The five years since the onset of the global financial crisis have seen policymakers across the globe strive to rebuild their financial systems to ensure robustness and mitigate contagion risks with a view to preventing future crises. In addition to strengthening the regulatory and supervisory framework, the Reserve Bank has also focused on mitigating risks amid asset quality concerns in the banking and non-banking space. It has set up early warning mechanisms and facilitated mechanisms for continuous monitoring of the credit quality of borrower accounts. It has initiated the process of countercyclical buffers to ensure financial soundness. NBFCs, in general, have a wider reach to the otherwise less banked customers and hence play a crucial role in promoting financial inclusion. Therefore, they also warrant careful supervision and regulation so as to ensure customer protection.

VI.1 Contagion risks from international banks’ balance sheets during the global financial crisis and the spillover effects on to sovereign balance sheets that got highlighted in the euro area crisis thereafter underscore the importance of a policy framework in ensuring financial stability. The recent exchange market pressures that were witnessed following the announcement of the US tapering of quantitative easing in the face of a weak domestic economy and stressed assets scenario of the banking sector brought to the fore the fragilities of the domestic market prompting sustainable macro-prudential solutions from Indian policymakers.

VI.2 In its efforts to foster a resilient financial system to ensure systemic stability, the Reserve Bank proactively stepped up measures to identify risky credit, to track and monitor such disbursals and to appropriately pre-empt delinquency, and where unavoidable to ensure quick and cost-effective retrieval processes so as to prevent losses and a possible system-wide contagion. It also strove to implement a fairer regime of credit pricing across bank and non-bank sectors. Initiatives for enhancing customer services and improving banking awareness and reach continue to hold priority in the Reserve Bank’s agenda on regulatory and supervisory measures.

Financial Stability Assessment

Asset quality of banks remains under stress due to a cyclical downturn, sector specific issues

VI.3 The soundness and asset quality parameters of the banking sector deteriorated during the year (Table VI.1). These indicators, however, showed signs of improvement during the last quarter. The capital to risk weighted assets ratio (CRAR) declined during 2013-14. Liquidity and profitability indicators continued to show stress.

VI.4 Various banking stability measures based on co-movements in bank equity prices indicate that the distress dependencies within the banking system that were rising since Q2 of 2013-14, have remained stable since January 2014. Stress tests assuming severe stress conditions show that although the system level CRAR of scheduled commercial banks (SCBs) remains well above the regulatory minimum, there is a need for higher provisioning to meet the expected losses under adverse macroeconomic conditions. However, under normal conditions further significant deterioration seems unlikely.

Implementation of FSDC and FSB reforms on course

VI.5 The sub-committee of the Financial Stability and Development Council (FSDC) is examining
ways for developing an account aggregation facility that will enable a customer to view all his/her financial assets at one location. It is also coordinating with financial sector regulators towards uniform implementation of certain recommendations of the Financial Sector Legislative Reforms Commission (FSLRC) that do not require legislative amendments/new legislations. The sub-committee, which met thrice during July 1, 2013 and June 30, 2014 is also pursuing the implementation of various reforms in India which have been agreed to under G-20 deliberations. In this regard, various inter-agency implementation groups have been set up (Box VI.1).

**Box VI.1 Implementation of Internationally Agreed Reforms in India**

The Financial Stability Board (FSB) was established in 2009 to coordinate the work of national financial authorities and international standard setting bodies at the international level and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. Since then, the FSB has proposed a vast spectrum of regulatory and supervisory reform measures which on the basis of their scope can be broadly grouped as measures/reforms: (a) to end too-big-to-fail syndrome; (b) to establish safe and secure markets and market infrastructure; (c) to address the issue of shadow banking; and (d) to establish macro-prudential frameworks.

As a signatory of G-20 and a member of the FSB, India is committed towards implementing the reforms that have been agreed to in the post-crisis international environment. The sub-committee of the Financial Stability and Development Council (FSDC) acts as a facilitator between various agencies and authorities in each jurisdiction to oversee the implementation of the reforms. It has set up inter-regulatory/inter-agency implementation groups in several critical areas with the mandate of identifying the way forward with regard to implementation of the reforms, the details of which are as follows:

- A working group on effective resolution regimes for financial institutions (Chairmen: Shri Anand Sinha and Dr Arvind Mayaram) has recommended that there should be a separate comprehensive legal framework providing necessary tools to resolve issues relating to all financial institutions and financial market infrastructures irrespective of the existing statutes governing various types of financial institutions. It also proposes the constitution of a single Financial Resolution Authority that is institutionally independent of the regulators/supervisors and the government. Other recommendations include initiating resolution action in a timely and speedy manner; avoiding erosion of value and minimising costs of resolution, while ensuring continuity of essential financial services such as payments and clearing and settlement; protecting depositors, insurance policyholders and client funds/assets through protection schemes and ensuring imposition of losses to shareholders and unsecured creditors.

- The recommendations of the Implementation Group for Over the Counter (OTC) Derivatives and Market Reforms (Chairman: R. Gandhi) are at various stages of implementation with timelines extending up to March 2015.

- The Clearing Corporation of India Ltd. has been identified to set up facilities to issue globally compatible legal entity identifiers; it is in the process of setting up the requisite technological infrastructure.

- The inter-regulatory/inter-agency Shadow Banking Implementation Group, is presently working on (i) assessing the compliance position of all the financial sector regulators in their regulatory domain vis-à-vis FSB policy guidelines; (ii) preliminary gap analysis to identify reform measures that can be implemented and those where implementation is not desirable; (iii) reasons for identifying certain reform measures as not desirable given the ‘comply or explain’ framework; and (iv) tentative timelines for implementing reforms.

- The inter-agency group on reducing reliance on credit rating agencies (CRAs) has observed that though there were references to CRA ratings in the regulations of respective segments of the financial sector, these served as a supplementary input for risk assessment. Market participants are, therefore, expected to do their due diligence prior to investments, such that there is no mechanistic reliance on CRAs.
ASSESSMENT OF THE BANKING SECTOR

Trends in key financial soundness indicators

VI.6 Slowdown in the domestic economy has caused strains on a number of companies/projects resulting in higher non-performing assets (NPAs) and restructured accounts in the Indian banking system in recent years. This has impacted bank profitability as evident from the dwindling return on assets. Increased provisioning requirements to cover delinquencies and rise in operating expenses (reflected in an increase in the cost-income ratio) adversely affected bank profitability, especially in 2013-14 (Table VI.1).

VI.7 The return on equity declined in most segments on account of lower profitability coupled with fresh infusion of capital post the implementation of Basel III capital norms since April 1, 2013. Though the all-India financial institutions (AIFIs) show improvements in their efficiency parameters, they also seemed to post weak performance in 2013-14 with respect to other parameters. To put in place an early warning system for prompt

<table>
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<tr>
<th>Table VI.1: Select Financial Indicators (Per cent)</th>
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<td><strong>Item</strong></td>
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<tr>
<td>1</td>
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<tr>
<td>CRAR #</td>
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<tr>
<td>Core CRAR #</td>
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<td></td>
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<tr>
<td>Gross NPAs to Gross Advances</td>
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<td></td>
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<tr>
<td>Net NPAs to Net Advances</td>
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<td>Return on Assets</td>
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<tr>
<td>Return on Equity</td>
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<td>Efficiency (Cost/Income Ratio)</td>
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<td>Interest Spread (Per Cent)</td>
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<tr>
<td>Liquid Assets to Total Assets</td>
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<tr>
<td>Restructured Assets to Gross Advances</td>
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#: Mar-13 as per Basel II and Mar-14 as per Basel III.
Note: 1. Core CRAR is calculated as Tier-I Capital/Total Risk Weighted Assets.
2. Liquid assets include cash and bank balances and investments in government securities.
3. Audited data for NABARD, SIDBI and EXIM for the year ended March 31, 2013.
4. Audited data for NHB for the year ended June 30, 2013; in case of NHB the financial year is July to June.
5. Un-audited data for March 31, 2014 for NABARD, SIDBI and NHB and audited data for EXIM.
Source: OSMOS returns (SCBs); Off-site surveillance returns (UCBs); PD returns (PDs); COSMOS returns (NBFCs); data received from FIs.
recognition of impending stress in the face of growing NPAs, the Reserve Bank issued a framework for revitalising distressed assets in January 2014. Under the proposals of the framework, the Central Repository of Information on Large Credits (CRILC) has been set up set up (Box VI.2).

**Box VI.2**

Framework for Revitalising Distressed Assets in the Economy: Pivotal Role for CRILC

Asymmetry in information is a fundamental challenge that impacts the quality of banks’ credit risk assessment and supervisors’ ability to track emerging credit risks in the system. With a mandate of activating and coordinating the mechanism to manage stressed assets in the economy so that transparent credit information becomes available for sound risk management and financial stability, the Reserve Bank introduced the ‘Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy’ in January 2014. The framework outlines a corrective action plan to incentivise: (i) early identification of problematic accounts, (ii) timely restructuring of accounts that are considered to be viable, and (iii) lenders taking prompt steps for recovery or sale of unviable accounts.

The Reserve Bank set up the Central Repository of Information on Large Credits (CRILC) in April 2014 to collect, store and disseminate credit data to lenders. CRILC’s essential objective is to enable banks to take informed credit decisions and early recognition of asset quality problems by reducing information asymmetry. CRILC captures borrower-wise details of funded and non-funded exposures including investments.

Banks are required to furnish credit information to CRILC on all their borrowers having aggregate fund-based and non-fund based exposure of `50 million and above with them. Notified systemically important non-banking financial companies and NBFC-Factors will also be required to furnish such information. In addition, banks are required to furnish details of all current accounts of their customers with outstanding balance (debit or credit) of `10 million and above. Lenders in India covered under the framework are also required to report the external commercial borrowings extended by their overseas branches/offices to Indian borrowers.

In order to capture early warning signals of financial distress faced by borrowers, the framework requires banks to report, among others, special mention accounts’ (SMAs) status of the borrower to CRILC on a real time basis.

While, SMA-1 (principal or interest overdue between 31-60 days) and SMA-2 (principal or interest payments overdue between 61-90 days) will be based on past due criteria, SMA-0 will contain non-past due accounts showing signs of incipient stress. When a bank reports a borrower as SMA-2 to CRILC, an auto flash report is sent to all other banks having exposure to that borrower so that the lenders can take necessary steps to form a joint lenders forum (JLF) and take necessary corrective actions as laid down in the framework.

The option under the corrective action plan by the JLF will generally include: (i) rectification, (ii) restructuring, and (iii) recovery. Forming a JLF will be mandatory for distressed borrowers engaged in any type of activity, with aggregate fund based and non-fund based exposure of `1 billion and more. Restructuring can be carried out either under the corporate debt restructuring mechanism or under JLF, but if not found to be feasible, JLF will initiate recovery measures. While incentives have been proposed to encourage lenders to agree collectively and quickly on resolution plans, non-adherence to regulatory guidelines has been disincentivised by way of accelerated provisioning.

For restructuring of dues of listed companies, lenders may be *ab-initio* compensated for their loss/sacrifice (diminution in fair value of account in net present value terms) by way of issuance of equities of the company upfront, subject to extant regulations and statutory requirements. Disincentives have also been proposed for: (i) willful defaulters and non-cooperative borrowers, making their future borrowings more expensive, and (ii) for auditors, advocates and valuers who provide incorrect opinions about borrowers and their assets leading to deterioration in the asset quality of banks.

The framework also prescribes more liberal regulatory treatment of asset sales and incentives for asset restructuring companies in order to improve the stress asset reconstruction and rehabilitation market. Necessary regulatory circulars on the proposals of the framework have been issued by the Reserve Bank. The framework became operational from April 1, 2014.
NPAs came to the fore for some banks, but health of the banking sector remains satisfactory

VI.8 The asset quality of the banking system showed deterioration during 2013-14 mainly reflecting the performance of public sector banks (PSBs). Not only were the gross and net NPA ratios of PSBs more than the industry averages, but they also accounted for about 92 per cent of the restructured standard advances (Table VI.2).

VI.9 The increase in the level of restructured standard advances since 2012-13 reflects potential hidden stress in the quality of loan assets. The improvement in NPAs during Q4 of 2013-14 needs to be cautiously examined in the face of the increased offload of loans to asset restructuring companies (ARCs) by banks (Table VI.3).

Increasing share of non-priority sector advances in NPAs

VI.10 The non-priority sector has contributed more in the deterioration of the loan asset quality of the banking sector in recent years. The proportion of aggregate gross NPAs in the priority sector to the gross NPAs of the system stood at 36 per cent at end-March 2014, down from about 40 per cent last year. Within the priority sector, the NPA ratio has risen for the medium and small industry segment (Table VI.4).

Major industry segments account for an over one-third share of total NPAs

VI.11 About 47 per cent of the aggregate credit outstanding by the banks was to the industrial sector, which alone accounted for over 58 per cent

### Table VI.2: Indicators

<table>
<thead>
<tr>
<th>Source: Off-site returns covering domestic operations of banks.</th>
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<tr>
<td></td>
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<tr>
<td>--------------------------------</td>
</tr>
<tr>
<td>Public sector banks</td>
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<tr>
<td>Private sector banks</td>
</tr>
<tr>
<td>Foreign banks</td>
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<tr>
<td>Aggregate</td>
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</tbody>
</table>

### Table VI.3: Loan Sales to ARCs

<table>
<thead>
<tr>
<th>Source: Off-site returns covering domestic operations of banks.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Group</td>
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<tr>
<td>------------</td>
</tr>
<tr>
<td>Public sector banks</td>
</tr>
<tr>
<td>Private sector banks</td>
</tr>
<tr>
<td>Foreign banks</td>
</tr>
<tr>
<td>All Banks</td>
</tr>
</tbody>
</table>

**Note:** Data show flows during the quarter.
of gross NPAs of the system as at end-March 2014. Gross advances to six industries - infrastructure, metal & products, textiles, chemical & chemical products, engineering industries and mining & quarrying - constituted 30 per cent of total advances and 36 per cent of gross NPAs.

Retail credit increases, but NPAs decline

VI.12 Retail credit increased marginally to form 19 per cent of gross credit as at end-March 2014, with individual housing loans as its largest component (47 per cent) followed by personal loans (36 per cent) and auto loans (14 per cent). Notwithstanding the marginal increase in retail loans outstanding, gross NPAs in retail credit fell to 2.0 per cent as compared to 2.3 per cent last year. This was also significantly lower than the overall gross NPA ratio.

MAJOR DECISIONS TAKEN BY THE BOARD FOR FINANCIAL SUPERVISION

VI.13 The Board for Financial Supervision (BFS) constituted in 1994, remains the principal guiding force behind the Reserve Bank’s supervisory and regulatory initiatives. The BFS met 11 times during July 2013 and May 2014. This inspection cycle covered 49 banks under the CAMELS approach and 28 banks under the risk based supervision (RBS) approach. The annual financial inspection memoranda with respect to all banks and AIFIs programmed for inspection during 2013-14 had been submitted to the BFS by April 2014. Baseline supervisory review of 15 foreign banks with small operations in India was also placed before the BFS.

VI.14 Some of the major issues discussed with the BFS this year pertain to broadening the capital base of select SCBs, process of supervisory stress testing of commercial banks, on-lending of the rural infrastructure development fund, subsidiarisation of foreign banks in India, quality of the management information system and data integrity, governance issues, faulty incentive structures/practices in banks for cross-selling insurance products, arbitrary interest rate charges, deficiencies relating to un-reconciled export bills for collection, rising stress in asset quality and need for periodic inspection of credit information companies.

VI.15 As directed by the BFS, the process of levying penalty was reviewed and a revised procedure for imposing penalty under the Banking Regulations Act (BR Act), 1949 was laid out. A thematic study on the modus operandi and action taken by banks in fraud cases involving an amount of `500 million and more was also undertaken by the Reserve Bank.

VI.16 Inspection of a nationalised bank indicated a sizeable increase in its NPAs, especially slippages and write-offs. The BFS directed a special scrutiny to determine the cause and also the measures taken by the bank to overcome this position. With regard to a major fraud reported by some banks, the BFS directed that a joint study be undertaken with the Securities and Exchange Board of India (SEBI) to find the lapses on the part of the bank and the company. A forensic audit was also initiated.

VI.17 With regard to scheduled urban cooperative banks (UCBs), the BFS reviewed 42 summaries of inspection reports, summaries of financial highlights for 30 UCBs rated between A+ and B and 12 UCBs rated between C+ and D. The proposal to revise the norms for including licensed UCBs in the Second Schedule to the Reserve Bank.

Table VI.4: Gross NPAs Across Sectors

<table>
<thead>
<tr>
<th>Sector</th>
<th>Mar-11</th>
<th>Mar-12</th>
<th>Mar-13</th>
<th>Mar-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>3.3</td>
<td>4.3</td>
<td>4.7</td>
<td>4.4</td>
</tr>
<tr>
<td>Medium &amp; Small Enterprises</td>
<td>3.6</td>
<td>4.0</td>
<td>5.1</td>
<td>5.2</td>
</tr>
<tr>
<td>Other Priority Sector</td>
<td>4.0</td>
<td>4.4</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Total Priority Sector</td>
<td>3.6</td>
<td>4.2</td>
<td>4.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Non Priority Sector</td>
<td>1.8</td>
<td>2.3</td>
<td>3.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Total</td>
<td>2.4</td>
<td>2.9</td>
<td>3.4</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Source: Off-site returns covering domestic operations of banks.
Bank of India Act (RBI Act), 1934 was approved. The BFS also called for a staggered deadline for migration to core banking solutions (CBS) across all UCBs depending on their deposit sizes.

VI.18 Based on a review of the status of 23 unlicensed district central cooperative banks (DCCBs), the BFS recommended initiation of regulatory action against these banks. On a review of the functioning of regional rural banks (RRBs), the BFS directed that a minimum CRAR of 9 per cent for all RRBs from March 31, 2014 should be prescribed. Further, the exemption from mark-to-market norms with respect to the statutory liquidity ratio (SLR) securities granted to RRBs since 1995 was withdrawn. The BFS also directed to prescribe a minimum CRAR of 9 per cent for state cooperative banks (StCBs) and DCCBs to be achieved by March 31, 2017 in a phased manner and approved issuance of long term deposits (LTDs) and innovative perpetual debt instruments (IPDIs) by StCBs/DCCBs for capital augmentation.

VI.19 In the non-bank financial companies (NBFCs) segment, the issues considered by the BFS included involvement in the gold loan business, self-regulatory organisation (SRO) for micro-finance institutions (MFIs), filing of records with the Central Registry of Securitisation Asset Reconstruction and the Security Interest of India (CERSAI), prohibiting from contributing capital to any partnership firm or being a partner in partnership firms and private placements by NBFCs. All NBFCs were advised that no advances should be granted against bullion/primary gold and gold coins.

COMMERCIAL BANKS

Regulatory initiatives

Efforts to bring about a fairer regime of pricing of credit

VI.20 Despite policy efforts to usher in transparency and rationality in the credit pricing framework, there have been certain concerns from the customer service perspective. These mainly relate to downward stickiness of interest rates, discriminatory treatment of old borrowers vis-à-vis new borrowers and arbitrary changes in spreads. In response, the Reserve Bank constituted a working group (Chairman: Shri Anand Sinha) comprising members from banks, the Indian Banks’ Association (IBA), academia and the Reserve Bank to examine the issues related to discrimination in credit pricing and to recommend measures for a transparent and appropriate pricing strategy under a floating rate regime.

VI.21 Its major recommendations include: (i) move towards computation of base rate on the basis of the marginal cost of funds by banks, particularly those with lower weighted average maturity of deposits; (ii) ensuring that any price differentiation is consistent with a bank’s credit pricing policy factoring risk adjusted return on capital by the board of the bank; (iii) framing an internal policy of the bank spelling out the rationale for and range of the spread in case of a given borrower, as also delegation of powers with respect to loan pricing; (iv) ensuring no increase in the spread charged to an existing customer, except in case of deterioration in the credit risk profile of the customer; and (v) setting the reset interest rate periodicity in floating rate loan covenants with resets allowed on those dates only.

VI.22 The other recommendations include: (i) a sunset clause for benchmark prime lending rate contracts so that all the contracts thereafter are linked to the base rate; (ii) developing a new benchmark for floating interest rate products, viz. the Indian banks’ base rate by IBA and its periodic dissemination; (iii) giving benefit of interest reduction on the principal on account of pre-payments on the day the money is received by the bank without waiting for the next equated monthly installment (EMI) cycle date to effect the credit;
(iv) offering the choice of ‘with exit’ and ‘sans exit’ options for customers at the time of entering the contract with regard to retail loans; and (v) calling for a more robust grievance redressal system in banks that is responsive to customers’ needs.

VI.23 Further, the Reserve Bank may penalise banks which do not put in place adequate measures, as evidenced by repeated complaints. The working group also made recommendations to bring in greater transparency enabling comparability across banks and informed decision making by customers. The public comments received on the report are under examination and guidelines will be issued to banks in due course.

Capital and provisioning requirements for exposures to entities with unhedged foreign currency exposure

VI.24 As exchange rate volatility may affect the health of the banking system through spillover effects from the corporate sector, it has been proposed to increase the risk weight and provisioning requirement on banks’ exposures to entities having excessive unhedged forex exposure positions. The guidelines issued in January 2014 provide the methodology to compute incremental provisioning and capital requirements.

Recent developments on implementation of Basel III

VI.25 While all 27 jurisdictions that comprise the Basel Committee had implemented Basel III capital regulations as at April 2014, India implemented Basel III with a delay of three months (from April 1, 2013 instead of January 1, 2013 as originally scheduled) to align the implementation schedule with the beginning of the financial year.

VI.26 The Reserve Bank has extended the end date for full implementation of Basel III capital regulations by one year (to March 31, 2019) to provide some lead time to banks on account of potential stresses on asset quality and consequential impact on the performance/profitability of the banks. With the extension, full implementation of Basel III in India will slightly exceed the internationally agreed end date of January 1, 2019. With regard to the introduction of countercyclical capital buffers in India, an internal working group is following up on public comments on its draft report (Box VI.3).

Box VI.3

Basel III: Countercyclical Capital Buffer

In the aftermath of the financial crisis in 2008, the group of central bank governors and heads of supervision showed a commitment to introducing a countercyclical capital buffer (CCCB) framework (September 2009). Subsequently, in December 2010, the Basel Committee on Banking Supervision (BCBS) published ‘Guidance for national authorities operating countercyclical capital buffer’ to propose a framework for dampening excess cyclicality of minimum regulatory capital requirements arising out of the Basel II framework, with an aim of maintaining a flow of funds from banks to the real sector in economic downturns by using capital accumulated in good times.

Moreover, in boom times as the banks will be required to shore up capital, they may be restrained from extending indiscriminate credit. The BCBS guidance proposes a credit to GDP gap (difference of credit to GDP ratio from its historical trend) as the main indicator to decide on the starting point for imposition of CCCB. However, BCBS also mentions that national supervisors may take into consideration other supplementary indicators which may be used in conjunction with the credit to GDP gap to impose CCCB which may go up to 2.5 per cent of the total risk weighted assets of a bank. To operationalise the CCCB framework in India, an internal working group (Chairman: Shri B. Mahapatra) was constituted at the Reserve Bank. Triggering the CCCB too early out of excessive caution may involve sacrificing growth while complacency and failure to trigger a buffer decision may lead to the building up of pressure.

(Contd....)
Given this context, the working group tried to dovetail the CCCB framework prescribed by the Basel Committee to Indian conditions, proposed suitable modifications where required and recommended the following in its December 2013 draft report on the implementation of the CCCB framework in India:

- While the credit to GDP gap will be used for an empirical analysis to facilitate the CCCB decision, it may not be the only reference point for banks in India and the credit to GDP gap may be used in conjunction with other indicators like growth in gross NPA (GNPA).
- The lower threshold (L) of the CCCB framework when the buffer is activated may be set at 3 percentage points of the credit to GDP gap, provided its relationship with GNPA remains significant and the upper threshold (H) may be kept at 15 percentage points of the credit to GDP gap.
- CCCB shall increase linearly from 0 to 2.5 per cent of the risk weighted assets (RWAs) of the bank based on the position of the gap within the threshold range (between 3 and 15 percentage points). However, if the gap exceeds H, the buffer will remain at 2.5 per cent of the RWA, and there is no buffer requirement if the gap falls below L.
- Supplementary indicators will include the incremental credit-deposit ratio for a moving period of 3 years, the industry outlook assessment index and the interest coverage ratio. These variables need to be considered along with their correlation with the credit to GDP gap.
- The CCCB decision may be pre-announced with a lead time of 4-quarters and the Reserve Bank may apply discretion in terms of use of indicators while activating or adjusting the buffer. The framework may be operated in conjunction with a sectoral approach that has been successfully used in India over a period of time. For all banks operating in India, CCCB will be maintained on a solo basis as well as on a consolidated basis in India.

The same set of indicators that are used for activating CCCB may be used to arrive at a decision for CCCB’s release phase. However, instead of a stringent rules-based approach, flexibility in terms of use of judgment and discretion may be provided to the Reserve Bank for operating CCCB’s release phase. Further, the entire CCCB may be released promptly at a single point in time.

The final report will be placed on the Reserve Bank’s website after suitable modifications following comments received from various stakeholders on the draft. The Reserve Bank issued its final guidelines on ‘Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards’ on June 9, 2014. These guidelines take into account the phase-in arrangement, definition of LCR, high quality liquid assets (HQLAs), liquidity risk monitoring tools and LCR disclosure standards as proposed in the BCBS standards. Accordingly, LCR will be introduced on January 01, 2015 but the minimum requirement will be set at 60 per cent and rise in equal annual steps to reach 100 per cent by January 01, 2019. The guidelines also take into account the range of HQLAs available in the Indian financial markets and their liquidity vis-à-vis the liquidity instruments prescribed in the BCBS standard.

Keeping this in view, G-secs up to 2 per cent of net demand and time liabilities have been allowed to be included as Level 1 HQLAs. Further, while covered bonds, residential mortgage backed securities (RMBS) and corporate debt securities (including commercial paper) of rating between A+ and BBB- have not been included as Level 2 HQLAs, eligible common equity shares with 50 per cent haircut have been allowed to be included as Level 2B HQLAs. A quantitative impact study conducted by the Reserve Bank in December 2013 on a sample of banks to assess their preparedness for the Basel III liquidity ratios indicates that the average LCR for these banks varied from 54 per cent to 507 per cent.

**Framework for domestic-systemically important banks (D-SIBs)**

VI.27 The draft D-SIB framework in India which was released for public comments in December 2013 tries to ensure that the probability of failure of a bank with higher systemic importance is reduced by requiring additional capital and also subjecting these banks to other stringent regulatory/supervisory measures. The draft framework discusses the proposed methodology to be adopted by the Reserve Bank for identifying D-SIBs and the quantum of additional common equity Tier 1 capital (CET-1) applicable to such banks. The identification methodology is largely based on an indicator-based approach being used by BCBS to identify global SIBs. The indicators proposed to assess D-SIBs are size,
interconnectedness, lack of substitutability and complexity, with more weights given to size. The interconnectedness, substitutability and complexity indicators are further divided into multiple indicators. Based on systemic importance scores, banks will be classified into 4 buckets (Table VI.5).

Depending on the bucket where a D-SIB is classified into, an additional CET-1 requirement (between 0.2 to 0.8 per cent of risk weighted assets) will be applicable to it.

Committee to review the governance of boards of banks in India

VI.28 In its initiatives for improving corporate governance practices in banks, the Reserve Bank constituted a committee of experts (Chairman: Dr P.J. Nayak) to review board governance standards for banks in India. The main recommendations of the committee (May 2014) are: (i) strengthening the governance structure of PSBs by removing constraints such as dual regulation (by the Ministry of Finance and the Reserve Bank), manner of appointment of directors to boards, (ii) fully empower boards in PSBs, (iii) setting up of an autonomous Bank Investment Company (BIC) to hold equity stakes in banks; and (iv) the transition for these should be in three phases.

VI.29 Other recommendations pertain to withdrawal of Reserve Bank’s nominees on the boards of PSBs; separation of CMDs’ posts into executive MD and non-executive chairman; creation of a specific category of investors in banks called authorised bank investors (ABIs); raising of the ceiling for promoter investors’ stake to 25 per cent; permitting private equity funds including sovereign wealth funds to take a controlling stake of up to 40 per cent in distressed banks and increasing the limit for voting rights to 26 per cent. Recommendations of the committee are being examined taking into account the comments received from banks, IBA and the public.

Licensing of new banks in the private sector

VI.30 In-principle approvals were given to two new applicants in April 2014 to set up banks under the guidelines on licensing of new banks in the private sector issued on February 22, 2013. Going forward, the Reserve Bank intends to use this licensing exercise to revise the guidelines appropriately and move to give licences more regularly, that is, virtually ‘on tap’. Building on the discussion paper on ‘Banking Structure in India-The Way Forward’ (August 2013), draft guidelines for ‘Payment Banks’ and ‘Small Banks’ were placed on the Reserve Bank website in July 2014.

Supervisory initiatives

Risk-based supervision’s initial experience and the way forward

VI.31 In line with the BFS directives, 28 banks have been assessed under the RBS framework (SPARC – Supervisory Program for Assessment of Risk and Capital) beginning 2013-14. These banks account for approximately 60 per cent of the banking sector’s assets and liabilities and cover a cross-section of banks (on an ownership basis). The SPARC framework is a departure from the compliance oriented and point-in-time performance based assessment carried out under CAMELS and CALCS.

VI.32 SPARC’s design enables evaluation of present and future risks with a view to identifying concerns building up in a bank or the system and intervening appropriately in a timely manner. The continuous nature of supervision under SPARC entails on-going interaction between banks and
supervisors and is not limited to periodic meetings/inspections. The SPARC framework is designed to have greater off-site assessment, monitoring and supervision with focused on-site inspections in identified concern and risk areas.

Cross-border supervision and cooperation

VI.33 The Reserve Bank has been entering into bilateral Memoranda of Understanding (MoUs) with overseas supervisors for effective cross-border supervision and cooperation in accordance with extant domestic legal provisions and BCBS principles. It has made substantial progress in supervisory information sharing and cooperation within jurisdictions where Indian banks are operating by entering into MoUs.

Institution of supervisory colleges

VI.34 Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. The Reserve Bank has been actively participating in supervisory colleges conducted by overseas home regulators of foreign banks operating in India. In its capacity as the home country supervisor, the Reserve Bank set up supervisory colleges for Bank of India and Bank of Baroda in February 2014. These are in addition to those already set up earlier for State Bank of India and ICICI Bank Ltd. These supervisory colleges are likely to emerge as a key tool for consolidated supervision in the context of significant and growing overseas operations of Indian banks.

Inspection of overseas branches of Indian banks

VI.35 Global operations of Indian banks are spread across 54 countries. In order to assess the financial position, systems and control of overseas branches, inspection of 8 banks in 5 overseas jurisdictions covering almost 60 per cent of the total overseas assets of Indian banks was undertaken in 2012-13. In 2013-14, inspection of 6 banks in 6 jurisdictions covering another 20 per cent of the total overseas assets was undertaken.

Thematic review of adherence to KYC/AML norms conducted in 36 banks

VI.36 In the wake of allegations against banks by an online media portal, a thematic review of adherence to Know Your Customer (KYC)/anti-money laundering (AML) norms in 36 banks (foreign, private sector and public sector) was conducted in two spells. The first review in April 2013 included 29 banks and the second in May 2013 included 7 banks. Follow-up action concluded in July and August 2013 respectively. Monetary penalties were imposed on 28 of the 36 banks and the remaining were issued caution letters.

Development of the OSMOS system in a XBRL environment

VI.37 In order to facilitate user friendliness and for incorporating advances in technology while keeping pace with regulatory changes and emerging supervisory requirements, the off-site monitoring and surveillance (OSMOS) system set up in 1997, is being re-developed. Although the scope and coverage of the returns generated through OSMOS have been periodically reviewed and updated, the advantages of the eXtensible Business Reporting Language (XBRL) environment for data reporting need to be incorporated in OSMOS and select other returns to ensure efficient data collection, maintain quality and integrity of data and improve data accessibility for robust supervision.

URBAN COOPERATIVE BANKS

Revised criteria for qualifying as financially sound and well managed

VI.38 The criteria for UCBs to be classified as financially sound and well managed (FSWM) were modified with effect from October 1, 2013 in keeping with the improvement in the performance indicators of the sector. The change envisaged that besides other parameters, UCBs with gross
NPAs of less than 7 per cent and net NPAs of not more than 3 per cent will qualify as FSWM as against the earlier condition of net NPAs of less than 5 per cent.

**Extension of the disclosure requirements to Tier I UCBs**

VI.39 Tier II UCBs had earlier been advised to disclose certain information as ‘Notes on Accounts’ to their balance sheets along with several other additional disclosures. The disclosure requirements have been extended to Tier I UCBs also from the year ended March 31, 2014.

**Inclusion of primary UCBs in the Second Schedule to the RBI Act, 1934**

VI.40 Applications from UCBs for inclusion in the Second Schedule to the RBI Act, 1934 will be considered on fulfilling certain criteria such as demand and time liabilities (DTL) of not less than ₹7.5 billion on a continuous basis for one year; CRAR of minimum 12 per cent; continuous net profit for the previous 3 years; gross NPAs of 5 per cent or less; compliance with cash reserve ratio (CRR)/SLR requirements; and no major regulatory and supervisory concerns.

**Migration to core banking solutions (CBS)**

VI.41 As at end-March 2014, of the 1,589 UCBs, 510 had implemented CBS fully while 465 had done so partially. The revised timeframe for implementing CBS for Tier I UCBs (other than unit banks) is June 30, 2014, for unit banks it is December 31, 2014 while for Tier II UCBs, it stays unchanged.

**Conditional approval to grant unsecured loans to priority sectors**

VI.42 In order to promote lending to priority sectors and to provide impetus to the objective of financial inclusion, UCBs fulfilling certain conditions and with prior approval of the Reserve Bank, have been allowed to grant unsecured loans up to ₹10,000 for productive purposes up to 15 per cent of total assets. Such loans granted by UCBs will be exempt from the aggregate ceiling on unsecured exposure of 10 per cent of total assets.

**Select guidelines relating to market operations**

VI.43 Well managed UCBs can undertake intra-day short selling of government securities (G-secs) with the permission of the Reserve Bank. Intra-day short sales will provide increased liquidity to the

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G-sec market and is also relatively less risky as compared to the normal short sale where the short sale position is carried over to the next day exposing UCBs to market risks. UCBs have been permitted to invest in eligible market infrastructure companies such as the Clearing Corporation of India Ltd. (CCIL), the National Payments Corporation of India Ltd. (NPCIL) and the Society for World Wide Inter-Bank Financial Telecommunication (SWIFT).

Consolidation of UCBs through mergers/acquisitions
VI.44 With regard to consolidation of UCBs through merger of weak entities with stronger ones, the Reserve Bank received 183 proposals for mergers up to March 2014 and it had issued 134 NOCs/sanctions of which 116 have been notified for mergers by respective RCS/CRCS.

VI.45 The maximum number of mergers were in Maharashtra, followed by Gujarat and Andhra Pradesh (Table VI.6). Guidelines for transfer of assets and liabilities of UCBs to commercial banks were issued in February 2010.

RURAL COOPERATIVES AND REGIONAL RURAL BANKS
Status of state and central cooperative bank licenses
VI.46 The Committee on Financial Sector Assessment (Chairman: Dr Rakesh Mohan) in 2009 recommended a non-disruptive phasing out of unlicensed cooperative banks by March 31, 2012. However, in view of the large number of cooperative banks functioning without licenses (17 out of 31 StCBs and 296 out of 371 DCCBs), the Reserve Bank relaxed the licensing norms. The revised norms include: (i) minimum CRAR of 4 per cent, and (ii) no/rare default in CRR/SLR requirement for the last one year. As at end-March 2014, 23 DCCBs (Uttar Pradesh-16, Maharashtra-3, Jammu & Kashmir-3 and West Bengal-1) remain unlicensed and appropriate regulatory action is being initiated by the Reserve Bank.

Prescription of minimum CRAR for StCBs/DCCBs
VI.47 Although the CRAR framework was introduced in StCBs/DCCBs in December 2007, no minimum level of CRAR had been prescribed. Based on the BFS approval, a minimum CRAR of 9 per cent has been prescribed for StCBs and DCCBs. A roadmap has also been laid down for achieving a minimum CRAR of 7 per cent on an on-going basis by March 31, 2015 and 9 per cent by March 31, 2017. Since StCBs/DCCBs have limited avenues for mobilising additional capital resources, they have been permitted to issue LTDs (subordinated) and IPDIs with the prior approval of the Reserve Bank.

Migration to core banking solutions (CBS)
VI.48 As at end-June 2014, of the 32 StCBs, 30 had implemented CBS fully while 2 had done so partially. Out of 371 DCCBs, 317 had implemented CBS fully while 31 had done so partially, and remaining 23 banks are unlicensed. StCBs and DCCBs have been advised to complete CBS implementation by September 30, 2014.

Amalgamation of RRBs
VI.49 In the current phase of amalgamation beginning October 1, 2012 geographically contiguous RRBs within a state under different sponsor banks are to amalgamate so as to have just one RRB in medium sized states and 2 or 3 RRBs in large states. Accordingly, 44 RRBs have been amalgamated into 18 new RRBs within 12 states bringing down their effective number to 56. Consequent to the amalgamation, 13 RRBs have been included in the Second Schedule of the RBI Act, 1934 while 31 erstwhile RRBs have been excluded.

Prescription of minimum CRAR of 9 per cent for RRBs
VI.50 As per the recommendations of the Committee on Recapitalisation of RRBs for Improving CRAR (Chairman: Dr K.C. Chakrabarty),
38 RRBs had been fully recapitalised to the extent of ₹21 billion as on March 31, 2014. After the amalgamation and recapitalisation of weak RRBs, the CRAR position of the RRBs as on March 31, 2013 was reviewed. A minimum CRAR of 9 per cent on an on-going basis was prescribed for all RRBs with effect from March 31, 2014.

Guidelines for classification and valuation of investments by RRBs

VI.51 RRBs were exempted from application of the mark-to-market (MTM) norms with respect to SLR securities till March 31, 2013 and were allowed to classify their entire investment of SLR securities under ‘held to maturity’ (HTM). However, on review, RRBs have been advised to introduce MTM norms with respect to SLR securities beyond 24.5 per cent of DTLs held in the HTM category with effect from April 1, 2014 and to classify their investments into three categories: HTM, held for trading (HFT) and available for sale (AFS).

THE DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION

VI.52 A wholly owned subsidiary of the Reserve Bank, the Deposit Insurance and Credit Guarantee Corporation (DICGC) extends deposit insurance to all banks including local area banks (LABs), RRBs and cooperative banks across India. The number of registered insured banks as at end-March 2014 stood at 2,145 comprising 89 commercial banks, 58 RRBs, 4 LABs and 1,994 cooperative banks. The present limit of deposit insurance in India is ₹100,000. As at end-March 2014, 92 per cent (1,370 million) of the total number of accounts were fully protected by DICGC, as against the international benchmark\(^1\) of 80 per cent. Amount-wise, the ₹24 trillion insured deposits accounted for 31 per cent of the total assessable deposits as against the international benchmark of 20 to 40 per cent. At the current level, the insurance cover works out to 1.3 times per capita income.

VI.53 During 2013-14, the aggregate claims settled by DICGC were nearly half (₹1 billion with respect to 51 cooperative banks) of those settled last year. The Deposit Insurance Fund (DIF) for claim settlement of depositors of banks taken into liquidation/reconstruction/amalgamation stood at ₹406 billion as on March 31, 2014 yielding a reserve ratio (DIF/insured deposits) of 1.7 per cent. The DIF accumulates from the transfer of DICGC’s annual surplus net of taxes.

IADI steering committee meeting on revision of core principles

VI.54 The core principles for effective deposit insurance systems were issued in June 2009 by the International Association of Deposit Insurers (IADI) and BCBS. In order to review and update the core principles and to develop a proposed set of revisions, IADI established an internal steering committee in February 2013. The final revised set of core principles is expected to be released shortly.

NON-BANKING FINANCIAL COMPANIES

Protection of depositors’ interests

VI.55 To ensure timely payment of deposit liabilities all deposit taking companies have been tightly regulated by the Reserve Bank fairly successfully. However, recent episodes like the ‘Saradha Scam’ have underscored the need to go beyond a regulatory and supervisory focus on regulated entities to malfeasance in the unregulated space. With a multiple regulator set up in the non-banking sector, the Reserve Bank has taken several initiatives to increase public awareness and ensure clarity on legislative reforms and their effective enforcement.

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\(^1\) Accepted as a rule of thumb at the First Annual Conference of the International Association of Deposit Insurers (IADI) in Basel, Switzerland in May 2002.
VI.56 The measures taken by the Reserve Bank to achieve these twin objectives **inter alia** include a joint advertising campaign in the mass media with the Ministry of Consumer Affairs and the Ministry of Corporate Affairs to increase public awareness, organising town hall events and country-wide investor awareness campaigns, particularly in Tier II and III cities, strengthening the existing inter-regulatory coordination mechanism through state level coordination committees (SLCCs) for better and effective enforcement of existing legislations including the option to take coordinated action to deal with malpractices. The Reserve Bank has also written to all the state governments for enacting the Protection of Interest of Depositors’ Act that facilitates speedy action against unauthorised acceptance of deposits.

**Guidelines with respect to private placement of non-convertible debentures (NCDs)**

VI.57 The Reserve Bank recently observed large-scale issuances by NBFCs, often on tap from retail investors through NCDs with features similar to those of public deposits. In order to bring NBFCs on par with other financial entities as far as private placements are concerned, they have been advised to: (i) restrict the maximum number of subscribers to the private placements of NCDs, (ii) put in place their board’s approved policy for resource planning which will **inter alia** cover the planning horizon and the periodicity of private placements, and (iii) the minimum subscription amount for a single investor has been stipulated at ₹2.5 million and in multiples of ₹1 million thereafter.

**Modifications in pricing of credit by NBFCs-MFI**

VI.58 The revised interest rates charged by NBFCs-MFI (effective from Q1 of 2014-15) will be the cost of funds plus margin as per extant guidelines or the average base rate of the 5 largest commercial banks by assets multiplied by a factor of 2.75, whichever is lower. The average of the base rates of the 5 largest commercial banks (with respect to the size of domestic assets) indicated by the Reserve Bank on the last working day of the previous quarter will determine interest rates for the ensuing quarter.

**Ensuring financial stability**

VI.59 Unlike commercial banks, deposits form a very small component of the overall liability of NBFCs as they predominantly rely on institutional sources including bank borrowings and capital/ money markets for their funding requirements. Risk to financial stability from the sector emanates from these inter-linkages between NBFCs and other financial intermediaries and their funding dependencies. Accordingly, the regulatory guidelines are tuned towards discouraging a higher degree of leverage and having adequate capital buffers so as to ensure that any stress on their balance sheets is absorbed rather than transmitted to the financial system. Some of the regulatory and supervisory instructions issued in 2013-14 are set out in the following paragraphs.

**Lending against security of a single product–gold jewellery**

VI.60 Following the recommendations of the working group (Chairman: Shri K.U.B. Rao) set up to study issues related to gold imports and gold loans of NBFCs in India, guidelines were issued to all NBFCs (excluding PDs). The loan to value (LTV) ratio for loans against the collateral of gold jewellery was raised to 75 per cent from 60 per cent with effect from January 08, 2014.

**Restructuring of advances by NBFCs**

VI.61 As indicated in the Second Quarter Review of Monetary Policy 2013-14 (October 29, 2013), the extant instructions on restructuring of advances by NBFCs have been reviewed in view of the recommendations of the working group (Chairman: Shri B. Mahapatra) to review prudential guidelines
on restructuring of advances by banks and financial institutions. Accordingly, mere extension of date of commencement of commercial operations (DCCOs) up to a specified period will not tantamount to restructuring for infra, non-infra and commercial real estate projects, although it will attract provisioning norms for all new loans and stocks of loans. A special asset classification benefit will be made available to corporate debt restructuring and consortium cases including a small and medium enterprises (SME) debt restructuring mechanism, apart from infrastructure and non-infrastructure project loans subject to certain conditions. The special asset classification benefit will, however, be withdrawn with effect from April 1, 2015 with the exception of that on provisions related to changes in DCCOs with respect to infrastructure as well as non-infrastructure project loans. Early recognition of financial distress has been institutionalised through CRILC (Box VI.2).

Credit enhancement in securitisation transactions

VI.62 In order to provide some capital relief to the originators, banks and NBFCs have been allowed a reset of credit enhancement in securitisation transactions, depending on the overall performance of the transactions and factors such as the credit quality of the securitised assets, pool characteristics and nature of underlying assets.

Buyback of assets from SCs/RCs by defaulters and acquisition of assets by SCs/RCs from sponsor banks

VI.63 Securitisation companies (SCs)/reconstruction companies (RCs) which were not permitted to acquire any NPAs from their sponsor banks on a bilateral basis are now allowed to do so but only through participation in auctions conducted by sponsor banks. Promoters of the defaulting company/borrowers or guarantors are allowed to buy back their assets from the SCs/RCs provided such a buy back minimises the cost of litigation and time, arrests further diminution in the value of the assets and helps in the resolution process.

Committee on comprehensive financial services for small businesses and low income households

VI.64 The committee (Chairman: Nachiket Mor) made several recommendations regarding NBFCs (see Box IV.2). Before taking a view on allowing more entities into the sector, the Reserve Bank decided to keep in abeyance for a period of one year (from April 2014), issuing of certificates of registration (CoR) to companies proposing to conduct non-bank financial institution (NBFI) business in terms of Section 45 I(a) of the RBI Act, 1934. Exceptions to this were CoR applications already received by the Reserve Bank on or before March 31, 2014, CoR applications that may be submitted by prospective systemically important core investment companies, infrastructure finance companies, infrastructure debt fund companies and NBFCs proposing to conduct microfinance business.

VI.65 As part of the guidelines issued by the Reserve Bank for granting new banking licenses, non-operating financial holding companies (NOFHCs) were notified as a separate category of NBFCs. NOFHCs will hold the bank as well as all other financial services’ companies regulated by the Reserve Bank or other financial sector regulators, possible under existing regulatory framework.

Other risk mitigating measures

VI.66 The existing definition of ‘infrastructure lending’ for NBFCs has been harmonised with that of the master list of infrastructure sub-sectors notified by the Government of India. With a view to capturing the reach and geographical spread of institutions in the sector, a branch information return has been introduced for all the existing NBFCs.

VI.67 NBFCs are allowed to set up ‘White Label ATMs’ upon obtaining a NOC from the Reserve Bank. Three key parameters involved are
continuous profitability, maintaining the required CRAR on an on-going basis and absence of any major supervisory concerns.

VI.68 With an objective of filtering out companies that may be doing NBFI business without having a valid certificate of registration issued by the Reserve Bank, it was decided to find out the number of finance companies operating in the country as per the records of the Ministry of Corporate Affairs and those registered with the Reserve Bank. A prima facie analysis of the financials of some of these companies appears to meet the principal business criteria for registration and appropriate action is envisaged for such companies.

CUSTOMER SERVICE

Complaints received and disposed

VI.69 To facilitate fair practices and ethical treatment of customers of banking services across the country, the Reserve Bank has undertaken multiple initiatives. Major among these are the institution and development of the Banking Ombudsmen (BO) scheme that provides a free and easy grievance redressal avenue for bank customers. While efforts are on to increase awareness about its presence in rural and semi-urban areas, the scheme remains highly successful for nearly 2 decades, having addressed over 70,000 complaints annually (Box VI.4).

Box VI.4
Grievance Redressal Mechanism in Banks and the Banking Ombudsman Scheme

The Reserve Bank has created institutional arrangements like the office of the Banking Ombudsman (BO), the Banking Codes & Standards Board of India (BCSBI), customer service committees of the boards in banks, a standing committee on customer service, a customer service committee at the controlling office/branch level, nodal department/nodal officer for customer service, grievances redressal cell and the customer service department for enhancing the quality of customer services in the banking industry.

To facilitate easy access to customers and also to offer a fair and quick resolution of complaints, banks are required to: (i) keep a complaints register at a prominent place in their branches to enable customers to register their complaints, (ii) have a system of acknowledging the complaints, when received through letters, (iii) fix a timeframe for resolving the complaints received at different levels, (iv) prominently display at branches the names and contact details of officials entrusted to redress complaints, and (v) place a complaint form on the home page of the bank’s website.

To ensure an individual bank board’s oversight on the internal grievance redressal mechanism, banks have been advised to place a review of complaints before their boards/customer service committees along with an analysis of the complaints received. It has been mandated that their boards provide exclusive time to review and deliberate on issues concerning customer services. Banks have also been advised to set up branch-level customer service committees with representation from different segments of customers.

The Banking Ombudsman Scheme

With a view to providing a hassle-free alternative dispute redressal mechanism at the apex level free of cost, the Reserve Bank introduced the BO scheme in June 1995 under Section 35A of the Banking Regulation (BR) Act, 1949, and it is in operation in 15 BO offices across India. Since its introduction, the scheme has been revised four times (2002, 2006, 2007 and 2009) to keep pace with the changing banking scenario.

Customers can approach the BO citing deficiency in banking services on 27 grounds including issues related to credit cards, internet banking, deficiencies in providing promised services by both the bank and its sales agents, levying service charges without prior notice to the customers, non-adherence to the fair practices code adopted by individual banks and non-adherence to BCSBI’s code of bank’s commitment to customers. The BO scheme is applicable to all commercial banks, regional rural banks and scheduled primary cooperative banks operating in India. The

(Contd....)

Uniformity in intersol charges

VI.70 In order to ensure that bank customers are treated fairly and reasonably without any discrimination and in a transparent manner at all branches of banks/service delivery locations under the CBS environment, banks were advised to follow a uniform, just and transparent pricing policy and not discriminate between their customers in the home branch and in non-home branches.

Simplifying norms for periodical updation of KYC

VI.71 KYC norms have been simplified to reduce the practical difficulties/constraints expressed by bankers/customers in this regard. For obtaining/submitting fresh KYC documents for periodic updation at frequent intervals, banks were advised to conduct a full KYC exercise at a less frequent interval for medium and low risk accounts. Requirement of submission of address proof were current address differed from permanent address has been removed for opening a bank account or for updation of information for an existing account, if the customer submits an ‘Officially Valid Document’ giving his details of his permanent address. The information available from Unique Identification Authority of India (UIDAI) as a result of the e-KYC process has been made acceptable as an ‘Officially Valid Document’ under the Prevention of Money Laundering Act.

Enhancement of customer service for ATM transactions

VI.72 With a view to enhancing efficiency in automated teller machine (ATM) operations, banks were advised to display messages regarding non-availability of cash in ATMs before a transaction is initiated, displaying the ATM ID clearly in the ATM premises, making forms for lodging ATM complaints available within the ATM premises and also displaying the name and contact details of officials with whom the complaint can be lodged.

VI.73 Banks were also instructed to make available sufficient toll-free telephone numbers for lodging complaints/reporting and blocking lost cards to avoid delays and also attend to requests on priority, proactively register the mobile numbers/e-mail IDs of their customers for sending alerts and enable time out sessions for all screens/stages of ATM transactions.

Other customer benefitting measures

VI.74 With a view to ensuring fairness and equity in the charges levied by banks for sending SMS alerts to customers, banks have been advised to leverage the technology available with them and with telecom service providers to ensure that such charges are levied on all customers on an actual usage basis.

VI.75 Banks have been prohibited from levying penal charges for non-maintenance of minimum balance in any inoperative account. The additional services available to such inoperative accounts may, however, be withdrawn based on inactivity. Banks have been restricted from levying foreclosure charges/pre-payment penalties on all floating rate term loans sanctioned to individual borrowers.

Complainants can file their complaints in any form, including online submission through the Reserve Bank website. On an average, BO offices receive over 70,000 complaints annually, mainly from customers from metro/urban areas, accounting for about 72 per cent of the total complaints received during 2013-14. Some of the reasons attributed to the greater share of complaints from metro and urban areas are greater availability of banking services, financial literacy and expectation levels of bank customers and greater awareness about the scheme among residents of these areas as compared with their counterparts in semi-urban and rural areas.

The Reserve Bank and the BO offices continue with their efforts to spread awareness for the scheme in rural and semi-urban areas through awareness campaigns/outreach activities and town hall events.
VI.5. Box VI.5: Implementation of Recommendations of FSLRC

The Financial Sector Legislative Reforms Commission (FSLRC) was set up in March 2011 ‘with a view to rewriting and cleaning up the financial sector laws to bring them in tune with the current requirements’. The Commission submitted its report on March 22, 2013. In its report, the Commission has proposed a financial regulatory architecture comprising seven agencies.

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| Reserve Bank of India (RBI) | • Monetary policy  
• Microprudential supervision of and consumer protection with reference to banking and payment systems |
| Unified Financial Agency (UFA) | • Microprudential supervision of and consumer protection with reference to all financial firms (other than those of banking and payment systems)  
• Regulation of organised financial trading |
| Financial Sector Appellate Tribunal (FSAT) | Hear appeals against RBI for its regulatory functions, the UFA, decisions of the FRA and some elements of the work of the Resolution Corporation. |
| Resolution Corporation | DICGC will be subsumed into the Corporation which will work across the financial system |

The Commission also produced a draft “Indian Financial Code” - a non-sectoral and principle-based single legislation for the financial sector. The Commission suggested laying the foundation for financial regulatory process around four themes, viz., clarity on objectives and avoiding conflicts of interest; precisely defined powers; operational and political independence; and accountability mechanisms through a process of judicial oversight.

The Commission’s report is one of the most important and well researched reports in Indian financial history. It provides a welcome emphasis on consumer protection and suggests setting up of new institutions such as the Resolution Corporation which are much needed. There are many merits in the overall approach adopted by

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the Commission – a non-sectoral approach to financial sector regulation, principle based law, focus on regulatory independence and accountability, the principles of neutrality and competition, structured process of regulation making, etc. The Commission’s recommendations on improved corporate governance and transparency of the regulators are welcome.

The FSLRC has laid out the need for focussed attention on consumer protection. In particular, it has highlighted the responsibility of financial institutions in determining the suitability of products sold to a consumer. One could debate whether consumer protection should be within the sectoral regulator or in a new Financial Redressal Authority (FRA). While the former structure will allow the sectoral regulator to acquire information quickly and adapt regulations if necessary, the latter structure will allow redressal for products spanning multiple regulators. On balance, perhaps we should first strengthen consumer protection departments in sectoral regulators before embarking on FRA to fill gaps.

The proposal to set up a Resolution Corporation which will facilitate the resolution of failing financial firms at the least cost to the exchequer is also much needed. The Working Group of the Reserve Bank to prepare the regime for the financial sector in India, set up by the FSDC, has offered details on such an agency. Some proposals of the FSLRC in this regard will, however, need to be carefully reviewed so as to ensure that depositors’ interests remain protected and the Resolution Corporation’s powers to examine financial firms does not duplicate or overlap with that of the regulators.

The broad approach set out by the FSLRC for the monetary policy process accords with the thinking in the Reserve Bank. The FSLRC’s emphasis on the need for a clear monetary framework was followed by the report of the Reserve Bank’s Expert Committee to Strengthen and Revise the Monetary Policy Framework (Chairman: Dr. Urjit Patel). The accountability structures for monetary policy proposed in the Report are broadly acceptable. However, some tweaking with regard to the composition of the Monetary Policy Committee and its constitution as an executive body will be needed. The proposed enhanced role for the government in monetary policy making also need to be discussed. The Reserve Bank has flagged these issues with the Government of India.

The Reserve Bank has already commenced implementing several recommendations of the FSLRC which are governance enhancing in nature and which do not require legislative changes. These recommendations relate to consumer rights and protection, the process of regulation making, accountability, constitution and selection process for the members of regulator’s board, functioning of the Boards, greater transparency in reporting and performance evaluation, capacity building, etc. Following the suggestion to move to a time defined (90 days) approval process, the Reserve Bank has published the ‘Timelines for Regulatory Approvals’ and ‘Citizens’ Charter’ for delivery of services. As recommended in the Report, all investigations in the Reserve Bank are conducted within a time bound process and with systems in place to review any investigation exceeding the timeline. The Reserve Bank is in process of further fine tuning the investigation process. Two Committees constituted by the Reserve Bank are examining the kind of capacity building necessary within the Reserve Bank and in the financial market segments regulated by it, both for the staff and also for the directors on the Boards of banks and other regulated entities. Thus, several recommendations, to the extent that they do not require legislative changes, are already in the process of being implemented by the regulators.

Yet there are residual concerns, some of which are outlined below:

**Proposed regulatory architecture**

The first set of concerns relate to the proposed regulatory architecture. The Commission’s proposals appear to be inadequately substantiated in some respects, such as the rationale for, and analysis of the costs and benefits of, creating new institutions and breaking up existing ones. The Commission discusses the synergies which could be realized in bringing together some regulators. There is, however, no discussion on the synergies which will be lost by dismantling other regulators. There is little empirical analysis of the costs and benefits of the proposed regulatory architecture, despite the Commission’s emphasis on rigorous cost benefit analysis as the foundation of all regulation making.

There are also some inconsistencies in the Commission’s approach. While, on the one hand, it suggests regulation of organised trading of financial products and commodities trading should be centralised with one regulatory agency, regulation of NBFCs, which perform bank-like activities, is not proposed to be with the banking regulation. There are instances where the Commission proposes to entrust an agency with a certain responsibility but leaves the powers for exercising the tools necessary for discharging the responsibility with another agency. For example, the Reserve Bank has responsibility for managing the internal and external value of the rupee, and more broadly, for macroeconomic stability. The ability to shape capital inflows is now recognised as part of the macro-prudential tool kit. Yet, by suggesting taking away control over inward capital inflows, more specifically debt flows, from the Reserve Bank, the FSLRC takes away an important tool from the Reserve Bank.

There are strong arguments, especially stemming from the experiences of the global financial crisis, for the powers of macro prudential regulation, regulation of systemically (Contd...
important financial firms, regulation of all deposit taking and credit institutions, regulation of debt oriented capital inflows, regulation of money, government securities, debt and forex markets, and the management of public debt remaining with the central bank. These arguments have been underweighted by the FSLRC.

The Commission’s approach to certain segments of regulation could be inimical for the financial sector given the economy’s stage of development. A case in point is the implied position that all current account transactions should be totally free of regulation. Again, while the proposed approach to neutrality and competition is commendable, such an approach towards foreign banks and foreign entities needs some moderation and caution. The overall approach of increasing competition needs to be weighed against the considerations of the health of financial firms and of financial stability. The proposals that certain financial service providers like hedge funds, private equity funds, venture funds and micro financial institutions need not be microprudentially regulated appear to overlook recent global developments in this regard. Regulators across the world collect data from regulated entities based on their fiduciary relationship with such entities. The recommendation prohibiting regulators from obtaining information directly from the regulated entities is restrictive and against global best practices. The proposal to leave the objectives of monetary policy open to repeated review will preclude the central bank from acquiring monetary credibility. Such objectives should be clearly specified by the Act and approved by the Parliament.

**Judicial oversight**

The FSLRC mentions that regulators are “mini states” with powers of the legislature, executive and judiciary encapsulated within a single entity. It proposes an elaborate checks and balances mechanism consisting of objective standards of governance for regulators, a structured regulation process, a performance measurement mechanism and oversight by a judicial tribunal.

Checks and balances are certainly needed. There are already checks and balances in place, including review by constitutional courts like high courts through writ petitions. Senior-most officers of the regulator are appointed, and can be removed, by the government. Proposals by the Commission with regard to an annual report by the regulators are welcome suggestions which will add to the accountability and oversight over regulators.

The proposal to create an FSAT, however, and to subject everything that a regulator does – framing of regulation, policy decisions, the decision-making process, even the exercise of regulatory judgement – carries serious dangers of excessive legal oversight. A regulator often seeks to fill in gaps in laws, contracts and even regulations by exercising sound judgment based on experience. But not everything the regulator does can be proven in a court of law and it would be counterproductive to put in place a mechanism wherein every regulatory decision is second-guessed. These dangers are particularly pronounced in a developing country where the combination of a slow moving legal system and an inexperienced tribunal could slow down the process of regulation making and introduce distortions in the system.

In any country, and especially a developing economy like ours, a healthy respect for the regulator is a critical part of the regulator’s toolkit of checks and balances for the regulated. By making the regulator’s every action subject to checks by the private sector is tantamount to depriving the power of the regulator to command, even to influence good behaviour.

The Commission lays a great deal of emphasis on according the strongest independence to the central bank. Its recommendations, however, do not add up to that; rather they may constrain any independence which the regulator enjoys currently.

**Regulation and principle-based law**

The Commission’s proposal on non-sectoral approach carries the risk of excessive generalization. Globally, there are different sets of prudential norms for different sectors (e.g. Basel norms for banking, solvency norms for insurance, etc.). The sectoral approach is proposed to be at the level of regulation, which will result in a “mammoth superstructure” of regulations super-imposed over a “slender base of law”.

Again, a principle-based law, while bringing in a new approach, passes the responsibility of rule-making to the regulators which should primarily be the responsibility of the legislators. It entails many challenges in interpreting the law and could lead to unnecessary litigation, with avoidable additional cost on the financial system. It may be useful to start in a measured way in a small area of regulation than to move across the board towards principle-based regulation.

**Indian Financial Code – Gaps**

The draft Indian Financial Code is comprehensive, but will require significant efforts before it can be accepted as law. The Commission, for reasons not explained, has sought to redefine accepted terms such as banking, deposits, government securities, etc. The resulting definitions are open to wide interpretation. There are also some differences between the recommendations and observations in the Report and the draft Model Law. These also need to be reconciled. Finally, some gaps will have to be filled if the legislation is to be effective.

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3 Dissent note to the FSRLC Report by Shri P. J. Nayak
the overall recommendations need to be carefully assessed keeping in view balancing the regulator’s freedom to evolve with changing needs of the economy while ensuring customer protection (Box VI.5). With a view to ensuring a more robust financial system and mitigating the risks therein, the Reserve Bank will continue in its endeavour to support and nurture the banking and non-banking sectors while considering customer protection and satisfaction.