III POLICY ENVIRONMENT

Empowered by the statutory power to issue directions to banks on resolution of stressed assets, the Reserve Bank consolidated in 2017-18 the stressed assets resolution framework, with the Insolvency and Bankruptcy Code as the lynchpin. Concomitantly, liquidity risk management practices of commercial banks were aligned with international standards. The move to allow voluntary transition of co-operative banks into small finance banks is likely to open newer growth horizons for them. In progressive alignment with the oversight framework for banks, the Reserve Bank strengthened regulatory requirements for government owned non-banking financial companies.

1. Introduction

III.1 Declogging the large overhang of stressed assets in the banking system has ascended the hierarchy of priorities in the conduct of policies to safeguard financial stability in India. In this context, the Reserve Bank has adopted a multi-pronged strategy consisting of recognition, provisioning and resolution of non-performing assets (NPAs). The rapid recovery of economic activity from the transient disruptions associated with demonetisation and the implementation of the goods and services tax (GST) in an environment of macroeconomic stability provided tailwinds for an intensification of those efforts during 2017-18. Given this overarching priority, the Reserve Bank also reviewed and refined its regulatory and supervisory policies during the year in order to catalyse the banking system into scaling up the reach and quality of the financial intermediation needs of a digitising economy. Financial inclusion and ongoing improvement in customer services remained concomitant goals. This chapter presents an overview of the policy environment for the banking system that evolved during 2017-18 and 2018-19 so far in pursuit of these goals, with a focus on regulatory and supervisory policies.

III.2 The rest of the chapter begins with developments in monetary policy and liquidity conditions as they shaped financial activity during the year in Section 2. Regulatory policies are covered in Section 3, presenting the progress made under the Insolvency and Bankruptcy Code (IBC) framework as well as under other initiatives and in the managing of liquidity risks. An empirical evaluation of the efficacy of macro-prudential policies is a special feature of this section. Measures initiated by the Reserve Bank to encourage dynamism and efficiency in niche areas of banking are covered in Section 4. A well-designed regulatory policy is best enforced by efficient supervision. Developments in supervisory policies, including cyber security measures and fraud reporting are covered in Section 5. With non-banking financial companies (NBFCs) growing rapidly in recent years, the Reserve Bank has been engaging in stronger monitoring and regulation of this sector. These policy initiatives are set out in Section 6. Policy developments in other focal areas of the Reserve Bank including credit delivery, financial inclusion, consumer protection and payment and settlements systems are covered in sections 7 to 10, respectively. Section 11 concludes with a forward-looking assessment.

2. Monetary and Liquidity Management: Policy Developments

III.3 The banking sector in India plays a crucial role in monetary policy transmission in keeping with its predominant position in the financial system. During 2017-18, the Monetary Policy Committee (MPC) voted for a 25 basis points (bps) rate cut in August 2017 and maintained *status quo* through the rest of the year in the policy rate as the balance of risks around the inflation trajectory tilted to the upside. With several of these risks materialising in the ensuing months, the MPC raised the policy rate twice – by 25 bps each in June and August 2018. In its October and December 2018 meetings, the MPC kept the policy rate unchanged. However, the policy stance was changed from neutral to calibrated tightening in the October 2018 meeting. Consistent with the stance of monetary policy, liquidity management operations endeavoured to modulate system liquidity around a position closer to neutrality by employing variable rate reverse repo auctions with a preference for longer tenors, security issuances under the market stabilisation scheme (MSS), cash management bills (CMBs)[1] and open market operations (OMOs). Variable rate reverse repo/repo operations of 14-day and 7-day tenors continued modulating frictional liquidity mismatches. The width of the policy corridor was narrowed from 100 bps in April 2016 to 50 bps in April 2017 following which, volatility in the call money market reduced - the standard deviation of the weighted average call money rate (WACR), the operating target of monetary policy, declined from 0.19 in 2016-17 to 0.10 in 2017-18.

III.4 System level liquidity went through alternative phases during the period under review and accordingly, the Reserve Bank's policy responses were varied. During Q1: 2017-18, the Reserve Bank auctioned treasury bills (tenors ranging from 312 days to 329 days) aggregating ₹1 trillion under the MSS in April and in May 2017, to drain surplus liquidity as part of daily absorption operations of ₹4.6 trillion (reverse repo, MSS and CMBs). In Q2: 2017-18, liquidity absorption had to be topped up with open market sales of ₹600 billion (₹200 billion each in July, August and September). Bolstering liquidity draining operations under the liquidity adjustment facility (LAF) in Q3: 2017-18, the Reserve Bank conducted open market sales to absorb ₹300 billion on a durable basis (₹200 billion in October and ₹100 billion in November). System liquidity flipped into deficit transiently in the second half of December due to the usual advance tax outflows and again from February, which was managed through regular LAF operations, including additional variable rate repo operations (₹250 billion each) of longer tenors (24 to 31 days) to equilibrate end-year liquidity mismatches associated with balance sheet adjustments. Standalone primary dealers (SPDs) were allowed to participate in the auction conducted on March 28, 2018.

III.5 During 2018-19, liquidity conditions alternated between largely surplus conditions in Q1 and intermittent phases of deficits in Q2. The deficits became persistent in Q3 due to sharp increase in currency in circulation (CiC) and forex operations by the Reserve Bank (up to December 19, 2018). Surplus liquidity was managed through LAF variable rate reverse repo

[1] CMBs are short-term money market instruments that are issued by the Reserve Bank on behalf of the central government to help the latter in tiding over its temporary cash flow mismatches.

auctions of various tenors. Variable rate repos of maturities ranging between 1 to 56 days were employed to assuage deficit conditions. The Reserve Bank also injected durable liquidity amounting to ₹1.36 trillion through OMO purchases during April-November 2018. For the month of December, another ₹500 billion of liquidity injection through OMO purchases has been announced of which ₹200 billion has already been conducted till December 19, 2018.

3. Regulatory Policies

III.6 During the year under review, key policy initiatives encompassed a revised framework for resolution of stressed assets. The Reserve Bank's other regulatory initiatives included, *inter alia*, progressive alignment of liquidity risk management with international standards, measures to strengthen the co-operative banking system as a purveyor of inclusive bank credit and a host of miscellaneous measures which have forward-looking implications.

3.1 Resolution of Stressed Assets

III.7 The enactment of IBC, 2016 and the amendment to the Banking Regulation Act, 1949 in 2017 marked a watershed in the evolution of the regime for resolution of financial stress in India, empowering creditors to deal with troubled financial assets in a transparent, time-bound manner (Box III.1).

Box III.1: Insolvency and Bankruptcy Code - Impact so far

Introduced in May 2016, the IBC is a game changer in the resolution of NPAs in India because it provides a framework for time-bound insolvency resolution (180 days extendable by another 90 days) with the objective of promoting entrepreneurship and availability of credit while balancing the interests of all stakeholders. The IBC represents a paradigm shift in which creditors take control of the assets of the defaulting debtors, in contrast to the earlier system in which assets remained in possession of debtors till resolution or liquidation.

The experience so far has been encouraging with IBC providing resolutions to some large corporate debtors. Raw data suggests that the number of cases ending with liquidation is about four times higher than those ending with a resolution plan (Table 1). A granular analysis however reveals that more than three-fourth of the cases closed by liquidation (163 out of 212) were earlier under the Board for Industrial and Financial Reconstruction (BIFR) or defunct or both and thus, the intrinsic value of most of these assets had already eroded before they were referred to the IBC. Liquidation could be an efficient mode of resolution for debtors in default for long time

Table 1: Corporate Insolvency Resolution Process (CIRP)

Quarter	No. of CIRPs at the beginning of the Quarter	Admitted	Closure by			No. of Corporates undergoing Resolution at the end of the Quarter
			Appeal/ Review	Approval of Resolution Plan	Commencement of Liquidation	
Jan-Mar, 2017	0	37	1	0	0	36
Apr-Jun, 2017	36	129	8	0	0	157
July-Sept, 2017	157	231	15	2	8	363
Oct-Dec, 2017	363	147	33	8	24	445
Jan-Mar, 2018	445	194	14	13	57	555
Apr-Jun, 2018	555	244	18	11	47	723
Jun-Sept, 2018	723	216	29	18	76	816
Total	**--**	**1,198**	**118**	**52**	**212**	**816**

Source: Insolvency and Bankruptcy Board of India (IBBI) Newsletter.

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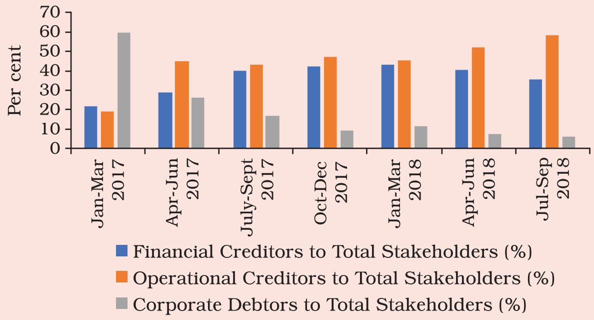
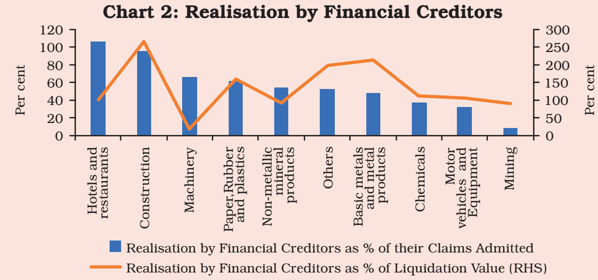
Chart 1: Corporate Insolvency Resolution Initiation by Different Stakeholders



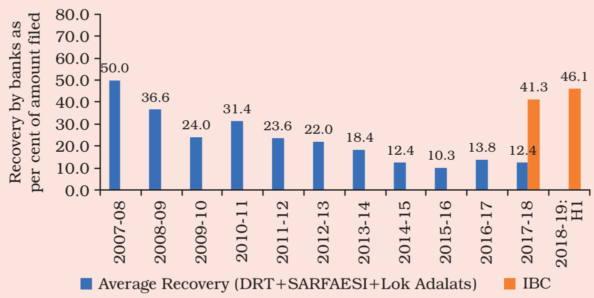
Source: IBBI.

Chart 2: Realisation by Financial Creditors



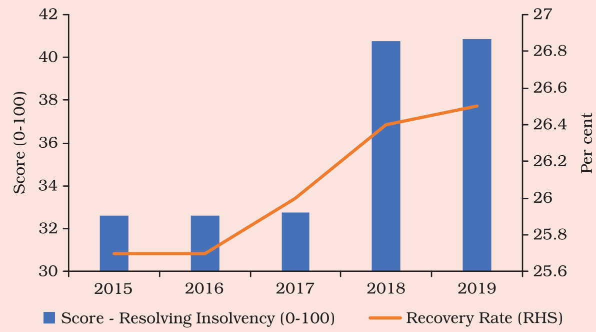
Note: Calculations pertain to 51 firms out of 52 firms for which the resolution plans were approved. Data on liquidation value and claims admitted for one firm is not available. The 51 firms can broadly be classified as Hotels and restaurants - 4, Construction – 3, Machinery – 4 Paper, rubber and plastics – 6, Non-metallic mineral products – 2, Others – 10, Basic metals and metal products –13, Chemicals – 3, Motor vehicles and equipment – 4 and Mining – 2. Classification of companies into different sectors is based on National Industrial Classification (NIC) – 2004 and information on companies is obtained from Capitalline Plus database.
Source: IBBI.

Chart 3: Recovery through Various Mechanisms



Note: Data on average recovery (DRT+SARFAESI+Lok Adalats) is not available for 2018-19: H1
Source: RBI and IBBI.

Chart 4: Insolvency Resolution and Recovery



Source: World Bank (www.doingbusiness.org)

wherein the scope for revival of the enterprise is low and liquidation value exceeded resolution value. As such, the number of liquidation orders should be seen as a natural step towards efficient reallocation of resources rather than an adverse consequence of IBC itself.

Operational creditors have filed the maximum number of CIRPs, followed by financial creditors. In May 2017, the Banking Regulation Act, 1949 was amended to empower the Reserve Bank to direct any bank to initiate insolvency resolution under the IBC framework in respect of a default, resulting in an increase in the number of cases initiated by financial creditors (Chart 1).

On an average, financial creditors have received 1.9 times the liquidation value. The realisation value as a proportion to admitted claims varies significantly across firms and sectors (Chart 2).

The average recovery through mechanisms that existed before IBC *viz.*, the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, Debt Recovery Tribunals (DRTs) and Lok Adalats has been declining over the years. The average recovery through IBC is greater than these mechanisms and is also improving gradually, pointing to the need and efficiency of such a channel (Chart 3).

Reflecting this, India's insolvency resolution score and recovery rate improved substantially in the World Bank's Ease of Doing Business Index, after the introduction of IBC, 2016 (Chart 4).

Going forward, as the IBC process matures, the proportion of cases filed by corporate debtors is expected to rise. Various amendments in the IBC have been introduced in the recent period such as giving home buyers the status of financial creditors and exempting the resolution applicants of micro, small and medium enterprises (MSMEs) from Section 29A (c) and (h) of the IBC to allow the existing promoters of MSMEs to participate in resolution process. These amendments should strengthen the resolution process and release resources for investment.

As on September 30, 2018, around 30 per cent of the ongoing resolution processes has exceeded the prescribed time limit of 270 days. Strengthening the infrastructure of insolvency resolution, including the proposed increase in the number of benches of National Company Law Tribunal (NCLT), should help reduce the overall time currently being taken for resolution under the IBC.

Reference

Insolvency and Bankruptcy Board of India: *Insolvency and Bankruptcy News*, various issues. Available on https://ibbi.gov.in/publication.html, accessed on October 19, 2018.

III.8 Two important policy initiatives taken in 2017-18 should expedite the resolution of stressed assets: First, the Reserve Bank issued guidelines on a revised framework for resolution of stressed assets on February 12, 2018. This framework, with the IBC as the lynchpin, replaced all previous resolution mechanisms in a step towards a steady state in which maximum value could be realised by all the stakeholders. While leaving the definition of a non-performing asset unchanged, it lays down broad principles that should be followed in the resolution of stressed assets, with clearly defined rules for ensuring credible outcomes. An Internal Advisory Committee (IAC) has guided these processes since June 2017, with a focus on large value stressed accounts.

III.9 In the revised framework, all lenders must put in place board-approved policies for resolution of stressed assets, including timelines for resolution. Stress in loans has to be identified immediately on default, classifying them as special mention accounts (SMA). Lenders – singly or jointly – should initiate steps to cure the default as soon as it occurs. The resolution plan (RP) may take any form – regularisation of the account by payment of all overdues by the borrower entity; sale of exposures to other investors; change in ownership; or restructuring. In respect of accounts with aggregate exposure of ₹20 billion and above, lenders are required to finalise and implement a resolution plan within 180 days from the date of first default, failing which the banks would have to refer the cases to the IBC.

III.10 Second, the IBC (Second Amendment) Act, 2018, which came into force on June 6, 2018 provided some relief to home buyers and MSMEs. The definition of financial debt was widened to include the amount raised from allottees under a real estate project, thus giving them the status of financial creditors. The promoter of a MSME would not be disqualified from bidding for the enterprise, provided that the promoter is not a wilful defaulter and does not attract other specific disqualifications. It also lays down the procedure for withdrawal of a case by the resolution applicant after its admission under IBC, 2016. The voting threshold was brought down to 66 per cent from 75 per cent for all major decisions such as approval of resolution plan, extension of corporate insolvency resolution process period, and to 51 per cent for routine decisions. The existing Section 29A of the IBC, 2016 has also been amended to exempt financial entities from being disqualified on account of NPAs. Similarly, an applicant holding an NPA by virtue of acquiring it in the past under the IBC, 2016 has been provided with a three-year grace period from the date of such acquisition during which the resolution applicant will not be disqualified under Section 29A.

3.2 Managing Liquidity and Market Risk

III.11 In contrast to the experience in other countries, the statutory liquidity ratio (SLR) has provided a segway for the smooth adoption of the liquidity coverage ratio (LCR) in India. The Reserve Bank has allowed up to 13 per cent of net demand and time liabilities (NDTL) within the SLR to be reckoned as level 1 high quality liquid assets (HQLAs) [2 per cent of NDTL under the marginal standing facility (MSF) and 11 per cent under the facility to avail liquidity for liquidity coverage ratio (FALLCR)] with effect from June 15, 2018. The FALLCR has been expanded by another 2 per cent of NDTL – within the mandatory SLR requirement, effective October 1, 2018. Hence, the carve-out from SLR under FALLCR available to banks goes up to 15 per cent of NDTL. Further, SLR would be reduced by 25 bps every quarter commencing from January 2019 until it reaches 18 per cent of NDTL.

III.12 On October 19, 2018, the Reserve Bank provided incentives to banks to lend to the NBFC sector. Banks can use government securities held by them equivalent to their incremental credit to NBFCs and housing finance companies (HFCs) as level 1 HQLA, in addition to the 15 per cent carve-out from SLR under FALLCR and limited to 0.5 per cent of each bank's NDTL. The exposure limit of banks to non-infrastructure NBFCs has also been raised to 15 per cent from the earlier 10 per cent. These initiatives are intended to ease temporary asset-liability mismatches that the NBFC sector is experiencing and will be available only up to December 31, 2018. Besides, on November 2, 2018, the Reserve Bank permitted banks to grant partial credit enhancement to bonds issued by non-deposit taking systemically important NBFCs (NBFCs-ND-SI) and HFCs registered with National Housing Bank (NHB) to improve their credit ratings and access to the bond market.

III.13 Banks were allowed to spread provisioning for mark-to-market (MTM) losses on investments held in the available for sale (AFS) and held for trade (HFT) categories for the quarters ended December 31, 2017, March 31, 2018 and June 30, 2018 with a view to addressing the systemic impact of the sharp increase in yields on government securities. The provisioning would be spread equally over up to four quarters commencing from the quarter in which the loss was incurred. Additionally, all banks have been advised to create an investment fluctuation reserve (IFR) from 2018-19 onwards to build-up adequate buffers against market risks in the form of increase in yields in the future. The same facility has also been extended to co-operative banks, effective July 6, 2018.

III.14 Banks were advised to make an objective valuation of state development loans (SDLs) reflecting their fair value, based on observed prices / yields effective December 31, 2018. Financial Benchmark India Private Ltd. (FBIL) has been entrusted with the task of making available prices of SDLs based on these principles.

III.15 Earlier, banks were permitted to exceed the limit of 25 per cent of the total investments under the held to maturity (HTM) category, provided the excess comprises SLR securities and the total SLR securities held under the HTM category are not more than 20.5 per cent of NDTL. In order to align SLR holdings under the HTM category with the mandatory SLR, the ceiling was reduced from 20.5 per cent to 19.5 per cent in a phased manner, *i.e.*, 20 per cent by December 31, 2017 and 19.5 per cent by March 31, 2018.

3.3 Macro-prudential Policies

III.16 In India, macro-prudential measures have been undertaken to address both the time dimension as well as the cross-sectional dimension of systemic risk. The time dimension of systemic risk is closely linked with pro-cyclicality of credit growth. On the other hand, the cross-sectional dimension is related to the distribution of systemic risk in the financial system. With the Indian financial system being dominated by the banking sector, macro-prudential measures have mainly addressed the banking sector while progressively striving for convergence across other regulated entities (Box III.2).

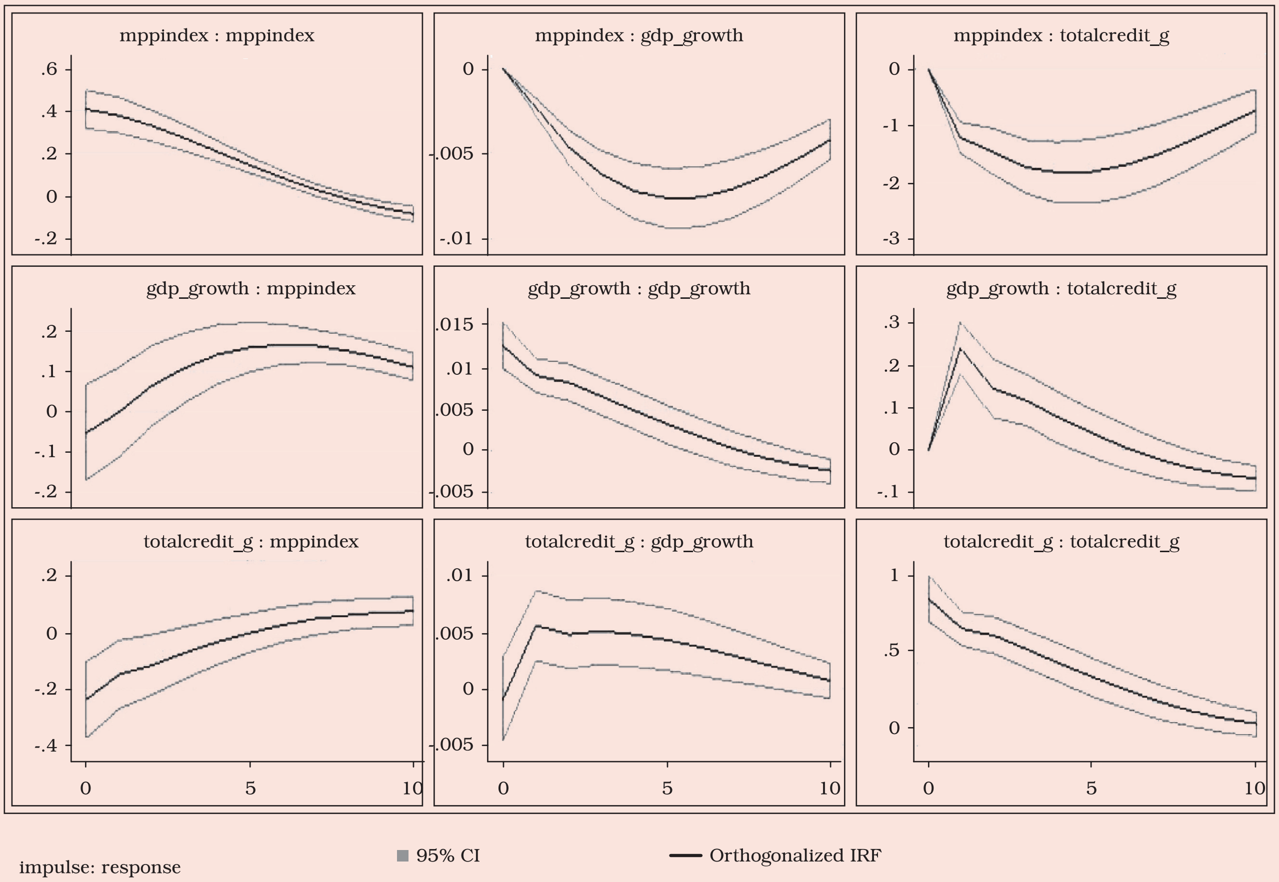
Box III.2: Macro-Prudential Policies in India

Macro-prudential instruments in the form of counter-cyclical provisioning, differentiated risk weights and loan-to-value (LTV) ratios especially for sensitive sectors such as residential housing and commercial real estate (CRE) – have been employed in India since 2004. An aggregate macro-prudential policy (MPP) index using risk weights and provisioning for standard assets in residential housing, CRE, consumer loans, capital market exposure and the cash reserve ratio (CRR) was constructed to provide a summary representation of policy interventions to preempt systemic risk (Akinci and Olmstead-Rumsey, 2017). A zero value is assigned to each of the measures in the base year 1999-2000. In the subsequent years, a value of one is added if any macro-prudential measure was introduced or tightened. Similarly, a value of one is subtracted if macro-prudential measures were loosened. If macro-prudential measures were tightened or relaxed multiple times during a year, one is added or subtracted as many times. If no action was taken in a year, there is no change in the value of the index. These individual indices are then aggregated horizontally to construct the MPP index.

The results from a panel vector auto-regression (VAR) using bank groups as panels for the period 1999-2000 to 2016 suggest that tightening of macro-prudential measures affects credit growth negatively with a one-year lag, in line with the consensus in the literature (Erdem *et al*, 2017; Verma, 2018) (Table 1). Similar results are found to be valid in case of sensitive sectors such as housing, CRE and consumer loans.

The impulse response of credit growth to one standard deviation shock to the MPP index is found to be negative up to four periods. Although tightening of MPP constrains gross domestic product (GDP) growth initially, this is neutralized within five periods (Chart 1).

Chart 1: Impulse Response of Credit Growth to Macro-Prudential Shocks



Note: Errors are 5% each side generated by Monte-Carlo simulation with 200 reps.

(Contd....)

Table 1: Impact of Macro-prudential policy (Three Variable Panel VAR)

Response of	Response to		
	Total credit growth (t-1)	GDP growth (t-1)	Ln (MPP Index(t-1))
Total credit growth(t)	-0.06 (0.096)	17.98*** (0.514)	-0.30*** (0.009)
GDP growth(t)	0.0078*** (.001)	0.6952*** (.005)	-0.0055*** (.001)
Ln (MPP Index(t))	0.1235*** (.022)	3.7632*** (.109)	0.9337*** (.004)
No. of obs. - 48			

Notes: 1. Figures in parentheses are standard errors.
2. ***p<0.01; **p<0.05; *p<0.10.

The EME country experience reinforces these results. Among various macro-prudential measures, risk weights and provisioning on standard assets are particularly effective in restraining credit growth in sectors such as housing and CRE. There are non-linearities involved in the impact of macro-prudential policies across phases of the credit cycle. In the final analysis too, this asymmetry plays out: macro-prudential measures have been able to restrain credit growth in targeted sectors during periods of exuberant growth, but their ability to lift credit growth during downturns has been limited.

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4. Policies in Niche Banking

III.17 In addition to these overarching measures, several steps were taken in 2017-18 to bring in dynamism and efficiency in niche areas of the banking space.

4.1 Reforms in Co-operative Banking

III.18 The Reserve Bank has been expanding opportunities for urban co-operative banks (UCBs) in an effort to mainstream them with differentiated banking models. It is in this context that eligible UCBs have been allowed to transit into small finance banks (SFBs) in line with recommendations made by a high-powered committee (Chairman: Shri R. Gandhi). Furthermore, participation in the LAF has been extended to scheduled state co-operative banks (StCBs) which are core banking solutions (CBS)-enabled with capital to risk weighted assets ratio (CRAR) of at least 9 per cent with effect from August 20, 2018. All scheduled UCBs and StCBs have been permitted access to the MSF, subject to eligibility criteria.

III.19 All UCBs have also been permitted to undertake eligible transactions for acquisition or sale of non-SLR investments in the secondary market in addition to undertaking eligible transactions with scheduled commercial banks (SCBs) and primary dealers (PDs). These initiatives are intended to bring efficiency in price discovery and harmonise regulations in the co-operative banking space.

III.20 The criteria for determining customer liability in the case of UCBs were reviewed in December 2017. The new directions focus on strengthening of systems and procedures, and clearly defining the responsibilities of banks and customers. In line with the criterion laid down for SCBs, the burden of proving customer liability shall lie with the UCBs that are also advised to formulate or revise board-approved customer relations policies, which clearly define rights and obligations of customers in case of unauthorised transactions in specified scenarios.

III.21 The Reserve Bank, in consultation with the Institute of Chartered Accounts of India (ICAI), has also finalised an indicative format for independent audit reports for multi-state UCBs and for UCBs registered under the Maharashtra Co-operative Societies Act, 1960 in order to address the issue of divergences in assessment of NPAs between statutory auditors and the Reserve Bank's inspection reports.

III.22 Furthermore, with a view to strengthening governance in UCBs, the Reserve Bank issued draft guidelines on constituting Board of Management (BoM) in addition to Board of Directors (BoD) in June 2018. Under the present legal framework, the BoD of a UCB performs both the executive and the supervisory roles and has the responsibility to oversee the functioning of the UCB as a co-operative society and as a bank. The draft guidelines proposed to make a provision in the UCBs' bye-laws for setting up a BoM, consisting of members with special knowledge and practical experience in banking and other relevant fields.

4.2 Legal Entity Identifier

III.23 The Legal Entity Identifier (LEI), which seeks to improve the quality and accuracy of financial data systems for better risk management, is a 20-character unique identity code assigned to entities that are parties to a financial transaction. The LEI code was introduced from June 2017 in a phased manner for participants (other than individuals) in over-the-counter markets for rupee interest rate derivatives, foreign currency derivatives and credit derivatives in India. It was made applicable for large corporate borrowers with an exposure of ₹500 million and above in November 2017 and they are required to obtain LEI codes by December 31, 2019. The LEI system will be implemented for non-derivative financial markets as well. Participants other than individuals undertaking transactions in the markets regulated by the Reserve Bank, *viz.*, government securities markets, money markets and foreign exchange markets, shall obtain LEI codes, and this process is scheduled to be completed by March 31, 2020

4.3 Prohibition on Dealing in Virtual Currencies

III.24 The Reserve Bank has repeatedly cautioned users, holders and traders of virtual currencies (VCs) about the various risks associated with them. On April 6, 2018, the Reserve Bank mandated that entities regulated by it shall not deal in VCs or provide services for facilitating dealing with or settling VCs. Regulated entities which provided such services were required to exit the relationship within three months from the date of the circular.

4.4 Loan System for Bank Credit

III.25 The guidelines mandating a minimum loan component of 40 per cent in fund based working capital finance with effect from April 1, 2019 were issued on December 5, 2018. This level would be revised to 60 per cent with effect from July 1, 2019. Effective April 1, 2019, a mandatory credit conversion factor (CCF) of 20 per cent has been prescribed for the undrawn portion of cash credit/ overdraft limits availed by large borrowers from the banking system. These guidelines intend to enhance credit discipline among the larger borrowers enjoying working capital facilities provided by banks.

4.5 Setting up of IFSC-Banking Units

III.26 The Reserve Bank modified guidelines prescribed for setting up of international financial services centres (IFSC) banking units (IBUs) effective May 17, 2018. The parent bank is required to provide a minimum capital of $20 million or equivalent in any foreign currency on an ongoing basis. While earlier, the minimum capital was required to be maintained with its IBU, the modified guidelines allow maintenance of the same at the parent level as per regulations in the home country. For foreign banks, the IBU is required to submit to the Reserve Bank a certificate to this effect obtained from the parent bank on a half-yearly basis.

4.6 Payments Banks and SFBs in Money Market

III.27 On October 29, 2018 the Reserve Bank clarified that payments banks and SFBs are eligible to participate in the call/notice/term money market both as lenders and borrowers, even before getting the SCB status. However, such participation is subject to the same prudential limits and other guidelines, as applicable in this regard, to the SCBs. This move will enable these financial institutions to access short-term liquidity and handle maturity mismatches more effectively.

5. Supervisory Policies

III.28 In its role as the financial stability watchdog and the lead supervisor of the financial system, the Reserve Bank maintains a close watch on incipient signs of financial vulnerabilities and takes timely policy measures to contain spillovers. In the recent period, supervisory efforts were aimed at realistic assessment of asset quality and ensuring adequate cyber security measures in commercial banks.

5.1 Board for Financial Supervision

III.29 The Board for Financial Supervision (BFS), constituted in November 1994, functions as a consolidated supervisor of the financial system comprising commercial banks, financial institutions and NBFCs. The BFS provided guidance on several regulatory and supervisory policy issues during the year, including the course of action to be pursued in respect of institution-specific supervisory concerns and the framework for enforcement action that might become necessary against regulated entities. Some of the major issues deliberated upon by the BFS in 2017-18 covered turnaround of banks with weak financial position, strengthening of cyber security in banks and guidelines on the role of the Chief Risk Officer and the Chief Technology Officer of banks. A sub-committee of the BFS has been constituted under the BFS Regulations, 1994 for considering agenda items on payment banks, SFBs, Local Area Banks (LABs), Credit Information Companies (CICs), small foreign banks, certain scheduled UCBs and asset reconstruction companies.

5.2 Banking Frauds

III.30 The extant guidelines require banks to report the names of third party entities (TPEs) like advocates, chartered accountants, valuers and architects involved in bank frauds to the Indian Banks Association (IBA) which, in turn, disseminates caution lists to the banks. In February 2018, the IBA was advised to initiate necessary action to put in place enhanced IT-enabled, user-friendly, web-based TPE reporting and disseminating infrastructure with suitable data security and control measures. Moreover, in view of the recent incidents relating to the Society for Worldwide Interbank

Financial Telecommunication (SWIFT) systems, banks were directed to strengthen various operational controls in their SWIFT system in a time-bound manner[2]. An expert committee (Chairman: Shri Y H Malegam) was formed in February 2018 to examine asset classification and provisioning practices of banks and the incidence of frauds.

5.3 Cyber Security Oversight Framework

III.31 The inter-disciplinary standing committee on cyber security constituted in 2017 provided strategic directions in cyber security related matters and examined concerns in the areas of card-based payments, mobile banking and vendor risk management. Recognising the importance of cyber security, IT examinations as well as focused thematic studies are being conducted to assess the level of cyber security preparedness in banks. Periodic cyber-drill exercises are undertaken, and the results are evaluated and shared with banks for improving their incident management capabilities. In order to address vulnerabilities in ATM security, banks were advised to implement security measures such as basic input-output system (BIOS) passwords, disabling auto-run facility and upgradation of operating systems in a phased manner.

III.32 The Reserve Bank introduced a basic cyber security framework for UCBs on October 19, 2018 requiring them to put in place a board-approved cyber security policy distinct from their IT policy. This would standardise technology adoption amongst UCBs and address cyber security breaches more effectively.

6. Non-Banking Financial Companies

III.33 NBFCs have been complementing banks as financial intermediaries by leveraging on their efficient and nimble operations and tailor-made products for niche areas. The need to strengthen their regulation and supervision has come to the fore in view of their rapid expansion in recent years. The Reserve Bank has been striving to harmonise regulatory requirements of various classes of NBFCs while putting in place specific policy measures for particular classes of NBFCs such as core investment companies and legacy NBFCs as needed.

6.1 Government Owned NBFCs

III.34 In 2017-18, the Reserve Bank aligned the regulatory requirements of government-owned NBFCs with those of privately owned NBFCs. Government-owned NBFCs will have to adhere to all regulations on income recognition, provisioning norms, corporate governance, conduct of business regulations, deposit directions and reserve funds by March 31, 2019. Asset classification norms have to be complied by March 31, 2020 and capital adequacy, leverage, exposure norms and statutory provisions are to be phased in progressively by March 31, 2022.

6.2 Core Investment Companies

III.35 Core investment companies registered as NBFCs primarily invest in group companies and do not carry out any other NBFC activity. They are required to invest up to 90 per cent of their net assets in equity shares, preference shares, bonds, debentures, debt or loans of group companies, while equity investments

[2] A recent large value fraud evolved partly due to the non-integration of the SWIFT system with the CBS. The risks arising from such malicious use of the SWIFT infrastructure has always been a component of banks' operational risk profile and the Reserve Bank had confidentially cautioned and advised them to put in place adequate safeguards, at least on three occasions since August 2016.

in group companies must constitute at least 60 per cent of net assets. In order to promote infrastructure development through investment in Infrastructure Investment Trusts (InvITs), core investment companies registered with the Reserve Bank as NBFCs were allowed to act as sponsors to InvIT issuances and to reckon holdings of InvIT units as part of the sub-limit of 60 per cent for equity investments in group companies. Exposures of core investment companies to InvITs are limited to their holdings as sponsors.

6.3 Regulatory Framework for NBFCs

III.36 As per the revised regulatory framework issued in November 2014, all the legacy NBFCs which were earlier allowed to carry on operations with a capital of ₹2.5 million were required to bring in a minimum capital of ₹10 million by March 31, 2016 and ₹20 million by March 31, 2017. The Reserve Bank has initiated supervisory action, including cancellation of the certificate of registration (CoR) of NBFCs that have not achieved the minimum prescribed net owned funds (NOF) by March 31, 2017.

6.4 Diversification of Activities of SPDs

III.37 The Reserve Bank enabled SPDs to provide comprehensive services to their foreign portfolio investment (FPI) clients. With effect from July 27, 2018 they have been permitted to offer foreign exchange products to their FPI clients. These activities would form part of SPD's non-core activities and they are directed to adhere to extant prudential and other regulations.

6.5 Securitisation Transactions of NBFCs

III.38 In order to encourage NBFCs to securitise/ assign their eligible assets, the minimum holding period (MHP) for securitisation of loans by NBFCs with original maturity above 5 years has been relaxed effective November 29, 2018 for a period of six months, subject to certain conditions.

7. Credit Delivery

III.39 Recognising that credit markets are prone to asymmetric information and rationing, the Reserve Bank undertook several policy initiatives in 2017-18 to expand access to bank credit to sectors vulnerable to exclusion/ pricing out. The focus was on MSMEs, and on galvanising priority sector lending to ensure credit flows for productive purposes.

7.1 Formalisation of MSME Sector

III.40 Guidelines were issued in February 2018 to facilitate the transition of MSMEs into the formal financial system by alleviating cash flow problems in the transition. The exposure of banks and NBFCs to GST-registered MSMEs continued to be classified as standard assets (180 days past due criterion) subject to certain conditions, including, *inter alia*, the aggregate exposure to the borrower not exceeding ₹250 million as on January 31, 2018 and the borrower's account being classified as standard as on August 31, 2017. In June 2018, this relaxation was extended to all MSMEs with aggregate credit facilities up to the specified limit, including those not registered under the GST. In respect of dues payable by GST-registered MSMEs from January 1, 2019 onwards, the 180 days past due criterion would be aligned to the extant 90 days past due NPA norm in a phased manner. The accounts of MSMEs that are not GST-registered as on December 31, 2018 would be governed by the 90 days NPA norm from January 1, 2019.

7.2 Co-origination of Priority Sector Loans by Banks and NBFCs

III.41 SCBs (excluding Regional Rural Banks (RRBs) and SFBs) were allowed to co-originate loans with NBFCs-ND-SI for the creation of eligible priority sector assets in order to provide a competitive environment for credit delivery to the priority sector. The arrangement entails joint contribution of credit by both lenders at the facility level and sharing of risks and rewards within an appropriate alignment of respective business objectives.

7.3 Priority Sector Lending Guidelines and Affordable Housing

III.42 Housing loan limits for eligibility for priority sector lending (PSL) were increased from ₹2.8 million to ₹3.5 million in metropolitan centres (with population of one million and above), and from ₹2 million to ₹2.5 million in other centres, in order to bring convergence between PSL guidelines for housing loans and the affordable housing scheme under the Pradhan Mantri Awas Yojana (PMAY). The overall cost of the dwelling unit in metropolitan centres and at other centres should not exceed ₹4.5 million and ₹3 million, respectively.

7.4 Priority Sector Lending by Urban Co-operative Banks

III.43 On May 10, 2018 guidelines were issued to harmonise priority sector lending (PSL) rules of UCBs with those of SCBs. Accordingly, medium-sized enterprises, social infrastructure and renewable energy will form part of the priority sector. The distinction between direct and indirect agriculture has been removed. Also, bank loans to food and agro-processing units will constitute PSL to agriculture. The achievement of priority sector targets will be included as a criterion for classifying a UCB as financially sound and well managed (FSWM).

8. Financial Inclusion

III.44 With growing empirical evidence on the potential development benefits from financial inclusion, the Reserve Bank's agenda has broadened from the initial focus on provision of credit and making available savings avenues to a larger remit of diverse services including transactions, payments and insurance, while continuing to wean away the financially disadvantaged sections of the society from informal sources of funds and the associated coercive practices. Steps were also taken during the year to strengthen existing schemes, such as business correspondents and lead bank scheme, so that they leverage on digital financial services in financial education and management of financial risks.

8.1 Business Correspondents' Registry Portal

III.45 The role of business correspondents (BCs) in expanding the reach of banking services in rural areas is gaining acceptance and recognition which is evident from the growth of 28 per cent in the number of transactions put through by BCs through the information and computer technology (ICT) channel. A registry portal developed by the IBA on the basis of the framework provided by the Reserve Bank was launched in February 2018 to enable banks to upload data pertaining to BCs employed by them. It is expected to sensitise the public with information on availability of BCs and their contact details once the portal becomes available for public consumption.

8.2 Lead Bank Scheme

III.46 The lead bank scheme (LBS) aims at co-ordinating the activities of banks and government agencies in enhancing the flow of bank finance to the priority sector and in the overall development of the rural sector. The Reserve Bank's committee of executive directors, constituted to study the efficacy of the system, has made several important recommendations in this regard. After taking into account the feedback from various stakeholders, the Reserve Bank issued guidelines aimed at improvement of the scheme in April 2018. State Level Bankers' Committee (SLBC) should focus on policy issues while routine issues may be delegated to specific sub-committee(s). Lead banks were advised to make available necessary infrastructure for lead district managers (LDMs) for their effective functioning.

9. Consumer Protection

III.47 The Reserve Bank is actively engaged in improving customer service in banks by addressing existing inadequacies and the need to benchmark it against international standards in order to instil timeliness and quality by harnessing technological developments and appropriate incentives to facilitate change.

9.1 Ombudsman Scheme

III.48 The banking ombudsman scheme is a cost-free apex mechanism for expeditious resolution of complaints of bank consumers. On similar lines, the ombudsman scheme for NBFCs was launched by the Reserve Bank under Section 45L of the Reserve Bank of India Act, 1934 with effect from February 23, 2018. To begin with, it has been operationalised for all deposit-taking NBFCs (NBFCs-D). Offices of the NBFC Ombudsman have started functioning from Chennai, Kolkata, Mumbai and New Delhi. Additionally, as the digital mode of financial transactions is gaining traction in the country, a dedicated ombudsman scheme for digital transactions would be implemented going forward.

9.2 Internal Ombudsman Scheme, 2018

III.49 The Reserve Bank issued instructions to appoint internal ombudsman to select SCBs in 2015. These were reviewed, and revised instructions were issued as Internal Ombudsman Scheme, 2018 as directions under Section 35A of the Banking Regulation Act on September 3, 2018. The Scheme covers all SCBs with more than ten banking outlets in India (excluding RRBs). It is expected to strengthen the grievance redressal mechanism in banks by enhancing the autonomy of the internal ombudsman.

9.3 Customer Protection for Users of Prepaid Payment Instruments

III.50 In order to bring all customers to the same level with regard to electronic transactions made by them, the Reserve Bank's extant guidelines on limiting customer liability in respect of unauthorised electronic transactions involving banks and credit card issuing NBFCs would be extended to the users of prepaid payment instruments (PPIs) issued by other entities currently not covered by the same.

10. Payment and Settlement Systems

III.51 An efficient payment and settlement system is the cornerstone of a modern financial system. The Reserve Bank is vested with oversight of the payment and settlement systems in India and is also the driving developmental force in ensuring safe, secure, sound, accessible and authorised payment systems in the country. Its endeavours in this area included extending the scope and enhancing the features of Real Time Gross Settlement (RTGS), National Electronic Funds Transfer (NEFT) and Unified Payments Interface (UPI). Comprehensive directions were also issued on the operations of issuers of PPIs during the year.

10.1 Inward Remittances and UPI

III.52 Credit to the final beneficiary of a foreign inward remittance was initially allowed through RTGS and NEFT and extended to Immediate Payment Service (IMPS) in December 2013, subject to the condition that the audit trail of the entire chain of remittance is maintained and such transfers take place only to KYC-compliant accounts and that banks abide by the provisions of the Foreign Exchange Management Act (FEMA). The National Payments Corporation of India (NPCI) was allowed to process the domestic leg of foreign inward remittances through the UPI while adhering to the same conditions as applicable to processing of domestic leg through IMPS and NEFT effective May 9, 2018.

10.2 Co-operative Banks as Issuers in UPI

III.53 StCBs and district central co-operative banks (DCCBs) have been allowed to participate as issuers in the UPI, effective March 2018 through the sub-membership route enabled by the NPCI. This participation is subject to the condition that these banks have permission from the Reserve Bank to offer mobile banking services.

10.3 Merchant Discount Rate for Debit Cards

III.54 The merchant discount rate (MDR) framework for debit cards was rationalised with effect from January 1, 2018. The new MDR framework endeavoured to achieve the twin objectives of promoting debit card acceptance by a wider set of merchants, especially small merchants, while ensuring sustainability of the business for the entities involved. The framework categorises merchants on the basis of turnover, adopts a differentiated MDR for QR-code based transactions and specifies a ceiling on the maximum permissible MDR for both card-present and card-not-present transactions. Banks are required to ensure that merchants on-boarded by them do not pass on MDR charges to customers while accepting payments through debit cards.

10.4 Interoperability in Prepaid Payment Instruments

III.55 The Reserve Bank laid down the framework for implementing interoperability of PPIs through card networks and UPI, effective October 16, 2018. Interoperability allows PPI issuers, system providers and system participants to undertake, clear and settle payment transactions across systems without participating in multiple systems.

10.5 Directions for Central Counterparties

III.56 The Reserve Bank put in place a policy framework for recognition of the foreign central counterparties (CCPs) and issued directions on capital requirement and governance framework for all CCPs on October 15, 2018. The directions covered broad principles on governance, including the composition of the board, roles and responsibilities of the board, appointment of directors and constitution of committees. It also sets out net worth requirements and the ownership structure for CCPs.

11. Overall Assessment

III.57 A sound and resilient financial system is a *sine quo non* for a modern economy that involves the widest sections of its society in sharing equitably the benefits of economic and social progress. Developments in 2017-18 and 2018-19 so far point to sustained efforts gathering traction in securing and entrenching financial stability. Looking ahead, the credit cycle is likely to gain strength as the Reserve Bank's efforts towards resolution of stressed assets expedite the process of de-toxifying bank balance sheets. Carrying this drive forward will require policy initiatives that address risk management practices, the changing nature of banking – especially the increasing use of technology, ownership neutrality in regulation, and sound corporate governance so that an inclusive and sound banking sector efficiently intermediates the financing requirements of sustained high growth in an environment of macroeconomic stability.