Chapter III

Policy Environment

The prudential and supervisory policies of the Reserve Bank aimed at fostering improvements in the overall health of the banking system and promoting financial stability. The Reserve Bank continued with initiatives to improve financial intermediation in the economy. Various developmental and regulatory policy measures are being taken for further strengthening the banking structure and enhancing the efficacy of the payment and settlement systems. Various structural reforms were introduced during the year to improve the business environment and increase formalisation of the economy. These are expected to be growth augmenting over the medium to long-term.

I. Introduction

III.1 Amidst visitations of turbulence in global financial markets and an environment rife with geo-political tensions, the relative calm engendered macroeconomic stability in India in the year 2016-17 enabled financial sector policies to focus on repair, consolidation and intensification of the agenda of reforms. Even as aligning the regulatory framework with the work of the Basel Committee on Banking Supervision (BCBS) under the Basel III framework remained a priority, including through the G20 processes, the Reserve Bank fine-tuned its regulatory and supervisory policies to ensure a sound, resilient and inclusive banking system. Effective financial sector oversight on the basis of three pillars – regulation, surveillance and enforcement, improving cyber security with greater digitisation and provision of better customer services to the vulnerable sections of the population – were concomitantly pursued.

III.2 Against this backdrop, the chapter enumerates policy initiatives undertaken in the banking sector during 2016-17 and 2017-18 so far. Policy initiatives in the area of monetary policy, liquidity management, credit delivery and financial inclusion are outlined from section II to section IV. Section V and VI discuss prudential regulatory and supervisory policies. Section VII to IX cover policy measures for non-banking financial companies, customer services and payments and settlements. Section X provides details of banking sector legislations and the last section gives concluding observations.

II. Monetary Policy and Liquidity Management

III.3 Monetary policy in India underwent a regime change during 2016-17. The amendments to the Reserve Bank of India (RBI) Act, which came into force on June 27, 2016, provided it the legislative mandate to operate the monetary policy framework with its objective explicitly defined as 'to maintain price stability while keeping in mind the objective of growth.' On August 5, 2016, the Government notified the inflation target as 4 per cent year-on-year growth in CPI-combined inflation with upper and lower tolerance levels of 6 and 2 per cent, respectively. The amended RBI Act also provides for the formation of a six-member Monetary Policy Committee (MPC) entrusted with the decision on setting the policy rate. In turn, the Reserve Bank was enjoined to set out the operating framework in the public domain explaining implementation of the MPC's decision. The Reserve Bank's monetary policy statement laid out the operating framework of the monetary policy and the adjustments thereto have

been reported in subsequent policy statements/ monetary policy reports (MPRs). The operating framework aims at modulating liquidity conditions so as to ensure that the operating target – the weighted average call money rate (WACR) – evolves in close alignment with the policy rate.

III.4 Liquidity operations were recalibrated under a revised framework announced in April 2016 which, *inter alia*, included smoothening liquidity supply through timely use of open market purchase / sale auctions in conjunction with normal liquidity facilities and fine-tuning operations. The objective was to progressively balance liquidity in the system to a position closer to neutrality. As a result, the net position under the liquidity adjustment facility (LAF) switched from an average daily liquidity injection (or system level deficit) of ₹813 billion during Q1: 2016-17 to an average daily absorption (or system level surplus) of ₹63 billion in October 2016. In the process, scheduled redemptions of FCNR (B) deposits during September-November 2016 were managed without any perturbations in market liquidity.

III.5 Beginning November 9, 2016 the demonetisation of high value specified bank notes (SBNs) resulted in currency in circulation declining by 50 per cent by January 6, 2017.[1] As low-cost current account and savings account (CASA) deposits surged into the banking system, a wall of system level liquidity moved through domestic financial markets threatening financial stability. To manage surplus liquidity, the Reserve Bank used a mix of both conventional and unconventional instruments: (i) temporary application of an incremental cash reserve ratio (ICRR) of 100 per cent on an increase in banks' net demand and time liabilities (NDTL) between September 16 and November 11, 2016; (ii) open market sales under the market stabilisation scheme (MSS); and (iii) variable rate reverse repos of various tenors ranging from overnight to 91-day. The peak level of liquidity absorbed reached ₹7,956 billion on January 4, 2017.

III.6 The incremental cash reserve ratio (ICRR) absorbed surplus liquidity of ₹4,000 billion. With the Central Government enhancing the limit on issuance of securities under MSS from ₹300 billion to ₹6,000 billion on December 2, 2016 by the Central Government, the Reserve Bank withdrew the ICRR. Anticipating liquidity surplus declining due to remonetisation, the Reserve Bank increasingly resorted to reverse repo operations to absorb the surplus liquidity released through maturing MSS securities, especially from January 14, 2017 onwards. In Q4: 2016-17 (since January 7), remonetisation progressed at an accelerated pace, with currency in circulation increasing cumulatively by about ₹4,373 billion. This reduced the liquidity surplus in the system to ₹3,141 billion as on March 31, 2017.

III.7 Anticipating that the surplus liquidity conditions may persist throughout 2017-18, the Reserve Bank provided guidance on liquidity in April 2017, which contained the following elements: (i) use of Treasury Bills (T-bills) and dated securities under the MSS up to ₹1 trillion; (ii) issuances of cash management bills (CMBs) of appropriate tenors up to ₹1 trillion in accordance with the memorandum of understanding (MoU) with the Government of India; (iii) open market operations; and (iv) fine tuning reverse repo / repo operations to modulate day-to-day liquidity.

III.8 For 2017-18, the limit on issuances of securities under the MSS was reduced by the Government to ₹1 trillion from ₹6 trillion. As the Government front-loaded spending ahead of the

[1] The estimated value of SBNs received as on June 30, 2017 was ₹15.28 trillion out of the total value of ₹15.44 trillion of demonetised bank notes.

monsoon, CMBs of different tenors were issued to manage temporary mismatch in government cash balance position. The Reserve Bank withdrew liquidity to the tune of ₹1 trillion from the system through the issuance of T-bills of tenors ranging from 312 days to 329 days under the MSS. The remaining liquidity surplus was absorbed primarily through the variable rate reverse repo auctions. During 2017-18 (up to November 10), currency in circulation increased by ₹3.2 trillion. However, its impact on reducing the surplus liquidity in the system was more than offset by higher expenditure by the government and large redemption of government securities, beside RBI's foreign exchange market operations. The average daily absorption of liquidity increased to ₹4,562 billion (including LAF, MSS and CMBs) during Q1: 2017-18 from ₹3,141 billion as at end-March 2017, but declined to ₹4,290 billion during Q2: 2017-18. As surplus liquidity conditions persisted, open market sales of ₹900 billion were conducted during 2017-18, so far. The festival related currency demand and gradual build-up in Government cash balances reduced the net average absorption of liquidity to ₹2,280 billion during Q3: 2017-18 (up to November 14). Meanwhile, the LAF corridor was reduced to ensure a firm alignment of the weighted average call rate (WACR) with the policy rate. The WACR traded closer to the repo rate, but with a softening bias from the second week of May 2017, reflecting persistent surplus liquidity conditions.

III. Credit Delivery

III.9 During 2016-17, policy measures regarding credit delivery focused on ensuring smooth flow of credit to the productive and vulnerable sectors of the economy. They also aimed at addressing information asymmetry through greater transparency and availability of information.

Interest Subvention Scheme on Short-term Crop Loans

III.10 With a view to ensuring availability of agricultural credit (including loans taken against Kisan Credit Card (KCC)) at a reasonable cost / at a reduced rate of 7 per cent per annum to farmers, the Government of India, through its budget announcement for the year 2006-07, had introduced an interest subvention scheme (2 per cent) for short term crop loans up to ₹0.3 million. This scheme is being implemented through public sector banks and private sector banks (reimbursement through the Reserve Bank), regional rural banks and co-operatives (reimbursement through NABARD). Currently, besides 2 per cent interest subvention, 3 per cent incentive is given for prompt repayment of loan reducing the cost to 4 per cent. This scheme is continuing for the year 2017-18 with the aim of delinking farmers from non-institutional sources of credit.

III.11 Besides, while earlier this interest subvention was available for a maximum period of one year, in order to discourage distress sale of crops by farmers, the benefit of interest subvention has been made available to small and marginal farmers having KCC for a further period of up to six months (post-harvest) on the same rate as available to crop loans against negotiable warehouse receipts. 2 per cent interest subvention is also available for the first year on restructured loans to provide relief to farmers affected by natural calamities.

Kisan Credit Card (KCC) Scheme

III.12 Kisan Credit Card Scheme aimed at providing adequate and timely credit support from the banking system under a single window to the farmers for their cultivation and other needs had been in operation since August 1998. Based on the recommendations of Working Group (Chairman: Shri T.M.Bhasin), and as accepted by

the Government of India, the Reserve Bank has revised the guidelines for Kisan Credit Card dated May 11, 2012, and August 7, 2012 (the latest master circular guidelines being dated July 03, 2017). Tenant farmers, oral lessees and share croppers are also covered under the scheme. The scheme provides for sanction of the limit for 5 years with simplified renewal every year. All the banks have been advised to implement the scheme. The issue of smart-cum debit card, mandated under the revised guidelines, will enable the farmers to access multiple delivery channels

Credit Flow to the MSME Sector

III.13 In April 2016, the first Bi-Monthly Monetary Policy Statement for 2016-17 announced that the Reserve Bank will lay out a framework for accreditation of credit counsellors who could act as facilitators to improve the access of entrepreneurs to the formal financial system. Accordingly, on July 11, 2017, the Small Industries Development Bank of India (SIDBI) launched the Certified Credit Counsellors (CCCs) scheme for micro, small and medium enterprises (MSMEs). This scheme aims to mitigate information asymmetry and the perception of high credit risks associated with the MSME sector.

III.14 The National Mission for Capacity Building of Bankers for financing the MSME Sector (NAMCABS) is being strengthened with a view to scaling up capacity building of commercial bank officials engaged in MSME lending. An impact assessment survey conducted during August-September, 2016 to assess the impact of NAMCABS workshops revealed that branches manned by trained personnel generally outperformed other branches, especially in lending to micro enterprises. It was, therefore, decided to continue with an enhanced and comprehensive capacity building programme christened as NAMCABS Version 2. The programme has been made more comprehensive by incorporating latest developments in terms of policy initiatives undertaken by the Government and the Reserve Bank. Equipping the officials with technological skills for efficacious discharge of their duties is also part of the programme. As on September 30, 2017, 7,497 bank officials had undergone training under this initiative.

III.15 With effect from August 11, 2016, factoring transactions on 'with recourse' basis became eligible for priority sector classification by banks carrying out the business of factoring departmentally to increase liquidity support for the MSME sector. Factoring transactions taking place through the Trade Receivable Discounting System (TReDS) platform are also eligible for classification under the priority sector.

III.16 In August 2015, banks were advised to incorporate in their lending policy to Micro and Small Enterprises (MSEs) with their boards' approval a clause for fixing a separate additional limit specifically for meeting the unforeseen / seasonal increase in working capital requirements, at the time of sanctioning / renewing working capital limits. In view of possible cash flow mismatches faced by MSE borrowers due to the withdrawal of the legal tender status of SBNs of ₹500 and ₹1,000 denominations, banks were advised to use the facility of providing above-additional limit (approved by their boards) 'working capital' to their MSE borrowers. This was a one-time measure up to March 31, 2017 which was normalised from the fresh working capital assessment cycle.

Priority Sector Lending Certificates

III.17 An important development during 2016-17 was the operationalisation of the Priority Sector Lending Certificates (PSLCs) scheme in April 2016. This scheme is a mechanism to incentivise banks to lend to different categories of the priority sector and thereby boost overall priority sector lending. PSLCs allow the market mechanism to drive priority sector lending by leveraging the

comparative strength of different banks. This scheme allows a bank, to sell the over-achievement of its target in a particular sector through PSLCs to another bank, which can buy it to meet its target in that sector, while selling its own over-achievement of the target in another sector to another bank and so on. The Reserve Bank has provided a platform to enable trading in PSLCs through its core banking solution (CBS) portal (e-Kuber).

High-level Task Force on Public Credit Registry

III.18 A public credit registry brings about transparency in credit markets and helps both creditors and borrowers. As announced by the Reserve Bank in August 2017 under the Statement on Developmental and Regulatory Policies, a High-level Task Force on Public Credit Registry (PCR) for India (Chairman: Shri Yeshwant M. Deosthalee) has been constituted. It has representatives from various stakeholders, including the Reserve Bank, banks, non-banking financial companies (NBFCs), industry bodies, and experts in information technology. The Task Force will review the current availability of information on credit, the adequacy of existing information utilities, and identify gaps that could be filled by a PCR. It will study best international practices to determine the scope of the PCR and the type of information and credit markets that the PCR should cover. The Task Force will also propose a state-of-the-art information system, allowing for existing systems to be strengthened and integrated, and suggest a modular, prioritised roadmap for developing a transparent, comprehensive and near-real-time PCR for India. The Task Force will submit its report within six months from the date of its constitution, *i.e.*, by April 4, 2018.

IV. Financial Inclusion

III.19 The Reserve Bank of India in co-ordination with the Government of India and other stakeholders has come up with various policy interventions to enhance financial inclusion and increase financial literacy in the country from time to time. This policy received further fillip during 2010 with the adoption of financial inclusion plans, which are self-set targets in blocks of three years which are developed by the Boards of the banks to expand the outreach in terms of outlets and access to a bouquet of products which, *inter alia,* includes KCCs and General Credit Cards (GCCs). In August 2014, the Government of India launched an ambitious financial inclusion mission; the Pradhan Mantri Jan Dhan Yojana (PMJDY) to ensure access to basic financial services of banking / savings and deposit accounts, remittances, credit, insurance and pension in an affordable manner. Up to December 6, 2017, 307 million accounts have been opened with a balance of ₹698 billion.

III.20 Against this backdrop, several policy measures were initiated during the year to ensure last mile access to financially excluded sections. To strengthen the business correspondent (BC) model, the Reserve Bank developed a framework for the BC registry. This registry shall capture information on both existing and potential business correspondents and will help in the effective monitoring and oversight of BC operations. This should help to further strengthen the BC eco-system through appropriate policy initiatives.

III.21 BCs also play a crucial role in initiating first-time customers into the domain of mainstream banking. Proper guidance and handholding is key to their continuing and deepening relationship with banking. Accordingly, the Reserve Bank has developed a framework for BC certification with basic and advanced level courses to enhance their functional and behavioural competencies.

III.22 The Indian Banks' Association (IBA) is in the process of putting in place a BC Registry and is taking forward the process of BC certification.

V. Prudential Regulatory Policy

III.23 The regulatory policies of the Reserve Bank are aimed at orderly development and conduct of banking operations, fostering overall financial stability and protecting depositors' interests. Given the bank-dominated financial system in India, the Reserve Bank is also striving to develop a more competitive, efficient and heterogeneous banking structure that can meet varied customer needs in an efficient manner.

Revitalising Stressed Assets

III.24 Early recognition, and time-bound resolution or liquidation of stressed assets is critical for de-clogging bank balance sheets and for efficient reallocation of capital[2]. The Reserve Bank and the Government of India have been working together to comprehensively address the challenge through a multi-pronged approach. Specific measures are aimed at strengthening the legal, regulatory, supervisory and institutional framework with the ultimate objective of facilitating quick resolution of stressed assets in a time-bound manner.

III.25 Several measures have been put in place for resolution of stressed assets through optimal structuring of credit facilities, the ability to change ownership / management, and greater transparency in the sale of stressed assets. The system of Prompt Corrective Action (PCA) under which specific regulatory actions are taken by the Reserve Bank if banks breach certain trigger points was revised recently. The endeavour is to ensure timely supervisory action by following a rule-based approach. In order to ensure effective supervisory action on serious violations / breaches, a separate Enforcement Department has been established.

III.26 In November 2016, the Reserve Bank revised its guidelines on resolution of stressed assets to further strengthen the regulatory framework for dealing with stressed assets. Some of the significant measures include harmonisation of the stand-still clause applicable in the case of the Strategic Debt Restructuring (SDR) Scheme with other guidelines; a scheme for sustainable structuring of stressed assets (S4A); flexible restructuring of existing long-term project loans to infrastructure and core industries; guidelines for projects under implementation; and clarification on the deemed date of commencement of commercial operations.

III.27 Banks were advised on April 18, 2017 to make suitable disclosures in the prescribed format, wherever either (a) the additional provisioning requirements assessed by the Reserve Bank exceeded 15 per cent of the published net profits after tax for the reference period or (b) the additional gross non-performing assets (NPAs) identified by the Reserve Bank exceeded 15 per cent of the published incremental gross NPAs for the reference period. It is expected that this will ensure greater transparency and promote better discipline in compliance with the Reserve Bank's prudential norms on income recognition, asset classification and provisioning (IRACP).

The Financial Resolution and Deposit Insurance Bill, 2017

III.28 The Bill aims to establish a framework to carry out the resolution of specified categories of financial service providers in distress, to provide deposit insurance to consumers of banking institutions and for designation of Systemically Important Financial Institutions by the Central Government. The draft Bill on Financial Resolution and Deposit Insurance consolidates the resolution

[2] Patel, Urjit R. (2017), "Resolution of Stressed Assets: Towards the Endgame", Inaugural Session of the "National Conference on Insolvency and Bankruptcy: Changing Paradigm", Mumbai, August 19.

provisions presently scattered in different statutes and introduces new requirements as classification of financial service providers into various categories of risk to viability, submission of resolution / restoration plans, *etc*. and new methods for resolution, in accordance with prevalent international practices. It proposes creation of a new specialised authority – Resolution Corporation, tasked with the responsibility of carrying out speedy and efficient resolution of financial service providers. The authority will take over the deposit insurance functions presently exercised by the Deposit Insurance and Credit Guarantee Corporation (DICGC).

Adoption of the Basel III Capital Framework for Banks

III.29 There has been significant progress towards implementation of Basel III risk-based capital standards, the liquidity standards, the standards for global and domestic systemically important banks (SIBs), the leverage ratio, the large exposure framework and the interest rate risk in the banking book (IRRBB). Basel III Capital Regulations will be fully phased in for Indian banks by March 31, 2019, *i.e.*, close to the internationally agreed date of January 1, 2019.

III.30 In the context of the transition to a Liquidity Coverage Ratio (LCR) of 100 per cent by January 1, 2019 the Statutory Liquidity Ratio (SLR) was reduced by 50 basis points from 20.0 per cent to 19.5 per cent of banks' net demand and time liabilities (NDTL) from the fortnight commencing October 14, 2017.

III.31 To align exposure norms for Indian banks with the BCBS standards, the Reserve Bank issued guidelines on the Large Exposures (LE) Framework on December 1, 2016, in terms of which banks' exposure to a single and group counterparty should normally not be more than 20 and 25 per cent of Tier 1 capital, respectively. The LE Framework will be effective from April 1, 2019.

III.32 In line with the revised BCBS framework on interest rate risk in the banking book, the Reserve Bank issued draft guidelines on governance, measurement and management of interest rate risks in banking books on February 2, 2017 for feedback / comments.

Prudential Regulatory Measures

III.33 With effect from October 20, 2016 it was advised that exposure to housing finance companies (HFCs) be risk-weighted as per the rating assigned by the rating agencies registered with Securities and Exchange Board of India (SEBI) and accredited by the Reserve Bank of India.

III.34 As a counter-cyclical measure, the loan to value (LTV) ratio, risk weights and standard asset provisioning rate for individual housing loans sanctioned on or after June 7, 2017 were also rationalised.

III.35 With effect from June 13, 2017, banks are permitted to use the ratings of INFOMERICS Valuation and Rating Private Limited for risk weighting their claims for capital adequacy purposes in addition to the existing six domestic credit rating agencies (CARE, CRISIL, FITCH India, ICRA, Brickwork Ratings and SMERA).

III.36 Guidelines for computing exposure for counterparty credit risk arising from derivative transactions and on capital requirements for bank exposures to central counterparties were issued on November 10, 2016 with a view to comprehensively capture the credit risk from all avenues. This will come into force from April 1, 2018.

III.37 As part of effective risk management, banks are required, *inter alia,* to have separate credit risk management from the credit sanction process. Given this, guidelines on role of the Chief Risk Officer, Chief Financial Officer and Chief

Technical Officer were issued on April 27, 2017 to bring uniformity and alignment with best practices.

Developmental Regulatory Measures

III.38 With effect from April 18, 2017 banks have been allowed to invest in Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) within the overall ceiling of 20 per cent of their net worth permitted for direct investments in shares, convertible bonds/ debentures, units of equity-oriented mutual funds and exposure to venture capital funds. Banks should put in place a board approved policy on exposures to REITs/ InvITs, which lays down an internal limit on such investments within the overall exposure limits with respect to the real estate and infrastructure sectors. In addition, banks will not invest more than 10 per cent in the unit capital of an REIT/ InvIT.

III.39 Following policy changes on "Financial Services provided by Banks" have been implemented with effect from September 25, 2017:

- In order to align prudential norms for investments in Category I and II Alternative Investment Funds(AIFs), banks were allowed to invest up to 10 per cent of the unit capital of an AIF-II (on similar line to AIF-I) beyond which they will require prior approval from RBI. However, investments by banks in Category III AIFs have been specifically prohibited. Further, with a view to restrict indirect exposure of the bank, a ceiling on the investments by banks' subsidiaries in AIF-III up to the regulatory minima prescribed by SEBI on Sponsor / Manager commitment has been prescribed.
- The minimum CRAR required for allowing general permission to banks' investments in financial services companies was 10 per cent (including 1 per cent buffer over the erstwhile minimum CRAR of 9 per cent). As the total capital requirements have increased due to the Capital Conservation Buffer (CCB) prescriptions, the minimum CRAR requirement has been aligned with the revised capital stipulations.
- Banks have been allowed to become Professional Clearing Members (PCMs) of commodity derivatives segment of SEBI registered exchanges subject to certain conditions. Further, banks' subsidiaries have been allowed to offer broking services in the commodity derivatives segment of the exchange subject to adhering to certain conditions.

III.40 Banks were allowed to provide partial credit enhancement (PCE) to bonds issued by corporates / special purpose vehicles (SPVs) for funding all types of projects with a view to encouraging corporates to avail of bond financing, subject to the Reserve Bank's guidelines. After a review, on May 18, 2017, banks were advised that capital requirements in the books of PCE provider may be re-calculated without reference to the constraints of capital floor and difference in notches if the reassessed standalone credit rating at any time during the life of the bond showed an improvement over the corresponding rating at the time of the bond issuance. To facilitate this, it was also advised that corporate bonds shall be rated by a minimum of two external credit rating agencies at all times and rating reports, both initial and subsequent, shall disclose both standalone credit rating and the enhanced credit rating. The aggregate exposure limit towards the PCE for a given bond issue from the banking system was increased to 50 per cent from 20 per cent of the bond issue size, with a limit of up to 20 per cent of the bond issue size for an individual bank.

III.41 Banks were permitted to raise funds through issuance of rupee denominated bonds overseas for the purposes of Perpetual Debt Instruments (PDI) qualifying for inclusion as Additional Tier 1 capital and debt capital instruments qualifying for inclusion as Tier 2 capital to provide a fillip to the market for the rupee denominated bonds overseas and for providing an additional avenue for Indian banks to raise capital / long-term funds. Banks were also permitted to issue rupee denominated bonds overseas for financing infrastructure and affordable housing.

Customer Protection – Limiting Liability of Customers in Unauthorised Electronic Banking Transaction

III.42 With the widespread use of electronic banking and rise in complaints relating to unauthorised / fraudulent transactions, a need was felt to have a comprehensive policy to limit the liability of customers, particularly those who are not at fault. In this regard, a set of guidelines have been issued to the banks in July 2017 for limiting the customer liability in unauthorised/ fraudulent electronic transactions.

Implementation of Indian Accounting Standards (Ind AS)

III.43 Directions were issued to SCBs (excluding RRBs) to comply with Indian Accounting Standards (Ind AS) for financial statements beginning April 01, 2018 with comparatives for the periods ending March 31, 2018 or thereafter. All-India Financial Institutions (AIFIs) (Exim Bank, NABARD, NHB and SIDBI) were also advised to follow the Ind AS for financial statements beginning April 01, 2018 (with previous year comparatives).

Building a Diversified Banking System

III.44 A discussion paper on wholesale and long-term finance banks was released in April 2017. It explores the scope of setting up more such differentiated banks alongside payments banks (PBs) and small finance banks (SFBs).

III.45 The on-tap licensing policy for universal banks and guidelines for small finance and payments banks are a further step in building a heterogeneous banking system. As different banks operate differently, they will be able to offer services to a wider range of customers, enhancing consumer welfare based on their reach, liquidity, capitalisation and market power. As part of the efforts to promote financial inclusion through a greater focus on small credit and payment / remittance facilities, the Reserve Bank issued licenses to eight small finance banks and six payments banks during 2016-17 taking the number of licensees to 10 SFBs and seven PBs. Nine SFBs and four PBs have commenced operations. PBs were also permitted to act as BCs for other banks. Separate operating guidelines were issued in October 2016 for PBs and SFBs considering the differentiated nature of their businesses and focus on financial inclusion.

Anti-Money Laundering and Combating Financing of Terrorism and Know Your Customer

III.46 Financial Action Task Force[3] (FATF) has made a series of recommendations for combating money laundering and financing of terrorism. FATF conducts Mutual Evaluation of its Members and other countries from time to time. India is a member of FATF. India's Mutual Evaluation was last conducted in the year 2010. The next Mutual Evaluation is expected to be conducted in the year 2020-21[4].

[3] FATF is an inter-government body that sets the standards for measures to counter terror financing, money laundering and other threats to international financial system.

[4] http://www.fatf-gafi.org/media/fatf/documents/assessments/Global-assessment-calendar.pdf

III.47 An important part of preparation for FATF mutual evaluation is conduct of National Risk Assessment (NRA) where risk of various sectors of the economy such as Banking, Insurance, Capital Markets, Designated Non-Financial Business and Profession (DNFBP) sectors are assessed. In this regard, the Government has set up a Working Group (WG) of its leading agencies for a NRA of various sectors, based on a methodology formed by the World Bank. The WG is assisted by various teams such as teams for banking sector, insurance sector, capital market sector, other financial institutions, DNFBPs, financial inclusion, *etc*. The exercise begins with the collection of data on sectors that are prone to money laundering. The country then has to prepare an action plan based on the level of risks identified.

III.48 The sectoral 'Working Group for Threat and Vulnerability Assessment of Banking Sector' was constituted in August 2015. The Group is chaired by the Reserve Bank and has members from various Government agencies as well as banks. Data for the exercise is being obtained from Government agencies, Regulated Entities and various Departments of the Reserve Bank in order to have a comprehensive coverage of the entire banking sector. Based on the exercise, the NRA report of the banking sector shall be finalised.

Capacity Building in Banks and AIFIs

III.49 The Committee on Capacity Building (Chairman: Shri G. Gopalakrishna) has made extensive recommendations pertaining to the overall human resource management (HRM) functions. The Committee has also made a number of recommendations for certification of staff. Banks were advised to prepare a comprehensive policy on the implementation of the Committee's recommendations for certification of staff by end-December 2016, incorporating an implementation path and monitoring plan under the supervision and monitoring of their boards.

Specialisation on Banks' Boards

III.50 In order to further align expertise in banks' boards with the changing contours of the banks' business, the fields of specialisation of directors on the boards of commercial banks (excluding RRBs) were broadened to include: (i) information technology; (ii) payment and settlement systems; (iii) human resources; (iv) risk management; and (v) business management to help bring in persons with professional knowledge and experience in these fields to the boards.

III.51 Considering the rapid innovation in banking and technology and also the crucial role of key managerial personnel such as the Chief Risk Officer (CRO), Chief Financial Officer (CFO) and the Chief Technology Officer (CTO) in the bank's risk governance structure, minimum qualifications were stipulated so that adequately qualified persons are chosen by the banks for these critical functions.

Branch Authorisation Policy

III.52 The branch authorisation policy has been extensively liberalised over the years consistent with public interest and the financial inclusion objective. During the year, in a major step towards financial inclusion, the term "Branch" has been replaced by "Banking Outlet", which includes both physical (brick and mortar) branches and Business Correspondent (BC) outlets. These 'Banking Outlets' can be manned either by the bank's staff or its BCs. Thus, the 'fixed point BC outlets' have been brought on par with the physical (brick and mortar) branches under the revised framework. This revised definition will enable banks to expand their network in remote rural areas in a cost-effective manner. Further, specific incentive has also been provided to banks for opening 'Banking Outlets' in Tier 3 to Tier 6

centres of north-eastern states, Sikkim and in left-wing extremism (LWE) affected districts by treating them as equivalent to opening banking outlets in unbanked rural centres (URC)[5]. This helps the banks in meeting the stipulation of opening 'at least 25 per cent of the total number of 'banking outlets' opened during a financial year in URCs.

VI. Supervisory Policy

Board for Financial Supervision (BFS)

III.53 The Board for Financial Supervision (BFS) constituted in November 1994 continues to exercise the role of an integrated supervisor over the financial system covering banks (both commercial and co-operative), local area banks (LABs), AIFIs, NBFCs and primary dealers (PDs). During July 2016 to June 2017, 11 meetings of the BFS were held to *inter alia* review the results of supervisory assessments of 96 banks and four AIFIs. Besides prescribing the course of action to be pursued for institution-specific supervisory concerns, BFS also provided guidance on several regulatory and supervisory policy issues.

III.54 Keeping in view the directions of the BFS, various initiatives were undertaken to strengthen the existing risk-based supervisory framework for banks. Thematic studies were conducted on areas like levy of commissions and charges by banks for various facilities availed by customers and trends in superannuation at senior level in PSBs. Best practices relating to IT infrastructure, CRILC reporting and core banking solutions were shared with commercial banks. Some of the major issues deliberated upon by the BFS include the turnaround of banks with weak financial positions, compliance culture, the need for enhanced disclosures, norms for appointing of statutory auditors, review of the prompt corrective action (PCA) and enforcement frameworks.

Developments in Risk-based Supervision

III.55 Introduced in 2012-13, the risk-based supervision under the Supervisory Programme for Assessment of Risk and Capital (SPARC) for banks operating in India has been successfully implemented over four supervisory cycles. The framework is inspired by international supervisory practices but has been conceptualised internally and developed by the Reserve Bank. It is a risk-centric forward-looking approach, which provides a comprehensive, consistent and objective basis for supervisory assessment of risk and capital using the integrated risk and impact scoring (IRISc), a proprietary risk scoring and aggregation model. By 2016-17, all SCBs operating in India (excluding RRBs and LABs) had been brought under SPARC framework.

III.56 Over the years, the Reserve Bank has been working for enhancing the efficacy and robustness of supervisory processes and improving supervisory communication. It has also undertaken a number of capacity building initiatives to sensitise banks on the importance of the risk-based approach and the SPARC framework. A variant model for small foreign banks having one/two branch operations in India was developed and implemented successfully over two years driven by the proportionality principle. The development of a suitable framework for supervising newly licensed SFBs and PBs is underway.

Revised Prompt Corrective Action (PCA) Framework for Banks

III.57 The Reserve Bank introduced the PCA framework for banks in December 2002. In

[5] An 'unbanked rural centre' (URC) is a rural (Tier 5 and 6) centre that does not have a CBS-enabled 'banking outlet' of a scheduled commercial bank, a small finance bank, a payments bank or a regional rural bank nor a branch of local area bank or licensed co-operative bank for carrying out customer-based banking transactions.

December 2014, the Sub-Committee of the Financial Stability and Development Council (FSDC-SC) directed that an early intervention mechanism in the form of a PCA framework be put in place for all regulated entities. Accordingly, an Internal Working Group was constituted by the Reserve Bank to undertake a comprehensive review of the existing PCA framework for banks, keeping in view the recommendations of the Working Group on Resolution Regimes (WGRR) for Financial Institutions in India (January 2014), the Financial Sector Legislative Reforms Commission (FSLRC) (March 2013) as well as international best practices. Capital, asset quality and profitability remain as key areas for monitoring under the revised framework. Further, leverage would be monitored in addition. The triggers for various indicators include Common Equity Tier-1 (CET1) ratio along with CRAR, the net NPA ratio, and return on assets (RoA). Certain risk thresholds have been defined – the breach of which will lead to the invocation of PCA and result in mandatory and discretionary actions as applicable. The PCA framework will apply without exception to all banks operating in India, including small banks and foreign banks operating through branches or subsidiaries. The PCA framework does not preclude the Reserve Bank of India from taking any other action it deems fit in addition to the corrective actions prescribed in the framework. The provisions of the revised PCA framework were implemented with effect from April 1, 2017, based on the financials of the banks for the year-ended March 31, 2017.

Developments in Cross-border Supervision

III.58 The Reserve Bank has made significant progress on supervisory information sharing and cooperation with banking supervisory authorities of overseas jurisdictions, entering into bilateral agreements (MoUs / Exchange of Letters on Supervisory Co-operation (EoLs) / Statement of Co-operation (SoC)) with overseas supervisors to strengthen supervisory cooperation. So far, the Reserve Bank has executed MoUs / EoLs / SoCs with 43 overseas supervisors. In addition, proposals for establishing supervisory co-operation arrangements with respect to 10 other overseas supervisors are in various stages of consideration. A framework for periodical sharing of supervisory information with respect to foreign banks operating in India with home supervisory authorities was also put in place during 2016-17.

III.59 The Reserve Bank has established supervisory colleges for State Bank of India, ICICI Bank Ltd., Bank of India, Bank of Baroda, Axis Bank Ltd., and Punjab National Bank, given their significant international presence. The main objectives of supervisory colleges are enhancing information exchange and cooperation among home and host supervisors and improving an understanding of the risk profile of the banking group thereby facilitating more effective supervision of internationally active banks. The meetings of the supervisory colleges are held once in two years.

Appointment of Statutory Central Auditors (SCAs) – Modification of Rest Period

III.60 The Rest and Rotation Policy for appointing SCAs for banks has been mandated to ensure that the audit functions are examined by a new team with a fresh perspective. The policy also aims to deter auditors and auditees from compromising adherence to audit principles. All private and foreign banks were advised on July 27, 2017 that an audit firm after completing four-year tenure in a particular private / foreign bank will not be eligible for appointment as SCA of the same bank for a period of six years.

Framework for Dealing with Loan Frauds

III.61 The process of migration of the batch processed fraud database to a web-based reporting architecture through XBRL is largely complete with banks and select financial institutions (FIs) starting the live reporting of Fraud Monitoring Returns (FMR) from April 1, 2017. Banks will submit fraud reports within the specified period in straight through processing mode, which will facilitate faster dissemination of fraud data. Banks will also update developments in fraud cases on 'as and when required' basis instead of doing it on a quarterly basis.

Inter Regulatory Forum (IRF) of Domestic Regulators

III.62 An Inter Regulatory Forum (IRF) of domestic regulators was set up with the approval of the Sub Committee of Financial Stability and Development Council (FSDC-SC) for monitoring of financial conglomerates (FCs). IRF has representation from other financial sector regulators / supervisors. A MoU was signed between regulatory authorities to facilitate the process of cooperation and exchange of information among peer regulators for strengthening the supervision of FCs and assessing risks to systemic stability.

III.63 For each FC group that has a significant presence in at least two financial market segments, a designated entity (DE) is identified by the IRF as the nodal entity to act on behalf of FC for facilitating communication and compliance with the principal regulator (PR), under whose jurisdiction the designated entity falls. The PR is solely responsible for consolidated supervision under the FC monitoring framework. The IRF coordinated oversight comprises of: i) periodic discussion meeting of all regulators with the designated entity of the FC and key group entities; and ii) submission of quarterly off-site returns (FINCON returns) to the principal regulator of the FC.

III.64 Currently, the IRF has identified a set of 11 FCs in the Indian financial sector based on their significant presence in two or more segments of the financial sector. They include five bank-led FCs, four insurance company-led FCs and two securities company-led FCs.

Supervisory Enforcement Framework

III.65 In view of the need for a unified and well-articulated supervisory enforcement policy and process, the Supervisory Enforcement Framework for action against non-compliant banks was approved by the Board for Financial Supervision. The framework should help make enforcement actions in the Reserve Bank transparent, predictable, standardised, consistent and timely and also improve overall compliance with the regulatory framework in the banking system.

III.66 As announced in the February 2017 Sixth Bi-monthly Monetary Policy Statement 2016-17, it was decided to establish a separate Enforcement Department in the Reserve Bank for developing a sound framework and processes for enforcement action. The Enforcement Department (EFD) commenced functioning on April 03, 2017.

VII. Non-Banking Financial Companies (NBFCs)

III.67 NBFCs play an important role in the Indian financial system by complementing and competing with banks and by bringing in efficiency and diversity into financial intermediation. The Reserve Bank's regulatory perimeter is applicable to companies conducting non-banking financial activity, such as lending, investment or deposit acceptance as their principal business. The regulatory and supervisory architecture is, however, focused more on systemically important non-deposit taking NBFCs (with asset size ₹5 billion and above) and deposit accepting NBFCs

with light touch regulation for other non-deposit taking NBFCs. Certain categories of entities carrying out NBFI activities are exempt from the Reserve Bank's regulation as they are being regulated by other regulators. They include housing finance companies (HFCs), mutual funds, insurance companies, stock broking companies, merchant banking companies and venture capital funds (VCFs), which are often referred to as the 'shadow banking system' (Box III.1).

Box III.1: Narrow Measure of Shadow Banking

The term 'shadow bank' was coined by Paul McCulley in 2007 in the context of the US non-bank financial institutions engaged in maturity transformation. A formal definition of shadow banking was given by the Financial Stability Board (FSB) as credit intermediation involving entities and activities outside the regular banking system.

Since 2011, the FSB has been conducting an annual monitoring exercise to track developments in the shadow banking system under a two-step approach – first, to cast the net wide by considering all non-bank credit intermediation to ensure that data gathering and surveillance cover all areas where risks to the financial system might potentially arise, and thereafter, to narrow the focus for policy purposes to the subset of non-bank credit intermediation where there are developments that increase the potential for systemic risk and there are indications of regulatory arbitrage. The narrowing down methodology is based on the FSB's High-Level Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities published in 2013.

As per the narrowing down methodology, non-bank financial entities are classified with reference to five economic functions: (1) management of collective investment vehicles with features that make them susceptible to runs; (2) loan provisions that are dependent on short-term funding; (3) intermediation of market activities that is dependent on short-term funding or on secured funding of client assets; (4) facilitation of credit creation (for example, through credit insurance); and (5) securitisation-based credit intermediation and funding of financial entities. The narrow measure of shadow banking does not include banks, insurance companies, pension funds, public financial institutions and the central bank (Table1).

Table 1: Classification of Shadow Banks based on Economic Function

Economic Function	Definition	Entity Types	Equivalent Indian Entities
EF1	Management of collective investment vehicles with features that make them susceptible to runs	Fixed income funds, mixed funds, credit hedge funds, real estate funds	
EF2	Loan provisions that are dependent on short-term funding	Finance companies, leasing companies, factoring companies, consumer credit companies	NBFCs, HFCs
EF3	Intermediation of market activities that is dependent on short-term funding or on secured funding of client assets	Broker-dealers	
EF4	Facilitation of credit creation	Credit insurance companies, financial guarantors, monolines	Mortgage guarantee companies
EF5	Securitisation-based credit intermediation and funding of financial entities	Securitisation vehicles	Securitisation/ reconstruction companies

As per the Shadow Banking Monitoring Report 2016 of the FSB, the total financial assets of the financial entities classified as shadow banking under the economic approach grew moderately by 3 per cent, *i.e.*, US$ 34.2 trillion in 27 jurisdictions as at end-2015. The US has the largest shadow banking sector representing 40 per cent of the total financial assets. Jurisdictions in the US, the UK and the euro area represented 65 per cent of the total global shadow banking at end-2015.

Based on the economic function approach, EF1 was by far, the largest among the five economic functions globally, representing US$ 22.2 trillion worth of assets at end-2015 or 65 per cent of the narrow measure. EF3 was the second largest economic function making up 11 per cent of the narrow measure, followed by EF5 (9 per cent), EF2 (8 per cent) and EF4 (0.4 per cent).

In India, EF2 constituted 99.7 per cent of the five economic functions.

References:

FSB (2013), *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities*, August.

FSB (2017), *Global Shadow Banking Monitoring Report 2016,* May.

New Categories of NBFCs

III.68 The NBFC segment has evolved considerably over a period of time in terms of operations, heterogeneity, asset quality, profitability and regulatory architecture. The Reserve Bank has been working on consolidating the various categories of NBFCs. At present, there are 12 categories of NBFCs[6]. The latest addition is the NBFC – Peer to Peer Lending Platform (NBFC-P2P).

III.69 Guidelines on NBFC-P2P have been issued by the Reserve Bank in October 2017. The Reserve Bank issued a discussion paper on regulation of the peer-to-peer (P2P) lending platform as a NBFC. The Government notified P2P as a NBFC activity on September 18, 2017 following which regulations were issued on October 4, 2017. The new regulations are expected to bring a major shift in crowd funding in India.

Revised Regulatory Framework for NBFCs

III.70 A revised regulatory framework for NBFCs was put in place in November 2014, which subsequently led to the issuance of regulatory directions to bridge the gap between banking and non-banking regulations. The year saw consolidation of the revised framework with focus on addressing risks, reducing regulatory arbitrage and simplifying regulations to facilitate smooth compliance culture among NBFCs. A few such measures are enumerated as under:

- Infrastructure Debt Fund-NBFCs (NBFC-IDFs) were earlier allowed to raise resources through issuance of bonds of minimum five-year maturity. To improve efficacy of the Asset Liability Management (ALM), NBFC-IDFs were allowed to raise funds through shorter tenor bonds and commercial papers (CPs) from the domestic market to the extent of up to 10 per cent of their total outstanding borrowings on April 21, 2016.
- With effect from July 28, 2016, guidelines relating to relief measures to be provided in areas affected by natural calamities were extended to NBFCs.

III.71 To address operational issues faced by NBFC-MFIs and to align with other stipulations on pricing of credit, on February 2, 2017, NBFC-MFIs were advised to use the average borrowing cost for the preceding quarter plus a margin instead of the average borrowing cost during the financial year plus a margin for computation of interest rate to be charged on loans.

III.72 Effective July 6, 2017, it was decided to extend the marketing and distribution network of the National Pension System (NPS) through NBFCs with asset size of ₹5 billion and above subject to certain conditions to maximise coverage under NPS. NBFCs will ensure that the NPS subscriptions collected by them from the public are deposited on the day of the collection (T+0 basis; with T being the date of receipt of clear funds, either by cash or any other mode).

III.73 NBFCs are increasingly outsourcing some of their operations on a continuing basis. In the process, NBFCs are exposed to various risks such as strategic risk, reputation risk, compliance risk, operational risk, legal risk, exit strategy risk, counterparty risk, country risk, contractual risk, access risk, concentration risk and systemic risk. Taking into consideration the need to put in place necessary safeguards for addressing the risks associated with outsourcing activities, guidelines on "Managing Risks and Code of Conduct in

[6] NBFCs can be divided into 12 categories, *viz.*, 1) Asset Finance Company (AFC); 2) Loan Company (LC); 3) Investment Company (IC); 4) Core Investment Company (CIC); 5) Factoring – NBFC; 6) Infrastructure Debt Fund Non-Banking Financial Company (IDF – NBFC); 7) Infrastructure Finance Company (IFC); 8) Non-Banking Financial Company-Micro Finance Institutions (NBFC-MFIs); 9) Non-Operative Financial Holding Company (NOFHC); 10) Mortgage Guarantee Companies (MGC); 11) NBFC-Account Aggregator (AA); and 12) NBFC-Peer to Peer Lending platform (NBFC-P2P).

Outsourcing of Financial Services by NBFCs" have been issued on November 9, 2017. The underlying principles behind these directions are that the regulated entity shall ensure that outsourcing arrangements neither diminish its ability to fulfil its obligations to customers and Reserve Bank nor impede effective supervision by the Reserve Bank. NBFCs have to take steps to ensure that the service provider employs the same high standard of care in performing the services as is expected to be employed by the NBFCs, if the activities were conducted within the NBFCs and not outsourced. Accordingly, NBFCs shall not engage in outsourcing that would result in their internal control, business conduct or reputation being compromised or weakened.

Asset Reconstruction Companies (ARCs)

III.74 At present there are 24 ARCs in the country, which are regulated and supervised by the Reserve Bank under the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act, 2002). After an amendment to the SARFAESI Act 2002 carried out in August 2016 through the Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, 2016, securitisation companies and reconstruction companies will be known as ARCs. Some salient features brought out through the amendment are:

i. As an ARC, a sponsor is required to be a fit and proper person in accordance with the criteria as may be specified in the guidelines issued by the Reserve Bank.

ii. An ARC is required to obtain prior approval of the Reserve Bank for appointing any director on its board of directors or as managing director or chief executive officer.

iii. The scope of funding by way of investment in security receipts (SRs) has been expanded by including non-institutional investors, which may be specified by the Reserve Bank in consultation with SEBI.

iv. The Reserve Bank's statutory powers to formulate directions on: (i) the fee and other charges, which may be charged or incurred for management of financial assets acquired by any ARC; and (ii) transfer of SRs issued by qualified buyers have been strengthened.

v. The Reserve Bank has been empowered to carry out audit and inspection of the ARCs. It has also been empowered to remove the chairman or any director or appoint additional directors on the board of directors of an ARC or appoint any of its officers as an observer to observe the working of the board of directors of such an ARC.

vi. The amount of penalty on the defaulting ARCs for failure to comply with any direction issued by the Reserve Bank has been substantially enhanced.

vii. The Reserve Bank has been designated as both the Adjudicating Authority and the Appellate Authority for imposing penalties on ARCs.

viii. No secured creditor, including ARCs, are entitled to exercise the rights of enforcement of securities under Chapter III of the SARFAESI Act, 2002 unless the security interest created in its favour by the borrower has been registered with the Central Registry.

III.75 Keeping in view the greater role envisaged for ARCs in resolving stressed assets, the minimum net owned fund requirement for ARCs was raised by the Reserve Bank from ₹0.02 billion to ₹1 billion with effect from April 28, 2017. 15 ARCs were inspected in the year 2015-16 and 10 in 2016-17.

Harmonisation in Regulatory and Supervisory Policies

III.76 Non-Banking Financial Company – Micro Finance Institution (NBFC-MFI) was introduced as a new category of NBFC in December 2011. During 2014-15 and 2015-16, a number of new NBFCs-MFI were registered and the sector showed healthy growth in total assets. It was, therefore, decided to put in place a system of inspection for these companies. Accordingly, 46 MFIs were inspected during 2015-16 and 36 in 2016-17.

III.77 A formal PCA framework was introduced for NBFCs on March 30, 2017. The framework envisages corrective action for NBFCs that will be triggered once an NBFC exhibits weaknesses in its financials in terms of capital strength, profitability or asset quality. NBFCs brought under PCA will be required to formulate and implement a corrective action plan.

III.78 A comprehensive information technology framework for NBFCs was issued on June 8, 2017, which contains guidelines for systemically important NBFCs (asset size greater than ₹5 billion) on IT governance, information and cyber security, IT risk assessment, change management, IS audit, business continuity planning (BCP) and IT services outsourcing. The guidelines are to be adopted by systemically important NBFCs by June 30, 2018. Along with these, a different and simpler set of IT guidelines were also issued for smaller NBFCs (asset size less than ₹5 billion) covering BCP, adequacy to file returns, management information systems and user policies.

VIII. Customer Service / Customer Protection in Banks

III.79 A significant initiative in the area of consumer education and protection was the operationalisation of the Charter of Customer Rights. The Reserve Bank had advised banks to formulate either an exclusive Customer Rights Policy keeping the spirit of the Charter intact or dovetail the existing customer service policies suitably to integrate the Charter and its tenets with the approval of the board. During 2016-17, all banks confirmed that their customer service policies were accordingly fine-tuned to incorporate the principles of the Charter of Customer Rights. In consultation with the Indian Banks' Association (IBA), the Reserve Bank also reviewed and standardised 10 most commonly used forms by bank customers. The IBA released standard specimens of these forms during the year to banks for implementation.

III.80 After a review of the criteria for determining customer liability in unauthorised electronic banking transactions, final guidelines on customer protection – limiting the liability of customers were issued on July 6, 2017. Taking into consideration the need to prevent misuse of the cheque drawing facility and avoiding penalising customers for unintended dishonour of cheques, all SCBs (including RRBs) were advised to have in place an appropriate and transparent policy approved by the board or its committee with respect to dishonour of cheques. Banks were advised to provide adequate relevant details of transactions in the passbooks and / or statements of accounts and also incorporate information about deposit insurance cover along with the limit of coverage upfront in passbooks.

Revision of the Banking Ombudsman Scheme

III.81 A comprehensive review of the Banking Ombudsman (BO) Scheme was undertaken in 2015-16 and an amended scheme came into effect from July 1, 2017 incorporating changes relating to the pecuniary jurisdiction of the BO, compensation and introduction of additional grounds of complaint on mis-selling and electronic and mobile banking. The Reserve Bank also opened and operationalised five new offices of the BO in Dehradun, Jammu, Ranchi, Raipur and an

additional office in New Delhi. The total number of BO offices has now reached 20.

III.82 The Reserve Bank is in the process of setting up an Ombudsman Scheme for NBFCs, which will initially cover all deposit-taking NBFCs and also those with customer interface and asset size of ₹1 billion and above. ARCs, infrastructure finance companies, infrastructure debt funds, core investment companies and NBFC-Factors will not be covered under the scheme for the time being. Based on experience, the coverage of the Ombudsman Scheme may be reviewed over time.

Complaint Management System

III.83 In addition to complaints being received in the offices of BOs, the Reserve Bank also receives complaints against regulated entities from their customers through the consumer education and protection cells (CEPCs) set up in every office. The Reserve Bank has initiated the setting up of a comprehensive complaint management system (CMS) with a view to harnessing IT for managing the increasing volume of complaints that it receives. This web-based application will integrate the grievance redressal mechanism in the Reserve Bank on a single IT platform to bring about better coordination and effectiveness and this will also help the Reserve Bank to manage the complaints more efficiently and also provide a robust management information system (MIS).

III.84 On receiving reports that banks were discouraging or turning away senior citizens and differently-abled persons from availing banking facilities in branches, banks were instructed to put in place explicit mechanisms for meeting the needs of such persons so that they do not feel marginalised. Instructions in this regard were issued in November 2017.

IX. Payment and Settlement Systems

III.85 The Reserve Bank's continued efforts towards migrating to a 'less-cash society' with wider adoption of electronic payments gained momentum during 2016-17. With the rapid advancement of technology and the advent of new developments and innovations in the payment landscape, the Reserve Bank enhanced its focus on the safety and resilience of the payment systems to ensure the smooth functioning of critical and systemically-important payment and settlement systems.

Cyber Risk and Cyber Security

III.86 The Reserve Bank performed a comprehensive IT examination of major banks to assess their cyber risk resilience and response. The Reserve Bank is also setting up a fully-owned subsidiary – the Reserve Bank Information Technology Private Limited (ReBIT) – that will only focus on the cyber security needs of the Reserve Bank and its regulated entities. ReBIT will: (i) carry out research in the area of cyber security, (ii) help the Reserve Bank monitor its networks, including RTGS and NEFT, (iii) help the Reserve Bank monitor computer systems of banks and their cyber security mechanisms during its regular inspections, and (iv) undertake specialised projects for the Reserve Bank on cybersecurity. Guidelines on cyber security frameworks in banks were issued by the Reserve Bank on June 2, 2016, which *inter alia*, require banks to have a board approved cyber security policy, a cyber-crisis management plan, gap assessment *vis-à-vis* the baseline requirements indicated in the guidelines, robust vendor risk management and reporting of unusual cyber security incidents within 2-6 hours. An inter-disciplinary Standing Committee on Cyber Security is being constituted to review the threats inherent in existing / emerging technologies, study adoption of various security standards / protocols and interface with stakeholders and suggest appropriate policy interventions to strengthen cyber security and resilience.

Payments System

III.87 Trade Receivables Discounting System (TReDS) is an institutional mechanism for facilitating the financing of trade receivables of MSMEs payable by corporate buyers through multiple financiers. All the three entities: Receivables Exchange of India Limited (formed by NSE Strategic Investment Corporation Limited and Small Industries Development Bank of India), Mynd Solutions Pvt Ltd and A. TREDS Limited (joint venture of Axis Bank and Mjunction Services Ltd), were issued final Certificate of Authorisation and have commenced operations. To support the settlement obligations emanating from these systems, the many-to-many settlement feature has also been enabled in the National Automated Clearing House (NACH) operated by the National Payments Corporation of India (NPCI).

III.88 As on November 2, 2017, 55 non-bank entities and 56 banks are permitted to issue and operate the payments system for pre-paid payment instruments (PPIs). In light of the developments in the field and with a view to foster innovation and competition, ensure safety and security, customer protection, *etc.*, a comprehensive review of all the instructions relating to the issuance and operation of PPIs was undertaken and Master Direction (MD) on the subject was issued on October 11, 2017. The MD gives a path for implementation of interoperability of PPIs including non-bank PPIs.

III.89 The Unified Payments Interface (UPI), for mobile banking transactions provides twin benefits of convenience of operations for customers (providing just a registered virtual address instead of details of bank accounts for making / receiving payments) and enabling merchant 'pull' payments. It is application-based and usable on smartphones with internet access. During the year, NPCI was given approval to go live for UPI. NPCI was also accorded approval to introduce USSD 2.0 (*99#) mobile banking facility (which can be used on any handset and does not require internet connection by the customers), which is integrated with the UPI.

III.90 In line with one of the major objectives of Vision-2018 for the payment and settlement systems and with a view to encourage innovative payment solutions in the country, instructions were issued to authorised card networks in the country in September 2016 for enabling interoperability in Quick Response (QR) based card payments. Subsequently, the QR code based acceptance infrastructure was expanded to facilitate payments based on UPI virtual address, Aadhaar number and Account Number + IFSC. This was launched as Bharat QR in February 2017.

III.91 In-principle approval has been accorded to NPCI to launch a pilot of BHIM-Aadhaar Pay to provide a channel for customers to make digital payments using their Aadhaar-seeded bank accounts at merchant locations. BHIM-Aadhaar Pay is a smart phone-based application. The transactions are processed as part of the existing Aadhaar Enabled Payment System (AEPS) with a separate transaction type assigned to them.

III.92 Additional settlements in the National Electronic Funds Transfer (NEFT) system at half-hour intervals were introduced on July 10, 2017 to enhance the efficiency of the system and add to customer convenience. The half-hourly settlements speed up the funds transfer process and provide faster credit to destination accounts.

X. Banking Sector Legislations

The Banking Regulation (Amendment) Act, 2017

III.93 The Banking Regulation (Amendment) Act, 2017 has amended the Banking Regulation Act, 1949, which has *inter alia* conferred power upon the Central Government for authorising the Reserve Bank to issue directions to any banking

company or banking companies to initiate insolvency resolution process in respect of a default, under the provisions of the Insolvency and Bankruptcy Code, 2016. The said amendment specifically empowered the Reserve Bank to issue directions to banking companies for resolution of stressed assets and also allow the Reserve Bank to specify one or more authorities or committees to advise banking companies on resolution of stressed assets.

Amendments to the Payment and Settlement Systems Act, 2007

III.94 The Finance Act, 2017 amended certain provisions of the Payment and Settlement Systems Act, 2007. The amendment provides that the Payments Regulatory Board will exercise functions relating to the regulation and supervision of payments and settlement systems under the Act instead of the existing Board for Regulation and Supervision of Payments and Settlement. The new Board shall have the Governor of the Reserve Bank as Chairperson.

The Specified Bank Notes (Cessation of Liabilities) Act, 2017

III.95 The act, *inter alia*, provides for specified bank notes (SBNs)[7] to cease to be liabilities of the Reserve Bank or the Central Government, exchange of SBNs and prohibition on holding, transferring or receiving SBNs, penalty *etc*.

Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016

III.96 The Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016 provides for targeted delivery of subsidies and services to individuals residing in India by assigning them unique identity numbers called Aadhaar numbers.

XI. Overall Assessment

III.97 During the year there was continued emphasis on improving the institutional framework for a sound banking system in the country. A multi-pronged approach was used to collectively address the problem of stressed assets in the system. The risk-based supervisory process of the Reserve Bank flags risks arising out of weak credit discipline and it suggests remedial actions. The new Enforcement Department in the Reserve Bank has been mandated to develop a rule-based, consistent framework to deal with breaches of law, rules and directions. Effective deterrence enforced through such actions is expected to contribute to the strengthening of the overall credit culture. The PCA system under which specific regulatory actions are taken by the Reserve Bank if banks breach certain trigger points was revised to ensure timely supervisory action.

III.98 Important policy measures were initiated during the year to make the payment and settlement systems more robust and customer-friendly and for moving payment transactions from cash / paper modes to electronic modes. Implementation of Ind AS and the Basel III framework will be areas of focus during 2017-18. The Reserve Bank also envisages steps for improving financial literacy levels including implementing Tier II of the capacity building programmes for financial literacy counsellors and bank branch heads in rural areas. Moving forward, the focus of the Reserve Bank will be on financial stability and financial inclusion combined with a vigil of systemic risks and risks arising out of global financial interconnectedness so as to ensure a healthy, resilient and inclusive banking sector.

[7] The term “specified bank note” means a bank note of the denominational value of ₹500 or ₹1,000 of the series existing on or before the 8th day of November, 2016.