Chapter III

Policy Environment

The Reserve Bank continued to fine-tune its prudential and supervisory policies to ensure that the banking system remained sound, resilient and inclusive. In order to achieve this objective, several policy measures were initiated. These include issuing guidelines for new bank licences for improving access to banking services, efforts to move towards a dynamic provisioning framework and revisions effected in policy regarding restructuring of advances by banks/financial institutions. Policy framework was released for setting up of wholly owned subsidiaries by foreign banks in India. Also, a Discussion Paper on banking structure was released and a risk-based supervisory approach for banks was adopted. Measures were introduced for rationalisation of bank lending against gold and bank finance for purchase of gold. Many new initiatives were also undertaken to improve financial inclusion and to make the payment and settlement system more efficient.

1. Introduction

3.1 Domestic structural factors combined with an adverse external economic environment led to tepid economic growth during 2012-13 and 2013-14 so far. The monetary policy stance during 2012-13 sought to balance the evolving growth-inflation dynamics through calibrated easing. During 2013-14, the Reserve Bank eased monetary policy further in early May, but undertook exceptional liquidity tightening measures since July to address macro-financial risks arising from exchange rate volatility. Since September 2013, even as Reserve Bank began a calibrated withdrawal of exceptional liquidity tightening measures on signs of improvement in the external environment, taking cognizance of the mounting inflationary pressures, the repo rate was increased by 25 basis points each on September 20, 2013 and in the Second Quarter Review of October 29, 2013.

3.2 Though the Indian banking industry weathered the recent global financial crisis largely unscathed, weakening asset quality has emerged as a major concern. The global financial crisis has brought into sharp focus, the need for reorienting prudential policies to have a macro dimension. In this evolving global and domestic environment, the Reserve Bank has been constantly reviewing and fine-tuning its regulatory and supervisory policies to ensure a sound, resilient, robust and inclusive banking system that is capable of taking on various challenges effectively. In this regard, the chapter enumerates the various policy initiatives undertaken in the banking sector during 2012-13 and 2013-14 so far with particular focus on regulatory and supervisory policies.

2. Monetary Policy

Monetary policy addresses the accentuated risks to growth while maintaining a vigil on inflation

3.3 The monetary policy stance during 2012-13 was geared towards addressing the sharp slowdown in growth while not jeopardising the objective of reigning in inflation. There was a front-loading of easing of the key policy rate, the repo rate, by 50 basis points in April 2012. Reflecting the transmission of earlier monetary policy tightening as also the beneficial impact of fiscal consolidation, a moderation in inflation was witnessed in the second half. Headline Wholesale Price Index (WPI) inflation (y-o-y) averaged 7.0 per cent in the second half of the year as against 7.7

per cent in the first half. By March 2013, WPI inflation on a point to point basis, moderated to 5.7 per cent.

3.4 Using the policy space made available by the softening of WPI inflation in the second half of 2012-13, the Reserve Bank reduced the repo rate by 25 basis points each in January 2013 and in March 2013, leading to a cumulative 100 basis points easing in 2012-13. The repo rate was further reduced by 25 basis points in May 2013 to 7.25 per cent to address the accentuated risks to growth while noting that upside risks to inflation were still significant.

3.5 After easing in Q1 of 2013-14, WPI inflation started rising. Retail inflation as measured by Consumer Price Indices (CPIs) also continued to remain elevated. Considering the imperative need to curb the mounting inflationary pressures and anchor inflation expectations and thereby strengthen the foundations of growth, the repo rate was increased by 25 basis points each in the mid-quarter review of September and the second quarter review of October 2013 to 7.75 per cent.

Measures undertaken to address the stress in liquidity conditions

3.6 The year 2012-13 was marked by periods of significant stress in liquidity conditions. These were brought on by a number of factors including high government cash balances maintained with the Reserve Bank, strong seasonal demand for currency, the Reserve Bank's intervention in the foreign exchange market and divergence between deposit mobilisation and credit off-take of banks. The Reserve Bank undertook a number of measures for liquidity management. The cash reserve ratio (CRR) was reduced in three stages by a cumulative 75 basis points in 2012-13, taking it to 4.0 per cent of net demand and time liabilities (NDTL) of banks, its lowest level since 1974. The statutory liquidity ratio (SLR) was reduced by 100 basis points to 23.0 per cent of NDTL of banks in August 2012. Besides the liquidity injected through the daily liquidity adjustment facility (LAF) operations, the Reserve Bank purchased government securities worth ₹1.5 trillion through open market operations (OMOs) during 2012-13.

3.7 During early 2013-14, liquidity conditions generally improved mainly because of drawdown of government cash balances and narrowing of the gap between deposit and credit growth. In order to contain exchange rate volatility in the domestic forex market, the Reserve Bank undertook a number of measures since mid-July 2013. The measures included increasing the MSF rate and the bank rate by 200 bps to 10.25 per cent, announcing an auction of ₹120 billion in open market sales of government securities, capping LAF borrowing access for each individual bank at 0.5 per cent of its NDTL and increasing the minimum daily maintenance of CRR from 70 per cent to 99 per cent of the daily average requirement on a fortnightly basis. Further, on August 8, 2013, the Reserve Bank announced auction of Government of India Cash Management Bills (CMBs). Accordingly, ₹960 billion of CMBs were auctioned in the following weeks.

3.8 In the wake of improvement in exchange market conditions, the Reserve Bank in its Mid-Quarter Review on September 20, 2013 began calibrated withdrawal of exceptional measures taken since mid-July. The MSF rate was reduced by 75 basis points to 9.5 per cent and minimum daily maintenance of CRR was reduced to 95 per cent of the average fortnightly requirement. Further, based on the assessment of liquidity condition and in anticipation of the seasonal pick-up in credit demand, festival-related currency demand, and the Government's borrowing programme in second half of 2013-14, with a view to easing the liquidity pressure the Reserve Bank conducted OMO purchases of ₹99.74 billion on October 7, 2013. Moreover, continuing with the gradual normalisation process, the MSF rate was

lowered by 50 bps from 9.5 per cent to 9.0 per cent, and additional access to liquidity through term repo up to 0.25 per cent of NDTL was announced on October 7, 2013. The first round of 7-day term repo was conducted on October 11, 2013 (₹190 billion) followed by 14-day term repo on October 18, 2013 (₹195 billion). As a result of these measures, the liquidity situation eased in October 2013. The Reserve Bank in its Second Quarter Review of Monetary Policy 2013-14 reduced the MSF rate further by 25 basis points to 8.75 per cent and hiked the repo rate by 25 basis points to 7.75 per cent; thereby completing the process of realigning the interest rate corridor to normal monetary policy operations. Also, Reserve Bank increased the liquidity access through term repos of 7-day and 14-day tenor from 0.25 per cent of NDTL of the banking system to 0.5 per cent.

3.9 Thus, monetary policy had to perform the difficult balancing act of controlling inflation and promoting growth and addressing the risks emanating from large current account deficit.

3. Credit Delivery

Priority sector loan limits raised for certain sectors to facilitate greater flow of credit

3.10 In order to increase flow of credit to certain segments covered under the priority sector, loan limits were raised with effect from April 1, 2013. Loan limits to farmers against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months was increased from ₹2.5 million to ₹5 million both under direct and indirect agriculture. In case of loans to dealers/sellers of fertilisers, pesticides, seeds, cattle feed, poultry feed, agricultural implements and other inputs, the limit was raised from ₹10 million to ₹50 million per borrower. Similarly, the limit of bank loans to Micro and Small Enterprises (MSEs) engaged in providing or rendering of services was increased from ₹20 million to ₹50 million per borrower/unit, provided they satisfied the investment criteria for equipment as defined in Micro, Small and Medium Enterprises Development Act, 2006.

Rupee export credit - interest subvention scheme extended

3.11 With a view to encouraging exports, the Government decided to continue to extend interest subvention of 2 per cent on pre and post shipment rupee export credit for certain employment oriented sectors, *i.e.*, handicrafts, carpet, handlooms, small and medium enterprises, readymade garments, processed agriculture goods, sports goods and toys. In addition, interest subvention was also provided to 235 tariff lines in engineering goods and 6 tariff lines in ITC (HS) and textiles goods for 2013-14. Further, the Government decided to increase the rate of interest subvention from 2 per cent to 3 per cent, effective August 1, 2013.

Guidelines issued for rehabilitation of MSEs

3.12 MSEs are prone to sickness due to structural and other constraints induced by internal/external factors. As these enterprises are not financially strong, they are susceptible to even minor disruptions and tend towards sickness. The stress induced at the initial stage, if not promptly addressed, can seriously jeopardise the enterprise leading to the closure of the unit in most cases. In order to hasten the process of identifying a unit as sick, early detection of incipient sickness and laying down a procedure to be adopted by banks before declaring a unit as unviable, the Reserve Bank issued revised guidelines on November 1, 2012 for rehabilitation of sick units in the MSE sector.

Structured mechanism suggested for monitoring credit growth to the MSE sector

3.13 In view of the concerns emerging from the deceleration in credit growth to the MSE sector, an Indian Banks' Association (IBA) led sub-

committee (Chairman: Shri K.R. Kamath) was set up to suggest a structured mechanism to be put in place by banks to monitor the entire gamut of credit related issues pertaining to the sector. Based on the recommendations of the Committee, guidelines were issued on May 9, 2013 which included the need for banks to strengthen their existing systems of monitoring credit growth to the sector and putting in place a system-driven comprehensive performance management information system (MIS) at every supervisory level, which should be critically evaluated on a regular basis; putting in place a system of e-tracking MSE loan applications and monitoring the loan application disposal process in banks, giving branch-wise, region-wise, zone-wise and state-wise positions and monitoring timely rehabilitation of sick MSE units.

Microfinance

SHG-Bank Linkage Programme (SHG-BLP) repositioned as SHG2

3.14 The SHG-BLP is a saving-led credit product for the unbanked poor. National Bank for Agriculture and Rural Development (NABARD) initiated the process of repositioning the SHG-BLP as SHG2. This approach is basically aimed at encouraging the poor to save. It includes SHGs introducing voluntary savings in groups or banks encouraging SHG members to open individual bank accounts for depositing their surpluses. This approach is also aimed at preparing the low literacy and low-income clients to progressively move from community banking endeavours to individual banking. Another aspect of the SHG2 is providing credit to SHGs as cash credit/ overdraft for a longer operational tenure instead of the present fixed tenor term loans. This shift provides considerable flexibility to SHGs in meeting their frequent credit needs; it also helps them in reducing their cost of borrowing.

3.15 It is observed that mature SHGs after 1-2 credit cycles tend to exhibit differential credit and financial service needs. These needs vary according to risk appetite and entrepreneurial skills of the SHG members. This has led to emergence of Joint Liability Groups (JLGs) within SHGs.

4. Financial Inclusion

Guidelines to facilitate smooth implementation of direct benefit transfer (DBT) scheme

3.16 In order to facilitate the smooth implementation of the Electronic Benefit Transfer (EBT) scheme for routing MGNREGA[1] wages, other social security benefits including proposed cash transfers with respect to subsidies on kerosene, LPG and fertilisers, guidelines were issued on November 30, 2011 to all scheduled commercial banks to ensure opening of Aadhaar-enabled bank accounts of all the beneficiaries including those residing in villages with less than 2,000 population. Banks were advised to expand their reach in remote locations either through a branch or Business Correspondent (BC) or other modes as every eligible individual should have a bank account for DBT to take place. State Level Bankers' Committee (SLBC) convenor banks of concerned states and Lead banks of selected districts were advised in October 2012 to co-ordinate with the state administrator and field level implementing agencies to ensure smooth rollout of Aadhaar enabled payment systems.

Branch expansion in unbanked rural areas to facilitate DBT scheme

3.17 To facilitate speedier branch expansion in unbanked rural centres for ensuring a seamless roll-out of the DBT/EBT scheme of the Government of India, instructions were issued to banks on May 28, 2013 that they may consider front-loading

[1] Mahatma Gandhi National Rural Employment Guarantee Act.

(prioritising) the opening of branches in unbanked rural centres over a three-year cycle co-terminus with their Financial Inclusion Plan (FIP) for 2013-16.

Bharatiya Mahila Bank Ltd. established

3.18 In order to address gender related aspects of empowerment and financial inclusion, Union Budget 2013-14 announced to set up India's first Women's Bank as a public sector bank with ₹10 billion as initial capital. As a follow up, the Reserve Bank gave licence to the Bharatiya Mahila Bank Ltd. on September 25, 2013. The registered office of the proposed Bharatiya Mahila Bank Ltd. will be in New Delhi. It will open at least 25 per cent of its branches in unbanked rural centres (population up to 9,999 as per the latest census). It will also observe the priority sector lending norms as applicable to the domestic banks.

Measures to improve financial inclusion and financial literacy for MSEs

3.19 The lack of financial literacy and operational skills including accounting, finance and business planning pose formidable challenge for MSE borrowers underscoring the need for facilitation by banks in these critical areas. Moreover, MSEs are further handicapped in this regard by the absence of scale and size. To effectively address these handicaps, guidelines were issued to SCBs on August 1, 2012 that the banks could either set up special cells at their branches separately or vertically integrate this function in Financial Literacy Centres (FLCs) set up by them as per their comparative advantage. The bank staff should also be trained through customised training programmes to meet the specific needs of the sector.

3.20 With a view to providing a guide for the new entrepreneurs in this sector, a booklet titled "Nurturing Dreams, Empowering Enterprises – Financing Needs of Micro and Small Enterprises – A guide" was launched on August 6, 2013 by the Reserve Bank. The booklet provides some critical information for budding entrepreneurs to take advantage of linking themselves with the formal banking sector.

Swarnajayanti Gram Swarozgar Yojana (SGSY) restructured as the National Rural Livelihood Mission (NRLM) to promote financial inclusion

3.21 The Ministry of Rural Development, Government of India has restructured the Swarnajayanti Gram Swarozgar Yojana (SGSY) as the National Rural Livelihood Mission (NRLM) with effect from April 1, 2013. NRLM is implemented through scheduled commercial banks (including RRBs[2]). To begin with, NRLM will ensure that at least one member from each identified rural poor household, preferably a woman, is brought under the SHG network in a time bound manner.

3.22 The scheme will further ensure that the poor are provided with requisite skills for: managing their institutions, linking up with markets, managing their existing livelihoods, and enhancing their credit absorption capacity and credit worthiness. NRLM will work towards achieving universal financial inclusion from both the demand and supply side. On the demand side, it will promote financial literacy among the poor and provide catalytic capital to SHGs and their federations. On the supply side, it will coordinate with the financial sector and encourage use of ICT based financial technologies, business correspondents and community facilitators like 'Bank Mitras'. NRLM is expected to reach all districts by the end of 12th Five-Year Plan.

[2] Regional Rural Banks.

Know Your Customer (KYC) norms simplified to facilitate financial inclusion and customer service

3.23 In order to ease some of the avoidable inconveniences faced by customers due to some provisions in KYC guidelines, the Reserve Bank initiated steps to reduce the inconvenience a customer faces while opening a bank account or when transferring his account to another place. If the address on the account opening form and that on the document submitted as identity proof is the same, then that document (like passport, driving licence) can be accepted as proof of both identity and address. The MGNREGA Card can also be accepted as an officially valid document for opening an account without any limitations of a "small account". Also, transfer of accounts for customers who migrate to a new place on account of a new job or transfer has been made convenient. Further, detailed guidelines have been issued to banks in order to determine "beneficial owner" as defined under the Prevention of Money Laundering Rules, 2005.

5. Prudential Regulatory Policy

Licences to new banks in the private sector being issued to promote financial inclusion and for fostering greater competition

3.24 As per an announcement made in the Union Budget 2010-11, the Reserve Bank put out draft guidelines on licensing of new banks in the private sector on August 29, 2011 for public comments. The final guidelines were released on February 22, 2013 after amendments to the Banking Regulation Act, 1949 were made in December 2012. The last date for receipt of applications was July 1, 2013. The Reserve Bank received 26 applications for new bank licences. The applications are being processed. A High Level Advisory Committee will screen the applicants. The committee will make its recommendations to the Reserve Bank and the Reserve Bank's decision in this regard will be final. The rationale behind granting licences to new banks is to promote financial inclusion, support inclusive economic growth and foster greater competition in the banking sector.

3.25 According to the guidelines, entities/groups in the private sector which are owned and controlled by residents and entities in the public sector shall be eligible to set up a bank. The promoters/promoter groups with existing Non-Banking Financial Companies (NBFCs) can set up a bank, if found eligible. The promoters/promoter groups should be financially sound with a successful track record of 10 years and have a past record of sound credentials and integrity. Promoter/promoter groups' business model and business culture should not be misaligned with the banking model and their business should not potentially put the bank and the banking system at risk on account of group activities such as those which are speculative in nature or subject to high asset price volatility. The business plans submitted by an applicant should be realistic and viable and should address how the bank proposes to achieve financial inclusion. The bank shall open at least 25 per cent of its branches in unbanked rural centres. The bank shall comply with priority sector lending targets and sub-targets as applicable to the existing domestic banks.

3.26 New banks in the private sector will be set up through wholly-owned Non-Operative Financial Holding Companies (NOFHCs). A NOFHC shall be wholly owned by the promoters/promoter group. The initial minimum paid-up voting equity capital for the new bank shall be ₹5 billion. The NOFHC shall initially hold a minimum of 40 per cent of the paid-up voting equity capital of the bank which shall be locked in for a period of five years. The NOFHC will be registered as a NBFC and comply with corporate governance standards and prudential norms set out by the Reserve Bank. After the Reserve Bank gives an "in-principle

approval" for setting up of the bank, the actual setting up of NOFHC and the bank, re-organisation of the promoter group entities to bring the regulated financial services entities under the NOFHC as well as realignment of business among the entities under the NOFHC have to be completed within a period of 18 months from the date of "in-principle approval" or before commencement of the banking business, whichever is earlier. The aggregate non-resident shareholding from FDI, NRIs and FIIs in the new private sector bank shall not exceed 49 per cent of the paid-up voting equity capital for the first five years from the date of licensing of the bank. The Non-resident shareholding will be as per the extant FDI policy, after the expiry of the initial five year period.

Framework for setting up of wholly owned subsidiaries by foreign banks released

3.27 The Reserve Bank released the framework for setting up of Wholly Owned Subsidiaries (WOS) by foreign banks in India on November 6, 2013. The policy framework is guided by the two cardinal principles of reciprocity and single mode of presence. As a locally incorporated bank, the WOSs will be given near national treatment which will enable them to open branches anywhere in the country at par with Indian banks (except in certain sensitive areas where the Reserve Bank's prior approval would be required). The policy incentivises the existing foreign bank branches to convert into WOS due to the attractiveness of near national treatment. Such conversion is also desirable from the financial stability perspective, factoring in the lessons from the global economic crisis.

3.28 The policy framework states that banks with complex structures, banks which do not provide adequate disclosure in their home jurisdiction, banks which are not widely held, banks from jurisdictions having legislation giving a preferential claim to depositors of home country in winding up proceedings, *etc.*, would be mandated entry into India only in the WOS mode. However, foreign banks in whose case the above conditions do not apply can opt for a branch or WOS form of presence. A foreign bank opting for branch form of presence will have to convert into a WOS as and when the above conditions become applicable to it or it becomes systemically important on account of its balance sheet size in India. Foreign banks which commenced banking business in India before August 2010 shall have the option to continue their banking business through the branch mode; however, they will be incentivised to convert into WOS. To prevent domination by foreign banks, restrictions would be placed on further entry of new WOSs of foreign banks/ capital infusion, when the capital and reserves of the WOSs and foreign bank branches in India exceed 20 per cent of the capital and reserves of the banking system. The initial minimum paid-up voting equity capital for a WOS shall be ₹ 5 billion for new entrants. Existing branches of foreign banks desiring to convert into WOS shall have a minimum net worth of ₹ 5 billion. Priority sector lending requirement would be 40 per cent for WOS like domestic SCBs with adequate transition period for existing foreign bank branches converting into WOS. Certain measures from corporate governance perspective have also been built in so as to ensure that the public interest is safeguarded.

Relaxations made in branch authorisation policy

3.29 With the objective of rationalising the branch authorisation policy and to foster more competition, bank branching was made completely free for well managed domestic SCBs in every part of the country. On September 19, 2013 Reserve Bank notified that the general permission to domestic SCBs (other than RRBs) to open branches in Tier 2 to Tier 6 centres and in the rural, semi-urban and urban centres in North-

Eastern States and Sikkim without having the need to take permission from the Reserve Bank in each case, subject to reporting, is now extended to branches in Tier 1 centres also, subject to certain conditions.

Discussion Paper on banking structure released

3.30 A Discussion Paper on "Banking Structure in India - The Way Forward" was released on August 27, 2013. The Discussion Paper identified certain building blocks for the reorientation of the banking structure with a view to addressing various issues such as enhancing competition, financing higher growth, providing specialised services, and furthering financial inclusion. The overall thrust of the reorientation is to impart dynamism and flexibility to the evolving banking structure, while ensuring that the structure remains resilient and promotes financial stability. Some of the important issues covered in the Discussion Paper are small banks *versus* large banks, universal banking, conversion of Urban Co-operative Banks (UCBs) into commercial banks, consolidation in the banking sector, presence of foreign banks in India, government ownership of public sector banks, presence of Indian banks overseas and deposit insurance.

Dynamic provisioning for banks in the offing

3.31 A comprehensive provisioning framework for banks with dynamic and countercyclical elements is being contemplated to overcome the limitations of the current provisioning policy. In this regard, a Discussion Paper on 'Introduction of Dynamic Provisioning Framework for Banks in India' was released on March 30, 2012 for public comments. The primary objective of the dynamic provisioning framework is to smoothen the impact of incurred losses on the profit and loss account through the cycle. In the proposed framework, banks will be accumulating provisioning buffer during the period when the economy is growing and banks' credit losses are lower than the long run average. The accumulated buffer would be utilised during the slow growth/negative growth phase when the banks' credit losses increase. Final guidelines on dynamic provisioning will be released shortly.

Bulk deposits defined

3.32 Identifying bulk deposits is important from the viewpoint of asset-liability management (ALM). The term "bulk deposits", though not specifically defined, has been interchangeably used with "wholesale deposits" and has occasionally been used in the context of ALM guidelines. In the Reserve Bank's clarification dated May 16, 2007, deposits of ₹1.5 million or any higher threshold approved by banks' boards were termed "wholesale deposits". The position has been reviewed and it has been decided that with effect from April 1, 2013 the expression 'bulk deposits' would be used only for single Rupee term deposits of ₹10 million and above.

Curbs on bank finance for purchase of gold for speculative purposes

3.33 The significant rise in gold imports in recent years is a cause for concern. Direct bank financing for purchase of gold in any form, *viz.*, bullion/primary gold/jewellery/gold coins could lead to fuelling of the demand for gold for speculative purposes. In view of this, banks were advised that with effect from November 19, 2012, no advances should be granted by banks for purchase of gold in any form including primary gold, gold bullion, gold jewellery, gold coins, units of gold Exchange Traded Funds (ETF) and units of gold mutual funds. However, banks can provide finance for the genuine working capital requirements of jewellers.

Guidelines regarding bank lending against gold rationalised

3.34 As per the Reserve Bank guidelines, SCBs should not grant any advance against bullion/

primary gold. However, as specially minted gold coins sold by banks may not be in the nature of 'bullion' or 'primary gold', it was indicated in the Reserve Bank's clarification dated April 5, 2011 that there would be no objection to a bank granting loans against these coins. However, there is a risk that some of these coins would be weighing much more, thereby circumventing the Reserve Bank's guidelines. Accordingly, with effect from May 27, 2013, banks were advised that while granting advance against the security of especially minted gold coins sold by them, they should ensure that the weight of the coin(s) does not exceed 50 grams per customer and the amount of loan to any customer against gold ornaments, gold jewellery and gold coins (weighing up to 50 grams) should be within a banks' Board approved limit. The restriction on grant of loan against "gold bullion" will also be applicable to grant of advance against units of gold ETFs and units of gold mutual funds. Similar guidelines have also been issued to Regional Rural Banks (RRBs), State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs).

Prior approval mandatory for acquisition of shares in private sector banks

3.35 To enable banking companies in India to raise capital in accordance with the international best practices and to ensure that control of banking companies is in the hands of "fit and proper persons", provisions have been made in the Banking Regulation Act, 1949. This has been effected by an amendment notified by the Government of India *vide* Banking Law Amendments Act, 2012. The notification stipulates that it would be mandatory for persons to obtain prior approval of the Reserve Bank to acquire five per cent or more of the share capital of a banking company. The notification confers power upon the Reserve Bank to impose such conditions as it deems necessary while granting such approvals. In this regard guidelines are being issued to banks shortly.

Penal rates on premature withdrawal of rupee term deposits made transparent

3.36 On request from a depositor, a bank shall allow withdrawal of a rupee term deposit of less than ₹10 million, before the completion of the period of the deposit agreed upon at the time of making the deposit. However, banks will have the freedom to determine their own penal interest rates on premature withdrawal of term deposits. Banks should ensure that the depositors are made aware of the applicable penal rates along with the deposit rates.

Draft guidelines issued for unhedged foreign currency exposures of corporates

3.37 Unhedged foreign currency exposures of the corporates are an area of concern not only for individual corporates but also for the entire financial system. Corporates which do not hedge their foreign currency exposures can incur significant losses due to exchange rate movements. These losses may reduce their capacity to service the loans taken from banks and thereby affect the health of the banking system. In view of this, the Reserve Bank issued draft guidelines on July 2, 2013 on the methodology to be followed for computing incremental provisioning and capital requirements for exposure to corporates having unhedged foreign currency exposures. Draft guidelines also require banks to factor in the risk arising from high forex exposures of corporates in their internal rating processes and share this data with the concerned credit rating agencies so that the external bank loan rating may also factor in this risk. Based on the comments/feedback received, the Reserve Bank will finalise the guidelines and banks will be required to implement the same from October 1, 2013.

Carving out separate commercial real estate-residential housing segment

3.38 Commercial Real Estate (CRE) being a sector prone to volatility has attracted stricter

prudential norms from regulators globally. The Reserve Bank has also prescribed stricter prudential norms in terms of higher risk weight at 100 per cent and higher provision at 1.0 per cent for CRE standard assets as against generally a lower provision of 0.40 per cent for other standard assets. However, it was observed that the residential housing segment within CRE exposures exhibited lesser risk and volatility than the CRE sector taken as a whole. Accordingly, guidelines were issued to banks on June 21, 2013 regarding carving out a Commercial Real Estate - Residential Housing (CRE-RH) segment from CRE with lower risk weight at 75 per cent and lower provisioning at 0.75 per cent for standard assets as compared to CRE. CRE-RH would consist of loans to builders/developers for residential housing projects (except for captive consumption). It was also advised that such projects should ordinarily not include non-residential CRE.

Banks advised to bring uniformity in intersol charges to ensure fair treatment to customers

3.39 Intersol charges refer to charges levied on transactions conducted by customers at a branch other than the "home branch" in a Core Banking Solution (CBS) enabled environment. The issue was deliberated upon by the Committee on Customer Service in Banks (Chairman: Shri M. Damodaran). In this regard, it was decided that with a view to ensuring that bank customers are treated fairly and reasonably without any discrimination and in a transparent manner at all branches of banks/service delivery locations, banks should follow a uniform, fair and transparent pricing policy and not discriminate between their customers at home branch and non-home branches. Accordingly, banks were advised by the Reserve Bank on July 1, 2013 that if a particular service is provided free at home branch then the same should be available free at non-home branches also.

Prudential guidelines on restructuring of advances by banks/financial institutions revised

3.40 Some of the existing prudential guidelines on restructuring of advances by banks/financial institutions have been revised following the recommendations of the Working Group (Chairman: Shri B. Mahapatra) to Review the Existing Prudential Guidelines on Restructuring of Advances by Banks/Financial Institutions. The Working Group recommended that the Reserve Bank should do away with the regulatory forbearance regarding asset classification on restructuring of loans and advances generally in line with international prudential measures. However, in view of the domestic macroeconomic situation as also the global situation, it was decided to consider this measure after a period of two years. Accordingly, the regulatory forbearance on asset classification will stand withdrawn from April 1, 2015 except in case of change of date of commencement of commercial operation (DCCO) of infrastructure and other project loans. Further, provisioning requirement on all fresh standard restructured accounts has been increased to 5.00 per cent with effect from June 1, 2013. The increased provisioning requirement for the stock (as on May 31, 2013) of restructured standard accounts will be implemented in a more gradual way *i.e.* 3.50 per cent - with effect from March 31, 2014 (spread over the four quarters of 2013-14); 4.25 per cent - with effect from March 31, 2015 (spread over the four quarters of 2014-15); and 5.00 per cent - with effect from March 31, 2016 (spread over the four quarters of 2015-16).

3.41 Banks were advised that promoters' sacrifice and additional funds brought by them should be a minimum of 20 per cent of the banks' sacrifice or 2 per cent of the restructured debt, whichever is higher. Further, conversion of debt into preference shares should be done only as a

last resort and such conversion of debt into equity/ preference shares should be restricted to a cap, say 10 per cent of the restructured debt.

Procedure for migration to Advanced Measurement Approach (AMA) under Basel II Framework

3.42 With a view to enabling the upgradation of risk management framework as also capital efficiency likely to accrue to the banks by adopting the advanced approaches envisaged under the Basel II Framework and the emerging international trend in this regard, guidelines on Advanced Measurement Approach (AMA) were issued on April 27, 2011. Applications for migration to advanced measurement approach were opened for banks with effect from April 1, 2012 (Box III.1).

Box III.1:

Issues and Challenges in Implementing the Advanced Measurement Approach for Operational Risk Capital Computation

The advanced measurement approach (AMA) is the most risk sensitive and sophisticated approach among the three approaches, including the basic indicator approach (BIA) and the standardised approach (TSA), prescribed under the Basel II Framework for computing capital charge for operational risk (OR). This approach allows a bank to calculate its regulatory capital charge using internal models, based on internal risk variables and profiles, and not on exposure proxies such as gross income. AMA primarily depends on four elements: Internal Loss Data, External Loss Data, Scenario Analysis and Business Environment and Internal Control Factors (BEICF) for frequency and severity modelling for operational risk capital estimation as also the overall operational risk management (ORM).

Though AMA brings with it many requirements, it does not require banks to use a specific modelling methodology. Nevertheless, most banks today have converged on the Loss Distribution Approach (LDA). In LDA, the severity and frequency of operational risk losses are analysed and modelled separately. Once severity and frequency have been calculated, the aggregate loss distribution is typically generated using Monte Carlo simulation techniques (Corrigan, *et al.* 2013).

Key challenges faced by Indian banks aspiring to migrate to AMA

The major challenges faced by banks in implementing the AMA approach can be divided into three categories, *viz.*, internal governance issues, data issues and modelling/ quantification issues:

Internal governance issues

Basel II enjoins upon the Board and the senior management of a bank the core responsibility of active involvement in oversight of the operational risk management framework. While lack of resources may hinder the independence of ORM systems, demonstrating compliance with the qualitative aspects is a major challenge for banks. There are also uncertainties about determining which BEICFs to consider and how to build them into the operational risk capital computation model/s.

Data issues:

1. **Internal Loss Data**

   The major challenge that banks face in developing comprehensive models for operational risk is the scarcity of available internal operational loss data. Even the largest banks in India have no more than five to six years of data which mainly fall in the category of internal and external fraud event types. These challenges are further accentuated on account of certain endogenous and exogenous variations in the size, product complexity, business models, data thresholds and geographic location.

2. **External Loss Data**

   Paucity of internal loss data necessitates complementary use of scenario analysis and external loss data in AMA modelling. Absence of pooled industry data, reporting and other biases in data collected from public domain necessitate careful scaling, filtering and processing of this data. The judgmental element in data scaling may add to uncertainty and erroneous results in frequency and severity estimation using external data.

3. **Scenarios**

   While scenarios based on expert opinion may be used to complement the Value at Risk (VaR) based loss distribution approach (LDA), arriving at the likelihood of scenarios and maximum expected frequency has a degree of subjectivity and is a challenge.

(Contd...)

(...Concld.)

Modelling/quantification issues:

i. *High measurement standard*

The measurement standard of 99.9th percentile set under the advanced measurement approach is extremely high and implies that banks estimate the magnitude of an annual loss that would occur on average every 1000 years, which may require 100 to 200 fold extrapolation beyond observed data.

ii. *Nature of operational loss distributions*

Operational losses are commonly characterised as having a "heavy-tailed" distribution. Choice of different statistical distributions or modelling methodologies can markedly affect capital and hence there exists considerable potential for model error.

iii. *Dominance of high-severity and low-frequency losses*

Losses observed in various units of measure can be highly variable in terms of their frequency and severity with predominance towards high frequency low severity loss events.

iv. *Sensitivity to loss categorisation (granularity of operational risk categories)*

There is typically an uneven distribution of losses across the business line/event type matrix and sufficient internal loss data is available in very few operational risk categories.

v. *Integration of AMA elements*

The methodology to combine the four elements, *viz.*, internal data, relevant external operational risk data, scenario analysis and BEICFs for computation of operational risk VaR is a challenging task. Directly combining different sources of data into the econometric and statistical estimation of severity causes significant quantitative complexity.

The importance and value of advanced risk management practices and measurement cannot be overestimated. They play a critical role in protecting banks' value and the interests of stakeholders. However, implementing AMA for computing operational risk is a huge task and entails a well-planned and co-ordinated effort from all stakeholders. It will require an implementation methodology which is coherent and well-integrated.

References:

Bank for International Settlements (2011), "Operational Risk - Supervisory Guidelines for the Advanced Measurement Approaches", June, Bank for International Settlements (BIS).

Corrigan Josh, Neil Cantle and Fred Vosvenieks (2013), "Implementing and Integrating Next Generation Analytical Techniques in the Financial Industry", available at http://riskandsolvency.co.uk.

6. Supervisory Policy

Major decisions of the Board for Financial Supervision (BFS) during the year 2012-13

3.43 The Board for Financial Supervision (BFS), which was constituted in November 1994, continued to be the principal force behind the Reserve Bank's supervisory and regulatory initiatives. In BFS meetings, it was decided to make the format of the inspection report more risk focussed and a Monitorable Action Plan (MAP) with a timeline for completion was issued to the banks. This resulted in focussed supervisory attention on key supervisory concerns. Based on BFS' directions/guidance, thematic reviews were conducted in certain areas such as the KYC/AML[3] environment in banks, banks' exposure to the real estate/housing sector and major frauds beyond a threshold limit. Under directions from BFS, guidelines on a revised compensation structure have been issued to private sector and foreign banks.

3.44 With regards to supervision over urban co-operative banks (UCBs), BFS approved the Revised Graded Supervisory Action, financial restructuring of UCBs under directions and made the rating model for UCBs less complex. The BFS reviewed the regulations regarding rural credit institutions and approved a proposal to issue directions to unlicenced district central co-operative banks (DCCBs).

[3] Anti Money Laundering.

Internal audit control framework in banks rationalised

3.45 In order to have a strong internal audit control framework, banks were advised on June 26, 2012 to put in place similar policy guidelines and procedures as applicable in the case of compliance officers of banks for appointment/ changes of the head, internal audit.

KYC/AML guidelines in opening/monitoring of transactions in accounts

3.46 Banks were advised on September 13, 2012 to ensure strict adherence to the KYC/AML guidelines issued from time to time in opening, risk categorisation and monitoring of transactions in customer accounts. Banks were further advised that they will be held responsible for losses incurred by customers by way of deposits/ remittances from such accounts if they are found to be in violation of extant regulations/statutory requirements, besides inviting supervisory action.

Monitoring of non-performing assets (NPAs) and restructuring of advances

3.47 The Reserve Bank advised the PSBs on November 30, 2012 that they should take adequate steps to strengthen their risk management systems, credit appraisal and sanction process, post-sanction monitoring and follow-up and have a robust MIS mechanism for early detection of incipient weaknesses/distress and for taking steps for remedial measures and recovery of bank's dues. They were also advised that the restructuring of advances should be undertaken in a transparent and objective manner and in conformity with regulatory guidelines. The progress in reduction in NPAs and restructured accounts should be regularly reviewed.

Risk-based supervision (RBS) of banks

3.48 In the light of the recommendations of the High Level Steering Committee (HLSC) (Chairman: Dr. K. C. Chakrabarty) to review the supervisory processes for commercial banks, on September 28, 2012 banks were informed of the imminent transition to a risk-based approach to supervision from the supervisory cycle beginning April 2013 in two phases. They were also asked to put in place an institutional mechanism to monitor the progress made and ensure compliance to the best practices on risk management systems.

Fraud monitoring processes rationalised in order to provide greater operational autonomy to banks

3.49 In order to rationalise processes and procedures in the Reserve Bank and to provide increased operational autonomy to the top management of banks, the existing guidelines which require furnishing of a report on cases of attempted fraud involving an amount of ₹10 million and above to the Reserve Bank was dispensed with from November 15, 2012. However, the banks were advised to continue to place individual cases involving ₹10 million and above before the Audit Committee of their Boards.

Media allegations against banks and regulatory response

3.50 In March, 2013, an online media portal raised certain allegations against three private sector banks that these banks were indulging in practices that encouraged money laundering, sale of gold and other third party products such as insurance and wealth management.

3.51 The allegations by media against banks accelerated the process of undertaking scrutiny in 39 banks by the Reserve Bank during March-May, 2013. Based on the findings of the scrutinies, 36 banks were issued show cause notices for violation of certain regulations and instructions issued by the Reserve Bank. After considering the facts of each case and the individual bank's reply, the Reserve Bank came to the conclusion that some of the concerns were substantiated and warranted imposition of monetary penalty. Monetary penalty was imposed on 31 banks.

3.52 The thematic reviews of KYC/AML systems and compliance in banks revealed the need for better regulatory compliance by banks. Certain corrective measures were envisioned and subsequently various guidelines were issued to banks: (i) draft guidelines on wealth management services offered by banks; (ii) detailed guidelines on marketing and distribution of third party financial products; and (iii) detailed guidelines on KYC norms/AML standards/Combating of Financing of Terrorism (CFT).

3.53 Based on the thematic reviews and the follow-up action taken, the Reserve Bank has provided a list of actionable issues to banks. It has been felt that inspections and scrutinies have to be more targeted and the focus should be on 'the results' rather than 'the mere processes'. Therefore, with a view to improving the focus and quality of inspections and scrutinies of the Reserve Bank, a Guidance Note for inspecting officers, on the areas that may be concentrated upon while assessing the adherence to KYC/AML guidelines by banks was issued.

Title documents with respect to large value loan accounts to be subjected to legal audit

3.54 The Reserve Bank advised banks on June 7, 2013 to subject title deeds and other documents with respect to all credit exposures of ₹50 million and above to periodic legal audit and re-verification of title deeds with relevant authorities as part of a regular audit exercise till the loan stands fully repaid. Banks were also advised to furnish a review note to their Boards/audit committees of the Board at quarterly intervals on aspects such as number of loan accounts due for legal audit for the quarter, total accounts covered, list of deficiencies observed by the auditors, number of accounts in which the rectification could not take place and course of action to safeguard the interests of the bank in such cases.

Quantitative Impact Study (QIS) exercise initiated

3.55 Basel Committee on Banking Supervision (BCBS) initiated a Quantitative Impact Study (QIS) to assess the potential impact of a consultative document published in March 2013, "Supervisory Framework for Measuring and Controlling Large Exposures". The Reserve Bank, being a member of the Large Exposure Group, has initiated QIS in its jurisdiction by seeking details from six large banks (three from the public sector and three from the private sector). The results of data so collected have been submitted to BCBS for further analysis (Box III.2).

Box III.2:
Emerging Approaches to Large Exposures

One of the major lessons from the recent financial crisis is that banks did not always consistently measure, aggregate and control exposures to single counterparties across their books and operations. Historically also, there have been instances of banks failing due to concentrated exposures to individual counterparties. The need for banks to measure and limit the size of large exposures in relation to their capital has long been recognised by the Basel Committee on Banking Supervision (BCBS). BCBS issued its first guidance on credit exposures in 1991 as part of the wider goal of setting a minimum standard for sound prudential regulation and supervision of banking systems. This was followed by the 1999 BCBS document titled "Core Principles for Effective Supervision" which required that local laws and bank regulation must set prudent limits on large exposures to single or closely related group borrowers. The revised versions of the Core Principles published in 2006 and 2012 also included a reference to large exposure limits with a similar requirement. As per a 1991 BCBS document on large exposures, 25 per cent of total capital is the desirable target for an upper limit for single exposures.

(Contd...)

(...Concld.)

However, neither the 1991 guidance nor the Core Principles set out how banks should measure and aggregate their exposures to a single counterparty and a group of connected counterparties, which has resulted in considerable variation of practices across countries as well as banks. In view of the lessons learnt from the global financial crisis and with the objective of aligning the Large Exposures (LE) regimes across global jurisdictions, BCBS set up the Large Exposure Group (LEG) in March 2011 to review and refine the extant exposure norms. Based on LEG's recommendations, BCBS published the Consultative Document on "Supervisory Framework for Measuring and Controlling Large Exposures" in March 2013 soliciting comments on the proposed standards. The proposals, once finalised, would be implemented fully by January 1, 2019 which will be compatible with the Basel III Framework and global systemically important bank (G-SIB) transition period.

Major proposals included in the Consultative Document for the revised LE regime are:

- The revised LE framework is proposed to complement the Committee's existing work on risk-based capital standards and to serve as a simple backstop to the risk based capital framework. Credit quality and the amount expected to be recovered in the bankruptcy process are proposed to be kept out of the considerations in the large exposures standard and, hence, not reflected in measures of exposure values.
- The proposed standards focus on the concentration risk associated with the default of single private sector counterparties as well as a group of connected counterparties. Relationships of control and economic interdependence between counterparties, alone and/ or together, would provide grounds for establishing connections among counterparties, so that they form a group of connected counterparties.
- The scope of the LE regime would include exposures to funds, securitisation structures and collective investment undertakings in order to address concerns related to the shadow banking system. It also aims to limit contagion between systemically important financial institutions (SIFIs).
- While BCBS has recognised other types of concentration risks that could undermine a bank's resilience, such as, sectoral and geographical concentrations of asset exposure, exposures to sovereigns and intra-group exposures, the Committee will consider concentration risk arising from these types of exposures in its future work.
- The proposed LE framework would apply to all internationally active banks. Member countries have the option to set more stringent standards and option to extend the application to wider range of banks.
- Model risk should not have any bearing on exposure values in a large exposures framework.
- The threshold defining large exposure should be set at 5 per cent of a bank's eligible capital base.
- Banks should report to their supervisor all their large exposures or, if the number of large exposures is less than 20, their largest 20 exposures irrespective of their size relative to the bank's capital base.
- The large exposure limit may be fixed at 25 per cent of the Common Equity Tier 1 (CET1) or Tier 1 capital (as against the currently used total capital). The capital base on which the large exposure limit is calculated would thus consist only of capital that can absorb unexpected losses on a going-concern basis. Also, the tighter definition of capital employed would represent a tightening of the recommended large exposure limit.

The Reserve Bank's guidelines on containing concentration risk have evolved over a period of time and are guided by the BCBS guidance of 1991. These guidelines place a ceiling on a bank's exposure to a single or group borrower in terms of the bank's capital funds. It prescribes that credit exposure to a single borrower and borrowers belonging to a group should not exceed 15 per cent and 40 per cent of the bank's capital funds, respectively. The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) should not exceed 40 per cent of its net worth, as on March 31 of the previous year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds / debentures, units of equity-oriented mutual funds and venture capital funds should not exceed 20 per cent of its net worth. Further, banks may consider fixing internal limits for aggregate commitments to specific geographical areas and specific sectors so that the exposures are evenly spread across various sectors. These limits could be fixed by the banks having regard to the performance of different sectors and the risks perceived.

Reference:

Bank for International Settlements (2013), "Supervisory Framework for Measuring and Controlling Large Exposures - Consultative Document", March, Basel Committee on Banking Supervision.

Norms for empanelment of statutory central auditors of PSBs revised

3.56 With the implementation of core banking solution (CBS) in public sector banks (PSBs) with concomitant centralisation of information/ documents, streamlining of MIS and increased operational efficiency, it was considered necessary to revise the professional and other norms for selecting statutory auditors and for rationalising the existing system of extensive branch audit of PSBs. As per revised norms, besides prescribed experience, at least two partners of the firm or its paid Chartered Accountants must possess DISA/ CISA/ISA or any other equivalent qualification.

Financial Stability Board's peer review on resolution regimes

3.57 The Financial Stability Board (FSB) undertook a peer review on resolution regimes with the objective of evaluating the FSB jurisdictions' existing resolution regimes and any planned changes to those regimes using key attributes (KAs) as a benchmark. Among others, the resolution regime in India, which is a member of FSB, was also evaluated and a number of areas for reforms were identified. These include introduction of resolution regime for insurers and securities firms, extended powers to resolution regimes to address failures of banks and Systemically Important Financial Institutions (SIFIs) and extended tools and powers for supervisors to develop their own recovery and resolution plans for each SIFI.

Major developments relating to DICGC

3.58 During 2012-13, the Deposit Insurance and Credit Guarantee Corporation (DICGC) settled aggregate claims for ₹1,998 million with respect to 63 co-operative banks (15 main claims and 154 supplementary claims) as compared with claims for ₹2,873 million during the previous year. The size of the Deposit Insurance Fund (DIF) stood at ₹361 billion as on March 31, 2013, yielding a Reserve Ratio (DIF/Insured Deposits) of 1.7 per cent.

7. Regional Rural Banks

Interest subvention scheme for farmers extended to 2013-14 in order to ensure short-term production credit at affordable rates

3.59 The Government extended the interest subvention scheme to 2013-14 for providing short-term production credit at a concessional rate of 7 per cent to ensure availability of loans at affordable rates to farmers. The current subvention of 2 per cent coupled with the additional subvention of 3 per cent for prompt/timely repayment reduces the effective interest rate charged from farmers to 4 per cent per annum for production loans up to ₹0.3 million. The scheme has also been made applicable to private sector banks from the year 2013-14.

Branch expansion of RRBs in order to promote financial inclusion in rural areas

3.60 During 2012-13, 947 branches were opened by RRBs taking the cumulative number of branches to 17,856 spread across 635 districts in 26 states and one UT. It is now compulsory for all the new branches to be equipped with CBS. Sponsor banks are required to extend all necessary help in this regard, including financial assistance, training and back office support. As on March 31, 2013, CBS was fully implemented in all the 64 RRBs.

Recent regulatory initiatives for RRBs

3.61 During 2012-13, several policy initiatives were undertaken with regard to regulation of RRBs. In order to enhance the penetration of banking services in Tier 2 centres (with population 50,000 to 99,999) it was decided to allow RRBs to open branches in Tier 2 centres on par with the policy for Tier 3 to 6 centres. Further, RRBs were advised to allocate at least 25 per cent of the total

number of branches proposed to be opened during a year in unbanked rural centres (Tier 5 and Tier 6). It was also decided to delegate powers to the Regional Offices of the Reserve Bank to take decisions on RRBs' applications for opening, shifting, merger or conversion of branches, without reference to the concerned Empowered Committees, to expedite the process of disposal of applications.

3.62 In order to make basic banking facilities available in a more uniform manner across the banking system, RRBs were advised to offer a "Basic Savings Bank Deposit Account" which will offer certain minimum common facilities to all their customers. RRBs were advised to put in place a Board approved transparent policy on pricing of liabilities and ensure that the variation in interest rates on single term deposits of ₹1.5 million and above and other term deposits (*i.e.*, deposits less that ₹1.5 million) is minimal for corresponding maturities.

3.63 RRBs were also advised to review their existing IT and MIS framework and put in place a robust MIS mechanism for early detection of signs of distress at individual account level as well as at segment level and have system generated segment wise information on non-performing assets and restructured assets.

8. Non-Banking Financial Companies (NBFCs)

New category of NBFC created

3.64 During 2012-13, a new category of NBFC, *viz.*, Non-Banking Financial Company - Factors was created and a regulatory framework in the form of entry point capital and prudential regulations was placed on them.

Revised norms on lending against gold by NBFCs

3.65 NBFCs lending against collateral of gold jewellery were advised to maintain a loan-to-value (LTV) ratio not exceeding 60 per cent and to disclose in their balance sheets the percentage of such loans to their total assets. If the loans extended by a NBFC comprise 50 per cent or more of its financial assets, it shall maintain a minimum Tier-l capital of 12 per cent by April 01, 2014. All NBFCs were advised that no advances should be granted by them for purchase of gold in any form, including primary gold, gold bullion, gold jewellery, gold coins, units of gold Exchange Traded Funds (ETF) and units of gold Mutual Funds.

3.66 The recommendations of the Working Group to Study the Issues Related to Gold Imports and Gold Loans NBFCs in India (Chairman: Shri K.U.B. Rao) set up by the Reserve Bank and relating to NBFCs lending against the collateral of gold jewellery, were broadly accepted by the Reserve Bank and guidelines were issued covering *inter alia* aspects such as appropriate infrastructure for storage of gold ornaments, prior approval of the Reserve Bank for opening branches in excess of 1000 in number, standardisation of value of gold in arriving at LTV Ratio, verification of the ownership of gold jewellery and process and procedures for auction of gold jewellery

Revisions to Guidelines on Fair Practices Code for NBFCs

3.67 The Fair Practices Code has been revised to include sector specific features to enhance transparency and fair practices relating to micro lending and lending against collateral of gold in the light of operational issues surrounding these activities.

Margin caps for Non Banking Financial Company-Micro Finance Institutions (NBFC-MFI) revised

3.68 Given the problems being faced by NBFCs-MFI, the margin cap for lending by NBFCs-MFI irrespective of their size stands at 12 per cent till March 31, 2014. With effect from April 1, 2014,

margin cap as defined by the Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in MFI Sector (Chairman: Shri Y.H. Malegam) shall not exceed 10 per cent for large MFIs (loans portfolios exceeding ₹1 billion) and 12 per cent for others.

Guidelines issued for Core Investment Companies venturing into insurance business

3.69 In view of their unique business model a separate set of guidelines were issued for core investment companies (CICs), registered with the Reserve Bank, for their entry into insurance business. While the eligibility criteria, in general, are similar to that for other NBFCs, no ceiling has been stipulated for CICs in their investment in an insurance joint venture. Further, it was clarified that CICs cannot undertake insurance agency business. The guidelines include, *inter alia*, conditions such as owned funds not being less than ₹ 5 billion and the level of NPAs not being more than 1 per cent of the total advances. The CIC should have registered net profit continuously for three consecutive years. The track record of the performance of the subsidiaries, if any, of the concerned CIC should be satisfactory.

Directions issued to CICs regarding overseas investment

3.70 A separate set of regulations have been placed on overseas investments by CICs. All CICs require prior approval and registration with the Reserve Bank for investing in joint ventures/ subsidiaries/representative offices overseas in the financial sector. The total overseas investment should not exceed 400 per cent of the owned funds of the CIC out of which, overseas investment in financial sector should not exceed 200 per cent.

Guidelines issued with respect to private placement by NBFCs

3.71 Guidelines were issued with regard to private placement of non-convertible debentures by NBFCs after certain adverse features came to the notice of the Reserve Bank. The guidelines aim to bring NBFCs at par with other financial entities as far as private placement is concerned by restricting the maximum number of subscribers. NBFCs were also required to put in place a Board approved policy by September 30, 2013 for resource planning which, *inter alia*, would cover the planning horizon and the periodicity of private placement. The minimum subscription amount for a single investor has been capped at ₹2.5 million and in multiples of ₹1 million thereafter.

9. Financial Institutions

Borrowing limits for all-India term lending and refinancing institutions raised

3.72 As at end-March 2013, there were four financial institutions (FIs) under the full-fledged regulation and supervision of the Reserve Bank: Export-Import Bank of India (Exim Bank), National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI). The Industrial Investment Bank of India (IIBI), the fifth FI is under the process of voluntary winding up. During 2012-13, in view of the difficulties expressed by the concerned FIs, the aggregate borrowing limit of EXIM Bank was enhanced to 12 times of Net Owned Funds (NOF) for a period of one year, *i.e.*, upto August 31, 2013 thereafter it will revert to 10 times of NOF. For NHB, the “umbrella limit” under resource raising norms was raised from 100 per cent to 150 per cent of its NOF for a period

of one year, *i.e.*, upto January 31, 2014 after which it will revert to 100 per cent of NOF. For NABARD, the aggregate borrowing limit was enhanced to 11 times of NOF for a period of one year, *i.e.*, up to May 31, 2013, after which it will revert to 10 times of NOF.

10. Customer Service in Banks

Working group for revision and updation of the Banking Ombudsman Scheme, 2006

3.73 An internal Working Group for revision and updation of the Banking Ombudsman Scheme (BOS), 2006 was constituted by the Reserve Bank in July 2012. Some of the important recommendations of the Working Group pertain to extending BOS to non-scheduled urban co-operative banks, modifying the definition of 'bank' in BOS, pecuniary jurisdiction of BO, opening of new offices of BOs, new grounds for complaint, appointment of an additional ombudsman in offices with heavy volume of complaints and public awareness about BOS. The recommendations of the Working Group are being examined by the Reserve Bank for implementation.

Status of implementation of the recommendations of the Damodaran Committee on customer service

3.74 The Committee on Customer Service in Banks (Chairman: Shri M. Damodaran) had made 232 recommendations in its report. Of these, 155 recommendations stand implemented. Some of the important recommendations which are yet to be implemented are: minimum account balance- transparency, uniformity in charges for non-maintenance, charges for basic services, compensation for wrong returns of cheques by banks, internet banking - secure total protection policy, home-loans - non-discrimination between existing and new borrowers with floating interest rate and onus on banks to prove customer negligence. The Reserve Bank is in consultation with the Indian Banks' Association (IBA) for early implementation of these recommendations.

3.75 In order to further improve customer service in Indian banks and financial institutions, the Treating Customers Fairly (TCF) model can be attempted (Box III.3).

Box III.3:
Treating Customers Fairly: Obligation of Banks towards Customers

Treating Customers Fairly (TCF) is a consumer protection policy designed to address the problem of asymmetric information in the financial services industry where financial service providers possess certain information that the consumers do not. It is a regulatory initiative by which firms are required to consider their treatment of customers at all the stages of the product life-cycle, including the design, marketing, advice, point-of-sale and after-sale stages. By encouraging firms to re-evaluate their company culture and to inculcate the attitude of treating customers fairly, the outcome is likely to result in a more optimal one from the perspective of regulators, consumers and ultimately, firms. TCF is an initiative that was introduced by the Financial Services Authority (FSA), UK in 2006. In recent years South Africa also adopted TCF based on the UK version. South Africa's projected timeline for full implementation of the TCF policy is 2014.

As per FSA, 2006 desired outcomes of the TCF programmes are: (i) Consumers can be confident that they are dealing with firms where fair treatment of customers is central to their corporate culture; (ii) Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly; (iii) Consumers are provided clear information and are kept appropriately informed before, during and after the point of sale; (iv) Where consumers receive advice, the advice is suitable and takes account of their needs and circumstances; (v) Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect; and (vi) Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch providers, submit a claim or make a complaint. These outcomes of

(Contd...)

(...Concld.)

TCF are now well accepted across countries. In order to achieve these outcomes, cultural and operational aspects of the bank may need to change. Also, the firm needs to consider what the TCF programme means for each phase of the product life cycle.

In terms of implementing the TCF programme, the UK experience suggests that however well-worded the principles and rules may be, there are additional factors affecting successful implementation. This includes a change of mindset in the firm's leadership. Successful adopters of the TCF programme have been those where the CEO or managing director of the firm had typically endorsed the programme, spelt it out for middle management and employees and received regular data on consumer complaints and redress. Moreover, TCF measures were used to influence performance appraisal and incentive structures in a firm. The least successful firms were those that left it all to their compliance department (or an outside consultancy) to design a programme but whose feedback was neither presented nor understood at the Board level.

The Reserve Bank has also taken a lead in ensuring that bank's customers in India are treated fairly. Over the years, it has initiated several customer-centric measures and inculcated a culture of treating customers fairly through regulatory and supervisory interventions. The Reserve Bank initiative led to the setting up of the Banking Codes and Standards Board of India (BCSBI), an autonomous and independent body, which has been entrusted with the task of setting codes and standards for banking services in India. The Codes of Commitment are binding on BCSBI members and non-compliance thereof by member banks is a valid ground of complaint under the Banking Ombudsman Scheme (BOS). In a bid to empower consumers and protect their rights, the Reserve Bank has also instituted the Banking Ombudsman Scheme as an apex level, cost free grievance redressal mechanism for deficiencies in services by banks.

The intent and basic structure for TCF is in place in India for banking products of scheduled banks. However, it is now being considered to extend the TCF structure to third party products, *viz.*, mutual funds, capital market and insurance products sold by banks and also extending the BOS Scheme to non-scheduled banks.

References:

Feasibility (Pty) Ltd (2010), "Treating Customers Fairly"- A Discussion Paper prepared for the Financial Services Board.

Financial Services Authority (FSA) (2006), "Treating Customers Fairly– Towards Fair Outcomes for Consumers".

11. Payment and Settlement Systems

3.76 The Reserve Bank undertook policy initiatives as outlined in the Payment System Vision Document 2012-15. The focus of these was towards migrating payment transactions from cash/paper modes to electronic modes and also increasing the accessibility of payment systems to people who are presently excluded. The major policy initiatives taken during the year are outlined below.

Access to centralised payments systems widened

3.77 Access to centralised payments systems was further widened in April 2012 by enabling all licensed banks to access these systems through the sub-membership route as well. There were around 652 sub-members in the National Electronic Funds Transfer (NEFT) system and 509 in the Real Time Gross Settlement (RTGS) system as on June 30, 2013.

Various measures undertaken to make NEFT more efficient

3.78 In order to facilitate a more efficient handling of the increasing volumes in NEFT, two enhancements were brought about in the system. An additional batch at 8:00 am was introduced taking the total number of batches to 12 on weekdays and 6 on Saturdays. Further, the feature of continuous release of credit messages was introduced with the objective of providing an increased time-window to destination banks to process inward transactions. In order to encourage the migration of small value transactions from cash or cheque mode to NEFT, customer charges for transactions upto ₹10,000 were reduced to ₹2.50 from ₹5.00. Additionally, in order to bridge the large gap between the branches covered under NEFT and the National Electronic Clearing Service (NECS), banks were advised to take necessary steps to ensure that all NEFT-enabled branches

also offer the Electronic Clearing Service (ECS). As a result, the number of bank branches in NECS now stands increased to 75,641 from 59,000.

Merchant Discount Rates (MDR) for debit card transactions rationalised to encourage its usage even for small value transactions

3.79 In order to encourage all categories and types of merchants to deploy card acceptance infrastructure and for facilitating acceptance of cards for even small value transactions, the MDR[4] structure for debit card transactions was rationalised capping the maximum rate that can be charged by banks to (i) not exceeding 0.75 per cent of the transaction amount for value upto ₹2000; (ii) not exceeding 1 per cent for transaction amount for value above ₹2000. This is expected to enhance acceptance of debit cards over Point of Sale (PoS) and encourage small merchants to deploy PoS terminals.

Oversight of payment systems made more robust

3.80 An oversight framework commensurate with international standards prescribed by the Committee on Payment and Settlement Systems (CPSS) has been put in place to monitor the activities of the 44 authorised entities (both bank and non-bank) operating payment systems in the country. Also, the Clearing Corporation of India Limited (CCIL) was assessed against the new PFMI[5] principles.

Technical Committee recommends continuation of IFSC and implementation of International Bank Account Number (IBAN)

3.81 Various payment systems operating in India use different codes (IFSC, MICR, BIC) for identifying banks/branches for settlement and for transaction routing. With all the major banks adopting CBS, there was a demand from these banks for doing away with branch identifiers in IFSC[6] for routing RTGS and NEFT transactions. Further, there were demands for introducing uniform account numbers across banks which will help in avoiding wrong credits under payment systems. Technical Committee to Examine Uniform Routing Code and Account Number Structure (Chairman: Shri Vijay Chugh) was constituted by the Reserve Bank to study these issues. The major recommendations of the Committee are: (i) continuing the branch identifier in IFSC in view of validation checks built around this by a large number of banks to prevent credits going to wrong accounts; (ii) use of IFSC for routing purposes in all payment systems including new payment systems (iii) implementing IBAN in banks to bring in uniformity and enhance the efficiency in systems that use account numbers as a critical input for successful processing of payment transactions as it would help in validating the account number at the originating stage; (iv) use of a 26-character long IBAN with alpha bank-id as it will require minimum changes across banks. However, the Committee noted that IBAN will not bring in portability of accounts across banks. The Report of the Committee is under examination.

Introduction of giro based payments system envisaged for convenient bill payments

3.82 Although a wide range of payment instruments and payment channels are currently available in the country, there is no dedicated system for facilitating bill payments. To overcome this problem and for providing common infrastructure for all bill payment needs of the public, Committee to Study the Feasibility of

4 Charges paid by merchants for card payments.

5 Principles for Financial Market Infrastructure.

6 Indian Financial System Code.

Implementation of Giro based Payment System in India (Chairman: Shri G Padmanabhan) was constituted. The Committee noted deficiencies existing in bill payments system like lack of interoperability, high cost of cash collection for billers and poor accessibility outside big cities. The Committee also noted lack of coordinated initiative by billers to put in place a common and interoperable country-wide bill payment system.

3.83 The Committee recommended that a giro based payment system christened the "India Bill Payment System" (IBPS) may be designed and implemented in the country which will provide bill payment services to all stakeholders at one single place. It will provide multiple touch points through multiple channels to bill payers providing the comfort of accessing and paying bills at their convenience. The Committee also recommended that a separate organisation needs to be set up to operate and manage the IBPS in a professional manner and run on commercial lines which may be authorised by the Reserve Bank under the Payment and Settlement Systems Act, 2007. The Report has been examined and the proposal to set up the Giro Advisory Group has been approved by the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS).

Security of electronic payments strengthened

3.84 To strengthen electronic modes of payments and further mitigate the risks faced by customers/ banks, guidelines have been issued to banks and other stakeholders to put certain security measures in place in a time bound manner. These measures include: (i) issuing only domestic cards unless a customer asks for an international card; (ii) issuing EMV cards to people who use the cards internationally; (iii) setting a threshold amount on a magnetic stripe card for international transactions; (iv) securing PoS terminals to prevent data compromise; (v) putting in place techniques to prevent frauds; (vi) placing controls on the number of beneficiaries that can be added to internet banking account and number of online transfers; (vii) introducing additional factor of authentication for online payments; and (viii) considering implementing digital signatures for large value payments for all customers.

Next Generation RTGS (NG-RTGS) System replaces the existing RTGS

3.85 In view of the increasing volumes and changing business requirements, the Reserve Bank is replacing the existing RTGS with a new system which provides for improved functions and features. Some of the new features implemented in the new system are advanced liquidity management facility; Extensible Markup Language (XML) based messaging system conforming to ISO 20022; real time information and transaction monitoring and control systems; and gridlock avoidance mechanism and advanced queue management techniques. In NG-RTGS, the ISO 20022 message formats are being used for transmitting RTGS messages, this is first instance across the globe, of usage of this message formats for high value payment systems.

12. Banking Sector Legislation

Banking Laws (Amendment) Act, 2012

3.86 The Banking Laws (Amendment) Act, 2012 came into force from January 18, 2013. The Act gives the Reserve Bank powers to supersede the board of directors of a banking company subject to a total period of 12 months and appoint an administrator till alternate arrangements are made. It also confers power on the Reserve Bank to raise the ceiling on voting rights from 10 to 26 per cent in a phased manner. In order to ensure that control of banking companies is in the hands of "fit and proper persons", prior approval of the Reserve Bank is required in case of acquisition of 5 per cent or more shares or voting rights in a banking company.

3.87 The Reserve Bank has been given the power to collect information and inspect associate enterprises of banking companies. The definition of "approved securities" is modified to restrict them to Central or State Government securities and such other securities as may be specified by the Reserve Bank. Banking companies can issue preference shares subject to regulatory guidelines issued by the Reserve Bank. Nationalised banks can raise capital through "bonus" and "right" issues and can increase or decrease the authorised capital with approval from the Central Government and the Reserve Bank without being limited by the ceiling of ₹30 billion. Penalties for violations have been substantially increased.

The Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Act, 2012

3.88 The Amendment Act (except Section 8 and Section 15 (b)) was brought into force with effect from January 15, 2013. The Act amends the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) and the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI Act). The definition of "bank" both in the SARFAESI Act and in the RDDBFI Act is amended to include 'multi state co-operative bank' so that the provisions of said Acts apply to multi-state co-operative banks and the measures for recovery through the Debt Recovery Tribunals (DRTs) would now be available to them. Securitisation and reconstruction companies can now convert any part of the debt into equity/shares of a borrower company. Secured creditors can acquire the immovable property in full or partial satisfaction of their claim against the defaulting borrower, in times when no buyer for the amount of reserve price is available.

The National Housing Bank (Amendment) Bill, 2012

3.89 This Bill was introduced in the Lok Sabha on April 30, 2012. It seeks to amend the National Housing Bank (NHB) Act, 1987. The Bill provides for transfer of shareholding of the Reserve Bank in NHB to the Central Government to avoid conflict of ownership and regulatory role. It confers power on the Central Government to increase the authorised capital of NHB. To ensure uniform control over non-banking financial companies including housing finance companies, powers related to registration and regulation over housing finance companies are proposed to be transferred to the Reserve Bank. NHB will concentrate on supervision and financing of such institutions.

The Micro Finance Institutions (Development and Regulation) Bill, 2012

3.90 This Bill was introduced in the Lok Sabha on May 22, 2012 with a view to provide a statutory framework for promotion, development, regulation and orderly growth of micro finance institutions (MFI) and thereby to facilitate financial inclusion. It provides for constitution of Micro Finance Development Council at the national level to advise the Central Government on formulation of policies related to growth and development of micro finance institutions. It has similar provisions at the state and district levels. It prohibits micro-finance institutions from carrying on the activities of micro-finance services without registration with the Reserve Bank but allows existing non-banking finance companies registered under the Reserve Bank of India Act, 1934 to continue such services without registration. It empowers the Reserve Bank to cancel the registration of a micro-finance company for failure to carry on the business of providing micro-finance services, contravention of the conditions of registration or directions

issued by the Reserve Bank. It also empowers the Reserve Bank to issue directions to micro-finance institutions in public interest and also to inspect the accounts of the micro-finance institutions and take necessary action.

The Regional Rural Banks (Amendment) Bill, 2013

3.91 This Bill seeks to amend the Regional Rural Banks Act, 1976 and was introduced in the Lok Sabha on April 22, 2013. It provides for managerial and financial assistance from sponsor banks to RRBs to be continued beyond the first five years of functioning of the RRBs. It provides for the authorised capital of each RRB to be enhanced from ₹50 million to ₹5 billion. It also provides for issued capital of each RRB to be not less than ₹10 million. It has a provision for RRBs to raise capital from sources other than the Central Government, the State Government and the sponsor bank subject to the condition that in no event the combined shareholding of the Central Government and the sponsor bank shall be less than 51 per cent. It also has a provision for shareholders to elect the directors.

The National Bank for Agriculture and Rural Development (Amendment) Bill, 2013

3.92 This amendment bill was introduced in the Lok Sabha on May 6, 2013. It makes a provision for transfer and vesting of the subscribed capital of the Reserve Bank in NABARD to the Central Government. It empowers the Central Government to increase the capital of NABARD from ₹50 billion to ₹200 billion. It also enhances the scope of operations of NABARD for lending purposes. It provides for establishing and maintaining of a fund to be known as the National Rural Credit (Short Term Operations) Fund by NABARD for providing financial assistance by way of loans and advances.

Prevention of Money Laundering (Amendment) Act, 2012

3.93 This amendment act came into effect from February 15, 2013. It introduces the concept of "corresponding law" to link the provisions of Indian law with laws of foreign countries and provides for transfer of proceeds of the foreign predicate offence in any manner in India. It enlarges the definition of offence of money laundering to also include activities of concealment, possession, acquisition or use and projecting or claiming the same as untainted property.

13. Overall Assessment

3.94 A number of key policy decisions were taken during 2012-13. The Reserve Bank pursued a well nuanced monetary policy maintaining a delicate balance between price stability and growth objectives not losing sight of incipient financial stability issues that have come to the fore recently. In this regard, the monetary policy tried to use the available space to front-load policy rate reductions and calibrate the easing cycle, being mindful of the macro-economic risks emanating from the twin deficits.

3.95 During the year, various measures were undertaken towards promoting financial inclusion, increasing the credit flow to the productive sectors of the economy and the development of the financial sector. Guidelines were issued to facilitate smooth implementation of the DBT scheme for routing MGNREGA wages, other social security benefits and various subsidies through bank branch/BCs. KYC and AML norms were simplified and rationalised to facilitate financial inclusion. In view of the vulnerabilities in the current account balance and to restrain demand for gold for speculative purposes some curbs were imposed on bank finance for purchase of gold/ bullion. To ward off risks to the health of the

banking sector arising out of unhedged foreign currency exposures of corporates some prudential measures were undertaken. To overcome the limitations of the current provisioning policy, a comprehensive provisioning framework for banks with dynamic and countercyclical elements is being contemplated. With a view to promoting financial inclusion and fostering greater competition, final guidelines for issue of licences for new banks in the private sector were released and applications were invited for new bank licences. Various new measures were initiated to improve customer services at banks based on the recommendations of the Damodaran Committee. Prudential guidelines on restructuring of advances by banks/financial institutions were revised following the recommendations of the Mahapatra Working Group. Various important measures were initiated in order to make the payment and settlements system more robust and customer friendly and for moving payment transactions from cash/paper modes to electronic modes. To make the regulatory powers of the Reserve Bank more effective and to increase the access of the nationalised banks to the capital market, the Banking Regulation Act, 1949 was amended. Anti-money laundering laws were further strengthened to bring them at par with international standards.

3.96 Going forward, continued attention on financial stability and financial inclusion combined with a vigil on systemic risks and risks arising out of global financial interconnectedness would ensure a healthy, resilient and inclusive banking and financial sector, which can contribute towards sustained and inclusive growth of the Indian economy.