Chapter I

Perspective and Policy Environment

Introduction

1.1 The year 2015-16 saw an increase in financial stability concerns for emerging market economies (EMEs) though such concerns eased for advanced economies. The performance of most EMEs was marked by severe domestic imbalances emanating from economic slowdown and downturn in credit growth coupled with rising stress in corporate and financial sectors making them vulnerable to the changing external financing conditions.

1.2 In the group of EMEs, India stood out in terms of higher economic growth despite two consecutive years of deficient monsoon. The banking sector, however, was under stress primarily on account of the burden of non-performing assets (NPAs) which increased sharply during the year.

1.3 Apart from prudential regulatory measures, to supplement the existing supervisory processes, an asset quality review (AQR) of banks was conducted during 2015-16 to address concerns over NPAs. AQR brought to the fore significant discrepancies in the reported levels of impairment and actual position and hence, led to increase in provisioning requirements for banks. Although aimed at better recognition of and provisioning for NPAs in the medium- to long-term, AQR resulted in an adverse impact on the profitability of banks in the short term. Hence, the banking sector's performance as captured through the annual accounts of banks showed a continued deterioration during the year when compared to the previous year.

1.4 The aggregate balance sheets of scheduled commercial banks (SCBs) showed a single-digit growth in 2015-16. The slowdown in credit growth was significant. Growth in profits showed a decline, primarily on account of a sharp increase in provisions made by public sector banks. Given the falling profit levels, both return on assets (RoA) and return on equity (RoE) showed a decrease. Notwithstanding these adverse developments, the capital adequacy positions of banks, including that of public sector banks, showed an improvement during the year mainly due to the capital infusion by the Government and changes in the treatment of revaluation reserves, foreign currency translation reserves (FCTR) and deferred tax assets (DTAs). These changes are expected to align the capital adequacy framework in India more closely with the Basel Committee on Banking Supervision's (BCBS) guidelines.

1.5 The year was also marked by the introduction of several regulatory, supervisory and developmental measures aimed at addressing short-to medium-term concerns, including mis-selling of financial products/services and cyber security along with a long-term vision of developing a sound, competitive, inclusive and customer-friendly banking sector.

Major policy measures for scheduled commercial banks*

I. Measures for improving the system's ability to deal with distress

Regulatory reinforcements

1.6 As part of the framework for revitalising distressed assets, on June 13, 2016, the Reserve Bank introduced the Scheme for Sustainable Structuring of Stressed Assets (S4A) for a deep financial restructuring of large accounts. Also, the process

* Relevant policy measures undertaken till December 6, 2016 have been included.

of selling stressed assets by banks was further streamlined to facilitate better valuation, price discovery and creation of a vibrant stressed assets market. Further, keeping in view the difficulties often faced by micro, small and medium enterprises (MSMEs) in resolving/restructuring their stressed bank loans, in consultation with the government the Reserve Bank of India released a separate framework for revival of distressed loans in this sector on March 17, 2016.[1]

1.7 To complement the existing risk-based capital standards and to provide a back-stop measure to contain concentration risks, the Large Exposures Framework was issued on December 1, 2016 to limit a bank's exposure to a single counter-party or a group of connected counter-parties. Alongside, a complementary framework for discouraging large borrowers to depend solely on banks for their funding needs was released on August 25, 2016 to contain concentration risks for the banking system as a whole.

1.8 As part of liquidity risk management, on May 28, 2015 draft guidelines for the Net Stable Funding Ratio (NSFR), measuring the funding resilience of a bank over a longer time horizon, were laid down. This is expected to limit the banks' reliance on short-term wholesale funding and promote funding stability. The Reserve Bank issued draft guidelines on June 22, 2016 with regard to counter-party credit risks and exposures to central counter-parties in over-the-counter (OTC) derivative transactions.

1.9 In order to facilitate the mobilisation of additional capital to meet Basel III capital regulations, ownership limits in private sector banks were rationalised. Separate ownership limits were laid down for natural (individuals) and legal persons (entities/institutions); and within legal persons, higher limits were prescribed for well-diversified financial institutions. While the shareholding proportion for natural persons and non-financial entities was capped at 10 per cent, the cap for non-regulated or non-diversified and non-listed financial institutions was fixed at 15 per cent. The shareholding proportion for regulated, well-diversified and listed/supra-national institutions/ public sector undertakings/government financial institutions was proposed to be capped at 40 per cent.

II. Supervisory measures

1.10 For focused attention on asset quality with regard to large borrowal accounts across banks, AQR was conducted during 2015-16. The Review extensively used off-site data and other data dumps in a coordinated manner and compared the quality of these loan assets against applicable Reserve Bank norms. The banks were advised about the position that emerged from the review along with a recommendation to appropriately adjust impairments in their books.

1.11 The Central Repository of Information on Large Credits (CRILC) has proved to be an important tool for effective off-site supervision. Efforts were made to further improve the quality of CRILC data by modifying its reporting mechanism with respect to external ratings and industry. Additionally, the dates of assets turning into NPAs and special mention accounts (SMAs) were captured in the database for an insight into the ageing of stressed accounts.

1.12 The ambit of risk-based supervision (RBS), which helps in timely identification of supervisory concerns and their mitigation, was further widened

[1] The Ministry of Micro, Small and Medium Enterprises, Government of India, had notified this 'Framework for Revival and Rehabilitation of Micro, Small and Medium Enterprises' vide their Gazette Notification dated May 29, 2015. The Reserve Bank helped revise the framework so as to make it compatible with the existing regulatory guidelines on 'Income Recognition, Asset Classification and Provisioning pertaining to Advances' issued to banks by the Reserve Bank.

with migration of all scheduled commercial banks (excluding Regional Rural Banks and Local Area Banks), during the supervisory cycle 2016-17. While retaining the underlying concepts and principles of the main model, during the supervisory cycle 2015-16, a smaller RBS model, as a variant model, was developed for the small banks operating as a branch with few/niche business lines.

1.13 To address supervisory concerns emanating from IT and cyber security, the IT examination of major banks was taken up during the year. Further, the SWIFT ecosystem of certain banks was tested on a sample basis. Banks were advised to develop a risk-based approach in tackling cyber threats through a board-approved cyber-security policy.

1.14 To deal with concerns relating to banking sector frauds, the Central Fraud Registry (CFR), a web-based searchable database of frauds containing data for the last 13 years was made operational on January 21, 2016. This will help in timely identification and mitigation of frauds and also serve as a potent tool for banks in taking informed business decisions. At the instance of the Reserve Bank, a Committee on Large Value Banking Frauds was also set up at Department of Financial Services, the Ministry of Finance in order to have greater coordination and synchronised action among various agencies, including investigating agencies.

III. Measures for broadening and deepening access to finance

1.15 There were two major developments during 2015-16 which will shape the financial landscape in the years to come and will also be instrumental in furthering financial inclusion. First, in-principle approvals for setting up payments banks to eleven applicants were granted on August 19, 2015 and on September 16, 2015, in-principle approvals were granted to ten applicants for setting up small finance banks (SFBs). Accordingly, two entities – the Capital Small Finance Limited and Equitas Small Finance Bank Limited – commenced operations as small finance banks, while Airtel Payments Bank Limited began operating as the first payments bank. Secondly, on August 1, 2016 guidelines for 'on tap' licensing of universal banks in the private sector were released. Following the Reserve Bank discussion paper on 'Banking Structure in India: The Way Forward,' the process of continuous authorisation will keep competitive pressure on existing banks and, with financial inclusion as an integral part of the proposed business plan of a given bank, this will also help in enhancing financial inclusion. Chapter V of this report provides further details of various policy developments and progress achieved in the area of financial inclusion.

1.16 Leveraging technology in the retail delivery of financial services is turning out to be a game changer for the financial landscape in India. It is a cost-effective means of reaching last mile finance and thus helps in financial inclusion. For providing a greater impetus to card-based retail payments, an Acceptance Development Fund (ADF) is being designed to step up the card acceptance infrastructure. Further, the Unified Payments Interface (UPI) was launched on August 25, 2016 to give a boost to mobile banking. This is expected to revolutionise retail payments given the high degree of penetration of mobile phones in the country.

1.17 Apart from the use of technology by the mainstream banking institutions, recent years have also witnessed the entry of several alternative non-financial institutions providing financial services, typically known as Fin Tech. The entry of these alternative institutions is expected to improve competition in the financial sector. However, it can also pose challenges resulting in long-term systemic concerns. Accordingly, on July 14, 2016 the Reserve Bank set up an inter-regulatory working group to examine various aspects related to Fin Tech innovations and the related risks and opportunities.

1.18 In India, financial literacy has been regarded as a process that provides demand side support for financial inclusion. Accordingly, till date various initiatives have been taken by all stakeholders to enhance awareness about finance among the general public (details in Chapter V).

1.19 While expanding the reach of finance and financial literacy, the Reserve Bank has been conscious about protecting the rights and interests of customers, particularly small customers. Accordingly, the Reserve Bank has formulated the Charter of Customer Rights and banks were advised to formulate board-approved customer rights' policies on similar lines. Further, the Banking Ombudsman (BO) scheme was reviewed during the year along with the rationalisation/augmentation of offices of BO. For informed policies for customer protection, the Reserve Bank also took up the issue of mis-selling of third-party financial products by banks in rural/semi-urban areas as a subject for a field level study. Similarly, for enhancing awareness about fictitious money transfers in the name of the Reserve Bank, a pan-Indian awareness campaign too was undertaken.

1.20 On November 26, 2015 the Central Registry of Securitisation Asset Reconstruction and Security Interest in India (CERSAI) was notified as the Central KYC Records Registry (CKYCR) for receiving, storing and retrieving KYC records of customers in digital form. This will ensure a single KYC across all financial products and thus make financial access more convenient. The CKYCR has started its 'live run' with effect from July 15, 2016.

IV. Other measures

1.21 In pursuance of the non-legislative recommendations of the Financial Sector Legislative Reforms Commission (FSLRC) for capacity building in banks, banks were advised to identify specialised areas for certification of their staff. For benchmarking India with the international best practices with regard to green finance, the Reserve Bank set up a working group in September 2016. SCBs (excluding RRBs) were advised to follow Indian accounting standards as notified under the Companies (Indian Accounting Standards) Rules, 2015 from the financial year 2018-19 (with previous year comparatives). To enhance monetary policy transmission and transparency in the methodology for determining interest rates on loans, banks were mandated to compute base rates based on marginal cost of funds.

Regulatory and supervisory measures in the co-operative and non-banking segments

1.22 In recent years, a general guiding principle for the regulation of the co-operative and non-banking financial segments has been minimising regulatory arbitrage between banks and these segments. In pursuance of this principle, steps were taken to further harmonise the regulatory treatment of NBFCs, for instance, regulations on the framework for revitalising distressed assets, reporting frauds and options on refinancing of project loans.

1.23 The existence of unlicensed district central co-operative banks (DCCBs) has been a regulatory concern. With the implementation of the revival scheme announced by the central government, the number of unlicensed DCCBs was reduced to only three as at end-September 2016 from 23 as at end-June 2013.

Way forward for the banking sector

1.24 In pursuance of the long-term vision of developing a sound, competitive, inclusive and customer-friendly banking sector, the Reserve Bank will continue with the on-going regulatory and supervisory reforms and also explore newer areas. The possibility of creating new kinds of differentiated banks, such as custodian and wholesale financing banks, will also be explored. The Business Correspondent (BC) model, which has been at the heart of financial inclusion efforts by the Reserve Bank, will be scaled up further to expand its outreach to remote rural areas through registry, certification and training of these entities. Following the 'Payment and Settlement Systems in India – Vision 2018,' payment infrastructure will be stepped up to address the five Cs of coverage, convenience, confidence, convergence and cost. Further, to address customer services-related concerns in the non-banking segment, the Reserve Bank will also take up the issue of designing an appropriate ombudsman scheme for NBFCs.