XI RESERVE BANK'S VISION AND AGENDA FOR 2014-15

The Reserve Bank intends to further improve the financial sector through a series of initiatives that rest on five pillars. Its work agenda includes working with the government to strengthen the monetary policy framework. To strengthen the banking structure, the Reserve Bank will put in place a system for licensing differentiated banks and move towards on-tap licensing of universal banks. Several complementary steps, like refining priority sector guidelines and KYC norms are also under consideration. The Reserve Bank will continue its efforts to broaden and deepen financial markets through an array of initiatives. Besides, ongoing efforts will reinforce the regulatory and supervisory regimes, with a view to reducing distress in financial and non-financial firms.

XI.1 In mid-2013-14, the Reserve Bank set itself a medium-term agenda of transforming the financial sector, to turn it into a stronger, deeper, more efficient and inclusive system. This agenda was built on five pillars. The approach encompasses: (i) strengthening the monetary policy framework; (ii) increasing diversity and competition in banking industry while improving governance in existing banks; (iii) broadening the choice of financial instruments, and deepening and enhancing liquidity in financial markets; (iv) improving access to finance; and (v) reinforcing the financial system's ability to cope with stress.

Towards improving Monetary Policy Framework and Transmission

Disinflation Path and Implementation of a New Monetary Policy Framework

XI.2 As explained in Chapter I, high and persistent inflation has become a key risk to the growth outlook and to overall macroeconomic stability. The Reserve Bank has set out a disinflation path, with the goal of containing consumer price index CPI inflation to 8 per cent by January 2015 and 6 per cent by January 2016. The outlook segment of Chapter I spells out the Reserve Bank's approach to strengthening the monetary policy framework and addressing impediments to the transmission of monetary policy. It intends to take this approach forward in coordination with the government, recognising the government's efforts to augment supply capacity, as well as the Reserve Bank's traditional focus on managing aggregate demand. Both the supply and demand side approaches are necessary for lowering inflation. As such, monetary, fiscal and structural policies have to play complementary roles in containing inflation. The Union Budget for 2014-15, by stressing adherence to the fiscal consolidation path and providing direction for addressing supply constraints, will help the Reserve Bank follow the disinflationary path laid out in the January 2014 Monetary Policy Statement, viz., containing CPI inflation to 8 per cent by the beginning of 2015 and 6 per cent by the beginning of 2016.

XI.3 The Finance Minister's 2014-15 budget speech indicated the government's commitment to putting in place a modern monetary policy framework in consultation with the Reserve Bank. Implementation of the proposed new monetary policy framework could go a long way in building monetary policy credibility and anchoring inflation expectations.

Improving forecasting and analytical capabilities through state-of-the-art modelling exercises

XI.4 The forecasting and analytical abilities of a central bank are essential to understand inflation and growth dynamics, as also transmission of monetary policy. Recognising this, the Reserve

Bank has an agenda to develop an array of models that can serve as a useful support for monetary and macroeconomic policy formulation and analysis. Like many other central banks, the attempt will be to develop such models through dedicated technical teams over the medium-term.

Efforts to strengthen the banking structure

Towards a more competitive, efficient and heterogeneous banking structure

XI.5 A heterogeneous banking system can meet varied customer needs in a more efficient manner. It can offer a wider range of customer services that can enhance consumer welfare as different banks can operate differently based on their reach, liquidity, capitalisation and market power considerations. Overall, the banking system can become more competitive and efficient as it becomes more varied.

XI.6 The first Bi-monthly Monetary Policy Statement for 2014-15 dated April 1, 2014 stated that the Reserve Bank will start working on the framework for differentiated bank licences and on-tap universal licenses, building on the discussion paper on "Banking Structure in India - The Way Forward" and using the learning from the recent licensing process. This was also reaffirmed in the Union Budget 2014-15. Differentiated banks serving niche interests are contemplated to meet credit and remittance needs of small businesses, the unorganised sector, low income households, farmers and migrant workers.

XI.7 Accordingly, the Reserve Bank in mid-July 2014 issued separate draft guidelines for licensing of Small Banks and Payment Banks. After obtaining comments and suggestions from the stakeholders, the final guidelines are expected to be issued later in the year.

Basel III Leverage Ratio Framework

XI.8 The experience drawn from the global financial crisis suggests that the build-up of excessive on-balance sheet, as well as off-balance sheet leverage in the banking system was at the core of the financial fragilities those were witnessed. In this context, based on recent recommendations by the Basel Committee on Banking Supervision (BCBS), the Reserve Bank will issue revised guidelines on the leverage ratio. Any final adjustments to the Basel III leverage ratio will be carried out by 2017, with a view to migrating to a Pillar 1 treatment of advanced minimum capital and liquidity requirements on January 1, 2018. In addition to the framework for leverage ratio, the Reserve Bank is also finalising a framework for counter-cyclical capital buffers taking into account BCBS's recommendations on the same.

Review of the exposure limits for single/group borrowers

XI.9 In order to contain the maximum loss a bank could face in the event of a sudden failure of a counterparty or a group of connected counterparties and retain its solvency, the Reserve Bank has put in place single and group borrower exposure limits. BCBS revised its standards on large exposures in April 2014, under which the exposure limits for 'single' and 'group of counterparties' were kept at 25 per cent of Tier I capital. Our current exposure limits to a group of borrowers is much higher at 40 per cent of capital funds (plus 10 per cent for infrastructure finance). It is proposed to review the exposure norms in 2014-15, to gradually align them with the revised global standards. The tightening of exposure norms will also help in risk mitigation during cyclical downturns as banks exposure under the framework will be more granular and diversified to a large number of unrelated counterparties rather than being concentrated to a handful of large and related counterparties.

Improving the soundness of non-bank financial intermediaries

XI.10 While banks are unique in financial system as they provide checkable deposit facilities and have credit creation capacity, non-bank financial companies (NBFCs) occupy a vital position in the financial system by providing niche services at low intermediation costs. The Reserve Bank is at present engaged in reviewing the extant regulatory framework for NBFCs, keeping in view the developments in the sector, the recommendations made by various committees and suggestions made by Financial Sector Legislative Reforms Commission (FSLRC). Certain changes are being envisaged with a view to appropriately aligning regulation of similar activities by different financial intermediaries. Consequently, some of the areas being reviewed include prudential regulations with a view to strengthening core capital, asset classification and provisioning norms, acceptance of deposits, corporate governance, consumer protection and enhanced reporting, disclosures and transparency for the sector. In addition, the Reserve Bank is engaged in taking suitable steps to strengthen the supervisory framework.

XI.11 Other measures that are envisaged include examining the avenues available for resource raising by NBFCs with a view to enhancing availability of funding for the sector. The issue of raising of debentures through private placements will be relooked at in view of the revised regulations on private placements under the Companies Act 2013. The Reserve Bank also proposes to carry forward the work of the G-20 and Financial Stability Board (FSB) on shadow banking so as to identify possible areas of interconnectedness and entities that can pose risks to the formal financial sector.

XI.12 In the wake of recent revelations of unauthorised acceptance of deposits by some companies, the Reserve Bank is intensifying its publicity and customer awareness initiatives to educate the public on and the necessity of exercising appropriate diligence before depositing money with any entity. The State Level Coordination Committees (SLCCs) are being strengthened to allow for greater sharing of information between financial sector regulators and state governments and for facilitating coordinated action against recalcitrant entities. Further, steps are underway to strengthen the market intelligence function which is of particular significance for effective supervision of this sector.

Fortifying the supervisory framework for urban cooperative banks

XI.13 Urban cooperative banks (UCBs) were brought under the Supervisory Action Framework (SAF) with effect from March 1, 2012. The framework envisages pre-emptive action if the key financial indicators of a UCB deteriorate. It is proposed to strengthen SAF to identify problems and initiate corrective action at an early stage.

XI.14 The guidelines for mergers/amalgamations of UCBs that were framed during 2005-10 to facilitate consolidation and emergence of strong entities and for providing an avenue for non-disruptive exit of weak/unviable entities in the co-operative banking sector will also be reviewed. Efforts will be made to put in place a mechanism to facilitate mergers/takeovers of assets and liabilities of negative net worth banks without the acquiring bank having to bear the burden of the loss. At present, conversion of a UCB into a commercial bank is not permitted. The Reserve Bank plans to engage with the Government of India for enabling legal changes to help large and willing multi-state urban cooperative banks to convert themselves into commercial banks.

Improving stress testing

XI.15 Over the next few years, the Reserve Bank will make efforts to further improve its tools for stress testing of banks by including a wider array of indicators. The Reserve Bank has over the last three years developed considerable capacity and a well-established stress testing framework, but this could be refined further especially in a multi-factor setting. The Reserve Bank has been disseminating its stress results through its Financial Stability Report (FSR) that is published twice a year - June and December. The Reserve Bank also publishes its statutory Report on Trends and Progress of Banking in India. Henceforth, it intends to bring the latter as part of the December FSR for better synergy in publications.

Making financial markets deeper, wider and more liquid

XI.16 Deeper, wider, more liquid and efficient financial markets provide support to growth. To make this process more efficient and transparent, the Reserve Bank plans to undertake reforms in financial markets, set up an over the counter (OTC) derivatives trade repository and take several other steps in support of the debt management strategy.

Reforms in financial benchmarks

XI.17 In line with the recommendations of the Committee on Financial Benchmarks (Chairman: P. Vijaya Bhaskar), the Reserve Bank has advised Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Foreign Exchange Dealers' Association of India (FEDAI) to jointly set up an independent body for administrating major Rupee interest rate and foreign exchange benchmarks. The objective is to overcome the conflicts of interest in the benchmark setting process arising out of their current governance structure. The proposed independent body will implement the recommendations of the Committee on Financial Benchmarks and will ensure compliance with the International Organisation of Securities Commission (IOSCO) Principles on Financial Benchmarks. The benchmarks submission activities of the banks and primary dealers (PDs), including their governance arrangements for submissions, will be brought under the Reserve Bank's on-site and off-site supervision system.

OTC derivatives trade repository

XI.18 An appropriate public dissemination system will be instituted at Clearing Corporation of India Ltd. (CCIL) for disclosing the price and volume information relating to major inter-bank OTC foreign exchange (FX) derivatives, such as FX forwards and options, reported to the trade repository. This will help promote greater transparency and reduce information asymmetry.

Development of debt markets

XI.19 With a ₹6 trillion market-borrowing programme, sovereign debt markets assume a vital role in the conduct of fiscal policies and have spillover effects, including that on interest rates and the exchange rate. The Reserve Bank plans to articulate a comprehensive Debt Management Strategy with sound international practice, extending maturities to cater to the requirements of diverse investors, undertaking consolidation of public debt and reducing rollover risk through active switch / buyback operations.

XI.20 Improving the liquidity of the G-sec markets also remains a priority. In this context, a review of the guidelines for short sale and repo/reverse repo in G-secs is planned with a view to introducing limited re-repo/re-hypothecation of "repoed" government securities. Possible ways to revitalise market-making by PDs will also be examined. Introduction of the swap execution facility with central counterparty (CCP) in the interest rate swap (IRS) market will be a focus area during 2014-15. Upgradation of the NDS order-matching (NDS-OM) platform would be initiated with the objective of having faster throughput, enhanced functionalities, rich user interface and internationally compatible message formats. The feasibility of international settlements for Indian sovereign debt securities will also be examined.

Rationalisation of foreign exchange management

XI.21 Even though the current account deficit (CAD) has improved since Q2 of 2013-14, the need for robust capital flows in a capital deficit economy like India assumes importance to bridge the saving-investment gap. Against this backdrop, foreign exchange management will evolve keeping in view long-term objectives as well short-term developments in the external sector.

XI.22 The specific areas that will engage the Reserve Bank's attention include: (i) simplifying the foreign investment regime to ensure that it is user-friendly to all stakeholders; (ii) reviewing the scope of external commercial borrowings; and (iii) reviewing the foreign exchange derivative market to enhance its width and depth. With this in view, the proximate objective is to consolidate and rationalise extant regulations so as to provide a simple, comprehensive and transparent regime. The Reserve Bank's action plan includes a review of the borrowing regime for the infrastructure sector. A framework for multilateral agencies as well as Indian infrastructure financing companies to access the international market through rupee denominated bonds will also be explored.

XI.23 The foreign exchange market needs more products to help participants manage their foreign exchange risk. Non-residents, can also be granted greater access thereby taking the process of capital account liberalisation further. Foreign portfolio investors (FPIs) have now been granted access to the domestic exchange traded derivative markets. Further rationalisation of the procedure would be considered based on experience. Over the medium term, extending access to the OTC market to international stakeholders could also be considered. Besides, options market could be expanded over the coming years to allow market participants hedge more easily and cheaply.

Improving access to finance and protecting consumer interests

Improving access to finance

XI.24 Over the past several years, the Reserve Bank's efforts to improve access to finance for poor people and small enterprises have yielded positive results . Yet, in view of the sheer enormity of the task, these efforts have to go much further. Efforts will be made to use innovative products, technology, telecom infrastructure and the biometric data base of the government to onboard customers and improve accessibility to bridge the gap between performance and potential. The 'Know Your Customer' (KYC) guidelines will be re-examined with a view to making banking more friendly, while at the same time ensuring that it does not weaken anti-money laundering requirements. Priority sector guidelines have not kept pace with changing economic priorities and may lead to less efficient use of resources. During the course of the year, priority sector guidelines will be reviewed.

XI.25 In order to continue with the process of ensuring further penetration of banking services to the financially excluded people, banks were advised in January 2013 to draw up fresh 3-year financial inclusion plans (FIPs) for the period 2013-16. The focus under the new plan was to ensure increase in the volume of transactions, especially in Business Correspondents-Information and Communication Technology (BC-ICT) accounts, by increasing the flow of credit to small value customers, as greater use of technology is key to lowering transaction costs and making financial inclusion a viable proposition.

XI.26 Financial inclusion efforts will be supported by initiatives in the area of payment systems. Efforts will be made to provide a fillip to mobile banking in the country so as to leverage the potential of the high mobile density that exists in the country. Necessary groundwork will be undertaken to put in place standards for customer on-boarding, security of transactions and redressal of customer grievances, besides engaging with stakeholders to explore the feasibility of having a standardised application for mobile banking across banks.

XI.27 The empowered committees on micro, small and medium enterprises (MSMEs) set up at the

Reserve Bank's regional offices will be asked to more closely monitor and review the progress of restructuring / rehabilitation of sick MSE units to help in early detection of sickness in MSE units and their timely revival. Further, in order to provide quick and efficient financing options for the MSME segment, it is proposed to set up an electronic Trade Receivables Discounting System (TReDS). This system will bring together the MSMEs, their corporate buyers as well as financiers and reduce the constraints faced by the MSME segment in liquidity management.

Use of technology and payment systems to facilitate finance

XI.28 The actionable agenda for 2014-15 for payment and settlement systems will include putting in place the guidelines and operational parameters for a pan-India bill payment system which will facilitate anytime, anywhere system of making bill payments. Also, the consolidation of payment systems which offer similar services or cater to the needs of same market segments (for instance, electronic clearing service (ECS) and National Automated Clearing House (NACH) will be taken up.

Plan to frame comprehensive consumer protection regulations

XI.29 Regulation of any industry is guided by considerations of lowering risks, encouraging competition and adoption of fair practices to protect the interest of producers as well as consumers. The vulnerability of consumers, particularly retail consumers of services provided by financial intermediaries, including banks, is well recognised. Therefore, there is a pressing need for the creation of a unified consumer protection framework which will apply to all segments of the financial system. During 2014-15, the Reserve Bank proposes to frame comprehensive consumer protection regulations based on domestic experience and global best practices. A Charter of Customer Rights in collaboration with various stakeholders in the banking sector will be formulated. The charter is expected to act in future as a comprehensive financial consumer code which will better protect consumers of financial products and ensure that they have the necessary information available to make responsible financial decisions.

Planned initiatives on currency management

XI.30 The Reserve Bank is planning several initiatives with a view to improving currency management and providing better services for the common man. It is expected to launch the field trial of plastic notes by next year. The Reserve Bank is also looking at other alternatives for improving the life of banknotes. In view of the continuous increase in the number of notes in circulation, the Reserve Bank will harness technological advancements in the areas of storage, transport and distribution as also to set up a fully automated cash processing centre as a pilot project. It also proposes to introduce new series banknotes in order to take advantages of the latest innovations in the currency note printing technology and to stay ahead of counterfeiters, as also redesign coins to make them user friendly and long lasting. The Reserve Bank is also bringing about improvements in packing currency notes so as to make handling more labour friendly.

Improving the financial system's ability to cope with distress

XI.31 It is important to improve the financial system's ability to cope with stress and distress by not only providing for counter-cyclical buffers, but also by directly dealing with stress through effective resolution regimes. The Reserve Bank in 2013-14 has taken several initiatives in this regard and plans to carry the agenda forward by strengthening the corporate debt restructuring mechanism, credit information and the resolution regime.

XI.32 The Working Group on Resolution Regime for Financial Institutions (WGRRFI) after taking into consideration the key attributes for Effective Resolution Regimes advocated by the FSB submitted its report in January 2014. It assessed the need of a resolution regime for all financial institutions and financial market infrastructure (FMI) other than those owned and operated by the Reserve Bank of India, with an eye on overall financial stability. In coordination with FSDC, the Reserve Bank intends to take the process forward by seeking necessary legal and institutional changes and by creating of a resolution fund.

Research initiatives by the Bank

XI.33 A successful policy agenda and its implementation, broadly encompassing the five pillars mentioned earlier, needs research support. Accordingly, a research agenda has been drawn in the Reserve Bank. In the area of monetary policy, studies will cover aspects of desirable monetary frameworks and monetary transmission. In the area of banking the studies will cover the problem of deterioration in asset quality, capital raising for banks in the context of Basel III and systemically important banks. On access to finance, the credit portfolio of Indian banks will be analysed to understand the reach of finance to small borrowers. In the domain of corporate distress the reasons behind the rise in NPAs and impact of exchange rate volatility on corporate balance sheets will be explored. Other studies that are contemplated relate to the external sector, fiscal policy, financial integration, investment cycles and wealth effects.

XI.34 The research staff of the Reserve Bank has also explored possibilities for research collaboration with the in-house experts and visiting academics at the Centre for Advanced Financial Research and Learning (CAFRAL). Of particular interest are the subjects related to financial markets and exchange rates.

XI.35 The Reserve Bank is also planning to revamp the statistical data and information management system, with an emphasis on single point data collection, processing and dissemination. The objective is to improve data governance practices not only in the Reserve Bank but the banking sector as a whole. This will involve rationalisation and harmonisation of data across various returns, and data submission through XBRL (eXtensible Business Reporting Language) without manual intervention. For data sharing within and outside the Reserve Bank, a more structured data dissemination policy is envisaged. These initiatives in the areas of research and statistics are expected to improve analytical assessment in support of policy and operations in the Reserve Bank.