VI REGULATION, SUPERVISION AND FINANCIAL STABILITY

Effective and non-disruptive regulation and supervision of the financial system in general and banking sector in particular, is key to ensuring systemic financial stability. The Reserve Bank continued to maintain high standards of regulation and supervision in line with the international norms. Adoption of Basel III norms, which envisages complete implementation by commercial banks by end-March 2018 is one of the major steps in this direction. Under these guidelines, the banks would be required to gradually increase their capital base over a period of time. The banking sector remained robust with high capital adequacy, even though rising NPA levels emerged as a concern. The NPAs, however, are pro-cyclical in nature and a rise in the same may be a reflection of overall slowdown in the economy. The Reserve Bank has undertaken several initiatives like faster grievances redressal mechanism, facilitating better banking experience for the disabled and intra-bank transfer of deposit facility to benefit the common man.

VI.1 In the aftermath of the financial crisis, most of the analytical reports and empirical research pointed out absence of stringent regulation and supervision of financial system as one of the major factors which led to the crisis. Given the highly interdependent and globalised nature of the modern financial structure, problems which emanate in one country soon turn into systemic crisis, which are global in nature. In response to this experience, the regulators have become proactive in adopting regulations which ensure greater transparency, better governance practices, larger role for central banks in supervision and restricting growth of 'too-big-to-fail' financial institutions. In the case of India, the Reserve Bank, even before the outbreak of the global financial crisis, has been proactively implementing the prudential regulation policies. This regulatory stance has been vindicated by the recent developments. The Reserve Bank continued with its policy of adopting the best international regulatory policies, at the same time ensured that excessive regulation does not hinder the natural growth of the financial system, thereby putting constraints to the growth aspirations of the economy.

FINANCIAL STABILITY ASSESSMENT

VI.2 Pursuit of financial stability remained an integral element of the Reserve Bank's macrofinancial policy framework. The Reserve Bank continued its efforts towards putting in place a robust surveillance framework for the assessment of systemic risks and in this direction, a series of systemic risk assessment projects are under way. These projects combine elements aimed at the identification of contemporaneous developments in a number of risk factors in different segments of the financial system with forward looking elements.

Major findings of the Financial Stability Report (FSR)

VI.3 The Financial Stability Report published in June 2012 reiterated that the financial system of the country remains robust. Risks to stability are, however, elevated due to global factors and domestic macroeconomic factors. The Reserve Bank has been conducting periodic Systemic Risk Surveys and, the findings of these Surveys reveal that financial system stakeholders retain their confidence in the stability of the system.

VI.4 Risks from the global developments – growth slowdown, continuing instability in the euro area, uncertain capital flows and the impact of deleveraging by banks – will be accentuated by domestic macroeconomic risks. Domestic growth has slowed down. Savings and investment rates are also lower. Inflation has moderated but risks remain. Risks are also posed by the high levels of

current account and fiscal deficits. However, the intrinsic resilience of the domestic economy is high.

VI.5 Financial intermediaries remain robust. Banks continued to be well capitalised and profitable. Asset quality deteriorated but is not a cause for systemic concern. Credit and deposit growth in the banking sector has decelerated and banks' reliance on borrowed funds has increased. Banks remained resilient to credit, market and liquidity risks and would be able to withstand macroeconomic shocks, given their comfortable capital adequacy positions. However, distress dependencies between banks rose, warranting closer monitoring.

Financial Stability Development Council

VI.6 The Financial Stability and Development Council (FSDC) was set up in December 2010 with a view to providing focused attention on financial stability. The Council's remit also includes inter-regulatory co-ordination, macroprudential supervision of the economy, monitoring of financial conglomerates, financial inclusion and financial literacy. The sub-committee of the FSDC, headed by the Reserve Bank Governor, has evolved as the active operative arm of the Council since its establishment. In line with the mandate of the FSDC, the sub-committee, during the year, reviewed potential threats to the stability of the financial system, deliberated on issues requiring co-ordination between the financial sector regulators and various government departments and discussed measures for taking forward initiatives towards greater financial inclusion and literacy.

VI.7 The sub-committee of the FSDC was, during the year, assisted by two technical groups – a Technical Group on Financial Inclusion and Financial Literacy and an Inter Regulatory Technical Group. The sub-committee and its Technical Groups deliberated upon a host of issues during the year including a) the modalities for the introduction of infrastructure development funds (IDFs); b) development of the corporate bond market including the market for repo in corporate bonds and the market for credit default swaps; c) regulatory issues relating to wealth management/private banking undertaken by banks; d) concerns arising out of regulatory gaps in the non-banking finance companies (NBFC) sector and regulation of government sponsored NBFCs; e) impending risks from foreign currency convertible bonds and potential policy mitigants; f) implementing uniform KYC norms in different segments of the financial system and across the entire financial system; and g) putting in place a national strategy for financial education.

VI.8 With a view to institutionalising the framework for supervision of financial conglomerates (FCs) and monitoring and management of systemic risks emanating from the activities of FCs, the sub-committee of the FSDC has approved the creation of an Inter Regulatory Forum under the chairmanship of the Deputy Governor-in-charge of banking supervision at the Reserve Bank with Executive Director level membership from other peer regulatory/supervisory agencies. The Inter Regulatory Forum, would have responsibility for framing policies for the FCs (like identification, group-wide risk management, group-wide capital adequacy, corporate governance, *etc.*) as well as for conducting high level supervision of FCs. The Forum would also seek to strengthen the supervisory co-ordination/cooperation mechanism amongst the domestic supervisors for effective supervision of FCs.

ASSESSMENT OF THE BANKING SECTOR

Core Financial Soundness Indicators (FSIs) of SCBs

VI.9 SCBs remained well capitalised, as both CRAR (14.3 per cent) and core CRAR (10.4 per cent) under Basel-II stood much above the regulatory prescriptions (Table VI.1). Asset quality of SCBs, which recorded improvement during 2010-11, witnessed a deterioration during 2011-12. In absolute terms, the gross NPAs of SCBs, especially Public Sector Banks (PSBs), increased significantly during 2011-12 (Table VI.2). With decline in income from securities trading and due to higher risk provisioning, SCBs recorded a lower growth of 15.5 per cent in their net profit during FY 2011-12.

Table VI.1: Select Financial Indicators

(Per cent)

Item	End-March	Scheduled Commercial Banks	Scheduled Urban Co-operative Banks	All India Financial Institutions	Primary Dealers	Non-Banking Financial Companies-D	NBFCs-ND-SI
1	2	3	4	5	6	7	8
CRAR	2011	14.2	12.5	22.0	46.2	22.5	32.8
	2012	14.3	12.8	21.0	53.8	20.4	27.5
Core CRAR	2011	10.0	N.A.	N.A.	N.A.	17.2	30.5
	2012	10.4	N.A.	N.A.	N.A.	16.8	24.6
Gross NPAs to Gross Advances	2011	2.4	5.7	0.3	N.A.	0.9	1.9
	2012	2.9	5.2	0.4	N.A.	2.7	3.1
Net NPAs to Net Advances	2011	0.9	1.0	0.1	N.A.	#	0.8
	2012	1.2	1.4	0.1	N.A.	0.8	1.8
Return on Total Assets	2011	1.1	0.9	1.0	1.1	2.7	2.3
	2012	1.1	1.0	1.0	0.8	N.A.	1.8
Return on Equity	2011	13.7	N.A.	11.0	5.1	16.6	8.5
	2012	13.6	N.A.	12.0	4.4	N.A.	7.0
Efficiency (Cost/Income Ratio)	2011	46.2	49.9	24.0	36.1	72.0	68.7
	2012	45.3	52.0	18.0	44.1	N.A.	77.7
Interest Spread (per cent)	2011	3.1	N.A.	2.0	N.A.	3.5	1.9
	2012	3.1	N.A.	2.0	N.A.	N.A.	2.3
Liquid Asset to total assets	2011	29.8	N.A.	N.A.	N.A.	N.A.	N.A.
	2012	28.9	N.A.	N.A.	N.A.	N.A.	N.A.

N.A.: Not Available. #: Provisions exceed NPAs.

Note: 1. Data for 2012 is unaudited and provisional.
2. Data for SCBs is excluding LABs.
3. Data for SCBs covers domestic operations, except for CRAR.
4. Data for CRAR of SCBs is pertaining to Basel II norms.
5. Data on Scheduled UCBs exclude Madhavpura Mercantile Co-operative Bank Ltd.
6. For NBFCs-D data for 2012 pertain to the period ended December 2011.
7. For NBFCs-ND-SI data in respect of CRAR, gross NPA and Net NPA for 2012 pertain to the period ended December 2011.

Source: 1. SCBs: Off-site supervisory returns.
2. UCBs: Off-site surveillance returns.
3. NBFCs: Off-site supervisory returns.

Table VI.2: Bank Group wise NPA Ratios

Bank Group	End March	Gross NPAs to Gross Advances	Net NPAs to Net Advances	Restructured Standard Advance to Total Standard Advances
1	2	3	4	5
Public Sector Banks	2010	2.28	1.09	5.07
	2011	2.32	1.04	4.30
	2012	3.17	1.47	5.92
Foreign Banks	2010	4.26	1.82	0.54
	2011	2.54	0.66	0.23
	2012	2.68	0.61	0.14
New Private Sector Banks	2010	3.22	1.18	1.68
	2011	2.62	0.60	0.65
	2012	2.18	0.44	1.08
Old Private Sector Banks	2010	2.31	0.82	3.62
	2011	1.97	0.53	2.95
	2012	1.80	0.59	3.49

Accordingly, ROE of SCBs recorded a decline. Also, NIM decreased from 3.14 per cent to 3.07 per cent for the same period. The ratio of liquid assets to total assets had also come down during 2011-12 and stood at 28.9 per cent at end March 2012 as compared to 29.8 per cent as at end March 2011.

VI.10 In the case of scheduled UCBs an improvement in CRAR is observed. The gross NPA to gross advances ratio has declined indicating improvement in asset quality. On the other side however, the efficiency ratio deteriorated indicating an increase in cost relative to income.

VI.11 Even though the NPA ratio of SCBs showed an increase in 2012, an analysis using quarterly data since June 2000 brings out the cyclicality in asset quality of Indian banks (Box VI.1).

Box VI.1
NPAs and Credit Cycle

Asset quality is the key to understanding the financial health and soundness of the banking system. The literature identifies credit cycles as an important determinant of banks' asset quality. Cyclicality/pro-cyclicality has been defined as "dynamic interactions (positive feedback mechanisms) between the financial and real sectors of the economy" (FSF, 2009). Financial institutions tend to over-stretch their lending portfolio during economic booms and tend to retrench the same during economic downturns. It has been argued that an expansion in credit growth is associated with the deterioration in asset quality because when banks over-expand their lending, they tend to lower their credit standards. This behaviour translates itself into greater slippages in asset quality at matured stages of the credit cycle. The literature identifies various reasons for such pro-cyclical risk-taking behaviour of banks, *viz.*, "herd behaviour" (Rajan, 2005), "principal-agent problem" between shareholders and managers (Borio *et al*, 2001), "disaster myopia" or short-sightedness in underestimating the likelihood of high-loss low-probability events (Guttentag and Herring, 1986), among others.

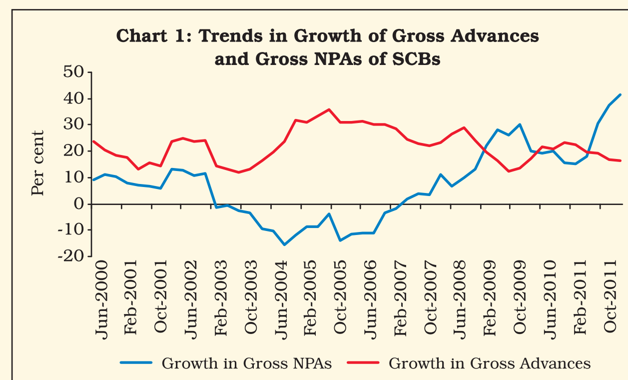
Asset quality has surfaced as an important concern for the Indian banking sector in the recent years. In the period immediately following the global financial crisis, when asset quality of banks in most advanced and emerging economies took a beating, the asset quality of Indian banks was largely maintained, partly on account of the policy of loan restructuring. However, between March 2009 and March 2012, the gross NPAs ratio has shown an increasing trend *albeit* a fall in 2010-11 (Table 1).

Table 1: Trends in gross and net NPAs ratio

Item	Mar 2008	Mar 2009	Mar 2010	Mar 2011	Mar 2012
Gross NPAs ratio (per cent)	2.39	2.45	2.51	2.36	2.94
Net NPAs ratio (per cent)	1.07	1.13	1.12	0.93	1.24

Source: RBI Supervisory returns.

A cursory look at the growth in bank credit and gross NPAs reveals a cyclical pattern (Chart 1). An empirical analysis to model asset quality of Indian banks as illustrated in equation (I), taking quarterly data from June 2000, suggests a lagged statistically significant positive relation between deviations from trend in credit to GDP (C-GDP) ratio (worked out using Hodrick-Prescott filter) and growth in gross NPAs for the second lag.[1] The deviations from trend in C-GDP ratio has been recommended as a principle guide by the Basel Committee on Banking Supervision (BCBS) for determining economic and financial cycles under its Basel III framework (BIS, 2010).



$$\text{NPA growth} = 0.678 + \underset{(4.93)^{*}}{736.58}\ \text{C-GDP}_{-2} \qquad - \qquad (I)$$

*Significant at 1 per cent level.

This exercise brings out the cyclicality in the behaviour of asset quality of Indian banks. Further, it justifies the counter-cyclical prudential regulatory policy, as pursued by the Reserve Bank, and corroborates the need to further strengthen such a policy by basing it on a more systematic and rule-based footing to effectively address the concern of asset quality.

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[1] The model did not yield statistically significant coefficients for any shorter and longer lags than that given in equation I.

Sensitivity Analysis

VI.12 Banking system is subjected to sensitivity tests to ascertain the resilience of banks to plausible shocks likely to emanate from interest rate risk and credit risk. This is then related to the overall capital adequacy of commercial banks in withstanding the applied shocks. The analysis is carried out both at the aggregate level as well as at the individual bank level based on supervisory data.

VI.13 Sensitivity analysis for interest rate risk of 81 SCBs was carried out for the year ended March 31, 2012. Under interest rate risk sensitivity analysis, CRAR of SCBs under Basel-II, went down to 11.9 per cent (from the existing 14.1 per cent) when measured under an assumed rise in yields by 150 bps, reflecting manageable financial leverage. The impact of credit risk sensitivity analysis on CRAR is also found to be manageable at the system level. If existing NPAs are assumed to increase by 150 per cent at the system level, the CRAR would decline from 14.1 per cent to 11.5 per cent and if only retail NPAs are assumed to increase by 150 per cent at the system level, the CRAR of the system would decline to 13.5 per cent.

MAJOR DECISIONS TAKEN BY BOARD FOR FINANCIAL SUPERVISION

VI.14 The Board for Financial Supervision (BFS), constituted in November 1994, has been the chief guiding force behind the Reserve Bank's supervisory and regulatory initiatives. During 2011-12, the BFS was reconstituted on account of reconstitution of the Central Board of the Reserve Bank. The BFS now has Shri Y.H. Malegam, Dr. Ela Bhatt, Dr. Rajeev Gowda and Shri Kiran Karnik as Director-members.

VI.15 The BFS had ten meetings during the year. The BFS reviewed, *inter alia*, the performance and the financial position of banks and financial institutions during 2009-10 to 2010-11. It reviewed memoranda on 88 inspection reports of banks/FIs (26 reports of public sector banks, 23 of private sector banks, 33 of foreign banks, 4 of local area banks, and 2 of financial institutions). Of these, while 6 reports were based on the financial position as on March 31, 2010, 82 reports were based on the financial position as on March 31, 2011.

VI.16 During the period, the BFS also reviewed 16 summaries of inspection reports pertaining to scheduled urban co-operative banks (UCBs), 4 summaries of financial highlights pertaining to scheduled UCBs classified in Grade I/II and 22 summaries of financial highlights pertaining to scheduled UCBs rated between A+ and B-.

VI.17 As directed by BFS, a committee was formed to revise the annual financial inspection (AFI) report format to make it more focused. Based on the recommendations of the committee, a revised format has been implemented from the inspection cycle in 2012. The revised format and the new guidelines would result in optimal utilisation of supervisory resources besides reduction in the time taken for inspection and issuance of crisp inspection reports.

VI.18 While deliberating on the financial inspections of All India Financial Institutions, the BFS decided to alter the periodicity of their inspection from annual to once in two years, as these entities do not pose any systemic risks and their performance is supervised by the Reserve Bank on continuous basis through off-site surveillance mechanism.

VI.19 The compensation practices, especially of large financial institutions, were one of the important factors which contributed to the recent global financial crisis. Employees were too often rewarded for increasing the short-term profit without adequate recognition of the risks and long-term consequences that their activities posed to the organisations. These perverse incentives amplified the excessive risk taking that severely threatened the global financial system. As desired by the BFS, based on the principles and standards issued by FSB, draft guidelines on compensation of whole time directors /Chief Executive Officers/other Risk takers and Control function staff were issued. Taking into account the comments received on the draft guidelines from public as also stipulations suggested by BCBS, the final guidelines on compensation to private banks and foreign banks were issued in

January 2012. These guidelines would require banks to have effective governance of compensation, to reduce incentives towards excessive risk taking, alignment of compensation with prudent risk taking and stakeholder engagement in compensation.

VI.20 While discussing the parameters considered by a private housing development corporation for sanction of housing loans, the BFS observed that since the stamp duty registration and other documentation charges are not realisable, these should not be reckoned for arriving at the eligible bank finance. Accordingly a revised circular was issued advising banks not to include stamp duty, registration and other documentation charges in the cost of the housing project. BFS also observed that it was not appropriate for banks to accept the valuation of the properties without counter checking it from the available market sources. Accordingly, a circular has been issued to all banks.

VI.21 After obtaining approval from the BFS, the license of the Madhavpura Mercantile cooperative Bank Ltd., Ahmedabad was cancelled with effect from the close of business on June 04, 2012 and the Central Registrar of Co-operative Societies, New Delhi (CRCS) was also requested to issue an order for winding up the co-operative bank and appoint a liquidator.

VI.22 While considering issues relating to unlicensed StCBs/DCCBs, BFS directed, *inter alia*, that 43 unlicensed banks (StCB-1, DCCBs-42), be prohibited from accepting fresh deposits, immediately. Apart from other directions, the BFS has also directed that the unlicensed StCBs/DCCBs will be given extension of time for six months to comply with the licensing requirements. Accordingly, directions were issued to 43 unlicensed banks.

COMMERCIAL BANKS

Regulatory Initiatives

Implementation of Basel III Capital Regulations

VI.23 In December 2010, the Basel Committee on Banking Supervision (BCBS) issued Basel III capital regulations as a response to the lessons learnt from the financial crisis. Accordingly, the Reserve Bank issued final guidelines on the capital regulations on May 2, 2012 after due consideration of the comments / suggestions received from various stakeholders on the draft guidelines. These guidelines would become operational from January 1, 2013. However, the minimum capital requirement including capital conservation buffers will be introduced in a phased manner and will be fully implemented by March 31, 2018.

VI.24 Under Basel III, total capital of a bank in India must be at least 9 per cent of risk weighted assets (RWAs) (the BCBS requirement is minimum 8 per cent of RWAs). Tier 1 capital must be at least 7 per cent of RWAs (6 per cent as specified by the BCBS); and Common Equity Tier 1 (CET1) capital must be at least 5.5 per cent of RWAs (4.5 per cent as specified by BCBS). Due to the transitional arrangements the capital requirements of banks may be lower during the initial periods and higher during later years. Therefore, banks have been advised to do their capital planning accordingly.

VI.25 In addition to the minimum requirements as indicated above, a capital conservation buffer (CCB) in the form of common equity of 2.5 per cent of RWAs is required to be maintained by banks. Total capital with CCB will be 11.5 per cent (9 per cent CRAR+2.5 per cent CCB) of RWAs. Under the Basel III rules, total capital with CCB has been fixed at 10.5 per cent (8 per cent CRAR +2.5 per cent CCB).

VI.26 Under Basel III, a simple, transparent, non-risk based leverage ratio has been introduced. The Basel Committee will test a minimum Tier 1 leverage ratio of 3 per cent during the parallel run period from January 1, 2013 to January 1, 2017. Reserve Bank has prescribed that during this parallel run period, banks should strive to maintain their existing level of leverage ratio but, in no case the leverage ratio should fall below 4.5 per cent. Banks having leverage below 4.5 per cent should strive to achieve the target as early as possible. The leverage ratio requirement will be finalised taking into account the final proposal of the Basel Committee.

Dynamic Provisioning Guidelines

VI.27 At present, banks generally make two types of provisions *viz.*, general provisions on standard assets and specific provisions on non-performing assets (NPAs). Since the level of NPAs varies through the economic cycle, the resultant level of specific provisions also behaves cyclically. Consequently, lower provisioning during upturns, and higher provisions during downturns have procyclical effect on the real economy.

VI.28 To address pro-cyclicality of capital and provisioning, efforts at international level are being made to introduce countercyclical capital and provisioning buffers. Reserve Bank accordingly prepared a discussion paper on countercyclical (dynamic) provisioning framework.

VI.29 The Dynamic Provisioning (DP) framework is based on the concept of expected loss (EL). The average level of losses a bank can reasonably expect to experience is referred to as EL and is the cost of doing business. It is generally covered by provisioning and pricing. The objective of DP is to smoothen the impact of incurred losses on the P&L through the cycle, and not to provide general provisioning cushion for expected losses. More specifically, the DP created during a year will be the difference between long run average expected loss of the portfolio for one year and the incremental specific provisions made during the year.

VI.30 The parameters of the model suggested in the discussion paper are calibrated based on data of Indian Banks. Banks having capability to calibrate their own parameters may, with the prior approval of Reserve Bank, introduce DP framework using the theoretical model indicated by Reserve Bank. Other banks would have to use the standardised calibration arrived at by the Reserve Bank.

Proprietary Trading by Banks

VI.31 In the aftermath of the financial crisis, Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in July 2010, with a view to bringing about significant reforms in the US financial system. This law aims to improve transparency to ensure better consumer protection, eliminate loopholes that allow risky and abusive practices to go on unnoticed and unregulated, introduce stringent rules for credit rating agencies and impose tough new capital and leverage requirements on financial firms that make it undesirable to get too big. One of the later additions to the Dodd-Frank Wall street reform is the Volcker Rule, which restricts banks' ability to undertake proprietary trading. These set of reforms may increase borrowing costs in the short run but in the long run would result in a more robust financial system (Box VI.2).

Box VI.2

Impact of Volcker Rule on India

The Volcker rule is part of the Dodd–Frank Wall Street Reform and Consumer Protection Act, which was signed into a law in the aftermath of the global financial crisis in 2007-2008. The most discussed section of the rule is the restrictions on proprietary trading by the nation's largest banks. In other words, a bank cannot trade in the investment markets with the intent of making money, unless it is done on behalf of a customer. A bank can serve as a middleman, but not as a trader for its own benefit. The rule requires federal banking agencies, the Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) to issue regulation to prohibit insured deposit taking institutions and their affiliates from engaging in "proprietary trading" and investing in, sponsoring or having certain business relationship with hedge fund or private equity fund (limiting a bank's investments in proprietary trading to no more than 3 per cent of the Tier 1 capital).

It has been argued that the rule, if implemented in India, would reduce trading in bond markets, including government bond markets, and increase borrowing costs for governments, investors and companies; deter banks from breaking into new markets by substantially curtailing their risk-taking abilities. Concerns are also expressed that short-term foreign exchange swaps would also be subject to the restrictions and such restrictions could squeeze USD funding significantly outside the US and could accelerate the deleveraging of European banks by liquidating foreign assets. The rule, however, is expected to be useful in reinforcing financial stability.

Supervisory Initiatives

High Level Steering Committee to review the Supervisory Policies, Procedures and Processes for commercial banks

VI.32 Though the banking sector in India has witnessed considerable changes in recent years with sizeable growth in size, number and complexities of banks' businesses, the supervisory processes at the Reserve Bank have, remained largely unchanged. With a view to improving the quality of it's supervisory processes/techniques and benchmarking them with the global best practices, Reserve Bank had set up a High Level Steering Committee (HLSC) under the Chairmanship of Deputy Governor, Dr. K. C. Chakrabarty, comprising experienced supervisors, practicing /retired bankers and an academician as members. The HLSC has sought to transform the extant supervisory approach of examining the past performance through a transaction-testing based (CAMELS) framework to using trend analysis to find risk drivers and predicting the path and passage of risks in the banks' books. The Committee is of the view that the supervisory apparatus should not just focus on regulatory compliance or solvency of a bank but also on assessing the riskiness of a bank, its preparedness to take on various risks *vis-a-vis* the risk mitigation strategies. The Committee intends to drive the banks towards adopting a risk based business conduct within an indicative time-frame through a system of incentives and disincentives. The Committee has submitted its report on June 11, 2012. The recommendations of the committee are being examined for implementation.

Bilateral Memorandum of Understanding (MoU) with its Overseas Counterparts on Cross Border Supervision and Cooperation

VI.33 The Reserve Bank has been entering into bilateral MoUs with overseas supervisors for effective cross border supervision and cooperation in accordance with the extant domestic legal provisions and the Basel Committee on Banking Supervision (BCBS) Principles. Six such MoUs have been signed with China Banking Regulatory Commission (CBRC) South African Reserve Bank (SARB), Dubai Financial Services Authority (DFSA), Qatar Financial Centre Regulatory Authority (QFCRA) Qatar Central Bank (QCB), and Central Bank of Oman as on June 30, 2012. Subsequently MoUs have been signed with Jersey Financial Services Commission (JFSC), FSA of UK, FSA of Norway and Central Bank of the Russian Federation (CBRF).

VI.34 The Reserve Bank has also been attending the Supervisory College meetings of the major foreign banks having presence in India. This has proved to be a useful and effective channel for sharing /exchanging supervisory information and establishing contacts with overseas supervisors. RBI is preparing to host Supervisory Colleges in respect of some of the bigger Indian banks with significant cross-border and cross-sector presence.

Thematic Reviews

VI.35 While general deficiencies are identified in the Annual Financial Inspections (AFI) process, certain observations having a bearing on the efficiency of the banking system need to be studied separately in a focused manner either through a thematic review or through special audits. The objective of these reviews is to evaluate the systems followed by the select banks and to gain deeper insight into the risk faced / practices followed by different banks, with a view to assessing regulatory/ supervisory concerns and systemic risk if any. The Reserve Bank has already initiated such a process and so far carried out two thematic reviews - on KYC and AML compliance in banks and real estate exposures of banks.

Inspection of Overseas Branches of Indian Banks

VI.36 The inspection of select overseas branches of Indian banks was undertaken in the month of May 2012. The last inspection of the overseas branches was conducted in May 2008. The present inspection covered select branches of Indian banks located in the regions of USA, UK, Hong Kong SAR, Singapore and Bahrain and accounting for 59 per cent of assets of overseas operations of Indian banks as on end-March 2012. The purpose of the inspection was to get first hand assessment of the processes at the overseas branches, supervisory

insight into the overseas operations of Indian banks, concerns, if any, on the risky exposures to products and process, especially in areas not permitted within the Indian jurisdiction and assessing the adequacy of risk management system and oversight of the Head Office on such overseas operations.

Sanctions Imposed on Banks/Financial Institutions for KYC/AML/CFT Violations

VI.37 Financial Action Task Force (FATF) is an inter-governmental body which sets international standards on anti-money laundering/combating financing of terrorism (AML/CFT). In 2009, the FATF along with Asia-Pacific Group on Money Laundering (APG) conducted an evaluation of India's AML/CFT framework and identified some gaps. An AML/CFT Regulatory Framework Assessment Committee was constituted by the central government in 2010 to examine the effectiveness and consistency of AML/CFT regulatory framework in the country and make recommendations in the areas where gaps were found. Among other things, it was recommended by the Committee that the statistics on sanctions imposed on regulated entities for violation of AML/CFT guidelines may be included in Annual Reports of the regulators (Table VI.3).

CUSTOMER SERVICE

Complaints received and disposed

VI.38 Banking Ombudsman Scheme 2006 introduced and administered by the Reserve Bank is a cost free apex level grievance redressal mechanism for bank customers. During the year 2011-12 fifteen offices of the banking ombudsman (OBOs), situated across the country received 72,889 complaints about deficiency in banking services. Taking into account 4,618 complaints pending at the beginning of the year, OBOs handled 77,507 complaints in the year. OBOs disposed of 72,885 complaints during the year clocking the disposal rate of 94 per cent. As on June 30, 2012, 4,622 complaints were pending at OBOs.

VI.39 The Appellate Authority appointed under the Banking Ombudsman Scheme 2006 receives appeals against the award issued or decision given by the Banking Ombudsman. During the year 2011-12 the Appellate Authority received 351 appeals. Out of these, 304 appeals were non-maintainable. Of the remaining 47 maintainable appeals 19 were disposed in favour of customers and 16 in favour of banks. As on June 30, 2012, 12 appeals were pending.

Table VI.3: Actions Against AML/KYC/CFT Violations

Entities	Advisory notices issued*	Show cause notices	Letters of warning **	Entities penalised***	Penalty amount in ₹ millions
1	2	3	4	5	6
Scheduled Commercial Banks	1	2	1	1	2.5
Urban Co-operative Banks	67	43	46	35	9.2
District Central Co-operative Banks	-	-	-	2	1.0
Regional Rural Banks	-	-	-	-	-
Authorised Persons	-	-	-	-	-
Money Transfer Service Scheme	-	6	1	-	-
Authorised Money Changers	-	-	-	-	-
Authorised Card Payment Networks	-	-	-	-	-
Non Banking Finance Companies	-	-	-	-	-

* : Advisory notice: After calling for explanation of the bank, when the committee of senior officers decides to issue an advisory letter to the bank and issue of show cause notice (SCN) is not considered necessary.

** : Warning letter: After receipt of reply to the SCN, the Committee of senior officers decides to issue a warning letter and not to impose monetary penalty

*** : Penalised: When monetary penalty is imposed

Position of Applications and Appeals Received under RTI Act, 2005

VI.40 During the year 2011-12 fifteen offices of the Banking Ombudsman (OBOs) received 740 applications and 171 appeals under RTI Act out of which 703 applications and 157 appeals were disposed during the year.

Damodaran Committee Report Implementation

VI.41 The Committee on Customer Service in Banks (Damodaran Committee) which submitted its report in July 2011, had made a total of 232 recommendations. Out of these, 107 recommendations have since been implemented and Indian Banks Association (IBA) has issued operating guidelines to the member banks in this regard. The Reserve Bank has had two rounds of discussions with the IBA and representatives of BCSBI, Institute for Development and Research in Banking Technology (IDRBT), National Payment Corporation of India (NPCI) to work out the modalities for taking forward the implementation task of the remaining recommendations made by the Damodaran Committee. The IBA has constituted a sub-group to prepare its response in this regard by referring to the relevant international standards and best practices. Some of the main issues under discussion include charges on non-home branch transactions; penalty for cheques returned; onus on banks to prove customers' negligence in fraudulent internet / ATM transactions; compensation policy for protecting customers in case of unauthorised / fraudulent transactions through internet banking / card products and appointment of chief customer service officer.

Reserve Bank and Common Man

VI.42 The Reserve Bank is a public institution serving the public interest. The Reserve Bank has taken several steps which directly or indirectly benefit the common person in recent times.

Display of Information by Banks

VI.43 The Reserve Bank asked the banks to ensure that accountholders have detailed information on the availability and the cost of various banking services offered to start a banking relationship. Banks have been advised to display information in comprehensive Notice Board in bank premises on various key aspects such as service charges, interest rates, services offered, product information, time norms for various banking transactions *etc.* This display enables customers to take informed decision regarding products and services of the bank and be aware of their rights as also the obligations of the banks to provide certain essential services.

Banking Facilities for Disabled

VI.44 Banks have been advised to ensure that all the banking facilities such as cheque book facility including third party cheques, ATM facility, internet banking facility, locker facility, retail loans, credit cards *etc.*, are invariably offered to the visually challenged without any discrimination. Banks have been advised to make at least one third of new ATMs installed as talking ATMs with Braille keypads and ensure that at least one talking ATM with Braille keypad is generally available in each locality for catering to needs of visually impaired persons.

Unclaimed Deposits/ Inoperative Accounts in Banks

VI.45 Keeping in view the public interest, detailed instructions have been issued to banks on dealing with unclaimed deposits / inoperative accounts and to find the whereabouts of the customers and their legal heirs. These instructions, *inter alia*, include annual review of accounts in which there are no operations, allowing operations in such accounts after due diligence and no charge to be levied for activation of inoperative accounts. Further, banks have been advised to display the list of unclaimed deposits/inoperative accounts which are inactive / inoperative for ten years or more on their respective websites.

Officially Valid Documents

VI.46 Letters issued by the Unique Identification Authority of India containing details of name, address and Aadhar number are now accepted as 'officially valid document' for opening all types of

accounts in banks. Documents like income tax return in the name of the sole proprietor and utility bills in the name of proprietary concern are also to be accepted for opening accounts of sole proprietary concerns.

Grievances Redressal by Banks

VI.47 To strengthen the grievances redressal mechanism (GRM) banks have been advised that they should: i) ensure that the principal nodal officer appointed under the Banking Ombudsman Scheme is of a sufficiently senior level, not below the rank of a General Manager, ii) Contact details of the principal nodal officer to be prominently displayed on the first page of the web-site so that the aggrieved customer can approach the bank with a sense of satisfaction arising from being attended at a senior level, iii) GRM should be made simpler even if it is linked to call centre of customer care unit without customers facing hassle of proving identity, account details, *etc*., and iv) adequate and wider publicity are also required to be given by the respective financial service provider.

Clarification on Nomination Rules

VI.48 It was observed that some banks were insisting attestation of signatures of customers on various forms filled by them. Clarification was issued to banks reiterating that only thumb impressions and not signatures made on various forms are required to be attested.

Intra-bank Deposit Account Portability

VI.49 It was observed that some banks were insisting on opening fresh accounts when customers approach them for transferring their account from one branch to another branch of the same bank, causing inconvenience to the customers. Banks were, therefore, advised that KYC once done by a branch of the bank should be valid for transfer of the account within the bank.

Abolition of Foreclosure Charges / Prepayment Penalty on Home Loans

VI.50 The Damodaran Committee had viewed foreclosure charges on flexible interest rate home loans as a restrictive practice deterring the borrowers from switching over to cheaper available source. It was therefore decided that banks will not be permitted to charge foreclosure charges / pre-payment penalties on home loans on floating interest rate basis, with immediate effect. It is felt that the removal of foreclosure charges/prepayment penalty on home loans will lead to a reduction in the discrimination between existing and new borrowers and the competition among banks will result in finer pricing of home loans with floating rate.

Unique Customer Identification Code for Banks' Customers in India

VI.51 It was observed that while some of the Indian banks had developed Unique Customer Identification Code (UCIC), there was no unique number to identify a single customer across the organisation in many banks. The UCIC will help banks to identify a customer, track the facilities availed, monitor financial transactions in various accounts, improve risk profiling, take a holistic view of customer profile and smoothen banking operations for the customer. While such a system for the entire financial system is desirable, it is likely to take quite some time for a complete roll out. As a first step in this direction banks were advised to initiate steps to allot UCIC number to all their customers while entering into any new relationships in the case of all individual customers to begin with. Banks were also advised that the existing individual customers may also be allotted UCIC by end-April 2013.

BANKING CODES AND STANDARDS BOARD OF INDIA

VI.52 The membership of Banking Codes and Standards Board of India (BCSBI) has grown from 67 banks in 2006 to 121 banks as of May 2012 and membership of 10 more banks is under process. The objective of setting up the BCSBI as an independent and autonomous body to ensure fair treatment to customers will be achieved only when the provisions of the codes are adhered to in letter and spirit by member banks. BCSBI continued to

monitor compliance with the provisions of the codes through an annual statement of compliance from members as also survey of select bank branches. During the year, BCSBI undertook survey of 2,083 branches and processing centres spread over 47 cities in India. The survey revealed perceptible improvement in compliance. BCSBI also continued its efforts to spread awareness of the organisation and the codes among the public by carrying out publicity campaigns through TV, radio and posters on bus panels. BCSBI officials also addressed gatherings of customers and bankers in customer meets and participated in town hall events conducted by the Reserve Bank as also in select outreach programmes of Banking Ombudsmen. BCSBI also arranged seminars of micro and small enterprises (MSE) borrowers and MSE trade and industry associations.

URBAN CO-OPERATIVE BANKS

Internet Banking

VI.53 Scheduled UCBs having minimum net worth of ₹ 1 billion, CRAR of at least 10 per cent, net NPA less than 5 per cent and have earned net profit continuously in the last three financial years were permitted to offer internet banking facility to their customers with prior approval of the Reserve Bank.

Revision in Limits of Housing Loans and Repayment Period

VI.54 The individual housing loan limits for UCBs were revised and UCBs in Tier-I category were permitted to extend individual housing loans up to a maximum of ₹3 million per beneficiary of dwelling unit and that in Tier- II up to a maximum of ₹7 million per beneficiary of a dwelling unit subject to extant prudential exposure limits. The maximum repayment period of housing loans granted by UCBs was revised from 15 years to 20 years.

Interest Rates on Rupee Export Credit

VI.55 AD category 1 UCBs were advised to extend interest subvention of 2 per cent on pre-shipment and post-shipment rupee export credit to specified sectors up to March 31, 2013.

Payment of Cheques/Drafts/ Pay Orders/ Banker's Cheques

VI.56 UCBs were advised not to make payment of cheques/drafts/pay orders/ banker's cheques, if they are presented beyond the period of three months from the date of such instrument with effect from April 1, 2012.

Access to NDS-OM

VI.57 UCBs fulfilling certain eligibility criteria such as minimum CRAR of 9 per cent, net NPA less than 5 per cent, minimum net worth of ₹ 250 million *etc*. were allowed direct access to Negotiated Dealing System- Order Matching (NDS-OM) with the prior approval of the Reserve Bank.

Dissemination of Credit Information of Suit-Filed Accounts

VI.58 UCBs were advised to submit quarterly a list of suit filed accounts of ₹ 10 million and above classified as doubtful or loss and a list of suit filed accounts of willful defaulters of ₹ 2.5 million and above to CIBIL and/or any other credit information company which has obtained CoR from the Reserve Bank and of which the bank is a member.

Supervisory Action Framework

VI.59 A revised supervisory action framework was introduced for UCBs with effect from March 1, 2012. The framework envisages, in the initial stage of deterioration in the financial position, self corrective action by the management of the UCBs themselves and supervisory action by the Reserve Bank in case the financial position of the bank does not improve.

Convergence of IAS with IFRS

VI.60 As announced in the Annual Policy Statement 2010-11, UCBs having net worth in excess of ₹ 3 billion were advised to take necessary steps to ensure that they are in readiness to adopt the International Financial Reporting Standards (IFRS) converged with the Indian Accounting Standards (IAS) from April 1, 2013 and those with net worth in excess of ₹2 billion but not exceeding ₹3 billion from April 1, 2014.

Restricted Letters of Credit (LC)

VI.61 UCBs were advised that in case of bills drawn under LCs restricted to a particular UCB, and if the beneficiary of the LC is not a borrower who has been granted regular credit facility by that UCB, the UCB concerned may, as per their discretion and based on their perception about the credit worthiness of the LC issuing bank, negotiate such LCs, subject to the condition that the proceeds will be remitted to the regular banker of the beneficiary of the LC. UCBs would have to adhere to the instructions of the Reserve Bank / RCS or CRCS regarding share linking to borrowing and provisions of Co-operative Societies Act on membership while negotiating restricted LCs.

Exposure to Housing, Real Estate and Commercial Real Estate

VI.62 UCBs' exposure to housing, real estate and commercial real estate loans were limited to 10 per cent of their total assets which could be exceeded by an additional 5 per cent of total assets for housing loans to individuals up to ₹1.5 million. With effect from April 26, 2012, UCBs have been allowed to utilise the additional limit of 5 per cent of total assets, for grant of housing loans to individuals up to ₹2.5 million, which is covered under the priority sector.

Merger and Amalgamation

VI.63 The consolidation of the UCBs through the process of merger of weak entities with stronger ones was set in motion through transparent and objective guidelines issued in February 2005. In January 2009 the Reserve Bank issued another set of guidelines for merger/acquisition of UCBs having negative net worth as on March 31, 2007. The process of merger/amalgamation requires the acquirer bank to submit the proposal along with some specified information to RCS / CRCS and the Reserve Bank. Pursuant to the issue of guidelines on merger of UCBs, the Reserve Bank received 168 proposals for merger upto March 2012 and issued NOCs to 125 proposals of which notifications have been issued for 107 mergers by respective RCs/CRCs (Table VI.4).

Table VI.4: Year-wise Progress in Mergers/ acquisitions as on March 31, 2012

Financial year	Proposals received by the Reserve Bank	NOCs issued by the Reserve Bank	Merger effected (Notified by RCS)
1	2	3	4
2005-06	24	13	5
2006-07	32	17	18
2007-08	42	28	24
2008-09	16	26	22
2009-10	26	17	12
2010-11	17	13	13
2011-12	11	11	13
Total	**168**	**125**	**107**

VI.64 Maximum number of mergers took place in the State of Maharashtra, followed by Gujarat and Andhra Pradesh (Table VI.5).

Table VI.5: State-wise Progress in Mergers/Acquisition of UCBs

States	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	Total
1	2	3	4	5	6	7	8	9
Maharashtra	2	12	14	16	6	7	8	65
Gujarat	3	4	5	1	1	2	4	20
Andhra Pradesh	-	1	3	1	3	1	-	09
Karnataka	-	-	1	2	-	-	-	03
Punjab	-	1	-	-	-	-	-	1
Uttarakhand	-	-	1	1	-	-	-	2
Chhattisgarh	-	-	-	1	-	1	-	2
Rajasthan	-	-	-	-	2	1	1	4
Madhya Pradesh	-	-	-	-	-	1	-	1
Total	**5**	**18**	**24**	**22**	**12**	**13**	**13**	**107**

RURAL CO-OPERATIVES

Developments in Rural Cooperative Credit Structure

Position of unlicensed StCBs/DCCBs

VI.65 The Reserve Bank on October 14, 2009 had issued guidelines for granting licence to those State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs) that had CRAR of 4 per cent and above, subject to condition that there is no default in maintenance of CRR/SLR during the last one year (default up to two occasions permitted). Accordingly, the Reserve Bank has been issuing licences to StCBs/DCCBs which satisfy the above relaxed conditions recommended by NABARD and periodical review of the unlicensed StCBs/DCCBs is being done in consultation with NABARD from time to time. After considering NABARD's recommendations with respect to inspections/quick scrutiny, 43 banks (StCB-1, DCCBs-42) have remained unlicensed as on March 31, 2012. Subsequently, two banks (Assam StCB and Giridih DCCB) have been licensed after they fulfilled the licensing norms. Currently, out of 43 banks, 41 DCCBs are unlicensed and continue to be under directions.

VI.66 A task force to monitor the progress of implementation of monitorable action plan (MAP) by the unlicenced DCCBs has been formed at respective Regional Offices (ROs) of the Reserve Bank with a view to ensuring that these banks attain the eligibility for issue of a licence in the shortest possible time. The task force would also examine alternative formal channels of credit in the regions where these banks are currently functioning so as to ensure that the banking services in these regions are not adversely affected. An 'Expert Committee' to review the STCCS has been constituted to make an in-depth analysis of STCCS. The committee is headed by Dr. Prakash Bakshi, Chairman NABARD and includes professionals in co-operatives.

Developments in Regional Rural Banks

Scheduling of RRBs

VI.67 Out of 82 RRBs, 2 amalgamated RRBs are yet to be included in the second schedule of the RBI Act, 1934.

Recapitalisation of RRBs

VI.68 The central government had, in September 2009, constituted a committee (Chairman: Dr. K.C. Chakrabarty) to study the current level of CRAR of RRBs and to suggest a roadmap for enhancing the same to 9 per cent level by March 31, 2012. The committee submitted its report to the government on April 30, 2010. The committee has assessed that 40 RRBs (out of 82) will require capital infusion to the extent of ₹22 billion. The reports received from NABARD show that as on June 6, 2012, 16 RRBs have been recapitalised fully whereas in 11 RRBs, the recapitalisation process is underway. To complete the process, the recapitalisation scheme has been extended up to 2013-14.

DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION

VI.69 Deposit Insurance and Credit Guarantee Corporation (DICGC) is a wholly owned subsidiary of the Reserve Bank. Deposit insurance extended by DICGC covers all commercial banks, including Local Area Banks (LABs) and Regional Rural Banks (RRBs) in all the States and Union Territories (UTs). All co-operative banks across the country are also covered by deposit insurance. The number of registered insured banks as on March 31, 2012 stood at 2,199 comprising 87 commercial banks, 82 RRBs, 4 LABs and 2,026 co-operative banks. With the present limit of deposit insurance in India at ₹0.1 million, the number of fully protected accounts (996 million) as on March 31, 2012 constituted 92.8 per cent of the total number of accounts (1,073 million) as against the international benchmark[2] of 80 per cent. Amount-wise, insured deposits at ₹19,043 billion constituted 33.0 per cent

[2] 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

of assessable deposits at ₹57,674 billion against the international benchmark of 20 to 40 per cent. At the current level, the insurance cover works out to 1.64 times per capita GDP as on March 31, 2012. The Corporation builds up its deposit insurance fund (DIF) through transfer of its surplus, *i.e.*, excess of income (mainly comprising premia received from insured banks, interest income from investments and cash recovery out of assets of failed banks) over expenditure each year, net of taxes. This fund is used for settlement of claims of depositors of banks taken into liquidation / reconstruction / amalgamation *etc.* During the year 2011-12, the Corporation settled aggregate claims for ₹2,873 million in respect of 58 co-operative banks (18 main claims and 40 supplementary claims) as compared with claims for ₹ 3,790 million during the previous year. The size of the DIF stood at ₹300 billion as on March 31, 2012, yielding a reserve ratio (DIF/Insured Deposits) of 1.6 per cent.

VI.70 The Financial Stability Board (FSB) undertook a peer review of deposit insurance systems among its member institutions based on the BCBS-IADI 'Core Principles for Effective Deposit Insurance Systems' and the assessment methodology. The peer review report observes that the global financial crisis has illustrated the importance of effective depositor compensation arrangements. The crisis resulted in greater convergence in practices across jurisdictions and emerging consensus about appropriate design features that include higher coverage levels, elimination of co-insurance, improvements in the payout process, greater depositor awareness, adoption of *ex-ante* funding by more jurisdictions, and strengthening of information sharing and coordination with other safety net participants.

VI.71 Some of the recommendations given in the peer review report are especially relevant for India in the context of (i) review of coverage levels to ensure that it strikes an appropriate balance between depositor protection and market discipline; (ii) prompt depositor reimbursement in situations when payout is the only choice to deal with a bank failure; this needs to be supported by comprehensive and prompt access to bank data, early information access via a single customer view, and robust information technology infrastructure; (iii) strengthening of degree of co-ordination between the deposit insurance agency and other safety net players to ensure effective resolution planning and prompt depositor payment; (iv) unambiguous and immediate access to reliable funding sources (including any back-up funding options) to meet the financing requirements.

VI.72 As part of its Golden Jubilee celebrations, DICGC hosted an international conference in collaboration with International Association of Deposit Insurers (IADI) on 'Role of Deposit Insurance in Bank Resolution Framework-Lessons from the Financial Crisis' in November 2011. The theme of the conference reflected the evolving thinking on the various elements of financial safety net framework in post-financial crisis period wherein need was felt for a well-defined resolution framework for banks and closer integration of the deposit insurance agency with other players in the safety net.

NON-BANKING FINANCIAL COMPANIES

Creation of New Categories of NBFCs

VI.73 During 2011-12 two new categories of NBFCs, *viz.*, Infrastructure Debt Funds-NBFC (NBFC-IDF) and the Micro Finance Institution (NBFC-MFI) were created and brought under separate regulatory frameworks. Detailed guidelines have been prescribed on the entry point norms, prudential norms for capital adequacy, asset classification and provisioning for both the categories of the NBFCs (Box VI.3 and VI.4).

Miscellaneous Instructions

VI.74 NBFCs have been allowed to participate in Credit Default Swap (CDS) market only as users and hence not permitted to sell protection and or enter into short positions in the CDS contracts.

Box VI.3
NBFCs - Infrastructure Debt Fund

In an emerging economy like India, garnering adequate resources for infrastructure projects, which typically have long gestation lags, is a major challenge. While infrastructure development is crucial for giving fillip to the growth impulses of the economy, traditional modes of bank finance are usually constrained by asset-liability mismatch considerations, given the long-term requirements of infrastructure finance. Against this backdrop, the Union Budget 2010-11 announced the setting up Infrastructure Debt Funds (IDFs) as a company structure (IDF-NBFC) and as a Trust structure (IDF-MF) to be regulated by the Reserve Bank and SEBI respectively, and which can provide long-term funding and refinance to infrastructure projects. IDFs will be investing only in public private partnerships (PPP) infrastructure projects which have completed one year of satisfactory commercial operations (COD) with a credit enhancement provided by the project authority (such as NHAI).

While all NBFCs would be eligible to sponsor IDF-MFs under certain conditions, only banks and infrastructure finance companies can sponsor IDF-NBFC with prior approval of the Reserve Bank. Regulation of the IDF-NBFC will be similar to that of IFCs except that certain regulatory concessions in the form of lower risk weights and higher exposure norms have been allowed in keeping with the low risk assets held by them. The IDF-NBFCs would raise resources through issue of either rupee or dollar denominated bonds of minimum 5 year maturity. The investors would be primarily domestic and off-shore institutional investors, especially insurance and pension funds which would have long term resources.

VI.75 Fixed deposits by NBFCs cannot be treated as financial assets. Consequently, interest income on fixed deposits with banks will also not be treated as income from financial assets.

VI.76 NBFCs were advised that if they fail to commence NBFI business within a period of six months from the date of issue of Certificate of Registration (CoR), their registration will stand withdrawn automatically.

VI.77 NBFCs were advised not to change the ownership prior to the commencement of business and regularisation of their CoR.

Box VI.4
NBFC-Micro Finance Institutions

In the initial years of development the microfinance sector was essentially an extension of the formal banking channel led by the bank-SHG model and was aimed at developing the habit of thrift as also bringing the borrowers under the formal credit delivery channel. Gradually, the Micro Finance Institutions (MFIs) moved towards a more formal, profit oriented approach and into company structures. Banks too found that MFIs enabled them to fulfil priority sector targets. In the recent years, the sector has become dominated by for-profit companies registered as NBFCs and regulated by the Reserve Bank. Further, not-for-profit companies established under section 25 of the Companies Act fulfilling certain criteria have been exempted from the Reserve Bank regulation.

There was an uneasy relationship existing between the for-profit MFIs registered as NBFCs and the state governments in the southern part of the country where the MFIs were concentrated on issues relating to multiple lending, over indebtedness of the borrower, higher rate of interest charged and coercive recovery practices. The above concerns were amplified by the perception that the MFI sector was disproportionately benefitting the private shareholders, including PE funds and other foreign investors at the expense of poor borrowers. The huge valuations attracted by SKS Microfinance in their initial public offering (IPO) and corporate governance issues in the company reaffirmed these perceptions.

Consequently, the Andhra Pradesh (AP) government promulgated the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act in October 2010 to regulate the functioning of microfinance entities in the state. Provisions of the act were onerous to comply with and resulted in bringing all MFI activities, including lending and collection activities by NBFCs to a complete halt.

In response, the Reserve Bank appointed the Malegam Committee to study the issues and concerns in the sector. Based on the recommendations of the Malegam Committee Report, the Reserve Bank issued regulatory guidelines for MFIs in December 2011. The guidelines address issues like eligibility parameters for classification as NBFC-MFI in the form of qualifying assets, entry point norms for NBFC-

(Contd...)

MFI, prudential norms, including capital adequacy and provisioning norms, pricing of credit, transparency in interest rates, multiple lending, over borrowing, ghost-borrowing, fair practices in lending, coercive methods of recovery, corporate governance.

The sector, however, in particular AP based NBFCs, plunged into severe crisis, as the entire AP based portfolios of the NBFCs had either to be provided for or written off, adversely affecting their NOF and capital adequacy.

In recognition of difficulties being faced by the MFI Sector, the Bank has modified the directions to MFI to enable them to register immediately with the Reserve Bank as NBFC-MFI so that funding by banks and lending to the sector is resumed. The modifications entail, *inter alia*, phasing out compliance to entry point capital by March 2014; redefining qualifying assets as those created on or after January 01, 2012; removal of 26 per cent cap on interest rate to allow for operational flexibilities and putting in place margin caps of 10 per cent for large NBFC-MFI (with asset size of ₹1 billion and above) and 12 per cent for others. In addition, the provisioning made towards AP portfolio as on March 2013 would be added back notionally over a period of five years till March 2017 for the purpose of ensuring compliance to NOF and CRAR. A revised Fair Practices Code has also been put in place taking into account the specific business model of the MFIs. The Reserve Bank is also in favour of putting in place SRO mechanism to ensure effective monitoring of sector.

Recently, the central government has introduced a Micro Finance Institutions (Development and Regulation) Bill 2012, which proposes to bring all MFI structures under the regulatory purview of the Reserve Bank. The bill, however, is yet to be enacted.

VI.78 As Core Investment Companies (CICs) may be required to issue guarantees or take on other contingent liabilities on behalf of their group entities, it was advised in May 2012 that CICs which are exempt from registration requirement must be able to meet these obligation without recourse to public funds, in case the liability devolves.

VI.79 In keeping with the central government's 'green' initiative, NBFCs were requested to take proactive steps in increasing the use of electronic payment systems, elimination of post-dated cheques and gradual phase-out of cheques in their day to day business transactions which would result in more cost-effective transactions and faster and accurate settlements.

VI.80 In the normal course of their business, NBFCs are exposed to credit and market risks in view of asset-liability transformation. Off-balance sheet exposures of NBFCs have increased with participation in the designated currency options and futures and interest rate futures as clients for the purpose of hedging their underlying exposures. Hence, the off-balance sheet regulatory framework has been expanded to introduce greater granularity in the risk weights and credit conversion factors for different types of off balance sheet items, including market related and non-market related.

VI.81 The extant guidelines on classification of frauds, approach towards monitoring of and reporting system for frauds for deposit taking NBFCs have been extended to NBFCs-ND-SIs as well, besides having to report the same in their balance sheets.

VI.82 NBFCs that are predominantly engaged in lending against the collateral of gold jewellery and face inherent concentration risk, besides facing operational risks in their functioning have been directed by the Reserve Bank to limit Loan to Value (LTV) to 60 per cent and raise Tier I capital to 12 per cent by April 01, 2014. They have also been prohibited from granting loans against bullion or primary gold and gold coins. Further, banks have been advised to reduce their exposure ceiling on a single NBFC, having gold loans to the extent of 50 per cent or more of its total financial assets, from the existing 10 per cent to 7.5 per cent of banks' capital funds, with certain concessions to the infrastructure sector. In addition, in order to strengthen the internal controls, such NBFCs have been directed to put in place a board approved policy for lending, encapsulating proper adherence to KYC norms, storage and insurance of gold received as collateral and fair and transparent auction procedures.

VI.83 The central government has notified the Factoring Regulation Act, 2011 on January 22, 2012 to regulate factors and assignment of receivables in favour of factors, as also delineate the rights and obligations of parties to assignment of receivables. The Resave Bank has since issued detailed guidelines on registration and regulation of factors including placing prudential regulation and reporting discipline on them. The banks and government companies are however exempt from registration under the Act. Factors seeking registration, need to fulfill minimum NOF of ₹5 crore; principal business criteria of factoring assets and income from such assets to be not less than 75 per cent of total assets and income respectively. Factors dealing in export / import factoring will need to also comply with FEMA regulation.

Issues and Concerns in the NBFC Sector

VI.84 In the light of the international concerns on shadow banking and potential threats to the financial system as well as to reduce the regulatory gaps that might exist between the NBFC sector and the rest of the financial system, the Reserve Bank set up a Working group on the Issues and Concerns in the NBFC Sector (Box VI.5). The working group examined the issue of non-financial

Box VI.5

Recommendations of the Working Group on the Issues and Concerns in the NBFC Sector

The NBFC sector in India has undergone a significant transformation in the past few years, with significant growth of non-deposit taking systemically important NBFCs (NBFC-ND-SI). The recent global financial crisis has also highlighted the risks arising from regulatory gaps, arbitrage and systemic inter-connectedness of the financial system. The Reserve Bank constituted a Working Group (Chairperson: Smt. Usha Thorat) to reflect on the broad principles that underpin the regulatory architecture for NBFCs keeping in view the economic role and heterogeneity of this sector and the recent international experience. The key recommendations of the Working Group are:

1. There is a need to raise the entry point norms for NBFCs to a minimum asset size of ₹50 crore for registration and that the twin-criterion for determining the principal business of an NBFC should be increased to 75 per cent of the total asset and total income, respectively, from the present 50:50 criteria;
2. NBFCs not accessing public funds may be exempted from registration provided their assets are below ₹10 billion;
3. Any transfer of shareholding, direct or indirect, of 25 per cent and above, change in control, merger or acquisition should have prior approval of the Reserve Bank;
4. To address concentration, the group recommended Tier I capital to be raised to 12 per cent, introduction of a liquidity ratio and alignment of prudential norms with those of banks.
5. NBFCs may be subject to regulations while undertaking margin financing, similar to banks while lending to stock brokers and merchant banks and as specified by the Securities and Exchange Board of India (SEBI) to stock brokers. Board approved limits for bank's exposure to real estate may be made applicable for the bank group as a whole, where there is an NBFC in the group. The risk weights for stand-alone NBFCs may be raised to 150 per cent for capital market exposures and 125 per cent for Commercial Real Estate (CRE) exposures. In case of bank sponsored NBFCs, the risk weights for Capital Market Exposures (CME) and CRE may be the same as specified for banks;
6. Financial conglomerate approach may be adopted for supervision of larger NBFCs that have stock brokers and merchant bankers in the group and government owned NBFCs may comply with the regulatory framework applicable to NBFCs at the earliest.
7. NBFCs may be given the benefits under SARFAESI Act, 2002;
8. Captive NBFCs, financing parent company's products, may maintain Tier I capital at 12 per cent and supervisory risk assessment of such companies should take into account the risk of the parent company;
9. For the purpose of applicability of registration and supervision, the total assets of all NBFCs in a group should be taken together to determine the cut off limit of ₹1 billion;
10. Disclosure norms needs to be strengthened for NBFCs with asset size of ₹10 billion. Such companies whether listed or not, should be required to comply with Clause 49 of SEBI Listing Agreements; and
11. Supervision of NBFCs with assets of ₹10 billion and above should be strengthened including stress tests to ascertain their vulnerability.

Box VI.6
Non-Financial Activities of NBFCs

One of the issues examined by Working Group on issues and concerns in the NBFC sector the principal business criteria under which a company is identified as an NBFC both, if its financial assets are more than 50 per cent of its total assets and income from financial assets comprise 50 per cent of the total income. Hence, unlike in the case of banks, NBFCs are allowed to conduct multiplicity of activities including non-financial activities not regulated by the Reserve Bank. A study was conducted to gauge the non-financial activities of NBFCs-ND-SI and the risks, if any, to them from such activities. The analysis revealed the following trends:

a) The non-financial activities undertaken by NBFCs include *(i)* Fee-based: distribution of financial and insurance products, remittance services, consultancy and advisory services, portfolio management, trademark fees (ii) Service oriented activities such as leasing of premises, computer training, BPO services, business support, charter services, travel and ticketing, maintenance services, tea packing (iii) trading, manufacturing, windmill-power generation, development of software, selling of computers, cloths or garments, agriculture and real estate, *etc*.

b) Only around 17 per cent of NBFCs-ND-SI are engaged in non-financial activities, hence not significant, both in terms of percentage of non-financial assets to total assets and/ or non-financial income to total income.

c) The extent of non-financial assets to the total assets of the NBFCs engaged in non-financial activities varied from 0.02 to 29.5 per cent. The non-financial income to gross income ranged from 0.01 to 86 per cent.

d) Most of the non-financial activity was in fee-based business or services. Activities such as trading, distribution of products or manufacturing activities were confined to only a few NBFCs-ND-SI.

The Working Group has recommended raising the threshold percentage of financial asset and financial income from 50:50 to 75:75 so that the primary content of the business reflects financial activity and the company focuses primarily on financial business.

activities of NBFCs and in the light of its recommendation on principal business of NBFCs, a study was conducted to gauge the non-financial activities of NBFCs-ND-SI (Box VI.6).