand and with a maturity period varying between one day to a fortnight. When money is borrowed or lent for a day,it is Call or Overnight money. When money is borrowed or lent for more than a day upto 14 days, it is notice money.

How can we describe the nature of the market?

It is a highly liquid, volatile and risky market. No collateral is required to cover the call money transactions.

What is the size of the market?

The size of the market for these funds in India is between Rs. 60,000 million to Rs. 70,000 million. The public sector banks account for 80% of borrowings and foreign banks/private sector banks account for the balance 20%. Non- bank financial institutions like IDBI, LIC, GIC etc, participate only as lenders in this market. Almost 80% of the requirement of call money funds is met by the non-bank participants and 20% from the banking system.

Why is this segment called 'call money market.' ?

As a statutory obligation, the commercial banks in India are required to maintain minimum cash balances with RBI known as Cash reserve Ratio (CRR). Banks borrow or lend among themselves to maintain the minimum CRR which is presently 4.5% of Net demand and time liabilities (NDTL). NDTL is the sum of a bank's liabilities to the banking system and to the public. Banks have to comply with CRR requirements based on the figures as on the reporting Friday every fortnight. Banks with lesser cash reserves, borrow from those who have surplus. Thus almost 80% of the call money transactions are inter bank trading. The interbank transactions are undertaken without the intermediation of brokers.

Who are the participants in the call money market?

Commercial banks and cooperative banks are the major participants on both the supply and demand sides of the call money market.

1. Scheduled Banks
2. Non-scheduled Banks.
3. Foreign Banks
4. Cooperative Banks.
5. Discount &Finance House of India (DFHI)
6. Primary dealers.

The lending participants are UTI, LIC, GIC, STCI, NABARD, Money market mutual funds, corporates etc.

What is the role of RBI in the call money market?

RBI intervenes in the call money market indirectly in two ways.
1. providing lines of finance to DFHI
2. Conducting Repo transactions.

What are Repos & Reverse repos?

Repo means RBI absorbs the excess liquidity from the banking system by selling short term securities. Reverse repo increases liquidity in the system. Repo transactions push up call money rates whereas reverse repos bring down the rates.

What is the link between call money market & other financial markets?

There is an inverse relationship between call rates and short term money market instruments like Cerificate of Deposit (CD) and Commercial Paper (CP). When call rates are high, banks raise funds through issue of CDs. When call rates are low, banks invest in CPs by borrowing from call money market and make profits.In order to meet SLR requirements, banks subscribe to government securities, which may result in short liquidity, and more demand for call money which in turn,causes rise in call money rates. Similarly if RBI raises CRR or Repo rate, more demand and hence call money rates go up. There is also a link between call money market and foreign exchange market.

How does the call money market affect foreign exchange operations?
There are chances of arbitrage operations between the two markets. Banks borrow dollars and swap them for rupees and lend in call money markets. Simultaneously for repayment they buy forward, which pushes up forward premium. Banks even fund forex positions by withdrawing from call money markets, which pushes up call rates.

What is call money rate?
Call money rate is the rate at which funds are borrowed in the call money market. It is highly volatile and varies even every minute, depending on demand and supply of call money. There are two call rates.
1. Inter bank call rates
2. DFHI lending rate.

The DFHI rate will usually be higher than inter bank rate.

What is MIBOR?
The National stock exchange has developed two rates called MIBOR and MIBID. MIBOR is Mumbai inter bank offer rate and MIBID is Mumbai interbank bid rate. MIBOR is arrived at by obtaining a weighted average of call money transactions of major banks and other players.

How do the call rates fluctuate?
In India the money market fluctuations are seasonal. During the slack seasons, banks have surplus funds and hence call money requirements are less. In busy seasons, there is high demand for call money. The call rates also vary accordingly.

What are the factors influencing call money rates?
1. Liquidity
2. Cash Reserve Ratio(CRR)
3. Stock Market Conditions.
4. Government legislation
5. Investment policy of major lenders
6. Foreign Exchange Market liquidity

How does RBI control the high volatility in call money rates?

The various measures adopted by RBI to control rate volatility are

1. Through Repos
2. By increasing the number of participants.
3. RBI has already exempted inter bank deposits for arriving at NDTL (Net demand and time liabilities) for the purpose of reserve requirements,and hence banks can borrow from other banks in the form of short term deposits to meet their fund requirements.

What are the factors behind tight money market conditions?

Tight money market means call rates going up due to heavy demand. The major factors behind this condition are

1. High demand for credit against sluggish deposit growth.
2. RBI intervention in Forex markets to stabilise the exchange rate of rupee against strong currencies.
3. Temporary withdrawal from money market for stabilising the forex market.

What is the latest trend in call rates?

Call money rates continued to fluctuate in the band of 4 to 5% in 2003-2004. The rates were almost nearer to Repo rates. The present rates hover around 4 to 4.25%.

What are the restrictions imposed by RBI to reduce the excessive reliance of banks on call money market?

RBI has issued prudential norms in this regard.

1. Lending of banks in the call money market should not exceed 25% of their owned funds.
2. Borrowings by banks should not exceed 100% of their owned funds or 2% of their aggregate deposits, whichever is higher.

The basic intention of RBI is to develop the Repo market thereby transforming the call money market to a pure interbank market.

What is Term Money Market?

Term Money Market is with maturity ranging from 3 months to one year. In India the Term Money Market has not developed much because the volumes are small and banks' participation is quite meagre. ❑

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AUGUST 2004

Theme No. 153 : INDIAN ACCOUNTING STANDARDS - PART I

A well informed customer will make the policy makers as well as organizations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of goods and services produced.

The 'SIB Students' Economic Forum' is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the 'SIB Students Economic Forum'. The topic in this issue is Indian Accounting standards.

What is meant by Financial Accounting?
Accounting is the language of business. The main objective is to report the results of business operations during a financial year. Financial Accounting has evolved with the advent of Joint stock companies. Since the liability of the company is limited by shares, the share holders require the financial details by way of statements such as profit & loss account and balance sheet. Thus Financial accounting can be termed as an information system to the various users such as share holders & investors, Government, management etc.

What do you mean by Compliance of Accounting standards by Banks?
Reserve Bank of India constituted a Working Group headed by Sri. N.D. Gupta, President of ICAI (Institute of Chartered Accountants of India) to have an overview of the short comings in compliance of accounting standards by Banks. These are guidelines issued by RBI, on the recommendations of the Working Group, to ensure a uniform and transparent set of standards in accounting by Indian Banks. It has already been implemented and is operational in Banks from March 2003 onwards.

What is the rationale behind introducing Accounting Standards in India?
The accounting policies vary from enterprise to enterprise. Generally accounting reveals the true financial position. But it was also used to hide some material facts. Hence RBI thought it necessary to recognise the need for greater transparency and

to set uniform standards across the country. The purpose of setting standards is to promote a better understanding of financial statements. The primary consideration is that the financial statements should present a true and fair view of the state of affairs of the enterprise as at the balance sheet date.

What are the fundamental assumptions in accounting?

1. Going concern: The enterprise is normally viewed as a going concern, as continuing in operation for the foreseeable future.
2. Consistency: It is assumed that accounting policies are consistent from one period to another.
3. Accrual: Revenues and costs are accrued and are recognised in relevant periods as they are earned or incurred (not as money is received or paid).

Who come under the purview of accounting standards?

The accounting standards apply to

1. All companies registered under the Companies Act 1956 and listed on a recognised stock exchange.
2. All other large commercial, industrial and business enterprises in the public and private sectors.

What is the major objective of issuing these guidelines?

The major objective is to ensure uniformity in preparation of financial statements and easy comparabilty of these statements. These statements should provide meaningful informations to the users.

Who are the major users of these information sources?

The various users are 1) Shareholders 2) investors 3) Banks & Financial institutions 4) creditors 5) employees 6) Government 7) Management & 8) customers.

What is the present status of Accounting Standards in India?

Institute of Chartered Accountants of India (ICAI) formed an Accouting Standards Board (ASB) in 1977 for issuing the various accounting standards and revisions. ASB harmonizes the various accounting policies and practices followed in our country. The latest standards issued by ASB are AS - 28 & AS - 29.

What are the objectives of ASB?

The three objectives are

1. Financial reporting should provide useful and comprehensible information to present and potential investors, creditors and other users.

2. Financial reporting should help the users to assess the amounts, and timing of future cash receipts from dividends, sale and redemption so that the investors' cash flows are related to that of the enterprise.
3. Financial reporting should provide information about the economic resources and claims against those resources .

Why are Standard Accounting norms and disclosures found essential for Banks?

The major aim is to provide more transparency in disclosures and free flow of information to the investor public. Also it aims to provide a clear picture on efficiency and effectiveness in performance of Indian Banks vis-a vis the peers.

What is meant by US GAAP?

US GAAP stands for "United States Generally Accepted Accounting Principles". It is applicable to companies based in the USA or listed at Wall street. The Financial Accounting Standard Board of USA, established in 1973, is instrumental in setting the standards. USGAAP provides comprehensive information regarding the rules, practices and procedures to investors for taking sound financial decisions.

Explain some of the different approaches in accounting under US GAAP and the Indian Accounting Standards?

1. In India the financial statements are prepared in formats as per schedule VI of the Companies Act 1956. But under USGAAP no specific format is prescribed but the disclosure requirements have to be complied with.
2. Revaluation of assets is not permitted under USGAAP, but under Indian standards, the value enhancement is permitted and has to be credited to the revaluation reserves.
3. Under USGAAP financial leases are capitalised in the lessee's books of account, but in Indian Standards, the same is capitalised in the lessor's books.

Why do some Indian Banks/Companies prepare their financial statements as per 'GAAP' method?

Even though 'US GAAP' is a more stringent way of accounting, banks/ companies planning to raise resources in US and other foreign markets may have to prepare their financial statements as per GAAP method, which is a generally accepted method of accounting as per international standards. Moreover, the balance sheet and other financial statements prepared as per Indian standards may not be acceptable to the international community. US GAAP and Indian accounting Standards are divergent approaches. But efforts are already on to converge both.

Let us hope for a single "International Accounting Standard" in the near future.

What is meant by IAS 39?

IAS 39 is an International Accounting Standard which requires that all financial assets and liabilities, including derivatives should be recognised on balance sheets. The items which are treated as off- balance sheet and contingent items by Indian standards are to be recognised under IAS39.

How financial assets are classified under IAS 39?

1. All loans and receivables are to be classified subject to NPA (Non performing Asset) and income recognition norms.
2. Investments in securities under HTM (held to maturity) should be subject to impairment norms.
3. Investments under AFS (Available for sale) should be based on fair value or cost subject to impairment recognition.
4. Investments under HFT (held for trading) should be based on fair value or changes in fair value resulting in net profit or loss.

What are the major considerations governing the selection and application of accounting policies in the preparation of financial statements?

The major considerations are

1. Prudence: Provision is to be made for all known liabilities and losses, even though the amount cannot be determined with certainity.
2. Substance over form: The accounting treatment of transactions and events should be governed by their substance and not merely by the legal form.
3. Materiality: All material items, which influence the future decisions of the user, should be disclosed.

Which are the various Accounting Standards now operational in Banks?

Till date, Institute of Chartered Accountants of India (ICAI) has designed 29 Accounting Standards. The most relevant of these, are AS 1, 2, 3, 4, 5, 9, 15, 17, 18, 22, 23, 25, 27, 28 & 29.

We will continue our discussions on the above standards in the next issue.

(contd......)

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SEPTEMBER 2004

Theme No. 154 : INDIAN ACCOUNTING STANDARDS - PART II

A well informed customer will make the policy makers as well as organizations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of goods and services produced.

The 'SIB Students' Economic Forum' is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the 'SIB Students Economic Forum'. In the last issue we discussed in detail the objectives of formulating accounting standards. Now, we will study the contents of each accounting standard, which are operational in banks.

Explain the important standards operational in banks?

AS-1: This statement deals with the disclosure of significant accounting policies followed in the preparation and presentation of financial statements. The purpose is to promote better understanding of financial statements. Such disclosure facilitates a more meaningful comparison between financial statements of different enterprises.

Some of the areas are:

1. Methods of depreciation & amortisation
2. Valuation of inventories.
3. Conversion of foreign currency items
4. Treatment of goodwill
5. Treatment of retirement benefits
6. Valuation of fixed assets.
7. Treatment of contingent liabilities.
8. Recognition of profit on long - term contracts.
9. Valuation of investments.

AS-2: The objective of this standard is to determine the value at which inventories are carried in the financial statements until the related revenues are recognised.

Inventories are assets in the form of raw materials, stock in process or finished goods. Net realisable value is the estimated selling price less the estimated costs to make the sale.

AS-3: The title of this standard is Cash Flow Statements. The objective is to provide information on the cash flows of an enterprise to the users of the financial statements. Cash flows are inflows and outflows of cash and cash equivalents. Cash comprises cash on hand and demand deposits. Cash equivalents are short term highly liquid investments that are readily convertible to cash.

AS-4: This is the statement on contingencies and events occuring after the balance sheet date. A contingency is a situation, the gain or loss of which will be determined only on the occurrence or non-occurrence of one or more uncertain future events.

AS-5: It deals with
1) Net profit or loss for the period
2) Prior period items and extra ordinary items.
3) Changes in Accounting policies.

The objective of this standard is to prescribe the classification and disclosure of certain items in the P&L account to ensure uniformity. The standard warrants disclosure of certain extra ordinary and prior period items in the Notes on Accounts to the balance sheet of banks. AS-5 also specifies regarding treatment and disclosure of changes in accounting policies.

AS-9: This is concerned with the recognition of revenue in the P&L account. Revenue is the gross inflow of cash and other considerations arising from the ordinary activities of an enterprise. This standard requires that the recognition of revenue in P&L account should be proportionate with the degree of completion of services under a contract. It means that if any item of income is not considered to be material, it may be recognised only when received.

AS-15: This standard deals with accounting for retirement benefits in the financial statements of employers. As per the standard, the retirement benefits in the form of PF and other schemes, payable by the employer for a year should be charged to the P&L account for the year. In the case of gratuity and other defined benefit schemes, the accouting treatment depends on the type of arrangement made by the employer. In short the standard requires accounting for all the liabilities, arising out of retirement,on an acturial basis.

AS-17: The standard establishes principles for reporting the financial information about the different types of products and services and the different geographical areas of operation. It is often called as "segment reporting". The disclosures required are either primary or secondary. As per the standard, banks have to report their business segment as primary reporting format. The business segments are treasury operations, other banking operations and residual operations. The secondary segment includes domestic and international geographic segments.

AS-18: This standard sets out the disclosure of the names, relationships and transactions between the enterprise and its related parties. Related parties for a bank are its parent /subsidiary/associate/key managenment personnel (KMP) and relatives of KMP. Public Sector banks need not disclose their transactions with subsidiaries as well as RRBs (Regional Rural Banks) sponsored by them. But they have to disclose their transactions with other related parties.

AS-22: This standard deals with accounting for taxes on income. The standard requires that tax expenses for the period, both current and deferred, should be included in the determination of net profit or loss for the period. Current tax is the amount of income tax determined to be payable in respect of taxable income for the period.Current tax is measured as the amount expected to be paid using the applicable tax rates. Deferred tax is the tax effect arising out of time differences. Time differences are the differences between taxable income and accounting income for a period that originate in one period and are eligible for reversals in subsequent periods.

AS-23: This standard prescribes procedures for recognising investments in associates. An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. The objective of this standard is to ensure that the recognition is based not merely on the proportion of investment but the intention to acquire exercising power.

AS-25: The standard prescribes the minimum content of an interim financial report. Interim financial report is a report containing either a complete set of financial statements or a set of condensed financial statements for an interim period. During the first year of operations of an enterprise, its reporting period may be shorter than a financial year.In such a case, that shorter period is not considered as an interim period.

AS-27: It deals with financial reporting of interests in joint ventures. A joint venture is a contractual agreement whereby two or more parties undertake an economic activity so as to obtain benefits from it. The objective of this standard is to report a venture's share on each of the assets, liabilities, income and expenses as separate line items in the financial statements.

AS-28: The objective of this standard is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. Recoverable amount is the higher of an asset's net selling price and its value in use.

AS-29: It deals with provisions, contingent liabilities and contingent assets. Provision means a liability of uncertain timing and amount. Contingent Asset or liability means a possible asset or obligation that arises from past events whose existence depends on the occurrence or non- occurrence of some uncertain future events.

What are the subjects covered in the other accounting standards?

AS-6	-	Depreciation Accounting.
AS-7	-	Accounting for construction contracts.
AS-8	-	Accounting for research & development.
AS-10	-	Accounting for fixed deposit
AS-11	-	Accounting for the effects of changes in FOREX rates.
AS-12	-	Accounting for Govt.Grants.
AS-13	-	Accounting for investments.
AS-14	-	Accounting for amalgamation.
AS-16	-	Borrowing costs.
AS-19	-	Lease
AS-20	-	Earning per share.
AS-21	-	Consolidated financial statements.
AS-24	-	Discontinuing operations.
AS-26	-	Intangible assets.

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SIB STUDENTS' ECONOMIC FORUM

OCTOBER 2004

Theme No. 155 : TRADING IN GOVERNMENT SECURITIES

A well informed customer will make the policy makers as well as organizations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of goods and services produced.

The 'SIB Students' Economic Forum' is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the 'SIB Students Economic Forum'. In this issue, we discuss on the trading activities undertaken by banks in the securities market.

What do you know about Government Securities?
Government securities are unique financial instruments in the financial markets of any country. These securities are issued by the central government and state governments.

Why the government security is called a gilt edged security?
The government security is a claim on the government. It is an absolutely secure financial instrument which guarantees certainity of both capital and interest. These securities are free of default risk or credit risk, which leads to low market risk and high liquidity.

How are these securities issued in the primary market?
The government securities are in the form of promissory notes. The name of the holder is registered in the Public Debt Office (PDO). The interest is payable half yearly. The securities are issued through PDO of the RBI by notification in advance. The issues are bought mostly by institutional investors.

Why do banks enter into the securities market?
Financial institutions like commercial banks are required to maintain their statutory reserve requirements in the form of government securities. Hence they purchase and sell these securities in the market.

What do you understand by 'Treasury operations'?
By Treasury operations, we mean trading in government securities in the martket. An investor Bank can purchase these securities in the primary market. Trading takes place in the secondary market.

What is meant by Liquidity adjustment facility (LAF)?

Banks are required to keep 5% of NDTL (Net Demand and Time Liabilities) as CRR (Cash Reserve Ratio) on a fortnightly basis for reserve requirements. The balances held with RBI by a bank at different centers provide for the CRR requirement, under the supervision of the treasury department. Banks having surplus funds above CRR, purchase securities from RBI with sell back obligation and earn interest. Likewise short liquidity position is overcome by incurring a cost through sale of securities to RBI. Sale by RBI is Repo and purchase by RBI is Reverse Repo. This mechanism is known as Liquidity Adjustment Facility (LAF). These days banks attach great importance for cash management in branches as maintaining minimum possible cash at branches, by remitting surplus cash to currency chests/RBI accounts, can result in maintanance of maximum balance at Bank's account with RBI. Banks can utilize this amount for gainful deployment in Treasury Operations.

How do banks undertake trading in government securities?

The SLR (Statutory Liquidity Ratio) requirements (presently 25%) are met by banks mainly by investment in government securities. The government undertakes deficit financing through borrowings by offering securities. RBI as Banker to the government,sells these securities in the primary market. Banks purchase these securities to meet SLR requirements. The current portion (held for trading) in the Bank's security portfolio is traded in the secondary market. The treasury departments of banks keep a close watch on security price movements and arrive at cost of investment and cost of disinvestment based on weighted average cost. The decision to hold till maturity or to trade is taken at the time of acquisition of a security. During the times of low credit off take and huge liquidity banks make investments on a large scale. With a watchful eye on the price movements in the secondary market, the securities are sold to willing buyers at a market determined premium or discount. The treasury departments in Banks undertake in depth studies on price movement of the securities, the interest rate changes in the economy, policy decisions of Government and inflationary trends. The Government of India policy decisions on taxation, borrowings etc affect the demand and supply of funds with resultant change in the interest rates. The inflationary trends also decide interest rate movements in the economy. The change in interest rates decide the security prices.

How do we estimate the returns on securities?

The important measures of returns on securities are

1. Coupon rate
2. Current yield
3. Yield to Maturity

Explain the terms 'coupon rate' & 'current yield'?

Coupon rate is the specified interest rate at the time of issue.

$$\text{Current yield} = \frac{\text{Coupon rate x 100}}{\text{Current Market Price}}$$

Eg: If a 10% GOI security of Rs.100/- is currently selling at Rs.120/- calculate the current yield?

Current yield = Coupon rate x 100 / current Market price

$$= \frac{10 \times 100}{120} = 8.33\%$$

Here when price of the security moved up from 100 to 120 the yield went down from 10% to 8.33%. In other words we can say decline in interest rate resulted in increase in the security price.

ie. Market price of security @10%=Rs.100/-
-do- @8.33%=Rs.120/-

What do you mean by the YTM (yield to maturity) concept?

YTM is the promised rate of return an investor will receive from a security purchased at current market price and held to maturity. YTM is declared based on the prevailing interest rate. The security prices maintain an inverse relationship with YTM. To arrive at YTM we equate the current market price with the discounted values of interest payments&terminal principal repayment. It is calculated by discounting the periodical interest and maturity principal inflows over the tenure of the instrument to their present market values. The rate at which these interest and principal inflows are discounted is called as YTM.

How can we calculate the present value of a bond?

The present value (PV) of a bond is determined using the following formula.

$$PV = \text{Coupon} / (1+YTM)^{1} + \text{coupon} / (1+YTM)^{2} + \ldots\ldots\ldots\ldots + (\text{coupon} + \text{face value}) / (1+YTM)^{n}.$$

Where n = No. of years till maturity
Coupon = Coupon rate x Face value.

Calculate the present value of a bond with face value Rs.100/, coupon rate 6%, terminal period 3 years and YTM 10%?

Using the above formula, we can arrive at the present value of the bond.

$$PV = 100 \times 0.06 / (1+0.10)^{1} + 100 \times 0.06 / (1+0.10)^{2} + (6+100) / (1+0.10)^{3}$$

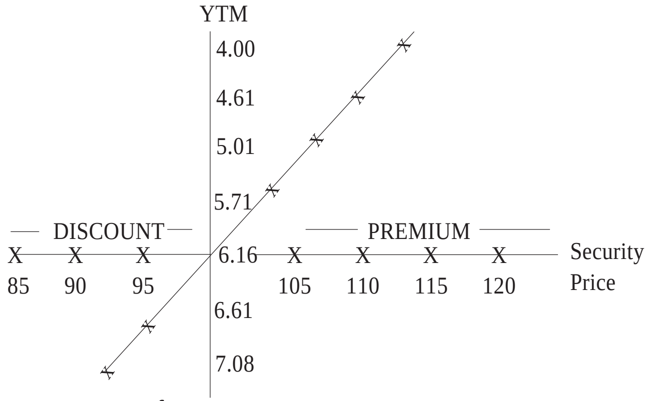
$$= 5.454 + 4.958 + 79.639$$

$$= 90.05$$

When we use the same formula at YTM 8%, the present value becomes 94.85. It means when the YTM is lowered from 10% to 8%, the present value of the bond increased from Rs. 90.05 to Rs. 94.85.

How can we graphically represent the security price movements?

Security Price movements in relation to YTM:- (Illustrative figures only)



Interest rate	YTM	Price of security	Premium/Discount
7.2%	6.16%	100	NA
6.8%	5.71%	105	+5 (Premium)
6.1%	5.01%	110	+10
5.5%	4.61%	115	+15
5.0%	4.00%	120	+20
7.5%	6.61%	95	-5
8.1%	7.08%	90	-10
8.6%	7.58%	85	-15

Premium is the increase in price of the security due to decrease in YTM. Discount is the decrease in security price due to increase in YTM.

How did banks book profits by trading in securities?

During the last two to three years, the interest rates were showing a steady decline. As part of the economic deceleration there was decline in interest rates almost to 300 basic points in 2001-02 alone. The resultant decrease in YTM pushed up security prices offering sufficient margin or premium for the players in the secondary market. The banks with huge investment portfolios with them booked high returns.

What is the latest development in the Government Securities Market?

During the current year the interest rates have started moving up as against the continuous softening last year. The major reason is the rise in inflation, much above the estimated levels. With interest rates firming up, the security prices witnessed a downward swing. The investment portfolios of banks are marked to market. Hence banks have to provide for depreciation on account of decline in security prices which in turn will affect the profitability of banks. From the half year results of commercial banks announced so far, it can be seen that in most of the cases the profits have declined due to lower return / losses from treasury operations. ❑

Theme No. 156 : BANCASSURANCE

A well informed customer will make the policy makers as well as organizations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organizations and improve the quality of goods and services produced.

The 'SIB Students' Economic Forum' is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the 'SIB Students Economic Forum'. The topic in this issue is "Bancassurance".

What do you mean by the concept 'Bancassurance'?
Bancassurance means distribution of insurance products through a bank's distribution network. It is an alternative business channel for banks. Now the insurance sector is opened up to private players. The insurance companies are fighting hard to maintain market share due to high competition. RBI has allowed banks to do insurance business for enabling them to increase earnings.

Why do banks turn more to alternative business channels?
With the implementation of banking sector reforms, Indian banks are exposed to stiff competition. The spreads (excess of income over expenditure) are narrowing. Hence they are compelled to shift their focus from interest based income to fee based income.

What is the biggest challenge in implementation of the scheme?
The biggest challenge is to obtain the harmonious integration of bank and insurance cultures. They are often different. Banks have purely service culture whereas the insurance companies have sales culture.

What are the motives behind the scheme?
Banks:

1. It is a means of product diversification.
2. It is a source of additional income.

Insurance Companies:

1. It is a tool for increasing their market share.
2. It helps them improve their premium turnover.

Customers:

1. It ensures them quality products.
2. It ensures delivery at door steps.
3. It ensures insurance at reduced competitive price.

How can banks implement the scheme successfully?

Banks have to adopt a sales culture in addition to the purely service culture. Bancassurance provides a potential source of income for the banks. They can increase their customer base and offer value added services. There is a negative perception of insurance that it is a security against death, accident etc. Banks can remove such misconceptions from the society by educating the customers that insurance is an investment option also. The success of the scheme mainly depends on the high level of understanding and commitment on the part of the bank staff.

What is the present status of the scheme in our country?

Banks and Non Banking Financial Companies (NBFCs) have been permitted to enter the insurance business under Insurance Regulatory and Development Authority (IRDA) Act 1999. Government of India has also allowed banks to undertake insurance business under section 6(1) of Banking Regulation act 1949. RBI permits banks to do insurance business

1) Joint Ventures- with risk participation.
2) Corporate agents of insurance companies - fee basis without risk participation.

What are the norms prescribed by RBI for banks to do insurance business other than as corporate agent?

1. Minimum net worth of Rs. 500 crores.
2. Minimum capital adequacy of 10%.
3. Reasonable level of NPAs(Non Performing Assets).
4. Continuous net profit for three consecutive years.
5. Satisfactory track record of subsidiaries.

What are the major requirements for a successful insurance business?

1. Asset Management and investment skills. 2. Distribution channels.
3. Capital adequacy

Why do banks feel that insurance is an ideal option in the highly competitive environment?

Banks have a large captive customer base. They have enough staff and wide network of branches. They can make use of their reach and existing customer base to maximise distribution of products and services. With adequate capital,banks have the exceptional skill to manage their assets. The scheme enables banks to improve their ROA (Return on assets)

What are the benefits available to banks through 'Bancassurance"?

1. They can generate greater fee income by increasing the overall sales.
2. They can retain the large customer base. Customer service can be improved by offering new value added services.
3. They can ensure more product penetration.
4. They get an opportunity to leverage existing assets.
5. The insurance schemes are tailor-made.
6. The emerging sales culture sharpen the marketing skills.
7. It is a means of product diversification.

What are the essential requirements for successful marketing of the scheme?

1. Clear understanding of the concept.
2. Meticulous selection of staff.
3. Effective training to upgrade marketing skills.
4. Efficient planning and implementation.

What are the different bancassurance models adopted around the world?

1. Distribution alliance.
2. Merger of bank & insurance company.
3. Joint venture between bank & insurance company.
4. Building own subsidiary.
5. Acquisition of an insurance company.

What are the common features of the different bancassurance models?

1. A wide customer base is already present.
2. A strong brand image is already existing.
3. Low cost for customer acquisition.
4. The products sold by banks are perceived as value added.
5. Bank staff is skilled in persuasive selling.
6. Cross- selling synergy is created.
7. Banks can create "one-stop shops".

Explain the meaning of cross-selling synergy?

Cross-selling is a strategy of pushing new products to existing customers. Synergy means the action of two or more working together to produce an effect greater than the sum of their individual effects.

Which is the most popular bancassurance model in Asia?

The most popular model commonly in operation in Asia is the distribution alliance. Under this model, banks have more opportunities for cross selling.

Is the 'Bancassurance' scheme popular in European countries?

Bancassurance enjoys the highest market share in France. The scheme commands almost 60% share with impressive growth in life insurance business. In many of the European countries bancassurance products represent 20 to 30%. A large portion of insurance buying in France is booked through banks. But in other countries, insurance sales are still driven by agents.

When did the first merger between a bank & an insurance company take place?

ING, the Dutch financial services firm was formed in 1990 through a merger of the country's largest insurance company, National Nederlanden NV and the NMB post bank. Recently in US, Citi bank and travellers group have merged.

What are the success stories in bancassurance operations abroad?

In Malaysia, Maybank launched its bancassurance operations in 1996. They were extremely cautious in selection of the products. The bank staff selected for the business were highly capable and skilled. The average sales by agents in Malaysia was one life policy per month per agent. But Maybank staff could sell almost ten times this average. In Hongkong the bancassurance based sales channels produced a rise in business of over 24%.

What is the scope for 'Bancassurance' in India?

The scheme is already in force in some form or the other. There is large scope for personal insurance products in our country. There is a huge market for life insurance products and householders' insurance products. Both LIC and GIC have a range of products. The Government has allowed tax benefits for life insurance premia.

What are the adverse factors in the development of 'Bancassurance' in India?

1. IT requirements such as net working, internet etc. are still at the initial stage.
2. The middle class feels the pressure of price rise and tax burden.
3. Product flexibility is very limited.

What are the essential requirements for the success of the scheme?

1. Knowledge about the customer needs and expectations.
2. Strong service delivery mechanism.
3. Integration of insurance products with banks' products.
4. Improvement in sales culture of banks.
5. High quality training to the field staff.
6. Bank referral scheme to be strengthened.
7. Product development and product diversification.

What is meant by "referral" business?

Banks provide physical infrastructure within their select branch premises to insurance companies for selling their insurance products to banks' customers. This arrangement is called 'referral' business. Banks undertake referral business with adequate disclosures and transparency by collecting referral fee based on premia collected.

❑

Theme No. 157 : GOLD CARD SCHEME FOR EXPORTERS

What do you mean by the gold card scheme for exporters?

With a view to simplifying the procedures and relaxing the credit terms to exporters in general, and small and medium exporters in particular, the gold card scheme was originally proposed by the Ministry of Commerce & Industry. The scheme has been framed by RBI in consultation with exporters and bankers, based on the provisions in the Exim policy 2003-04. There is a general feeling among the exporters especially small exporters that the terms and procedures for export credit from banks are very stringent. The major aim of introducing the card is to make credit terms more borrower friendly. The scheme provides certain additional benefits based on the past performance of exporters. The eligibility for the gold card is the exporter's good track record. The card holder is ensured simpler and efficient credit delivery from the banking system.

What are the other eligibility norms for the scheme?

1. The accounts maintained by the exporter should be in the "standard" category continuously for the last three years.
2. The operations in these accounts should be regular and no adverse feature has been noticed.
3. The scheme is not applicable to exporters who are included in ECGC black list or RBI defaulters' list / caution list.
4. Exporters who are incurring losses for the past 3 years are not eligible.
5. Exporters having overdue export bills more than 10% of current year turnover are also not eligible.
6. The scheme is intended mainly for small and medium exporters with satisfactory export turnover.
7. Bank's decision regarding creditworthiness of an exporter will be the basis of eligibility.

What are the major objectives / benefits under the scheme?

1. One of the major objectives is to identify good exporters based on the credit-worthiness and past export performance.
2. Under the scheme, the credit terms including interest should be more cost effective than those extended to other exporters.
3. The processing of application should be simpler and faster.
4. Initially a limit for a period of three years should be sanctioned with a provision for automatic renewal subject to the terms and conditions of the sanction.
5. Gold card holders should be given preference in granting PCFC (Packing credit in Foreign Currency).
6. The card holders may be considered for issuance of foreign currency credit cards for meeting urgent requirements.
7. The charges and fees in respect of advances under the scheme should be relatively lower than other export advances.
8. The norms regarding security and collaterals should be relaxed in the case of gold card holders.
9. Banks can sanction any other facility/ies to the card holder subject to current regulations.
10. The eligibilty under the scheme should be strictly based on credit worthiness and track record of the exporter.

What are the additional facilities offered by banks to card holders?

The card holders are eligible for value addition with access to banks' services such as ATM, internet banking, International debit/credit cards, Mobile banking and so on. All major commercial banks in the country have devised the Gold card scheme offering various benefits to the exporters. The details of the scheme are available in the web sites of banks.

What is the procedure of sanctioning limits under the scheme?

The permissible need – based limit is fixed based on the projected exports turnover. Banks sanction an "in-principle" limit to the card holders very liberally. Initially the limit is sanctioned for a period of three years. The renewal of the limit is automatic subject to fulfilment of the terms and conditions of the original sanction.

How do banks fix the interest rate under the scheme?

Presently banks fix interest rates on their borrowal accounts based on a risk based rating mechanism. Since the scheme is applicable only to credit worthy exporters with good track record the rating method followed in the case of card holders will be much transparent and soft. Hence the rate of interest and other terms are likely to be better than those charged for other exporters. The concessional rate on post shipment rupee credit applicable to 90 days will be extended for a maximum period of 365 days for card holders.

What are the instructions issued by RBI regarding the time frame for disposal of applications under the scheme?

RBI has directed banks to dispose of all fresh applications within a period of 25 days. The time frame for renewal is 15 days and for sanction of ad-hoc limit is 7 days.

Are the card holders eligible for additional limits?

RBI has advised banks to provide stand – by limits not exceeding 20% of assessed limit to facilitate urgent credit needs of exporters. In the case of exporters of seasonal commodities, peak level and non- peak level limits have to be specified.

What is the preference given to card holders over other exporters?

Card holders are given preference in their foreign currency requirements. PCFC loans are given to card holders on a priority basis against availability of foreign currency funds. The maximum rate of interest to be charged is LIBOR + 0.75%. Banks are allowed to levy service charge at a flat rate of 0.1% on the inter bank foreign currency borrowing, in case funds are raised from international market.

What are the extant instructions of RBI on the scheme?

1. Banks have to simplify the export application format.
2. The inventory norms should be relaxed in the case of unanticipated export orders.

3. While fixing the limit, the size and nature of the export order should be taken into account.
4. A system for performance appraisal should be introduced, to recognise the better performance and the resultant benefits should be passed on to the exporter.

What is the instruction given to banks regarding ECGC premium?

In case of deserving card holders, bank can use its discretion to exempt them from ECGC guarantee under the packing credit guarantee–scectoral- scheme of ECGC.

❑

Theme No. 158 : INDIAN FINANCIAL SYSTEM

What is the role of a financial system in an economy?

The financial system is an orderly mechanism or structure for financial transactions in any economy. It plays a key role in the smooth and efficient functioning of the economy. The major function of the financial system is mobilising resources from the surplus sector and allocating these resources to the needy sector. Thus it satisfies both the savings needs and investment demands of the community. It is a complex, well-integrated set of of sub-systems which facilitates the mobilisation and allocation of funds, efficiently and effectively.

The sub-systems are

1) Financial instituitions
2) Financial markets
3) Financial instruments
4) Financial services

Explain the various transformation mechanisms performed by the financial system?

The financial system performs the basic function of intermediation through four transformation mechanisms.

1) Liability-asset transformation: Accepting deposits as a liability and converting them into assets such as loans.
2) Size transformation:- Conversion of small deposits into large loans.
3) Maturity transformation: Offering deposit products to savers according to their liquidity preferences and providing loans of desired maturities to borrowers.
4) Risk transformation: distributing risks through portfolio diversification.

How can we classify the various financial institutions in the system?

The financial insitutions can be classified based on the major functions they perform.

1) Accepting deposits &lending – Banks.
2) Risk pooling and providing insurance cover –Insurance Companies.
3) Contractual savings- Pension funds, mutual funds

4) Market makers.
5) Financial service providers.

Discuss on the role of financial institutions in the system?

The financial institutions act as intermediaries. They serve as a link between depositors and borrowers. The depositors are buyers of securities and the borrowers are issuers of securities. Depositors and borrowers differ in regard to terms of risk, return, maturity and so on. Financial institutions play the role of intermediaries by aquiring claims on the borrowers and offering claims against themselves.

How do banks play a major role in the financial system?

Banks accept demand and time deposits from the public for the purpose of lending and investment. They also provide a range of financial services, including stock broking, security dealing and financial advice. Bank deposits are considered highly liquid, safe and reasonably remunerative. Above all the public prefer banks to other players due to the high level of convenience and easiness of transactions.

What is the role of an insurance company?

Insurance companies specialise in providing contingent promises by underwriting economic risks associated with death, illness and other exposure to loss. Insurance companies are divided generally into life insurance and non-life insurance. In life insurance the risk is long term whereas most other insured risks are short term.

Discuss on contractual savings schemes?

People can invest their funds in collective investment vehicles such as mutual funds or private pension funds. These vehicles invest the pooled resources of individuals in a wide range of equity, debt and derivative promises. The ultimate risk inherent in the investment portfolio is borne by the individual and not by the investment vehicle.

What do you mean by “market makers”?

Market makers are institutions which make markets in financial securities like equities,government securities,derivatives and so on. They make primary markets by underwriting new issues and secondary markets by taking principal position as buyers or sellers of existing securities.

Who are the financial service providers?

The financial service providers provide service in the form of advice, broking and so on. Unlike other institutions in the financial system, they do not act as an intermediary between the promisor and the promisee. They charge a fee for the service provided by them. eg., share broker.

What is a financial market?

A financial market is a mechanism for the exchange or trading of financial products It comprises two distinct types of markets.

1) Money market
2) Capital market

Who are the major participants in the financial markets?

The major participants are

1) Investors
2) Borrowers
3) Lenders
4) Financial intermediaries.

What are the characteristics of financial markets?

1) The financial markets undertake large volume of transactions facilitating fast movement of financial resources from one market to another.
2) The savers themselves can decide on investments in bank deposits, stock markets bond markets etc.
3) The financial intermediaries dominate the various markets with their decision making capabilities and risk assessment skills.
4) The various segments of the financial markets are inter -linked .

What are the functions of a financial market?

1) It serves as an efficient payment mechanism.
2) It provides information about issuers of various instruments to the investors.
3) It performs portfolio management.
4) It provides liquidity through trading in securities.
5) It helps in diversifying and reducing risk.

What is a money market?

A money market is a market for short term debt instruments with maturity below one year. It is a highly liquid market. Short term securities are bought and sold in large denominations to reduce transaction costs.

What are the major segments/ instruments dealt with in the money market?

1) Call money market.
2) Certificate of deposit
3) Commercial paper
4) Treasury bills

What are the functions of a money market?

1) It serves as an equillibrium in the distribution of cash in accordance with the liquidity needs.
2) It helps management of liquidity and money in the economy by monetary authorities.
3) It provides access to users of short term money at realistic yield.

What is a capital market?

A capital market is the market for long term securities both equity and debt. It can be further classified into primary and secondary markets. The primary market is meant for new issues of shares ,bonds etc. The market where trading of already issued shares,bonds etc take place is the secondary market. The secondary market provides liquidity since the investor can buy or sell shares/other securities without any difficulty. The secondary market is also called a stock market.

What is the link between money market and capital market?

Financial institutions actively participate in both the markets. The funds raised in the money market provides liquidity for long term investment and redemption of funds in the capital market.

Discuss on the various types of promises traded in the financial markets?

As we already discussed, the financial system consists of markets. Market is defined as a place where things are traded. In financial markets the things traded are characterised as promises.

The various types of promises are

1) Debt promises
2) Equity promises
3) Contingent promises and so on.

Debt promise is to pay a certain sum on a certain future date like bank deposits, Govt. securities and so on.

Equity promise is a claim over the residual earnings of a company eg ; equity shares.

Contingent promise is to make specified payment under specified circumstance such as insurance, warranty, guarantee and so on.

There are other types of promises also, which are combination of any two or more of the above promises (mutual funds, private pension funds and so on).

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Theme No. 159 : BOARD FOR INDUSTRIAL & FINANCIAL RECONSTRUCTION (BIFR)

What do you know about BIFR?

BIFR means Board for Industrial & Financial Reconstruction. The board was set up as a quasi-judicial body for examining the industrial and financial reconstruction of sick industrial units. BIFR became functional with effect from 15th May 1987. It has wide ranging powers with regard to change/take over of management, reconstruction, amalgamation, sale, lease and so on without interference of any legislation or statutory body.

The Government wants to replace BIFR by establishing National Company Law Tribunal (NCLT). The new tribunal will come into effect only when the Companies (second) Amendment Act 2002 will be notified in the Government of India gazette. Once the Act comes into force BIFR will be replaced by the NCLT.

Give a brief idea on the genesis of BIFR?

In 1981, the Govt. of India set up a committee of experts under the chairmanship of Sri.T.Tiwari to examine the reasons for sickness in the medium and large sectors in the industry and recommend suitable remedies thereto.

The major recommendations were

1) Need for a special legislation.
2) Need for setting up of an exclusive quasi-judicial body.

Based on the above recommendations of the committee, the Govt. of India enacted a special legislation namely the Sick Industrial Companies (Special Provisions) Act, 1985 popularly known as the **SICA.** BIFR was set up under the Act and it became operational from 1987.

What are the objectives of SICA?

1) To timely detect the sick and potentially sick companies and undertake

revival of potentially viable units. By revival of the viable units, the idle investments will become productive.

2) To undertake closure of unviable units. By closure of unviable units, the locked up investments would get released for productive use elsewhere.

Which are the companies that come under the purview of SICA?

In 1991, the Government made extensive changes in the Act, including the criteria for determining industrial sickness. The major intention of the Government was to bring all Government companies under the purview of the Act. SICA applies to both public and private companies owning industrial undertakings:

i) Pertaining to industries specified in the 1^{st} schedule to the Industries (Development & Regulation) Act, 1951 (IDR Act) except the industries relating to ships and other vessels drawn by power.

ii) Not being "small scale industrial undertakings or ancillary industrial undertakings" as defined in section 3(i) of IDR Act.

What is the definition of a Sick company?

A Sick Industrial Company means a company having fulfilled all the following conditions

1) The accumulated loss of the company to be equal to or more than its net worth (Paid up capital plus free reserves).

2) The company should be in existence for atleast 5 years since the date of incorporation.

3) The company should have 50 or more workers on any day of the 12 months preceding the end of the financial year with reference to which sickness is claimed.

4) The company should have a factory license.

What is meant by a potentially sick Industrial Company?

It means an industrial company whose accumulated loss is more than fifty percent or more of its peak net worth during the immediately preceding four financial years.

What are the symptoms of a company becoming sick?

1) Frequent liquidity problems.
2) Fall in sale/profits.
3) Rapid increase in debtors.
4) Reduced working capital.
5) Unfavourable market developments.
6) Labour unrest.
   (The list is not exhaustive)

What are the obligations of a sick industrial company?

1) Make a reference to BIFR within sixty days from the date of finalisation of audited accounts for the financial year in which the company has become sick.
2) If the director board has sufficient reasons to form an opinion that the company has become sick, it can make a reference to BIFR within sixty days of forming such an opinion.
3) Application has to be made to BIFR under Form AA by a Government company and in Form A by an industrial company other than a Government company.

What is the role of BIFR in the case of a sick industrial company?

An industrial company which has accumulated loss equal to or exceeding its entire net worth is required to report to the BIFR as sick. They will conduct enquires to see whether the company is a sick company or not. If necessary they may appoint Operating Agency –OA (any Public Financial Institution, Bank or any other person) to enquire into and make a report. Within a period of sixty days the enquiry will be concluded by BIFR/OA.

What is an order by BIFR?

If the board is satisfied after the completion of enquiry that the company has become sick, BIFR has to make an order in writing whether it is possible for the company to make its net worth exceed the accumulated losses within a reasonable time. If not the board may direct the operating agency to prepare a scheme within a period of ninety days for any of the following:

1) Financial Reconstruction.
2) Change in management.
3) Amalgamation.
4) Sale or lease a part or whole of any industrial undertaking of such company.
5) Rationalisation of managerial personnel.
6) Other remedial steps as may be appropriate.
7) Winding up as a last resort.

❑

Theme No. 160 : MONEY MARKET INSTRUMENTS

What is a money market?

The market where money and other short term financial assets are traded is called a money market. Short term financial assets are those assets which are close substitutes for money catering to the short term requirements of borrowers. It provides an avenue for the lenders and investors to park their short term surplus funds.

What are money market instruments?

Money market instruments are short term instruments with varying degree of liquidity. They are generally traded at low cost. The money market in India is highly developed due to the presence of a variety of instruments with easy settlement terms available in the market.

The major instruments are

1) Treasury Bills
2) Commercial Papers
3) Commercial Bills
4) Certificate of Deposit
5) Ready Forward Repos
6) Call & Notice Money

What is a treasury bill?

Treasury bill is a promissory note issued by Reserve Bank of India on behalf of the Central Government to meet the short term liquidity shortfalls. The Government raises short term funds to bridge the temporary gap between receipts and expenditure. Treasury bills are always issued at a discount and are repaid at par on maturity. The yields are market determined based on the demand and supply and TDS (Tax deducted at source) is not applicable.

How does RBI issue Treasury bills?

Treasury bills are issued by RBI through auctions. The auctions are conducted at varying discount rates depending upon the bids usually on fortnightly or weekly basis. The bills can be subscribed by any person resident in India including individuals,firms,companies, corporate bodies and institutions (except state Government & Provident Fund). Generally there is no cut-off limit for borrowing by the Government, but RBI occasionally suggests a cap to restrict the borrowings. These bills are issued at discount with face value of minimum Rs. 1 lakh and its multiples.

What are the major features of Treasury bills?

1. They are negotiable securities, with attractive yields.
2. They are highly liquid with nil default risk.
3. They are eligible for inclusion as SLR security.
4. Transaction cost is very low.
5. Treasury bills are issued for maturities of 91 days and 364 days.

Define a Commercial Paper?

A commercial paper (CP) is an unsecured short term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. Commercial Papers are used by highly rated corporate borrowers for raising short-term funds by way of private placement. Financial institutions and Primary dealers can also issue CPs subject to the overall working capital limits.

What are the conditions for issuing CP?

1. The tangible net worth of the company should not be less than Rs. 4 crores as per latest audited balance sheet.
2. The company should be enjoying a fund based working capital limit.
3. All the accounts of the company should be in the “Standard Assets” category.
4. The company should have obtained the specified minimum rating from an approved credit rating agency.
5. The rating received from the agency should not be more than 2 months old.

What are the special features of CPs?

1) CPs are issued for a minimum period of 7 days and a maximum period of one year.
2) The interest rates are market determined based on demand and supply.
3) The minimum investment by a single investor should not be less than Rs.5 lakhs.
4) CPs are issued for minimum Rs. 5 lakhs and beyond in its multiples.
5) CPs are subscribed by individuals, Banks, Non - resident Indians, foreign institutional investors and so on.
6) Banks have to reduce the fund based working capital limits of the company to the extent of the issue.
7) CPs are issued in demat form at a discount to face value.

What is a commercial bill?

Commercial bill is a short term, negotiable, and self- liquidating instrument with low risk. Discounting of commercial bills is a form of working capital facility provided by banks to business firms. A bill is a written instrument containing an unconditional order, signed by the maker, directing to pay a certain sum of money only to a particular person, or to the order. When bills are drawn by seller on the buyer, they are called trade bills. When trade bills are accepted by commercial banks they become commercial bills.Banks usually discount these bills by keeping a certain margin. These bills are eligible for rediscount.

What are the major features of commercial bills?

1) Commercial bills can be traded by offering the bills for rediscounting.
2) Commercial bills have high degree of liquidity.
3) Commercial bills are transferable by endorsement and delivery.

What is a certificate of Deposit (CD)?

It is an unsecured, negotiable short - term instrument in bearer form, issued by scheduled commercial banks. It is a money market instrument issued by banks in the form of a usance promissory note for funds deposited with them. CDs help banks to mobilise bulk deposits from the market at competitive rates of interest.

What are the major features of CDs?

1) CDs are issued for face value of Rs.1 lakh and its multiples thereof.
2) CDs are issued for a minimum of 15 days to a maximum period of 12 months.
3) CDS are issued at market determined rates.
4) CDs can be issued by all scheduled commercial banks except Regional Rural Banks (RRBs).

What are the conditions for issue of CDs?

1) Banks have to maintain CRR & SLR on the issue price.
2) CDs can be issued only in demat form.
3) The repayment on maturity will always be made by way of crossed cheques.
4) No loans are allowed against CDs.

We have already dealt with call money markets and Ready Forward Repos in our earlier issues.

❏

Theme No. 161 : BANKING RISKS

What is meant by "Risk"?

The word "Risk" derives its origin from the Latin word "RESCUM" meaning risk at sea. Risk is associated with uncertainity. It is inherent in all activities. Risk is defined as the probability of unexpected outcome. Risk, like energy,cannot be destroyed. It can only be transferred to another.

Briefly describe the background of the various risks faced by banks?

Indian banks were operating in a highly regulated environment. As part of the banking sector reforms initiated in 1991, one of the major steps taken by RBI was deregulation of interest rates. Banks are now given freedom to formulate their own policies and procedures. RBI also introduced prudential accounting norms which included asset classification, provisioning and capital adequacy requirements. Banks are allowed to enter into new areas like merchant banking, mutual funds and so on as part of the move towards universal banking. As a result of these reforms in the banking industry, Indian banks have started operating in a highly competitive environment. Banks are now playing in a highly uncertain and risky field due to the integration with international markets. Customers have become more demanding. Banks have implemented technology in a big way. They have started concentrating more on marketing and innovation of newer products and services to remain competitive in the market. The banking industry, as a whole, is now encountering various risks mainly due to cross border dealings, adverse loan recovery,slow and expensive legal process and so on. The banking risks have created volatility in Net Interest Margin (NIM) in the short run and Net Economic Value (NEV) in the long run.

How is risk related to "capital"?

Risk is the probability of any adverse impact on the bank's capital due to unexpected events. The expected loss can be avoided or reduced by adequately pricing the products. It is the amount expected to be lost due to change in credit quality and resultant default by the borrower. The unexpected loss is to be borne entirely by the bank itself and hence is to be taken care of by capital.

What are the major types of risks encountered by banks?

As per Reserve Bank of India guidelines issued in October 1999, banking risks are grouped into three clearly identifiable categories. They are as follows

a) Credit Risk
b) Market Risk
c) Operational Risk.

What is Credit Risk?

Credit risk is the possibility of losses associated with diminution in the credit quality of borrowers or counter parties. It is the probability of a bank borrower/ counterparty failing to meet the obligations on agreed terms. The major reasons for such losses are

1) the inability of the borrower or counter parties to meet their commitments
2) the wilful default by the borrower or counter party to meet their commitments.
3) the reduction in the asset value arising from reduction in credit quality.

What is Market Risk?

Market risk is defined as the possibility of loss to a bank caused by the changes in the market variables. It is the risk to the bank's earnings and capital due to changes in the market level of interest rates, prices of securities, exchange rates and so on. As far as Indian Banks are concerned, market risk would primarily constitute

a) Interest rate risk
b) Foreign Exchange risk
c) Equity Price risk
d) Commodity price risk
e) Liquidity risk

What is Operational Risk?

Operational Risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from any external events. Thus operational risk results from deficiencies in internal processes,systems and procedures due to non-conducive work environment, incompetent staff, technology related problems or any other external reasons.

How is Risk Management undertaken in Banks?

With the implementation of banking sector reforms, banks have put in place appropriate policies to manage the various risks arising due to the fast changes taking place in the industry. RBI has been emphasizing the need for efficient measuring, monitoring and management of various risks in banks. Banks have to define the various types of risks indicating the tolerance levels. They have also to design various tools and rating models for risk management. Risk management involves creation of proper organisational set up manned by trained and qualified personnel ensuring effective corporate governance practices. The essential functions of risk management are identifying, measuring and monitoring the risk profile of the bank. The objective of risk management is to ensure that the risks are anticipated with clear understanding so that they can be measured and mitigated.

What is meant by Risk Based Supervision (RBS)?

As part of the monetary and credit policy statement 2000-01, RBI developed an overall plan for moving towards risk based supervision (RBS) of banks. The RBS approach entails supervisory attention in accordance with risk profile of banks in relation to their business strategies and exposures. The major aim is to minimise the impact of a crisis situation in the financial system. Banks have started redesigning their inspection and audit systems in line with RBS approach of RBI. The implementation of risk based auditing emphasises a major role to be played by internal auditors in risk mitigation. ❑

Theme No. 162 : CREDIT RISK

How do we define credit risk?

Credit risk is the possibility of losses associated with diminution in the credit quality of borrowers or counter parties. It is the potential risk when a bank borrower/counterparty fails to meet the obligations on agreed terms. The major reasons for such losses are

1) the inability of the borrower or counter parties to meet their commitments
2) the wilful default by the borrower or counter party to meet their commitments.
3) the reduction in the asset value arising from reduction in credit quality.

What are the major reasons for credit risk in banking operations?

The major activity of a bank is either lending or investment. Lending can be either fund based or non-fund based. In the case of fund based business, credit risk arises when principal or interest is not repaid as per the original terms and conditions. In non-fund business, if the constituents do not fulfil their commitments on crystallisation, credit risk arises. Credit risk also arises when the counter parties fail to make payments or effect settlements of securities.

What are the major components of credit risk?

Credit risk consists of primarily three components.

1. Quantity of risk, which represents the outstanding balance as on the date of default
2. Quality of risk, which represents the severity of loss, depending on the quality of assets
3. Probability of loss

What is meant by credit migration?

Generally default does not happen suddenly. The borrowers' creditworthiness and asset quality decline only gradually. This is known as credit migration.

What do you mean by Credit risk Management?

Banks have designed various policies to counter credit risk. Credit risk management emphasises the need for efficient monitoring of both the lending and investment portfolios. The new norms on capital adequacy call for efficient management of the credit portfolio. Banks have designed various tools and rating models for credit risk management. Credit Risk Management mainly focuses on three major aspects.

1) Solvency
2) Liquidity
3) Quality

Solvency is related to non-payment and liquidity is related to delay in payment. Quality is related to changes in the value of an asset.

What are the various steps in Credit risk Management?

The most critical stage in credit risk management is the measurement of risk. But in order to measure the risk, it has to be identified properly. Once the risk is identified and measured the next step is to control the risk mainly through monitoring. The major step in credit risk measurement is to quantify both expected loss(EL) and unexpected loss(UL).

How can we quantify both EL and UL?

The major components in quantification of EL and UL are

1) Probability of default (PD)
2) Expected exposure at default (EAD)
3) Loss given default (LGD)

Explain the terms Probability of default (PD), Exposure at default (EAD) & Loss given default (LGD)?

Probability of default (PD):

Probability means the likelihood of an event occuring in the immediate present or future. While measuring the risk, the probability is assigned weightage from 0 to 1 based on the likelihood of its occurrence or non-occurrence. In case an event is impossible to happen, its probabilty is 0. If an event is quite certain to occur, the value assigned is 1. The probability of default is arrived at with the help of internal credit rating systems in banks.

Exposure at default (EAD):

Exposure at default means the actual exposure of the bank at the time of default. The actual loss of the bank is also relative to the extent of credit exposure.

Loss given default (LGD):

Here bank arrives at the present value of future recoveries at the time of default. This is done on an assumption that there will be recovery by way of realisation of securities. Loss given default depends on the recovery rate. The present value of recovery as a percentage of exposure at the time of default is the recovery rate. Generally Loss given default is expressed in percentage as (100 – recovery rate).

How is expected loss arrived at ? Calculate the expected loss where bank has given a loan of Rs. 1 crore with PD 50% and recovery rate 60%?

Expected loss is arrived at using the formula
EL= PD x LGD x EAD

In the example,
PD = 50% = 50/100 = 0.5
LGD = 100- recovery rate = 100- 60 = 40% = 40/100= 0.4
Hence EL = 0.5 x 0.4 x Rs. 1,00,000,00/-
= Rs. 20,00,000/-

How is unexpected loss arrived at?

Unexpected loss is the difference between actual loss and expected loss. Unexpected loss can be calculated based on the volatility or variance of LGD and PD. If there is no variance in both LGD and PD, unexpected loss will be zero.It means unexpected loss results from the variance in both LGD and PD.

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JUNE 2005

Theme No. 163 : MARKET RISK

What is Market Risk?

Market risk is defined as the possibility of loss to a bank caused by the changes in the market variables. Market risk is diminution in the value of both on and off balance sheet exposures due to movements in various market variables such as exchange rates, interest rates and so on. It is the risk to the bank's earnings and capital. We discuss here the major constituents of market risk.

a) Interest rate risk
b) Foreign Exchange risk
c) Liquidity risk

What do you mean by Interest rate Risk?

Interest rate risk is the adverse impact on the net interest margin (NIM). Net interest margin is the difference between yield on funds and cost of funds. When the interest rate movements cause a fall in NIM, the financial position of the bank is affected adversely. The changes in interest rates affect not only earnings but also the value of on and off balance sheet items and future cash flows.

Describe the various types of interest rate risks?

Mismatch risk : arises from holding assets and liabilities with different principal amounts and maturity dates.

Basis risk : arises when the interest rates of various assets and liabilities undergo changes in different magnitudes.

Net Interest Position risk : arises while holding varying amounts of rate sensitive assets and liabilities in the balance sheet.

Embedded Option risk : arises when customers prepay advances or prematurely withdraw deposits exercising the embedded options available in these products in response to changing interest rates.

Price risk : arises as assets change value in accordance with movements in interest rates.

How do the interest rate movements affect the investment portfolio of banks?

As per RBI guidelines, the investments of banks are classified under two major heads.

a) Held to Maturity (HTM)
b) Held for Trading (HFT) & Available for Sale (AFS)

The investments under the second category (HFT & AFS) have to be marked to market at monthly /quarterly intervals. The value of investments are inversely proportional to interest rates. If the interest rates in the market go up, investments undergo depreciation and if interest rates decline, investments in the bank's portfolio gain in value. As per the current guidelines, any such depreciation will have to be accounted for in the books.

What are the various techniques for measuring interest rate risk?

The most popular method for measuring the future losses that occur in a portfolio of assets is Value at risk (VaR). The other methods are Maturity Gap analysis, Duration Gap analysis and so on.

Explain the technique of Value at Risk (VaR)?

Value at Risk (VaR) is an estimate of potential loss in a portfolio of assets/

liabilities over a given holding period at a given level of certainty. VaR is an estimate of the loss likely to suffer and not the actual loss. It measures only the potential loss and not the potential gain. The holding period would depend on the liquidity of the instrument/ market and would be one day, few days, few weeks or a year. The VaR amount would be different for varying levels of certainty.

What do you mean by Forex Risk?

Forex risk is the possibility of losses that a bank may suffer as a result of adverse exchange rate movements during a period in which it has open position either spot or forward, or a combination in an individual foreign currency. The banks are also exposed to interest rate risk which arises from the maturity mismatch of foreign currency positions, when interest rates of such foreign currencies change.

How do banks manage forex risk?

Banks usually fix appropriate limits for open, day light and over night positions. These limits are maintained by the forex departments of banks for each currency. Also they set stop-loss limits, aggregate gap limits and so on to monitor the forex risk.

What do you mean by Liquidity Risk?

Liquidity is the ability of banks to mobilize resources from the surplus sector and allocate the resources to the needy sector to facilitate loan growth. Liquidity is the ability to efficiently accommodate fall in deposits and other liabilities as well as growth in loans and other fund assets and also the possible funding of off balance sheet claims. Banks typically borrow short term and lend long term. Liquidity risk arises when there is mismatch in the maturity pattern of assets and liabilities and banks fail to manage the same.

What are the major forms of liquidity risk faced by banks?

1) Funding Risk : arises when there is unexpected withdrawal or non-renewal of deposits.

2) Time Risk : arises when banks fail to receive expected inflows of funds mainly due to loan assets turning irregular or non-performing.
3) Call Risk : arises mainly on account of crystallisation of contingent liabilities.

How do banks manage liquidity risk?

The major tool in the risk management system of banks is the Asset Liability Management (ALM). Under the system all assets and liabilities are arranged simultaneously on a continuing basis to ensure proper balance between mobilization and allocation of funds. Banks maintain maturity profiles by studying the impact of pre-payment of loans and premature withdrawal of deposits.

❑

Theme No. 164 : OPERATIONAL RISK

How do you define operational Risk?

Basel Committee on Banking Supervision defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition thus brings out the four broad causes of operational risk: people, processes, systems and external factors.

How do operational risks arise in banks?

Deregulation and globalization of financial services in the context of rapid advances in computing and telecommunications are making the operations of banks extremely complex and risky. A few specific causes of operational risks are:

- Use of highly automated technology such as integrated accounting systems, centralised banking capabilities etc. which invariably result in concentration of operational risks. The emergence of e commerce is also capable of exposing the banks to serious security breaches for which the losses can be significant.
- Complex and large volume activities undertaken by banks require adequate internal controls and back up systems.
- Growing use of outsourcing is a potential source of operational risk which a bank is exposed to.
- Acquisitions, mergers, demergers, consolidations, organizational restructuring etc. pose significant risks to the smooth integration of the various technology, business and organizational systems.

How does operational risk manifest itself?

Operational risk manifests itself in many ways. Some examples are:

- Theft
- Fraud
- Misreporting
- Money laundering
- Hardware failure
- Software failure
- Back up failure
- Telecom network failures
- Data entry errors
- Incomplete documentation
- Break down of accounting or other systems
- Insider trading
- Hacking
- Security lapses
- Natural disasters
- Man made disasters

What is operational risk management and what is its relevance?

Operational risk management refers to the identification, assessment, monitoring and control/ mitigation of operational risks facing banks.

Growing number of large operational losses world wide have led banks to view operational risk management in a more focussed manner. Management of operational risks has been in practice by way of fraud prevention, maintenance of internal controls etc but what is relatively new is the approach to operational risk management as a comprehensive practice comparable to the management of credit and market risk. Basel Committee on Banking Supervision has suggested that banks should maintain capital for the various operational risks they assume in the course of their business.

What are the key components of Operational Risk Management?

The key components are:

- Framing appropriate policies and procedures which should be documented and well communicated to the relevant staff.

- A mechanism to identify risks inherent in various products, activities processes and systems and an assessment of the probability of such risks.
- Periodic monitoring of operational risks by identifying key risk indicators that provide early warning signals.
- Sound system of internal controls.
- Appropriate testing of the efficacy of the overall operational risk management framework.

What are the various options for capital for operational risk under Basel II norms?

The New Capital Adequacy Framework, popularly known as Basel II has put forward various options for calculating operational risk capital. They are in the order of their increasing complexity, viz (1) Basic Indicator Approach. (2) Standardised Approach (3) Advanced Measurement Approaches.

What is the Basic Indicator Approach for the calculation of Capital for operational risk?

Under this approach banks have to hold capital for operational risk equal to a fixed percentage, referred to as alpha, of a single indicator, which is proposed to be "gross income"

$$K = (GI*\alpha)/n$$

Where

K = Capital charge under Basic Indicator Approach.

GI = annual gross income, where positive, over the previous three years.

n = number of the previous three years for which gross income is positive.

The α percentage as fixed by the Committee is 15%.

What is the Standardised Approach for the calculation of Capital operational risk?

Under the Standardised approach banks activities are divided into eight business lines (corporate finance, trading and sales, retail banking, commercial banking, payment & settlement, agency services, asset management, retail brokerage) against each of which an indicator is specified to reflect the size or volume of banks activities in that area. Within each business line the capital charge is calculated by multiplying the indicator by a factor referred to as beta assigned to that business line. The Basel II proposals also contain an Alternative Standardised Approach as per which the methodology is the same as for the Standardised Approach except that for retail banking and commercial banking the indicator is modified.

What are the Advanced Measurement Approaches for the calculation of operational risk capital?

Under Advanced Measurement Approaches banks would be allowed to use the output of their internal operational risk measurement systems, subject to qualitative and quantitative standards set by the Committee. The above approaches, which fall under three broad categories, are as under:

a) Internal Measurement Approaches:- which attempt to quantify the unexpected operational losses based on level of expected operational losses.
b) Loss Distribution Approaches:- which attempt to estimate the likely operational risk losses over some future horizon based on appropriate distributions.
c) Scorecard Approaches:- as per which an initial level of capital is determined and then modified over time on the basis of ‘scorecards’ that attempt to capture the underlying risk profile.

❑

Theme No. 165 : BANKING CASH TRANSACTION TAX

What do you know about Banking Cash Transaction Tax (BCTT)?

The banking cash transaction tax was introduced in the Finance Bill 2005 and is applicable to transactions with effect from 1st June 2005. Every scheduled bank shall collect the BCTT from every person who enters into a taxable banking transaction @ 0.1% with effect from 1st June 2005. The value of taxable banking transaction shall be the amount of cash withdrawal from an account or the amount of cash received on encashment of term deposits on a single day.

(a) Cash withdrawal from an account.

Any individual or HUF (Hindu Undivided Family) withdrawing cash exceeding Rs. 25,000/- on any single day from an account (other than a savings bank account) maintained with any scheduled bank shall be required to pay tax at the rate of 0.1% of the value of such transaction. All other entities, firms, companies etc., including state and central government establishments have to pay 0.1% if the withdrawals exceed Rs1 lakh on any single day from an account (other than a savings bank account) maintained with a scheduled bank. Proprietorship concerns are treated as individuals under the taxation law.

(b) Encashment of term deposits

The transaction tax is applicable to encashment (cash withdrawal) of term deposits exceeding Rs. 25,000/- for individual and HUF and Rs.1 lakh for other entities, firms, companies etc., including state and central government establishments. No BCTT shall be payable if the amount of term deposits are credited to any account with the bank.

What are the exempted category of accounts?

Withdrawal of cash from any savings bank account by any person is outside the purview of the tax. It may be noted that no such exemption is mentioned for any other accounts.

Who is liable to collect BCTT?

The liability to collect and remit banking cash transaction tax rests with scheduled banks.

Who is liable to bear the BCTT?

The person who enters into taxable banking transaction is liable to bear the BCTT.

How do banks compute the limit for transaction tax?

It is clarified that the exemption limit is arrived at account-wise in the case of accounts other than term deposits. However, in the case of fixed deposits it is branch-wise and not account (deposit) wise.

Whether benefit of basic exemption limit is available on taxable withdrawals/ encashment?

No. In case withdrawal is above the exemption limits, applicable tax (0.1%) on full amount have to be collected.

In the case of minor's account whether the transactions in this account are to be clubbed with the guardian's individual account?

The chapter on Banking Cash Transaction Tax clearly states that the tax is applicable only if the amount exceeds the prescribed limit based on withdrawal from each individual account. Hence the minor's account need not be clubbed with the individual account.

If the proprietor of two business units maintains two separate accounts with the same bank, is it necessary to club the transactions of both these accounts?

Since the incidence is account wise in the case of operative account the withdrawals from different accounts need not be clubbed.

If the proprietor of same business units maintains two separate accounts with the same branch, whether the above answer will change?

No. The tax incidence is account wise and no clubbing provisions are prescribed at present.

What are the other major points regarding transaction tax?

1. Withdrawal from PPF account is like withdrawal from savings bank account and hence tax is not applicable.
2. In the case of term deposits, the person concerned is to be taken as a single unit and encashment of term deposits in a single day have to be clubbed for the purpose of the tax.
3. No clubbing to be done for withdrawal from an account and aggregate withdrawal of term deposits.
4. All withdrawals by way of ATM cards from an account other than savings bank account are subject to transaction tax.
5. In the case of standing instruction to credit interest on term deposit to savings bank account, transaction tax does not apply as the same is not a cash transaction.

How do banks collect transaction tax?

Banks have to identify each transaction on a single day per branch per account of each customer. The duty of monitoring all the cash withdrawals on a single day will be on the bankers. When the withdrawal exceeds the limit of Rs.25,000 or Rs.1 lakh as per the status of the customer, the entire amount is subject to tax, irrespective of the earlier withdrawals being less than Rs.25,000 or Rs.1 lakh.

Are the bankers liable for collecting tax?

As per section 97, every scheduled bank shall collect the banking cash transaction tax and it shall be paid to the credit of the Central Government by 15th of every succeeding month. The scheduled bank who fails to collect the tax will be liable to pay the tax notwithstanding the fact that it has failed to collect the tax.

What are the penalties levied by Central Government?

1. In case of failure to collect tax, the assessees are required to pay an equal amount as penalty apart from tax with interest.
2. In case the assessees fail to remit the collected amount, a penalty of Rs.1,000 for every day subject to the maximum amount being equal to the tax.
3. As per section 101 of the Finance act 2005, the Government may impose an interest levy of 1% per month or part thereof for the non-payment or short payment of the tax collected by the assessee.

4. In case of failure to file the returns in time, the assessees are required to pay Rs.100 per day of failure.
5. In the case of failure to comply with notice issued under section 99(1) Rs.10,000 for each failure.

How does bank make remittance in respect of Bank cash transaction tax collected?

Even though each branch has to collect the tax separately there should be only single remittance of the tax collected by a bank to the Central Government account.

How does bank file return in respect of cash transaction tax?

Every bank has to file single monthly returns and consolidated single annual return within the prescribed time limit. In case of failure, the assessing officer may issue a notice to file the return within the time specified in the notice. The assessing officer may also demand for production of the supporting documents. The assessment order cannot be passed after the expiry of two years from the relevant financial year. In case an assessment results in refund, it is the duty of the bank to return the amount properly to the concerned account holder.

Is there any deduction available in respect of banking cash transaction tax?

As per the newly inserted section 36(1)(XII) of the Income-tax Act 1961, the expenditure by way of banking cash transaction tax is allowed as a revenue expenditure for persons whose income is chargeable under section 28 of the Act. The deduction is available for tax paid on both business and personal transactions.

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Theme No. 166 : FRINGE BENEFIT TAX

What do you know about Fringe Benefit Tax (FBT)?

By the Finance Act 2005, the Central Government has introduced a new levy of tax, viz Fringe Benefit Tax (FBT) on certain items of expenditure incurred by the employer in respect of the benefits provided or deemed to have been provided by him to his employees. Every person, within the meaning of employer, has to comply with the relevant provisions of the Act.

What is the major objective behind the introduction of FBT?

Certain items of expenditure incurred by the employers fully or partially results in providing benefits to it's employees. The expenditure is allowed as deduction in computing the taxable income of the employers. At the same time the benefits derived or deemed to have been derived by the employees out of such items of expenditure are not taxable as salary or perquisites in the hands of the employees. The major objective in introducing the "fringe benefit tax" is the difficulty in isolating the personal elements in respect of the benefits provided to the employees.

What is the meaning of "Employer" in this context?

An employer, for the purpose of this tax, shall mean a company, a firm, an association of persons or a body of individuals, a local authority and every artificial juridical person. Individuals including sole proprietorship concerns and HUFs (Hindu Undivided Families) do not come under the definition of employer for the purpose of this tax. Companies registered under section 25 of the Companies Act, Trust, Fund and institutions whose incomes are exempt u/s 10 (23C) and companies with a valid registration under section 12AA are also exempted from the fringe benefit tax.

What is the meaning of fringe benefit?

As per the provisions of the Finance Act 2005, fringe benefit means

(1) Any consideration for employment provided by way of any privilege, service, facility or amenity directly or indirectly by the employer whether by way of reimbursement or otherwise to his employees including former employees.

(2) Any free or concessional ticket provided by the employer for private journey of his employees or their family members. AND

(3) Any contribution by the employer to an approved super annuation fund for the benefit of their employees.

In addition to the above three items, Fringe Benefit is deemed to have been provided by the employer to the employees, if the employer has incurred any expense on or made payment for certain other items like entertainment, provision of hospitality, sales promotion, conveyance etc.

What is the applicability of FBT?

FBT is a tax to be paid by the employer in addition to the income tax from the assessment year 2006-07. FBT has to be paid on fringe benefits provided by the employer. Even if the employer does not pay any income tax or his income is exempt under the IT Act, FBT shall be paid.

Which are the entities that come under the purview of FBT but are otherwise exempt under IT Act?

1. Mutual Funds claiming exemption under section 10 of IT act.
2. Undertakings in free trade zones exempted under section 10 A of IT act.
3. Export oriented units claiming exemption under section 10B or 10 BA of IT act.

How are the various heads of expenditure valued for the purpose of calculating FBT?

The major heads of expenditure are generally valued at 20% for calculating FBT. Certain items are valued at 50% and 100%.

Which are the items valued at 50% for calculating FBT?

1. Festival Celebration
2. Use of health club & similar facilities.
3. Use of any other club facilities.
4. Gifts
5. Scholarships

Which are the items valued at 100% for calculating FBT?

1. Any free or concessional ticket for private journeys.
2. Contribution to super annuation fund.

Which are the major items exempted from FBT?

1. Expenditure on food and beverages provided to the employees.
2. Expenditure incurred on fee for participation in a conference by the employees.
3. Expenditure incurred on advertisement.
4. Any expenditure incurred on payment made to fulfil any statutory obligation with regard to employees.

Is there any scope for double taxation with regard to FBT?

Under FBT, the tax liability on certain benefits have been shifted to employer, that were hitherto taxable in the hands of the employees as perquisites. There exists mutual exclusion between the two. Under the provisions of the Finance Act, 2005, those perquisites taxable in the hands of the employee cannot be taxed as FBT in the hands of the employer and those benefits taxable as FBT in the hands of the employer cannot be taxed in the hands of the employee. Hence there is no scope for double taxation.

Is there any penalty for concealment of fringe benefits by the employer?

Under the new clause(d) of section 271(1) of the Act, the concealment of fringe benefits will attract penalty on the same lines as is for concealment of income. The maximum penalty can be three times of the amount of tax evaded. The minimum penalty shall not be less than the amount of tax evaded.

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OCTOBER 2005

Theme No. 167 : THE RIGHT TO INFORMATION ACT, 2005 - PART I

What is meant by the *Right to Information Act*?

The President of India gave assent to a major and crucial Act of the Parliament on 15th June 2005 viz, *The Right to Information Act 2005.* It is an Act meant to promote transparency and accountability in the working of every Public Authority by accepting and reinforcing the right of every citizen of the country *to secure access to information* under the control of Public Authorities. To facilitate the envisaged objectives, the Act also provides for the constitution of a Central Information Commission and State Information Commissions.

Why is the *Right to Information* so vital?

India is a democracy. Transparency of information and informed citizenry are very vital to the proper functioning of a democracy. To contain corruption and to hold Governments and their machinery accountable to the governed, the citizenry of the country must be well informed.

Is revelation of information always practical?

It is to be acknowledged that revelation of information in actual practice is likely to conflict with other public interests including efficient operation of the Governments, optimum use of limited fiscal resources and the preservation of confidentiality of sensitive information. Therefore, it is necessary to harmonise these conflicting interests while preserving the overriding importance of the democratic ideal.

Whether the Act is uniformly applicable to the whole country?

The Act is applicable to the whole of India Republic *except* the State of Jammu and Kashmir. It may also be noted that the provisions of sub-section (1) of section 4, sub-sections (1) and (2) of section 5, sections 12, 13, 15,16, 24, 27 and

28 of the Act only were in force from the date of enactment till 12th October 2005. The remaining provisions of the Act came into force only w.e.f 13th October 2005.

How is *information* defined in the Act?

Information means any material in any form, including records, documents, memos, opinions, advices, e-mails, press releases, circulars, orders, logbooks, contracts, reports, papers, samples, models, data material held in any electronic form and information relating to any private body which can be accessed by a Public Authority under any other law for the time being in force.

The word *record* includes

a) any document, manuscript and file;

b) any microfilm, microfiche (small sheet of microfilm on which many pages of material have been photographed; a magnification system is used to read the material) and facsimile copy of a document;

c) any reproduction of image or images embodied in such microfilm (whether enlarged or not); &

d) any other material produced by a computer or any other device.

How is the term *right* to be perceived?

The term *right* includes the right of:

(i) inspection of work, documents, records;

(ii) taking notes, extracts or certified copies of documents or records;

(iii) taking certified samples of material;

(iv) obtaining information in the form of diskettes, floppies, tapes, video cassettes or in any other electronic mode or through printouts where such information is stored in a computer or in any other device;

Mention some of the obligations of a Public Authority under the Act

Every Public Authority shall

a) maintain all its records duly catalogued and indexed in a manner and form which facilitates the *right to information* under this Act and ensure that all records that are appropriate to be computerised are, within a reasonable time and subject to availability of resources, computerised and connected through a network all over the country on different systems so that access to such records is facilitated.

b) publish within one hundred and twenty days from the enactment of this Act:

(i) the particulars of its organisation, functions and duties;

(ii) the powers and duties of its officers and employees;

(iii) the procedure followed in the decision making process, including channels of supervision and accountability;

(iv) the norms set by it for the discharge of its functions;

(v) the rules, regulations, instructions, manuals and records, held by it or under its control or used by its employees for discharging its functions;

(vi) a statement of the categories of documents that are held by it or under its control;

(vii) the particulars of any arrangement that exists for consultation with, or representation by, the members of the public in relation to the formulation of its policy or implementation thereof;

(viii) a statement of the boards, councils, committees and other bodies consisting of two or more persons constituted as its part or for the purpose of its advice, and as to whether meetings of those boards, councils, committees and other bodies are open to the public, or the minutes of such meetings are accessible to the public;

(ix) a directory of its officers and employees;

(x) the monthly remuneration received by each of its officers and employees, including the system of compensation as provided in its regulations;

(xi) the budget allocated to each of its agency, indicating the particulars of all plans, proposed expenditures and reports on disbursements made;

(xii) the manner of execution of subsidy programmes, including the amounts allocated and the details of beneficiaries of such programmes;

(xiii) particulars of recipients of concessions, permits or authorisations granted by it;

(xiv) details in respect of the information, available to or held by it, reduced in an electronic form;

(xv) the particulars of facilities available to citizens for obtaining information, including the working hours of a library or reading room, if maintained for public use;

(xvi) the names, designations and other particulars of the Public Information Officers;

(xvii) such other information as may be prescribed; and thereafter update these publications every year;

c) publish all relevant facts while formulating important policies or announcing the decisions which affect public

d) provide reasons for its administrative or quasi-judicial decisions to affected persons.

(will be continued in the next issue…)

Theme No. 168 : THE RIGHT TO INFORMATION ACT, 2005 - PART II

In the last issue we discussed the broad outlines of the *The Right to Information Act 2005,* covering *inter-alia,* the importance of the Act, obligations of the public authorities under the Act, need to harmonise conflicting interests when information is divulged etc. In this issue, we will discuss some of the remaining aspects of the Act.

Briefly explain the procedure for seeking information under the Act

A person, who desires to obtain any information under this Act, shall make a request in writing or through an electronic medium, in English / Hindi / in the official language of the area where the application is being made, along with the prescribed fee to :

(a) the Central Public Information Officer / State Public Information Officer, as the case may be, of the concerned public authority;

(b) the Central Assistant Public Information Officer or State Assistant Public Information Officer, as the case may be,

specifying the particulars of the information sought by him or her.

An applicant making request for information *shall not be* required to give any reason for requesting the information or any other personal details except those that may be necessary for contacting him ie, his identity particulars.

What is the authority concerned expected to do on receipt of the request?

The authority concerned, on receipt of the request, shall as expeditiously as possible and in any case, within thirty days of the receipt of the request, either provide the information on payment of such fee as may be prescribed or reject the request for any of the reasons specified in sections 8 and 9 of the Act.

Where the information sought for concerns the life or liberty of a person, the same shall be provided within forty-eight hours of receipt of the request.

Where a decision is taken to provide the information on payment of any further fee representing the cost of providing the information, the authority concerned shall send an intimation to the person making the request, with relevant directions in his regard.

What is to be presumed if no reply is received from the Information Officer or the authority concerned within the above time frame?

If the authority concerned fails to give decision on the request within the period specified (thirty days), he shall be deemed to have *refused* the request.

Where a request has been rejected, the authority concerned shall communicate to the person making the request:

i) the reasons for such rejection;

ii) the period within which an appeal against such rejection may be preferred; and

iii) the particulars of the appellate authority.

Does the Act provide for any exemption from disclosure of information?

Notwithstanding anything contained in this Act, there shall be no obligation to give any citizen :

(*a*) information, disclosure of which would prejudicially affect the sovereignty and integrity of India, the security, strategic, scientific or economic interests of the States, relation with foreign States or lead to incitement of an offence;

(*b*) information which has been expressly forbidden to be published by any court of law or tribunal or the disclosure of which may constitute contempt of court;

(*c*) information, the disclosure of which would cause a breach of privilege of Parliament or the State Legislature;

(*d*) information including commercial confidence, trade secrets or intellectual property, the disclosure of which would harm the competitive position of a third party, unless the competent authority is satisfied that larger public interest warrants the disclosure of such information;

(*e*) information available to a person in his fiduciary relationship, unless the competent authority is satisfied that the larger public interest warrants the disclosure of such information;

(*f*) information received in confidence from foreign Governments;

(*g*) information, the disclosure of which would endanger the life or physical safety of any person or identify the source of information or assistance given in confidence for law enforcement or security purposes;

(*h*) information which would impede the process of investigation or apprehension or prosecution of offenders;

(i) cabinet papers including records of deliberations of the Council of Ministers, Secretaries and other officers *(However, it is provided that the decisions of Council of Ministers, the reasons thereof, and the material on the basis of which the decisions were taken shall be made public after the decision has been taken, and the matter is complete or over, except such matters which come under the exemptions specified)*

(*j*) information which relates to personal information, the disclosure of which has no relationship to any public activity or interest or which would cause unwarranted invasion of the privacy of the individual unless the Central

Public Information Officer or the State Public Information Officer or the appellate authority, as the case may be, is satisfied that the larger public interest justifies the disclosure of such information:

Provided that the information which cannot be denied to the Parliament or a State Legislature shall not be denied to any person.

(k) information which would involve an infringement of copyright subsisting in a person other than the State.

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Theme No. 169 : REVISED CLAUSE 49 OF THE LISTING AGREEMENT

Revised Clause 49 of the listing agreement has been in the limelight for the past few months. Though, Securities and Exchange Board of India (SEBI), with the objective of improving the standards of corporate governance revised Clause 49 in October, 2004 itself, enforcement of the same was delayed due to various reasons. Readers must be remembering the controversies cropped up earlier in the year 2003 in the media on the issue of inclusion of the revised clause in the listing agreement when the Companies (Amendment) Bill, 2003 was pending before the Parliament and the arguments regarding the authority of SEBI to make regulations in respect of matters that fall within the apparent jurisdiction of the Department of Company Affairs. However, putting an end to all uncertainties, the *Revised Clause 49* is expected to come in to force w.e.f. 1st January, 2006.

When was Clause 49 introduced for the first time in the Listing Agreement?

Clause 49 was introduced in the Listing Agreement for the first time in the year 2000.

What does Clause 49 pertain to?

Clause 49 pertains to *Corporate Governance*. The subject of Corporate Governance was covered in one of our earlier issues in the year 2000.

What does Revised Clause 49 pertain to?

The Revised Clause 49 sets out a number of measures to raise the standards of corporate governance in listed companies. It includes amendments / additions to the provisions relating to definition of independent directors, strengthening the responsibilities of audit committees, further disclosure requirements, improving the quality of financial disclosures, requiring CEO/CFO certification of financial statements, periodical review of legal compliances by independent directors etc. It also includes certain non mandatory clauses.

Who was the Chairman of the Committee which recommended introduction of the Revised Clause 49?

Sri. N.R. Narayana Murti, who is an acclaimed corporate captain and now the Chief Mentor of Infosys Technologies Ltd, Bangalore. In fact, the first committee set up by SEBI to introduce Clause 49 was the Kumar Mangalam Birla Committee in the year 1999. SEBI adopted Kumar Mangalam Birla Committee's report and introduced Clause 49 in the year 2000. Certain amendments were since introduced with regard to the composition of the Board and Committees. The Narayana Murthy Committee was constituted towards the later part of 2002. The committee submitted their report in 2003. Committee again revised their report based on public feed back and the final recommendations were submitted towards the end of 2003. SEBI approved the revised recommendations of the Narayana Murthi committee in the year 2004 . Time limit for compliance was extended till 31 December 2005.

Cite a recent incident which underlines the importance of strict corporate governance norms

During the trial session in a U.S.Court, the submission made by the CEO of a Multi National Company (MNC) made big news recently. The company fraudulently reported large profit instead of loss in their financial statements. Asked in court, whether he was aware of the misstatements in the company's financial statements, the CEO replied that he was unaware of the same as he had not signed the financial statements. U.S laws, then, did not require the CEO to sign the company's financial statements. It is presumed that such instances paved way for the introduction of the Sarbanes- Oxley Act (SOX), signed by the U.S President in July 2002. SOX is perhaps the most far reaching legislation on corporate law in the history of the corporate world.

What necessitated the revision of Clause 49?

The core factor behind the existence, sustainability and progress of any listed company is the faith reposed in it by the investors and the general public. In the globalised scenario, companies rely on investments made by domestic and international investors to boost up their capital base. Protecting the interests of the investors calls for effective and constant vigilance by the regulator in the market behaviour of listed companies. In fact, the whole concept of corporate governance revolves around two factors - commitment to values and ethical business conduct. It reminds every one that business enterprises are much more than mere economic units and underlines the need for companies to become good corporate citizens contributing to social issues and charity. SEBI's action in revising the clause is a right step towards benchmarking governance norms with those of international standards. Companies with better corporate governance, in the long run would command better valuations in all spheres. By introducing the revision, SEBI has also upgraded the information supply by companies to the capital market.

What is the ratio stipulated for independent directors under the Revised Clause ?

Revised Clause stipulates that in companies that have an Executive Chairman, at least 50% of the board must comprise independent directors. For companies with non-executive Chairmen, one-third of the board must comprise independent directors.

What is the role of Stock Exchanges in ensuring compliance?

The Stock Exchanges have to ensure that all provisions of the revised clause 49 have been complied with by the companies seeking listing for the first time before granting the in-principle approval for such listing. There will be separate monitoring cells at Stock Exchanges to monitor compliance of the provisions of the Revised Clause 49 by listed companies.

Are there any exemptions from complying with Clause 49?

Clause 49 itself exempts companies whose paid- up share capital is less than Rs.3.00 crores or net worth is less than Rs.25.00 crores.

How the new culture of good governance benefit the companies?

Result / effectiveness of any law / norm is truly reflected only when it is complied with in letter and spirit. In most of the cases compliance involves meeting the letter of the law and not necessarily the spirit. A company's success is generally measured in terms of tangible aspects such as high turn over, good profits, good network etc. However, without the backing of good corporate governance and business ethics such successes may not be sustainable. A single wrong doing may tarnish the company's image built up over several years of perseverance and hard work.

In the words of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission "creating an ethical culture means instilling and maintaining a commitment to do the right thing, this time and every time, so much so that it becomes entwined in the essential DNA of the firm".

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JANUARY 2006

Theme No. 170 : SOUTH ASIAN FREE TRADE AREA (SAFTA) AGREEMENT

As a fall out of globalisation, the trade barriers between the countries are narrowing down. There are vigorous efforts among countries in different parts of the world to come together and create new platforms to deliberate on common issues and problems mainly with a view to explore the possibility of creating obstacle-free trade among the member countries. Such forums also pave way for reinforcing mutual trust and faith among the member countries. Though belated, there is a realization that it is high time to end the cold war prevailing between certain nations and instead , the need of the hour is to stand united on common issues and create congenial atmosphere to find out ways and means for overall prosperity of the region. Needless to say, that this is to be done without compromising on the principles of sovereign equality, independence and territorial integrity of all the member states. The Agreement on SAFTA is to be viewed in this background.

Who all are the contracting countries to the SAFTA Agreement?

SAFTA is an agreement between the SAARC (South Asian Association for Regional Cooperation) member countries comprising of the Republic of India, Islamic Republic of Pakistan, Democratic Socialist Republic of Sri Lanka, People's Republic of Bangladesh, Republic of Maldives, the Kingdom of Bhutan and the Kingdom of Nepal.

What was the driving force behind SAFTA Agreement?

The following aspects are considered to be the driving force behind the agreement:

- The commitment to strengthen intra-SAARC economic cooperation

- The desire to maximise the region's potential for trade and development

Incidentally, it is to be mentioned that another agreement viz, SAPTA (SAARC Preferential Trading Arrangement) signed in Dhaka on 11th April 1993 and which became effective from 7th December 1995 also acted as a stimulant to the formation of SAFTA. The Preferential Trade Agreement was envisaged primarily as the first step towards the transition to a South Asian Free Trade Area leading subsequently towards a Customs Union, Common Market and Economic Union.

The member countries were convinced that preferential trading arrangements among themselves will act as a stimulus to the strengthening of their national economies in addition to contributing to the SAARC economic resilience. Such an arrangement could result in expansion of investment and production opportunities, trade, and foreign exchange earnings in addition to economic and technological cooperation.

The agreement recognised that least developed countries in the region should be accorded special and differential treatment commensurate with their development needs.

When was the SAFTA Agreement signed?

Though the Preferential Trade Agreement envisaged a free trade area by the year 2001, there were obstacles on the way. The Agreement drafted by the Committee of Experts (COE) could be signed only on 6th January 2004 during the 12th SAARC Summit in Islamabad. As per the agreement signed, SAFTA would be in force from 1st January 2006. However, the target for actual trade was set for June-July.

Name certain other regional groupings of similar nature underlining the importance of regional co-operation

SAFTA can be compared to other regional groupings such as **NAFTA** (North American Free Trade Area), **EU** (European Union), **ASEAN** (Association of South East Asian Nations) etc, which are wholly based on the principle of economic integration.

Mention about the MFN (Most Favoured Nation) status envisaged in the agreement. What is the principle behind honouring a nation with MFN status?

Most Favoured Nation (MFN) status has its roots in the GATT agreement. The principle of MFN treatment can be inferred from Article 1 of GATT which says

"*With respect to customs duties and charges of any kind imposed on or in connection with importation and exportation or imposed on the international transfer of payments for imports or exports………… Any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties*".

Thus, any concession or privilege granted by one contracting party will be unconditionally granted to the like product of all other contracting parties. A country should not discriminate between it's trading partners and should give MFN status to all contracting parties equally. If one country grants another country a special favour such as lower customs duty for one of their products, it has to do the same for all other contracting members. However, the agreements permit certain exceptions under strict conditions. For example, countries can set up a free trade agreement that applies only to goods traded within the group – discriminating against goods from outside. They can also allow developing countries special access to their markets.

SAFTA agreement stipulates that the MFN approach to international trade would be followed by the SAARC member countries.

What determines the success of an agreement like SAFTA?
Success of an agreement like SAFTA can be ensured only if every participant in it observes the ground rules of equality laid down in the agreement. Otherwise such agreements will fail to deliver the goods envisaged.

Briefly mention the hitch experienced in the enforcement of SAFTA Agreement.

As already mentioned, SAFTA agreement envisaged that the signatories would automatically accept the MFN approach for trade. However, this was not the case with Pakistan. The reluctance on the part of Pakistan to confer MFN status to India posed a stalemate. (Incidentally, both countries being members of WTO, Pakistan should have accorded MFN status to trade with India long back). Though India accorded MFN status to Pakistan, they failed to reciprocate and maintained that Pakistan's implementation of SAFTA and its trade policy with India are two separate tracks of state policy. Though some may perceive that Pakistan's ratification of the agreement would imply acceptance of the MFN principle, it is suspected that they are still not prepared to give India a similar status even after ratifying SAFTA. The true value of SAFTA can be had only if the present stalemate on issues of trade between India and Pakistan are resolved amicably.

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Theme No. 171 : UNION BUDGET - PART I

In this issue we shall try to take a close look at the annual exercise of the announcement of Union Budget and some of the key terminologies associated with it.

What is meant by 'Pre budget economic survey'?

It is an exercise of reviewing the economy as a whole as a prelude to the budget preparation. Pre budget economic survey helps to take stock of the prevailing general situation of the economy, key problems and issues to be addressed, reforms to be implemented etc.

Which is the conventional date of presentation of Union Budget?

Conventionally budget presentations are made by the Finance Minister on the last day of February every year. Union Budget 2006-07 was announced on 28th February 2006.

What does Budget consist of?

Actual figures for the preceding years, figures for the current year and estimates for the following years are integral parts of every Budget.

Who gives final approval for the Budget?

Though the overall responsibility of preparation of Budget rests with the Finance Ministry, final approval is to be obtained from the Prime Minister.

Is budget announcement different from presentation of 'Annual Financial Statement'?

"Annual Financial Statement" is a statement of estimated receipts and expenditure of the Government of India which is one of the main budget documents. It is presented in compliance with the requirement under Article 112 of the Constitution, which stipulates that a statement of estimated receipts and expenditure of the Government of India has to be laid before Parliament in respect of every financial year. The Annual Financial Statement shows the receipts and payments of Government under three major heads viz, (i) Consolidated Fund, (ii) Contingency Fund and (iii) Public Account.

Briefly explain the above three heads viz, (i) Consolidated Fund, (ii) Contingency Fund and (iii) Public Account.

Consolidated Fund: The components of consolidated fund are: (i) all revenues received by the Government (ii) loans raised by the Government and (iii) receipts from recoveries of loans granted by the Government. All expenditure of Government are incurred from the Consolidated Fund. Normally for any withdrawal of amounts from the fund, authorisation is required from the Parliament.

Contingency Fund: Occasions may arise when the Government has to meet urgent unforeseen expenditure pending authorisation from Parliament. The **Contingency Fund** is an imprest (advance on loan) placed at the disposal of the President to incur such expenditure. Parliamentary approval for such expenditure and for withdrawal of an equivalent amount from the Consolidated Fund is subsequently obtained and the amount spent from Contingency Fund is recouped to the Fund.

Public Account: There are certain transactions, such as those relating to provident funds, small savings collections, other deposits etc in respect of which Government acts more as a banker. The moneys thus received are kept in the Public Account and the connected disbursements are also made there from. Public

Account funds, do not belong to the Government and have to be paid back later to the persons and authorities who deposited them. As such, Parliamentary authorisation is not required for payments from the *Public Account.*

What is meant by 'Finance Bill'? How is it connected to the Union Budget?

Finance Bill is a money bill as defined in Article 110 of the Constitution. At the time of presentation of the Annual Financial Statement before Parliament, a Finance Bill is also presented in fulfillment of the requirement of Article 110(1)(a) of the Constitution, detailing the imposition, abolition, remission, alteration or regulation of taxes proposed in the Budget.

Finance Bill is also accompanied by a 'Memorandum'. What is it's purpose?

'*Memorandum Explaining the Provisions of the Finance Bill',* is a document to facilitate understanding of the taxation proposals contained in the Finance Bill, their provisions and implications. Since the budget documents presented in terms of the constitution have to fulfill certain legal and procedural requirements they may not by themselves give a clear indication of the major features of the budget. The memorandum containing explanatory documents facilitates easy comprehension of the budget.

(to be continued…)

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MARCH 2006

Theme No. 172 : UNION BUDGET - PART II

In the previous issue we had discussed some of the key terminologies associated with the budget presentation. We shall take a closer look at Union Budget 2006-07 in this issue.

Brief overview of the economy

Since Budget is conventionally presented on the last day of February – ie, before the close of the financial year - CSO statistics for the whole of the financial year would not be available for inclusion in the budget document. Therefore actuals for the previous year and advance estimates for the current year (in which budget is presented) are included.

Overall growth rate of the economy in 2004-05 was 7.50%, manufacturing sector growth 8.1%; gross domestic savings (at current market prices) increased to 29.1% of GDP; gross capital formation increased to 30.1% of GDP.

CSO's advance estimates for 2005-06 :
GDP growth rate appx. 8.1%, manufacturing sector growth 9.4%, agricultural sector growth 2.3%, Inflation (as on 11th February) 4.02%, Non- food credit growth more than 25%.

- GDP growth target for 10th plan set at 10%.

- Revenue deficit for 2005-06 estimated at 2.6% and fiscal deficit at 4.1%.

What is the Gross Budgetary Support (GBS) for the plan?

In 2005-06, Gross Budgetary Support (GBS) for the Plan was Rs.143,497 crores. GBS for 2006-07 has been fixed at Rs.172,728 crores, representing an increase of 20.4 per cent.

Which are the 8 flagship programmes of the UPA Governnment to which bulk of the resources are earmarked in the budget?

(1) Sarva Siksha Abhiyan (2) Mid-day Meal Scheme (3) Rajiv Gandhi Drinking Water Mission (4) Total Sanitation Campaign (5) National Rural Health Mission (6) Integrated Child Development Services (7) National Rural Employment Guarantee Scheme and (8) Jawaharlal Nehru National Urban Renewal Mission.

The total allocation to the above 8 flagship programmes for 2006-07 is Rs.50,015 crores, representing an increase of Rs.15,088 crores (43.2 %) from the previous years allocation.

Which language received special attention in the budget by way of higher allocation for its promotion?

Urdu language. The allocation to the National Council for Promotion of Urdu Language has been increased from Rs.10 crores to Rs.13 crores.

What are the budgetary benefits proposed to single girl child in a family?

The girl child who passes VIIIth Standard Examination and enrols in a secondary school will be eligible for a sum of Rs.3,000 to be deposited in her name, and she would be entitled to withdraw the deposit on attaining the age of 18 years.

Mention some of the important sector-wise announcements?

AGRICULTURE & FISHERIES

- Farm credit to increase to Rs.1,75,000 crores in 2006-07
- Banks to open a separate window for Self Help Groups or joint liability groups of tenant farmers
- A one time interest relief of 2% (on the principal amount up to Rs.1.00 lakh) to farmers who have availed crop loans from scheduled commercial banks, RRBs (Regional Rural Banks) and PACS (Primary Agricultural Credit Societies) for Kharif and Rabi 2005-06.
- Short-term credit for agriculture to be made available at 7 per cent, with an upper limit of Rs.3.00 lakh on the principal amount.
- National Agricultural Insurance Scheme (NAIS) to continue.

- A Special Purpose Tea Fund to be setup.
- Central Institute of Horticulture to be established in Nagaland
- National Fisheries Development Board to be constituted.

MANUFACTURING / INDUSTRIES

- Increased budgetary allocation for 'Technology Upgradation Fund (TUF) Scheme' for Cotton Textile Industry , 'Scheme for Integrated Textiles Parks (SITP)', handloom sector etc.
- Proposal to launch 'Jute Technology Mission' in 2006-07 to harness the potential of jute. A National Jute Board to be established.
- Food processing to be treated as priority sector for bank credit.
- Government to set up 'National Institute of Food Technology Entrepreneurship and Management' .

SERVICES SECTOR

- Plan allocation proposed to be increased from Rs.786 crores to Rs.830 crores in 2006-07.
- Proposes to double India's share in world exports to 1.5 per cent by the year 2008-09.

INFRASTRUCTURE

- Targets to reach 250 million telephone connections by December, 2007.
- 'Indian Telegraph Act' will be amended in order to extend financial support to infrastructure for cellular telephony in rural areas.
- 40,000 more villages to be electrified under the Rajiv Gandhi Grameen Vidyutikaran Yojana.
- Special Accelerated Road Development Programme for the North Eastern Region
- 1,000 kms of 'Access-Controlled Expressways' to be developed on Design, Build, Finance and Operate (DBFO) model.
- National Highway Authority of India (NHAI) to be restructured and made more effective.

FINANCIAL SECTOR

- Government has so far injected Rs.16,809 crores into Nationalised Banks in the form of Special Securities for capital augmentation. (Adding the perpetual securities issued earlier, the total net capital support stands at Rs.22,808 crores). Government, in consultation with RBI proposes to convert these non-tradable special securities into tradable, *SLR-GOI-dated securities* to facilitate increased access of the banks to additional resources for lending to the productive sectors.

- Introduction of a Comprehensive Bill on Insurance in 2006-07 is under consideration.
- FII investment limit in Government securities to be increased from $ 1.75 billion to $ 2 billion and the limit on FII investment in corporate debt to be increased from $ 0.5 billion to $ 1.5 billion.
- Ceiling on aggregate investment by mutual funds in overseas instruments to be increased from $ 1 billion to $ 2 billion and the requirement of 10 per cent reciprocal share holding to be removed.
- Investor protection fund to be set up under the aegis of SEBI - funded by fines and penalties recovered by SEBI - to bolster confidence among retail investors.
- Access to be extended to qualified mutual funds, provident funds and pension funds to trade on the Negotiated Dealing System (NDS) in addition to the regulated entities, banks and primary dealers.

(to be continued…)

Theme No. 173 : UNION BUDGET - PART III

Highlights of Union Budget 2006-07 (continued..)

BUDGET ESTIMATES FOR 2006-07 :

- Total expenditure for 2006-07 is estimated at Rs.563,991 crores
- Plan expenditure for 2006-07 is estimated at Rs.172,728 crores, up by 20.4 per cent over the previous year.
- Non-Plan expenditure estimated to be Rs.391,263 crores, up by appx. 5.5 per cent over the previous year.
- Total revenue receipts of the Central Government estimated at Rs.403,465 crores
- Total revenue expenditure estimated at Rs.488,192 crores.
- Revenue deficit estimated at Rs.84,727 crores which is 2.1 per cent of the GDP.
- Fiscal deficit estimated at Rs.148,686 crores, which is 3.8 per cent of the GDP.

Indirect Taxes

- Customs duties - peak rate for non-agricultural products reduced from 15 per cent to 12.5 per cent.
- The duty on alloy steel and primary and secondary non-ferrous metals reduced from 10 per cent to 7.5 per cent. This will also be the rate of duty for ferro alloys.
- The import duty on steel melting scrap reduced to zero last year to be restored to 5 per cent so as to bring it on par with primary steel.
- The duty on mineral products to be reduced from 15 per cent to 5 per cent with a few exceptions.
- The duty on ores and concentrates reduced from 5 per cent to 2 per cent.
- Refractories will attract reduced duty of 7.5 per cent (earlier 10 per cent).

- Duty of basic inorganic chemicals reduced from 15 per cent to 10 per cent.
- Duty on major bulk plastics like PVC, LDPE and PP reduced from 10 per cent to 5 per cent. Simultaneously, the duty on naptha for plastics will be reduced to nil.
- Duty on styrene, EDC and VCM which are raw materials for plastics reduced to 2 per cent.
- Customs duty on 10 anti-AIDS and 14 anti-cancer drugs reduced to 5 per cent. Duty on certain life saving drugs, kits and equipment proposed to be reduced from 15 per cent to 5 per cent. These drugs will also be exempt from excise duty and countervailing duty (CVD).
- Duty on packaging machines reduced from 15 per cent to 5 per cent.
- Counter veiling Duty (CVD) of 4 per cent proposed on all imports with a few exceptions. Full credit of this duty will be allowed to manufacturers of excisable goods.
- Customs duty on vanaspati increased to 80 per cent, on par with the rate applicable to crude palm oil.
- The excise duty on man-made fibre yarn and filament yarn to be reduced from 16 per cent to 8 per cent and import duty from 15 per cent to 10 per cent.
- The import duty on raw materials such as DMT, PTA and MEG will also be reduced from 15 per cent to 10 per cent.
- Reduction in excise duty on aerated drinks, small cars, compact fluorescent lamps, specified printing, writing / packing paper, ready-to-eat packaged foods and instant food mixes .
- 8 % excise duty to be imposed on packaged software sold over the counter. Customized software and software packages downloaded from the internet will be exempt from this levy.
- Excise duty on DVD drives, flash drives and combo drives, condensed milk, ice cream, preparations of meat, fish and poultry, pectins, pasta and yeast fully exempted.
- Excise duty on footwear with retail sale price between Rs.250/- and Rs.750/- reduced from 16 per cent to 8 per cent. (Footwear carrying a retail sale price up to Rs.250 is already exempt from excise duty).
- LPG stoves up to a value of Rs.2,000 attract excise duty of 8 per cent.

This concessional rate will be extended to all LPG stoves without any value limit.

- Glassware will attract excise duty of 16 per cent on par with ceramicware and plasticware.
- Cess on domestically produced petroleum crude to be increased from Rs.1800/- per MT to Rs.2,500/- per MT.
- Excise duty on computers to be re-imposed at 12 per cent. Since excise duty will be eligible for full input tax credit, there should not be any impact on price.
- Excise duty 16 per cent to be imposed on set top boxes simultaneously reducing customs duty from 15 per cent to nil
- The excise duty on cigarettes to be raised by about 5 per cent.
- More services such as ATM operations, maintenance and management; registrars, share transfer agents and bankers to an issue; sale of space or time (other than in the print media for advertisements); sponsorship of events(other than sports events by companies); international air travel excluding economy class passengers; container services on rail excluding the railway freight charges; business support services; auctioneering; recovery agents; ship management services; travel on cruise ships; and public relations management services to be brought under the service tax net.
- National level Goods and Services Tax (GST) to be introduced w.e.f April 1, 2010, which will be shared between the Centre and the States. As a first step towards progressively converging the service tax rate and the CENVAT rate, service tax rate will be increased from 10 per cent to 12 per cent.

<u>Direct Taxes</u>

- The one-by-six scheme under the Income Tax Act obliging certain categories of persons to file returns will stand abolished.
- Minimum Alternate Tax (MAT) to be raised from 7.5% of book profits to 10 %.
- Reflecting the increase in implicit capital gains in securities transactions, an increase of 25 per cent, across the board is proposed on all rates of Securities Transaction Tax (STT).

- Investments in fixed deposits in scheduled banks for a term not less than five years to get benefits of section 80C of the Income Tax Act.
- The limit of Rs.10,000/- in respect of contribution to certain pension funds in section 80CCC to be removed subject to the overall ceiling of Rs.100,000/-
- The exemptions in the Income Tax Act under section 10 (23G) proposed to be removed as it is not relevant when interest rates are moderate.
- Co-operative Banks [other than Primary Agricultural Credit Societies (PACS) and Primary Cooperative Agricultural and Rural Development Banks (PCARDB)] to be excluded from tax exemption under section 80P of the Income Tax Act.
- Section 54EC and section 54ED are tax shelters. Scope of 54EC to be restricted to two institutions viz, NHAI and REC. Section 54ED to be abolished.
- Anonymous or pseudonymous donations to wholly charitable institutions will be taxed at the highest marginal rate. Such donations to partly religious and partly charitable institutions/trusts will be taxed only if the donation is specifically for an educational or medical purpose.
- Various changes have been announced in chapter XII-H (Fringe Benefit Tax) (FBT) - of the Income Tax Act. (Due to space constraint the details are not elaborated).

<u>Modernizing Tax Administration</u>

- To further modernize tax administration, Business Process Re-engineering (BPR) will be undertaken in Departments of Income Tax and Customs and Central Excise .
- A new innovation in the form of 'Statement on Revenue Foregone' (tax expenditure statement) will be introduced which captures the departures from the normal tax regime.

<u>VAT and CST</u>

- Since many States have successfully implemented VAT with effect from April 1, 2005, non-VAT States have been urged to join the mainstream soon.
- Liquefied Petroleum Gas (LPG) – Domestic - is proposed to be included in the list of 'declared goods' under the CST Act. ❑

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MAY 2006

Theme No. 174 : ECONOMIC VALUE ADDED (EVA) FRAMEWORK

WHAT IS 'EVA' FRAME WORK?

The Economic Value Added (EVA) Framework can be described as an effective financial tool to judge the true economic profit of an enterprise. It is a key performance measure linked to creation of share holder wealth. EVA is vastly used by Managers to gain superior information to make decisions that will create better shareholder wealth.

For measuring financial goals and objectives, companies adopt various measures. Growth in revenues or market share often forms the basis for formulating strategic plans. Companies may evaluate individual products or lines of business on the basis of gross margins or cash flow. Business units may be evaluated in terms of Return on Assets (RoA) or against a budgeted profit level. Finance departments usually analyze capital investments in terms of Net Present Value (NPV). However, prospective acquisitions are weighed against the likely contribution to growth in earnings. Incentives for key staff members are usually negotiated annually and are based on a profit plan.

Inconsistent standards, goals, and terminology result in faulty planning, defective operating strategy, and poor decision making. It is a cause of concern that several companies try to break accounting rules to inflate their earnings or try to bend the rules to smoothen their earnings so as to present a rosy picture to the unsuspecting investors. Ethics naturally take a back seat.

In the above context, a frame work like EVA is of great significance, which satisfies the requirement of a single measure of earnings that is capable of reliably indicating the intrinsic value of all companies in all times.

WHAT IS THE SIGNIFICANCE OF 'EVA' IN THE ABOVE CONTEXT?

EVA eliminates confusion by using a single financial measure that links all decision making with a common focus. The focus is on how to improve EVA.

HOW TO IMPROVE EVA?

EVA provides a common language for the users and allows all management decisions to be modeled, monitored, communicated and compensated in a single and consistent way - always in terms of the value added to shareholder investment.

HOW IS 'EVA' CALCULATED?

Put most simply, EVA is Net Operating Profit *minus* an appropriate charge for the opportunity cost of all capital invested in an enterprise.

ie; EVA= Net Operating Profit after Taxes – (Capital X The Cost of Capital)

EVA, thus gives stress to the *minimum rate of return* from an investment. As such, EVA is an estimate of true "economic" profit, or the amount by which earnings exceed or fall short of the required minimum rate of return that shareholders and lenders could get by investing in other avenues of comparable risk.

WHAT IS THE MOST DISTINCTIVE AND IMPORTANT ASPECT OF EVA?

The capital charge is the most distinctive and important aspect of EVA. Under conventional accounting, most companies appear profitable, but many in fact are not so profitable. In this context it is felt appropriate to quote 'Peter Drucker' from one of his articles:

"Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources…….Until then it does not create wealth; it destroys it."

EVA corrects this error by explicitly recognizing that when managers employ capital they must pay for it. That is to say, that the returns should commensurate with the cost of capital.

Thus, EVA shows the Rupee amount of wealth a business has created or destroyed in each reporting period. If the shareholders expect, say, a 10% return on their investment, they "make money" only to the extent their share of 'after-tax operating profits' exceeds 10% of equity capital. Everything before that is just building up to the minimum acceptable compensation for investing in a risky enterprise.

TWO BASIC PRINCIPLES OF FINANCE THAT 'EVA' ATTEMPTS TO INCORPORATE IN DECISION MAKING PROCESS:

EVA helps managers incorporate two basic principles of finance into their decision making process:

(i) Maximization of share holder wealth

(ii) the value of a company depends on the extent to which investors expect future profits to exceed or fall short of the cost of capital.

A sustained increase in EVA will bring an increase in the market value of a company. This approach has proved effective in virtually all types of organizations, from emerging growth companies to turnarounds. This is because the level of EVA isn't what really matters. Current performance already is reflected in share prices. It is the continuous improvement in EVA that brings continuous increases in shareholder wealth.

EVA has the advantage of being conceptually simple and easy to explain since it starts with familiar operating profits and mere deduction of charge for the capital invested in the company / business as a whole. By assessing a charge for using capital, EVA makes managers care about managing assets as well as income and helps them properly assess the tradeoffs between the two. This broader, more complete view of the economics of a business can make dramatic differences.

EVOLUTION OF 'EVA'

Stern Stewart & Co, a global consulting firm pioneered the development of its proprietary EVA® framework, which offers a consistent approach to setting goals and measuring performance, communicating with investors, evaluating strategies, allocating capital, valuing acquisitions, and determining incentive bonuses that make managers think like owners.

HOW POPULAR IS 'EVA' AMONG THE CORPORATE WORLD?

Managing for value has become the mantra of today's executives. A large number of companies worldwide now use EVA. Records reveal that most of them significantly outperform other companies in their line of activity. Companies as diverse as Siemens and Sony have publicly announced the formal implementation of EVA management systems in their quest for the value-maximisation proposition. In addition, numerous brokerage houses, such as Goldman Sachs and Credit Suisse First Boston, have adopted EVA as a principal method of equity valuation. Some Indian companies like Godrej also is reportedly using EVA as an effective management tool.

EVA-based valuation and performance management techniques can be effectively used by Boards of Directors, CEOs, CFOs and Corporate Strategists to improve their company's chances of success in Mergers & Acquisitions (M&A) and other major investments.

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JUNE 2006

Theme No. 175 : THE BANKING CODES AND STANDARDS BOARD OF INDIA (BCSBI)

RBI Governor, in his Monetary Policy Statement, April 2005 announced setting up of the Banking Codes and Standards Board of India (BCSBI).

WHAT IS *BCSBI*?

BCSBI is a society registered under the Societies Registration Act, 1860. It can be described as an independent and autonomous watch dog to monitor and to ensure that the banking codes and standards voluntarily adopted by banks are adhered to in true spirit by banks in delivering the services, as promised, to their customers.

The Registered Office of the Society is situated in the State of Maharashtra at Reserve Bank of India, C- 8/9, Bandra-Kurla Complex, Bandra (East), Mumbai - 400 051.

WHAT ARE THE MAIN AIMS AND OBJECTS OF THE SOCIETY?

The main aims and objects of the society are :

1. To plan, evolve, prepare, develop, promote and publish voluntary comprehensive Codes and Standards for banks, for providing fair treatment to their customers.
2. To function as an independent and autonomous watch dog to monitor and to ensure that the Banking Codes and Standards voluntarily adopted by banks are adhered to, in true spirit by banks in delivering the services, as promised, to their customers.
3. To conduct and undertake research of the Codes and Standards currently in vogue in and outside India.
4. To enter into covenants with banks on observance of the codes and standards and for that purpose to train employees of such banks about the Banking Codes.
5. To help people affected by natural calamities.

BACKGROUND OF SETTING UP OF *BCSBI*

S.S. Tarapore Committee on Procedures and Performance Audit of Public Services set up by RBI in 2003, recommended setting up of the BCSBI broadly on the lines of Banking Codes and Standards Board functioning in U.K.

The committee was set up to address the issues relating to availability of adequate banking services to common man. The mandate to the Committee included identification of factors that inhibited the attainment of best customer services and suggesting steps to improve the quality of banking services to individual customers.

The Committee felt the need for benchmarking of services offered by banks to their customers. Benchmarking will help banks to upgrade their package of services offered to their customers on a continuous basis.

After in depth study at the grass root level, the Committee concluded that there was an institutional gap for measuring the performance of banks against a bench mark reflecting the best practices (Code and Standards). Accordingly, the Committee recommended setting up of the Banking Codes and Standards Board of India.

EXPLAIN THE TERM 'CODE' IN THE PRESENT CONTEXT:

This is a voluntary Code, which sets minimum standards of banking practices for banks to follow when they are dealing with individual customers. It provides protection to customers and explains how banks are expected to deal with customers for their day-to-day operations.

The Code has been developed to

a. promote good and fair banking practices by setting minimum standards in dealing with customers;
b. increase transparency so that customers can have a better understanding of what they can reasonably expect of the services;
c. encourage market forces, through competition, to achieve higher operating standards;
d. promote a fair and cordial relationship between customers and their bank;
e. foster confidence in the banking system.

WHICH ARE THE KEY COMMITMENT AREAS OF BANKS?

i. to act fairly and reasonably in all dealings with customers.

ii. to help them understand how bank's financial products and services work.
iii. to help them use bank's account or service
iv. to treat all their personal information as private and confidential
v. to adopt and practice a non - discrimination policy

Other areas of commitment include providing various information such as interest rates, tariff schedules, terms and conditions, loan and deposit products, etc.

Every member bank is required to have a help desk / helpline at the branch, have a Code Compliance Officer at each controlling office above the level of the branch, display at each branch the name and contact number of Code Compliance Officer and display the name and address of the Banking Ombudsman. This is to help the customer in case his bank does not provide services as promised in the Code.

SCOPE FOR REDRESSAL

The customer should first approach the help desk of the branch/bank. In case the issue is not resolved, the Code Compliance Officer of the bank may be approached by the complainant. In case the issue is still not resolved to the satisfaction of the customer he should take it up with the **Banking Ombudsman.**

IS THERE SCOPE FOR REVIEW OF THE CODE?

The code will be reviewed within a period of three years. The review will be undertaken in a transparent manner.

WHAT IS THE NEED FOR A SEPARATE BODY SUCH AS *BCSBI*, WHEN WE ALREADY HAVE THE SCHEME OF BANKING OMBUDSMAN IN VOGUE?

Systemic issues with a view to enforcing a prescribed quality of service does not come under the ambit of Banking Ombudsman Scheme. Therefore, there was a felt need to set up an independent, autonomous body best suited for the function.

IS *BCSBI* A SEPARATE DEPARTMENT OF RBI?

Since the office of BCSBI is situated in RBI building, this can be a genuine doubt. The answer is NO. The Banking Codes and Standards Board of India is not a Department of the RBI. It is an independent body to ensure that the consumers of banking services get what they are promised by the banks.

WHO EXTENDS FINANCIAL SUPPORT TO *BCSBI*?

RBI extends financial support to the BCSBI for the initial 5 years. This is to ensure it's autonomy. The support will be only till BCSBI reaches its economic critical mass that will make it truly independent in its functioning and take a view on any bank without its existence coming under any threat.

WHETHER BANKS CAN BECOME MEMBERS OF *BCSBI*?

Membership of the society is open to all banks that sign the covenant with the society agreeing to comply with the codes and standards. A bank agreeing to comply with the codes and standards shall make an application to the society along with such fee as may be specified from time to time. Such member banks have to pay an annual subscription to the society. Member banks shall be entitled to get from the society, the information and particulars in respect of the national and international banking codes and standards. The Society will convene Annual General Meetings of the member banks every year.

ADMINISTRATIVE SET UP

There will be a Governing Council. The term of the first Governing Council shall consist of two successive terms of three years and two years respectively. On the expiry of the first term of three years, RBI will nominate members for the second term of two years. On the expiry of the term of the first Governing Council, the subsequent Governing Council shall be constituted in the manner specified. The Governing Council shall have not more than six members, consisting of:-

(1) upto three members nominated by Reserve Bank;

(2) upto two members nominated by the member banks in consultation with the Reserve Bank; and

(3) the Chief Executive Officer.

The Governing Council shall meet at least once in three months. The Governing Council may constitute committees for various purposes, on such terms and powers as it may consider necessary or desirable.

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