VI REGULATION, SUPERVISION AND FINANCIAL STABILITY

During 2016-17, the Indian banking sector had to cope with the concerns about deteriorating asset quality, on the one hand, and a sharp decline in credit growth, on the other, while supporting the government in its initiatives to further reach out to the public and in promoting digitalisation of the modes of payments in the economy. The branch authorisation policy was revised to harmonise the treatment of different forms of bank presence for the purpose of opening banking outlets in under-served areas. Empowered by requisite legislative provisions put in place by the government, the Reserve Bank focused on strengthening the institutional framework to address asset quality concerns by improving the recovery process and the early response mechanism. Having gained experience with the licensing of small finance and payments banks, the Reserve Bank explored the scope of introducing more differentiated banks such as 'wholesale and long-term finance banks' and also examined the regulatory challenges posed by innovations by Fin Tech entities in the financial landscape. Apart from focusing on the supervision of financial conglomerates and early response to asset quality deterioration, the Reserve Bank formalised a framework for taking enforcement action against banks for non-compliance with guidelines and instructions issued by it. For ensuring timely and effective redressal of customer grievances in non-banking financial companies (NBFCs), the Reserve Bank proposes to formulate an appropriate Ombudsman Scheme for NBFCs.

VI.1 The banking sector continued to grapple with the challenge of rising non-performing assets (NPAs) during 2016-17. In view of the mounting stress on asset quality, the banking sector's performance in terms of profitability and return on assets came under pressure in 2016-17. To deal with stressed assets, the existing regulations were revised in consultation with the stakeholders. Subsequent to promulgation of the Banking Regulation (Amendment) Ordinance, the Reserve Bank has taken several steps to expedite the process of resolution of certain large value stressed accounts. The market perception of this Ordinance seems to be positive for banks with relatively high level of non-performing assets (NPAs) and for firms with greater capacity to meet their interest obligations (Box VI.1). Further, in order to bring in greater transparency, banks were mandated to make suitable disclosures in the Notes to Accounts to Annual Financial Statements for 2016-17 and onward with regard to divergences in asset classification and provisioning from the Reserve Bank's supervisory assessment.

VI.2 Keeping in view the entry of differentiated banks and their role in financial inclusion, the branch authorisation policy was revised to harmonise the treatment of different forms of a bank's presence for the purpose of opening banking outlets in under-served areas. Licenses were issued to more players in the banking sector and some small finance banks (SFBs) and payments banks (PBs) began operations during the year. The Reserve Bank also explored the scope for operations of other types of differentiated banks to cater to the sector-specific financing needs of the economy.

VI.3 The Reserve Bank continued the process of harmonising the regulatory framework for cooperative banks and NBFCs with that of commercial banks. Apart from strengthening cooperative banks through mergers and licensing, there was also a move towards reducing the tiers

Box VI.1
Market Reaction to the NPA Ordinance*

The President approved the Banking Regulation (Amendment) Ordinance, 2017, on May 5, 2017. This ordinance empowers the Reserve Bank to direct banking companies to initiate insolvency proceedings in respect of corporate borrowers in default, under the provisions of the Insolvency and Bankruptcy Code, 2016 (IBC). It also enables the Reserve Bank to constitute committees to advise banking companies on resolution of stressed assets.

Following this, the Reserve Bank released a detailed action plan to implement the Ordinance on May 22, 2017. An Internal Advisory Committee (IAC) constituted by the Reserve Bank held its first meeting on June 12, 2017. The IAC recommended that all accounts with an outstanding amount greater than ₹50 billion, and with more than 60 per cent classified as non-performing by banks as on March 31, 2016 be resolved using the new IBC. Using these criteria, 12 accounts aggregating to around 25 per cent of the current gross NPAs were referred to the National Company Law Tribunal (NCLT), a statutory body responsible for judging insolvency proceedings under the new IBC law[1].

Against this backdrop, the following two events are analysed *viz.,* (i) the manner in which the market perceived the passage of the Ordinance empowering the Reserve Bank, and (ii) the reaction of stakeholders to the news of identification of default accounts.

With regard to the first event, *the event date* is defined as the date on which the Ordinance was approved (May 5, 2017). The *event window* around which the market response is analysed starts nine trading days before the event date and ends nine trading days after the event date. However, one week prior to the approval of Ordinance, the Finance Minister hinted at empowering the Reserve Bank to address the problem of non-performing assets (NPAs) in the Indian banking system. Since, it was likely that the stock market might have reacted prior to the actual event date, hence the principal empirical analysis here is based on the response of the stock market from five trading days prior to the event till the event date.

The response of the market is analysed by computing *abnormal returns (ARs),* which are defined as the difference between realised returns and expected returns. Expected returns are estimated by using the market model wherein for each company or bank, its stock returns are regressed on market returns separately over the *estimation window* starting 250 days prior to the event window and ending 30 days before the announcement date. The equation used for estimation is given below.

$$R_{i,t} = \alpha_i + \beta_i \times R_{M,t} + \epsilon_{i,t} \quad (1)$$

where, R_i is the individual stock returns over the estimation period, and R_M is the NIFTY 50 index return. The coefficients α_i and β_i computed over the estimation window are used to compute expected returns during the event window. The daily abnormal return is computed as a difference between the actual stock return and expected return calculated from Equation 1.

$$AR_{i,t} = R_{i,t} - E[R_{i,t}] \quad (2)$$

The aggregate abnormal returns are computed by cumulating up the abnormal returns across time during the event window.

$$CAR_{i(t_1\, t_2)} = \Sigma_{t=t_1}^{t_2} AR_{i\,t} \quad (3)$$

The analysis focuses on the 36 scheduled commercial banks for which stock market data are available. Those banks that have a non-performing asset to advances ratio (NPAR) above the sample median value for NPAR for all banks in 2015-16 are classified as *stressed* banks. The remaining are classified as *non-stressed* banks.[2] While a greater proportion of public sector banks are classified as stressed, almost all private sector banks are classified as non-stressed banks. The firm sample is divided into three sets on the basis of interest coverage ratio (ICR) in 2015-16: (i) low quality (ICR < 1), (ii) intermediate quality ($1 \leq$ ICR ≤ 2), and (iii) high quality (ICR ≥ 2).[3]

The event study analysis for all firms and associated banks is structured as follows: (i) comparison of stressed

* Based on CAFRAL research.

[1] Under the IBC, once a case is admitted to the NCLT, creditors have a maximum of 270 days to agree on a restructuring plan for the debtor, failing which the NCLT can order liquidation of the debtor.

[2] Bank-level data are obtained from the Database on Indian Economy (DBIE), RBI.

[3] Data for firms are from CMIE ProwessDx.

(Contd....)

banks and non-stressed banks, (ii) comparison of low quality, intermediate quality, and high quality firms, and (iii) comparison of low and high quality firms, segregated on whether their lead banks are stressed or non-stressed banks.[4]

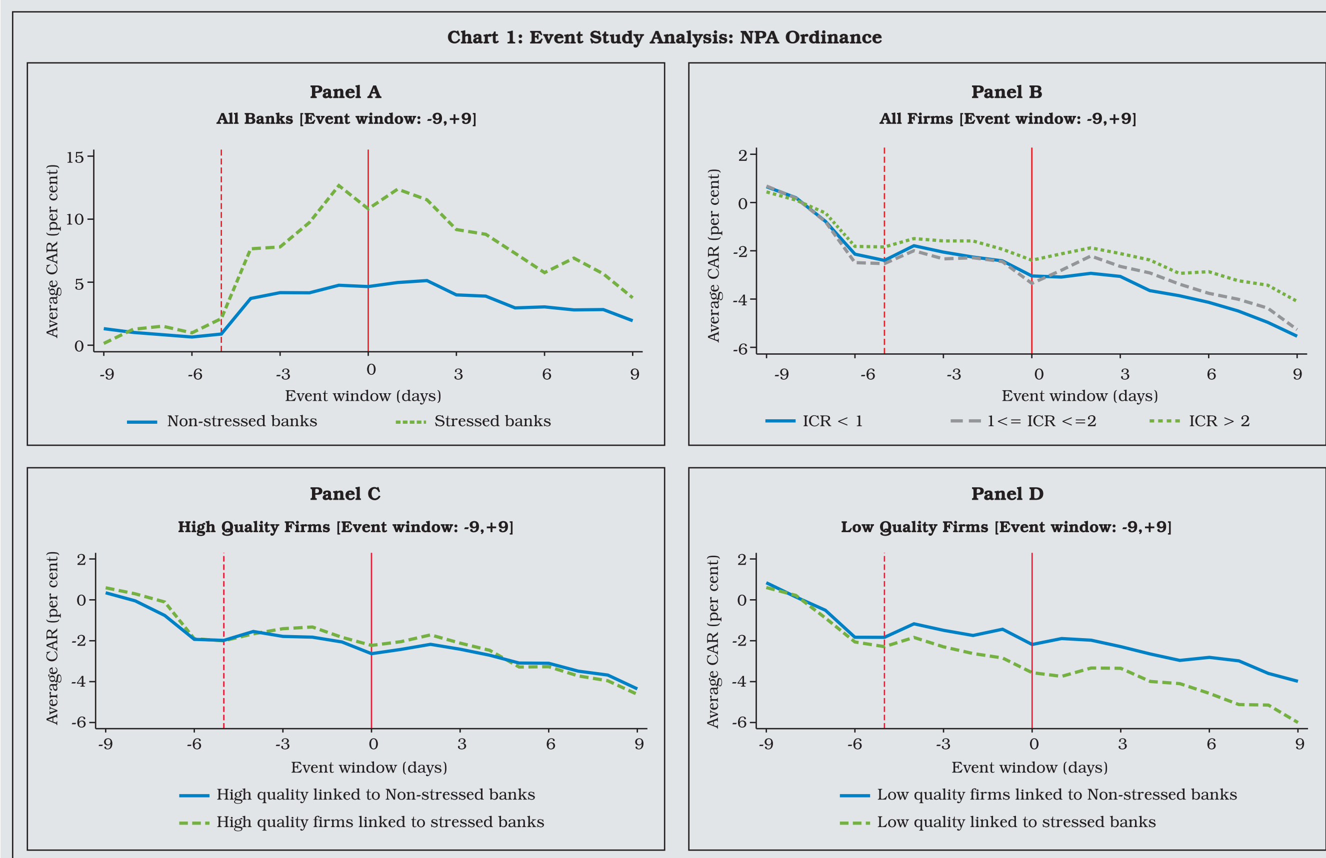
The second event study uses June 12, 2017 - the date of the IAC's first meeting - as the event date. It examines stock price reactions of the twelve firms that were referred to NCLT for resolution, and the lead banks of these firms. To study the relative market perception of these firms, all exchange listed firms in the same industry as the defaulter firms are used as *control* firms.[5] For the bank analysis, the thirty-six banks in the sample are divided into those that are the lead banks of any of these twelve defaulter firms and the remaining banks.

Results and Inference

Figure 1 displays the market response to the President's approval of the Banking Amendment Ordinance. Abnormal returns of stressed banks increased sharply following the Finance Minister's announcement (dashed red line at -5 in Chart 1, Panel A). This pattern continues till the event date which is the passage of the Ordinance. In contrast, non-stressed banks witnessed a more modest increase in abnormal returns. Strikingly, abnormal returns between stressed and non-stressed banks widened to almost 5 per cent indicating that markets perceived the amendment would help stressed banks in resolving their NPA problem. Panel B shows that low and intermediate quality firms performed worse than high quality firms. Overall, these results indicate that the recent amendment to the existing Banking Regulation Act is perceived by the market as being more positive for stressed banks, but negative for low and intermediate quality firms.

The remaining panels in Chart 1 further explore which firms are driving these results, based on whether the firm's lead bank is classified as stressed or non-stressed. Panel C and Panel D examine the market reaction of low and high quality firms, separating firms that are related to stressed

Chart 1: Event Study Analysis: NPA Ordinance

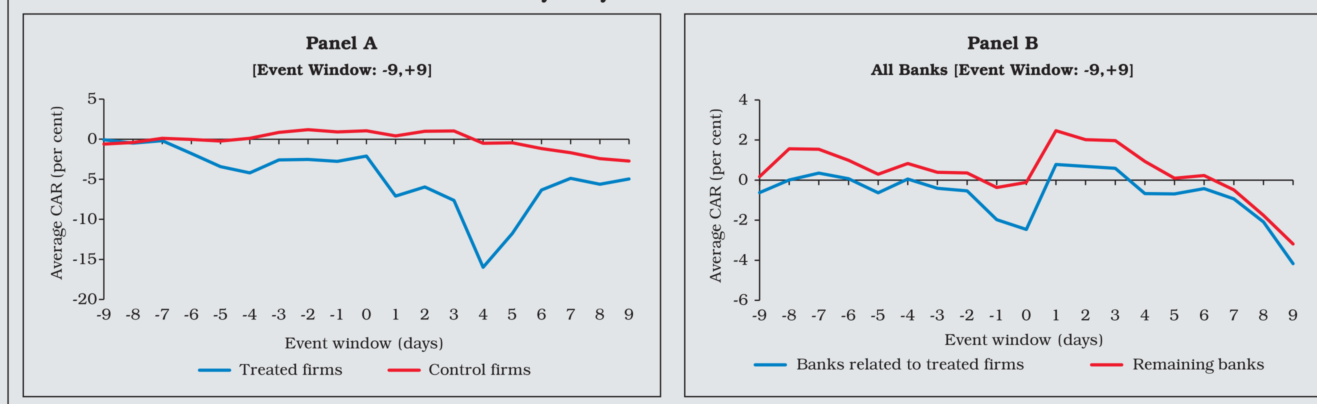


[4] The lead bank data are from CMIE.

[5] Firms with insufficient stock trading data are excluded from the control sample.

(Contd....)

Chart 2: Event Study Analysis: Identification of Default Accounts



banks *vis-à-vis* non-stressed banks. Low quality firms linked to stressed banks performed worse than low quality firms linked to non-stressed banks. In contrast, high quality firms linked to stressed banks performed better than high quality firms linked to non-stressed banks at least in the days immediately following the event date. It appears that the market lost confidence in low quality firms linked to stressed banks but high quality firms linked to stressed banks are seen in a positive light. One possible explanation is that high quality firms linked to stressed banks benefit from a balance sheet clean-up of stressed banks. The market may also be reflecting long term benefits to high quality firms possibly through the reallocation of resources away from low quality firms (Hsieh and Klenow, 2009 and Kulkarni, 2017).

The second event study focuses on the date of the IAC's first meeting on June 12, 2017 when defaulter accounts were identified. Chart 2 displays the response of the market to the announcement in reference to defaulter accounts. Panel A shows that defaulter firms realised a decline in abnormal stock returns relative to other firms belonging to the same industry as the defaulter firm. The identification of these firms by the Reserve Bank was a clear indication of their poor financial health, and it is evident that market stakeholders lost confidence in these firms. Panel B displays how the market responded to the lead banks of defaulter firms relative to other banks. In general, the abnormal returns increased for both the sets of banks immediately after the event.

In summary, both event studies point to a positive market reaction for banks but a negative market reaction for distressed firms. Thus, based on the market reaction, the Ordinance is good news for stressed banks as well as high quality borrowers. It has the potential to increase efficiency of capital allocation in the Indian economy with significant positive spillover effects on healthy firms and to rejuvenate the banking sector.

References:

1. Hsieh, C. and Klenow, P. (2009). "Misallocation and manufacturing TFP in China and India." The Quarterly Journal of Economics, 1124(4), 1403-1448.

2. Kulkarni N. (2017). "Creditor rights and allocative distortions: Evidence from India." CAFRAL Working Paper.

in the cooperative structure with a view to bringing down the cost of borrowings for final borrowers. Keeping in view the greater role envisaged for asset reconstruction companies (ARCs) in resolving stressed assets, regulatory norms for them were revised.

VI.4 With the entry of new forms of differentiated banks, the Reserve Bank began the process of developing a suitable framework for supervising payment banks and small finance banks. The Reserve Bank also identified a revised set of 11 financial conglomerates (FCs) for monitoring purposes. The Reserve Bank formalised a framework for taking enforcement action against banks for non-compliance with guidelines and instructions issued by it.

FINANCIAL STABILITY UNIT (FSU)

VI.5 FSU is responsible for analysing the risks to financial stability, undertaking macro-prudential surveillance through systemic stress tests and other tools, and disseminating information relating to the status of and challenges to financial stability through the bi-annual Financial Stability Report (FSR). FSU also acts as secretariat to the sub-committee of the Financial Stability and Development Council (FSDC), a coordination council of regulators for maintaining financial stability and monitoring macro-prudential regulation in the country.

Agenda for 2016-17: Implementation Status

VI.6 As planned, FSR was published in December 2016 along with the Report on Trend and Progress of Banking in India (RTP) and in June 2017. Towards strengthening the stress testing framework, a methodology for estimating sectoral probability of defaults to model the dynamics of risk weighted assets was developed and its output is being assessed.

VI.7 FSU is coordinating the macro-level stress testing exercise of all commercial banks as part of the Financial Sector Assessment Programme (FSAP) conducted jointly by the International Monetary Fund (IMF) and the World Bank. The Unit carried out stress tests based on the scenarios agreed upon under FSAP so as to broaden the scenario-based stress test analysis. The key emerging sectoral vulnerabilities of banks have also been analysed.

VI.8 The FSDC sub-committee held two meetings in 2016-17 and reviewed various issues including establishing a statutory financial data management centre, developing corporate bond market, minimum assured return scheme under the National Pension System (NPS), regulation of spot exchanges, setting up of computer emergency response team for the financial sector (CERT-Fin), roadmap for the National Centre for Financial Education, single pension regulator for the pension sector in India, extant macro-prudential framework in India, and framework for identification of systemically important financial institutions (SIFIs). The status of the recommendations of the financial stability board (FSB) peer review of India and the progress of FSAP 2017 were also discussed by the sub-committee.

VI.9 Inter-Regulatory Technical Group (IRTG), a sub-group of the FSDC sub-committee held one meeting during the year and discussed the implementation of the recommendations of Legal Entity Identifier (LEI) working group.

Agenda for 2017-18

VI.10 In the year ahead, FSU will continue to conduct macro-prudential surveillance, publish the bi-annual FSR and conduct meetings of the FSDC sub-committee. The feasibility of expanding the contagion (network) analysis to urban cooperative banks will also be examined.

REGULATION OF FINANCIAL INTERMEDIARIES

Commercial Banks: Department of Banking Regulation (DBR)

VI.11 DBR is the nodal department for regulation of commercial banks. The regulatory measures focus on ensuring a healthy and competitive banking system in the country to promote financial stability, and cost effective and inclusive banking services.

Agenda for 2016-17: Implementation Status

Financial Stress and Reinforcements

VI.12 During 2016-17, the Reserve Bank further strengthened the regulatory framework for dealing with stressed assets, *inter alia*, by revising its

guidelines on the resolution of stressed assets; *viz.*, the strategic debt restructuring (SDR) scheme, the scheme for sustainable structuring of stressed assets (S4A), flexible structuring of existing long term project loans to infrastructure and core industries; and guidelines for projects under implementation. Keeping in view the critical role of the bankruptcy and insolvency regime in shaping the business environment as well as resolution of debtors in distress, the government enacted the Insolvency and Bankruptcy Code, 2016 in May 2016. This single law will override multiple and overlapping laws and adjudicating forums dealing with financial failures and insolvency of companies and individuals in India (Box VI.2).

VI.13 With a view to further strengthening banks' ability to resolve their stressed assets effectively and to enhance transparency in the entire process, the Reserve Bank issued guidelines on sale of stressed assets by banks on September 1, 2016. The guidelines require banks to identify and list internally, at least once a year, the specific financial assets identified for sale to other institutions, including securitisation companies (SCs)/reconstruction companies (RCs).

Branch Authorisation Policy

VI.14 The Reserve Bank issued final guidelines on May 18, 2017, clarifying on what constitutes a 'banking outlet' and harmonising the treatment of different forms of bank presence for the purpose

Box VI.2
The Insolvency and Bankruptcy Code, 2016

The Insolvency and Bankruptcy Code (IBC), 2016 consolidates and amends the laws relating to reorganisation and insolvency resolution of corporate persons (excluding financial service providers), partnership firms and individuals in a time bound manner for maximising the value of assets of such entities. Some of the key aspects of the IBC are set out below.

1. IBC lays down a resolution process that is time bound (180 days) and is undertaken by professionals. It creates an institutional mechanism for the insolvency resolution process for businesses either by coming up with a viable survival mechanism or by ensuring their prompt liquidation.
2. IBC's institutional infrastructure comprises four pillars, *viz.*, insolvency professionals, information utilities, adjudicating authorities and the Insolvency and Bankruptcy Board of India (IBBI).
3. While insolvency resolution for companies will be adjudicated by the National Company Law Tribunal (NCLT), the same for firms and individuals will be adjudicated by the Debt Recovery Tribunals (DRTs). The IBBI is the apex body for promoting transparency and governance in IBC's administration.
4. Where a corporate debtor has defaulted in paying a debt, the corporate insolvency resolution process may be initiated by a financial creditor, an operational creditor or the corporate debtor itself.
5. A default-based test for entry into the insolvency resolution process permits early intervention when the corporate debtor shows early signs of financial distress.
6. On the distribution of proceeds from the sale of assets, first priority is accorded to the costs of insolvency resolution and liquidation, and second to the secured debt together with workmen's dues for the preceding 24 months. Central and state governments' dues are ranked lower in priority.

By providing an effective legal framework for timely resolution of insolvency and bankruptcy, IBC will support the development of credit and corporate bond markets, strengthen debt recovery, encourage entrepreneurship, improve ease of doing business and facilitate more investments. The code proposes a paradigm shift from the existing 'debtor in possession' to a 'creditor in control' regime. Moreover, the priority accorded to secured creditors is advantageous for entities such as banks.

IBC's success hinges to a great extent on the efficient functioning of information utilities. An adequate number of insolvency professionals will also be needed to handle the large number of cases. More benches of NCLT may also have to be set up as the volume of references increases.

of opening banking outlets in under-served areas (Box VI.3).

Diversification of Lending Base

VI.15 Towards aligning the exposure norms for Indian banks with the Basel Committee of Banking Supervision (BCBS) standards and to further diversify the banks' lending base, on December 1, 2016, the Reserve Bank issued final guidelines on large exposures framework (LEF), effective April 1, 2019. The exposure limits will consider a bank's exposure to all its counterparties and groups of connected counterparties.

VI.16 To encourage funding from sources other than bank credit for the corporate sector, the Reserve Bank, in August 2016, issued guidelines on enhancing credit supply for large borrowers through market mechanism, effective April 1, 2017.

VI.17 Scheduled commercial banks (SCBs) were advised that housing finance companies (HFCs) will be risk weighted in a manner similar to that of corporates to bring uniformity in the application of risk weights among banks on their exposures.

VI.18 Banks were allowed to invest in Real Estate Investment Trusts (REITs) and Infrastructure

Box VI.3
Rationalisation of Branch Authorisation

The first bi-monthly monetary policy statement 2016-17 announced on April 5, 2016 proposed to redefine branches and permissible methods of outreach, keeping in mind the various attributes of banks and the types of services that are sought to be provided. Accordingly, based on the report of an internal working group and public comments on the report, final guidelines clarifying what is a 'banking outlet' and harmonising the treatment of different forms of bank presence for the purpose of opening outlets in under-served areas were issued on May 18, 2017 as under:

Banking outlet: A banking outlet includes a branch as well as business correspondent (BC) outlet, among others. For a domestic scheduled commercial bank (DSCB), a small finance bank (SFB) and a payment bank (PB), it is a fixed point service delivery unit, manned by either bank's staff or its BC where services of acceptance of deposits, encashment of cheques/ cash withdrawal or lending of money are provided for a minimum of four hours per day for at least five days a week. If it provides services for less number of hours per day and days in a week, it is considered a part-time banking outlet.

Unbanked rural centre (URC): It is a rural (Tier 5 and 6) centre that does not have a core banking solution (CBS) enabled banking outlet of an SCB, a PB, an SFB or an RRB nor a branch of a local area bank or a licensed co-operative bank for carrying out customer based banking transactions. Thus, the role of technological advances in banking services is recognised as against the earlier definition based on a brick and mortar structure.

Conditions for opening banking outlets: At least 25 per cent of banking outlets opened during a financial year must be opened in unbanked rural centres. Pro-rata benefit for part-time banking outlets will also be extended. The opening of a banking outlet/part-time banking outlet in a Tier 3 to 6 centre of north-eastern states, Sikkim and left wing extremism affected districts, notified by the Government of India, will be considered as equivalent to opening a banking outlet/part-time banking outlet in a URC. A bank opening a brick and mortar branch in a rural (Tier 5 and 6) centre which – owing to the presence of a BC outlet of another bank – is not defined as a URC, will also be eligible for the same incentive. Similar treatment will be given for opening a banking outlet in a rural centre which is served only by a banking outlet of a PB.

Micro Finance Institution (MFI) structure of SFBs: Towards preserving the advantages of the MFI/NBFC structure of SFBs to promote financial inclusion, they have been allowed three years from the commencement date, to align their banking network with the extant guidelines. Till such time, the existing structure may continue and the existing branches will be treated as banking outlets though not immediately reckoning for the 25 per cent norm. Nevertheless, during this period of three years, the 25 per cent norm will be applicable for all the banking outlets opened or converted from the existing MFI branches in a year.

Role of board of directors: Financial inclusion being the overarching objective of the revised framework and given the operational flexibility being provided to banks, the boards of banks have been accorded overall responsibility to ensure that all the guidelines are complied with, in letter and spirit.

Investment Trusts (InvITs) within the overall ceiling of 20 per cent of net worth for direct investment in convertible bonds/ debentures, units of equity-oriented mutual funds and exposures to venture capital funds.

Capital and Risk Management

VI.19 With a view to developing the market for rupee-denominated bonds overseas and providing an additional avenue for raising capital, banks were permitted to issue rupee-denominated perpetual debt instruments (PDI) overseas as part of additional tier (AT)-1 capital and debt capital instruments as part of Tier 2 capital.

VI.20 The guidelines on capital requirements for banks' exposures to central counterparties, issued on November 10, 2016 and effective from April 1, 2018, specified the credit risk treatment for exposures to central counterparties arising from over the counter derivatives transactions, exchange traded derivatives transactions, securities financing transactions and long settlement transactions. The Reserve Bank also issued guidelines for computing exposure for counterparty credit risk arising from derivatives transactions.

VI.21 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 risk in banking book on February 2, 2017 for feedback/comments.

VI.22 In April 2015, the Reserve Bank had formulated a scheme for setting up of IFSC banking units (IBUs) by banks in International Financial Services Centres (IFSCs). The instructions under the scheme were modified in light of the feedback from stakeholders (Box VI.4).

Box VI.4
Modifications in Permissible Activities of IFSC Banking Units (IBUs)

The scheme for setting up of IFSC banking units aims at enabling banks to undertake activities largely akin to those carried out by overseas branches of Indian banks. Certain activities are, however, not allowed in view of the fact that IBUs are functioning from the Indian soil and the legal and regulatory framework is still governed by domestic laws and there is no separate financial sector regulator for IFSC. Nevertheless, IBUs were allowed progressively to undertake more activities as recently as in April 2017 as summarised below:

1. IBUs may undertake derivative transactions including structured products that the banks operating in India have been allowed. However, IBUs shall obtain the Reserve Bank's prior approval for offering any other derivatives products.
2. Fixed deposits accepted by IBUs from non-banks cannot be repaid prematurely within the first year. However, fixed deposits accepted as collateral from non-banks for availing credit facilities from IBUs or deposited as margin in favour of an exchange, can be adjusted prematurely in the event of a margin call or a default in repayment.
3. An IBU can be a trading member of an exchange in the IFSC for trading in the interest rate and currency derivatives segments that banks operating in India have been allowed to undertake.
4. An IBU can become a professional clearing member of the exchange in the IFSC for clearing and settlement in any derivatives segment.
5. IBUs are allowed to extend the facilities of bank guarantees and short term loans to IFSC stock broking/ commodity broking entities.
6. Any financial institution or a branch of a financial institution including an IBU operating in IFSC can maintain special non-resident rupee (SNRR) accounts with a bank (authorised dealer) in the domestic sector for meeting its administrative expenses in Indian rupee. These accounts must be funded only by foreign currency remittances through a channel appropriate for international remittances which will be subject to extant FEMA regulations.

A Task Force (Chairman: Minister of State for Finance) is monitoring the progress in the development of IFSCs. The Reserve Bank is a member of the task force.

VI.23 After a review of the criteria for determining customer liability in unauthorised electronic banking transactions, the final guidelines on customer protection – limiting liabilities of customers – have been issued.

VI.24 A regulatory framework making elements of Basel III standards selectively applicable to the All India Financial Institutions (AIFIs) is being put in place.

VI.25 An Aadhaar enabled one time pin (OTP) based e-KYC process was allowed in December 2016 for on-boarding of customers subject to certain conditions. The Reserve Bank also prescribed a customer due diligence procedure for opening accounts of judicial persons such as the government or its departments, societies, universities and local bodies like village *panchayats*.

VI.26 The Reserve Bank issued directions to scheduled commercial banks (excluding RRBs) to comply with Indian Accounting Standards (Ind AS) for financial statements beginning April 1, 2018 onwards, with comparatives for the periods ending March 31, 2018 or thereafter. Banks were also advised to submit proforma Ind AS financial statements for the half year ended September 30, 2016. The Reserve Bank is in the process of finalising the draft guidelines on key aspects of expected credit loss (ECL) under Ind AS to ensure minimum standards as also consistency in the application of the standards to the extent possible (Box VI.5).

Box VI.5
Implementation of Ind AS - Guidance on the Expected Credit Loss Framework

The implementation of Ind AS will mark a major shift from the current accounting framework followed by banks in India which is based on a melange of accounting standards and regulatory guidelines, especially in certain key areas such as classification and measurement of financial instruments, and impairment of financial assets.

Recent developments in the banking system underscore the continued importance of adequate provisioning, commensurate with the increase in credit risk. Applying an incurred loss provisioning framework can result in impairments that are recognised after the loss event has occurred, when the probability of default is close to 100 per cent. Provisions are not made as credit risk increases significantly (although short of default) even where bank management has information about stress/future likely losses.

Ind AS 109 expresses the view that delinquency is a lagging indicator of significant increase in credit risk. Banks are, therefore, expected to have credit risk assessment and measurement processes in place to ensure that credit risk increases are detected ahead of exposures becoming past due or delinquent, for timely transfer to lifetime expected credit losses. The standard differentiates between the three stages of credit risk:

- The financial assets in Stage 1 are those with no significant increase in credit risk since initial recognition, or financial instruments that have low credit risk at the reporting date. For these assets, 12-month expected credit losses (ECLs) are recognised in profit or loss.
- The financial instruments in Stage 2 are those which have experienced a significant increase in credit risk since initial recognition, but with no objective evidence of impairment. For such assets, lifetime ECLs are recognised. This accounting treatment is based on the rationale that an economic loss arises when ECLs significantly exceed initial expectations. By recognising lifetime ECLs following a significant increase in credit risk, this economic loss is reflected in the financial statements.
- The financial instruments in Stage 3 comprise those for which objective evidence indicates impairment at the reporting date. These are typically non-performing loans where the bank considers that the borrower is unlikely

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to pay the existing debt. Lifetime ECLs are recognised for these exposures.

The estimated overall impact of Ind AS on regulatory capital is likely to be adverse mainly due to the impairment requirements under it. In view of the capital constraints already faced by many banks, particularly public sector banks, the Reserve Bank believes that it may be appropriate to introduce transitional arrangements for the impact of accounting changes on regulatory capital. The primary objective of a transitional arrangement is to avoid a 'capital shock', by giving banks time to rebuild their capital resources following a potentially significant negative impact arising from the introduction of ECL accounting.

The Reserve Bank is also considering the introduction of 'regulatory floor' for provisioning in the regulatory capital calculation, *i.e.,* when a bank makes lower accounting provisions than the standardised regulatory floor amounts, the shortfall would be deducted from the bank's common equity tier (CET)1 capital, which would incentivise robust provisioning.

VI.27 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 in a backdrop of in-principle approvals and licenses issued to set up payments banks and small finance banks (Box VI.6).

VI.28 Considering payments banks and small finance banks' differentiated nature of business and their focus on financial inclusion, separate operating guidelines for these banks were issued in October 2016. The guidelines elaborate upon the areas of prudential regulations, risk management, ownership and control regulations, corporate governance, and banking operations to be adhered to by these banks.

VI.29 As part of the efforts to promote financial inclusion through a greater focus on small credit and payment/remittance facilities, the Reserve

Box VI.6

Discussion Paper on Wholesale and Long-Term Finance Banks

The proposed differentiated banks – wholesale and long-term finance (WLTF) banks – are expected to focus primarily on lending to infrastructure sector and small, medium and corporate businesses. They can mobilise liquidity for banks and financial institutions directly originating priority sector assets, through the securitisation of such assets and actively dealing in them as market makers. They may also act as market-makers in securities such as corporate bonds, credit derivatives, warehouse receipts and take-out financing. These banks can provide refinance to lending institutions and may be present in capital markets in the form of aggregators. The primary sources of funds for these banks could be a combination of wholesale and long term deposits (above a large threshold), debt/equity capital raised from primary market issues or private placement, and term borrowings from banks and other financial institutions.

Financial structures in some countries support banks concentrating on wholesale and long-term financing. Some of these institutions in the public sector, which began as part of the government-backed development policy, have begun their transition towards privatisation.

The stipulations for WLTF banks, expected to be different from universal banks, are mooted as: (i) higher initial minimum capital of ₹10 billion, (ii) negligible lending exposure to the retail sector, no savings accounts, and a higher threshold for term deposits of above ₹100 million, (iii) exemption from Statutory Liquidity Ratio (SLR) requirements and some relaxation in the prudential norms on liquidity risk, and (iv) exemption from a mandatory rural presence and priority sector lending requirements.

The issues for discussion posed by the discussion paper are: (i) whether there is a need for licensing WLTF banks when their proposed activities are currently allowed for universal banks, (ii) whether the time is opportune for this, (iii) what will be the net impact of such players on the financial system, and (iv) whether the proposed regulatory framework is appropriate.

Bank issued licenses to eight SFBs and six PBs during the year taking the number of licensees to 10 in case of SFBs and seven in case of PBs. Eight SFBs and four PBs have commenced operations.

VI.30 The Depositors' Education and Awareness (DEA) Fund, started in February 2014, had accumulated a corpus of ₹124 billion at end-March, 2017, and a total of 2,145 banks were registered for transfer of unclaimed amounts to the DEA Fund.

VI.31 The fields of specialisation for the directors on the boards of commercial banks (excluding RRBs) were broadened in May 2017 to include (i) information technology, (ii) payment and settlement systems, (iii) human resources, (iv) risk management, and (v) business management to bring in persons with professional knowledge and experience in these fields to the banks' boards.

VI.32 An inter-regulatory working group (Chairman: Shri Sudarshan Sen, Executive Director) was set up in July 2016 with members drawn from the Reserve Bank, SEBI, IRDA, PFRDA, IDRBT, select banks and rating agencies to examine the granular aspects of Fin Tech, particularly from the perspective of reorienting the regulatory framework. The report of the working group was submitted to the Reserve Bank in February 2017 for consideration.

Agenda for 2017-18

VI.33 The Reserve Bank will continue to focus on improving the institutional framework for a sound banking system in the country, particularly addressing asset quality issues. Implementation of Ind AS and the Basel III framework will be the areas of focus during 2017-18.

VI.34 In the context of Ind AS implementation, the Bank will issue guidelines on regulatory floors for asset provisioning. Guidelines on mechanics of the transitional arrangements will also be issued.

VI.35 The Reserve Bank will analyse the Ind AS financial statements submitted by banks for the quarter ended June 30, 2017 as part of the regulatory reporting. It will review other extant instructions in the light of Ind AS implementation.

VI.36 A discussion paper on margin requirements for non-centrally cleared derivatives was issued in May 2016. The final guidelines on margin requirements for non-centrally cleared derivatives will be issued, after a review of the developments globally, as also the availability of infrastructure required for exchange of such margins in India.

VI.37 The revised framework for securitisation, the minimum capital for market risk and the guidelines on corporate governance as per Basel standards shall also be issued.

VI.38 The Basel III norms prescribe two minimum standards for banks – the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) – for promoting short-term resilience of banks to potential liquidity disruptions and resilience over a longer-term time horizon, respectively. The LCR guidelines are effective in India since January 1, 2015. The draft guidelines on NSFR were issued in May 2015. The final guidelines will be issued during 2017-18.

VI.39 The revised regulatory framework for the AIFIs, including extension of various elements of Basel III standards relevant to these institutions, will be issued after due consultations with stakeholders.

Cooperative Banks: Department of Cooperative Bank Regulation (DCBR)

VI.40 The Reserve Bank continues to play a key role in the revival and strengthening of the cooperative banking sector by fortifying the regulatory and supervisory framework. In this context, DCBR, in charge of prudential regulations of cooperative banks, took the following initiatives in 2016-17.

Agenda for 2016-17: Implementation Status

Harmonisation of Regulatory Policies

VI.41 Taking the process of harmonisation of regulations forward, cooperative banks fulfilling certain criteria were allowed to issue/ redeem long term (subordinated) deposits (LTDs) without the prior approval of the Reserve Bank provided mandatory disclosure requirements were made. The guidelines on non-SLR investments by rural cooperative banks were aligned with those for urban cooperative banks (UCBs). Guidelines were issued for deployment of point of sale (POS) terminals and issuance of prepaid instruments by all cooperative banks.

Revival and Licensing of Unlicensed DCCBs

VI.42 The government launched a scheme for revival of 23 unlicensed DCCBs (Uttar Pradesh -16, Maharashtra - 3, Jammu and Kashmir - 3 and West Bengal - 1) in November 2014. Accordingly, a tripartite agreement in the form of a memorandum of understanding was signed between the central government, the concerned state government and NABARD. With the release of funds by the government, the concerned state government and NABARD, banking licenses were issued to the unlicensed DCCBs in Uttar Pradesh, Maharashtra and West Bengal, bringing down the number of unlicensed DCCBs to three by September 30, 2016. Licensing of the remaining DCCBs has been taken up with the state of Jammu & Kashmir. There is also a move towards reducing the tiers in the cooperative structure with a view to reducing the cost of borrowings for final borrowers (Box VI.7).

Box VI.7

Two-tier Rural Cooperative Structure in Jharkhand

The short term cooperative credit structure (STCCS) of the country primarily meets the crop and working capital requirements of farmers and rural artisans. The pyramid of STCCS is primarily 3-tier and is federal in nature within a state. The apex level is the state cooperative bank (StCB), at the district level there are district central cooperative banks (DCCBs) and at the village level, there are primary agricultural credit societies (PACS). Across India, there are more than 93,000 PACS having a membership base of 120 million. The structure of STCCS is not uniform across the states with a 3-tier structure in 16 states and 2-tier structure in 13 smaller states and union territories where PACS are directly affiliated to StCBs. There is a mixed structure in three states – 2-tier in some districts and 3-tier in others.

Notwithstanding the phenomenal outreach and volume of operations, the financial health of STCCS has been a matter of concern. In a 3-tier credit structure, each tier adds to cost and margins leading to an escalation in the cost of borrowings for the ultimate borrowers. The interest rate structure also varies from one state to another. Since STCCS deals with relatively larger number of small value loan accounts as compared with commercial banks and RRBs, the transaction cost also tends to be high.

The relevance of the three-tier credit structure has been examined by several committees in the past (notably, those headed by Professor V. S. Vyas, Shri Jagdish Capoor, Professor Vaidyanathan and Dr. Prakash Bakshi). The Vyas Committee argued for the elimination of one of the tiers to bring down costs for ultimate borrowers. The NABARD Act, 1981 was amended in 2003 to provide for direct refinance to DCCBs but no concrete action has been initiated towards reducing tiers in STCCS.

(Contd...)

In 2013, the Jharkhand State Cooperative Bank (JStCB) took a path breaking initiative and approached the Reserve Bank to approve establishment of a 2-tier rural cooperative structure in the state to replace the age-old 3-tier structure. The state proposed to merge all the DCCBs with JStCB. Considering the merits of the request, 'in-principle' approval was given for the amalgamation of all eight DCCBs with JStCB in October 2013. However, since the Dhanbad DCCB went to court against the state's decision of amalgamation, the state came up with a revised proposal to amalgamate seven DCCBs with JStCB. The Reserve Bank accorded 'in-principle' approval to the revised proposal in November 2014.

NABARD carried out a snap scrutiny of the amalgamated entity in March 2017 following an infusion of a ₹500 million grant by the state that enabled JStCB to achieve CRAR of more than 9 per cent. It was observed that the amalgamation of STCCS entailed a stronger structure in terms of improvements in operational, managerial and governance efficiency. Consequently, the Reserve Bank conveyed its final approval to the amalgamation proposal on March 30, 2017 and the state government issued a notification for amalgamation of seven DCCBs with JStCB on March 31, 2017. The new entity started functioning from April 1, 2017, ushering an era of 2-tier cooperative credit structure in the state, barring the pending court case of the Dhanbad DCCB.

Scheduling, Licensing, Mergers and Voluntary Conversions

VI.43 During the year, one state cooperative bank – the Telangana State Cooperative Apex Bank Ltd. – was included in the second schedule to the RBI Act, 1934. Five merger proposals received from UCBs were approved, out of which two proposals were implemented, two proposals are under process while one proposal was withdrawn by the target bank. Further, three UCBs voluntarily converted themselves into non-banking institutions under Section 36A (2) of the Banking Regulation Act, 1949.

Other Developments

VI.44 A scheme of financial assistance to UCBs for implementing the core banking solution (CBS) was announced on April 13, 2016 in consultation with IDRBT/Indian Financial Technology and Allied Services (IFTAS) (a subsidiary of IDRBT). Under the scheme, the initial setup cost of ₹0.4 million is paid by the Reserve Bank to IFTAS. During the year, 23 UCBs implemented CBS under the scheme taking the number of CBS-compliant UCBs to 1,301 out of a total of 1,561 UCBs.

Agenda for 2017-18

VI.45 Further harmonisation of the guidelines for rural and urban cooperative banks will continue to be an agenda for 2017-18. The Reserve Bank will pursue the process of recapitalisation and licensing of the remaining three DCCBs in Jammu & Kashmir under the rehabilitation scheme approved by the government to create an environment where only licensed rural cooperative banks operate in the banking space. The supervisory action framework for UCBs, framed in 2014, will be reviewed with a view to engaging with the concerned banks at an early stage for corrective action. Implementation of CBS under the scheme of financial assistance to UCBs will be taken forward during the year. The Reserve Bank will formulate certain standards and benchmarks for CBS in UCBs in consultation with IDRBT in order to make it more robust.

Non-Banking Financial Companies (NBFCs): Department of Non-Banking Regulation (DNBR)

VI.46 NBFCs play a vital role in providing credit by complementing commercial banks and also cater to some niche sectors. DNBR is entrusted

with the regulation of the NBFC sector with a view to providing a conducive environment for orderly growth of the sector as also protecting the interests of depositors and customers.

Agenda for 2016-17: Implementation Status

VI.47 During the year, the Reserve Bank issued guidelines on NBFC-account aggregators (NBFC-AAs). Subsequently, the process of registering NBFC-AAs has been initiated. The guidelines to banks for relief measures in areas affected by natural calamities, were extended *mutatis mutandis* to NBFCs.

VI.48 The guidelines on pricing of credit were issued for NBFC-microfinance institutions (NBFC-MFIs) to ensure that the average interest rate on loans sanctioned during a quarter does not exceed the average borrowing cost during the preceding quarter plus the margin, within the prescribed cap. Guidelines in respect of disbursal of loans in cash by NBFCs were amended to align these with the requirements under the Income Tax Act, 1961.

VI.49 Keeping in view the role of asset reconstruction companies (ARCs) in resolving stressed assets as also the recent regulatory changes governing the sale of stressed assets by banks to ARCs, the minimum net owned fund requirement for ARCs was fixed at ₹1 billion on an on-going basis, effective April 28, 2017 (Box VI.8). In terms of Section 30A, 30B and 30C of the SARFAESI Act, 2002, the Reserve Bank has designated Adjudicating Authority for imposing penalty on ARCs for non-compliance of any direction issued by the Reserve Bank. Further, the Reserve Bank has designated the Appellate Authority for deciding on an appeal filed by the aggrieved party. These guidelines will come into force after its notification by the central government.

VI.50 The NBFC sector has evolved over a period of time resulting in a variety of categories of NBFCs. The different categories were envisaged to promote specific sector/ asset classes and

Box VI.8
Asset Reconstruction Companies: Progress and the Way Forward

During the late 1990s, in view of the rising level of bank NPAs, the Narasimham Committee II and Andhyarujina Committee were constituted to examine the scope for banking sector reforms and the need for changes in the legal system to resolve NPAs. These committees suggested a new legislation for securitisation, empowering banks and financial institutions (FIs) to take possession of the securities and sell them without the intervention of the court. Accordingly, the SARFAESI Act (the Act) was enacted in 2002 to provide an enabling environment for resolution of NPAs and for strengthening the financial sector. It provides three alternative methods for recovery of NPAs – securitisation, asset reconstruction and enforcement of security interests. It envisaged the formation of asset reconstruction companies (ARCs) under Section 3 of the Act.

ARC's primary goal is to acquire, manage and recover the financial assets which have been classified as NPAs by the banks/FIs. Presently, there are 24 ARCs in the country. The Reserve Bank has been assigned powers under the Act to regulate and supervise ARCs. An ARC can acquire and keep the financial asset – NPAs – in its own balance sheet or transfer it to one or more trust(s) (set up under Section 7 of the Act) at a price at which the asset was acquired from the originator (secured lender). Most of the deals are structured with a 15 per cent upfront payment to the seller banks/ FIs and issue of security receipts (SRs) for the remaining amount with a defined cash-flow waterfall. Management fee, a primary source of income for ARCs, has priority (after netting the expenses) over redemption of SRs. The trusteeship of such trusts vests with the ARC.

The net owned fund requirement for ARCs was raised from ₹20 million to ₹1 billion effective April 28, 2017 with a view to attract serious players to the business. Other recent measures for encouraging the sector include 100 per cent foreign direct investment (FDI) under the automatic route, removal of the limit on shareholding by a sponsor, and inclusion of additional qualified buyers for investments in SRs.

hence different sets of regulatory prescriptions were put in place. There are NBFCs catering to asset financing, infrastructure financing, microfinance, lending, *etc*. At present, there are eleven categories of NBFCs – Asset Finance Company (AFC), Loan Company (LC), Investment Company (IC), Core Investment Company (CIC), NBFC-Factor, IDF-NBFC, Infrastructure Finance Company (IFC), NBFC-MFI, NOFHC, NBFC-AA and Mortgage Guarantee Company (MGC). In line with the Reserve Bank's medium term goal of moving toward activity-based regulation rather than entity-based regulation, the rationalisation of multiple categories of NBFCs into fewer categories is under way.

Agenda for 2017-18

VI.51 Going forward, the Reserve Bank will rationalise the NBFCs into fewer categories. The Bank will oversee the time-bound implementation of Ind AS, converged with IFRS, by NBFCs.

SUPERVISION OF FINANCIAL INTERMEDIARIES

Commercial Bank: Department of Banking Supervision (DBS)

VI.52 DBS supervises all SCBs (excluding RRBs), local area banks (LABs), payment banks, small finance banks and AIFIs within the existing legal and regulatory framework, based on supervisory inputs received through off-site monitoring and on-site inspections.

Agenda for 2016-17: Implementation Status

VI.53 During 2016-17, all SCBs operating in India (excluding RRBs and LABs) were brought under risk based supervision – Supervisory Programme for Assessment of Risk and Capital (SPARC). The Reserve Bank also started the process of developing a suitable framework for supervising PBs and SFBs. The supervisory process is being strengthened by incorporating elements of continuous supervision in off-site monitoring (Box VI.9).

VI.54 The inter-regulatory forum for monitoring financial conglomerates (IRF-FC) identified a revised set of 11 FCs in the Indian financial sector including five bank-led FCs, four insurance company-led FCs and two securities company-led FCs, based on their significant presence in two or more segments of the financial sector.

VI.55 A revised prompt corrective action (PCA) framework for banks was rolled out for implementation from 2017-18 based on the financials of banks for the year ended March 31, 2017. The PCA matrix notified under the revised framework specifies indicators and risk thresholds

Box VI.9
Asset Quality Review (AQR) in Perspective – Lessons Learnt

The Asset Quality Review (AQR), undertaken in 2015-16 for all major banks together, was aimed at making banks recognise their asset quality realistically. It provided valuable insights on asset quality at the individual bank/system level and ensured uniformity in identification of non-performing assets (NPAs) at the system level. Further, the early finalisation and communication of divergences in provisioning gave banks more time for effecting the additional provisioning over subsequent quarters. AQR was extensively based on off-site data from the Central Repository for Information on Large Credits (CRILC). The exercise clearly brought out the importance of data analysis for effective supervision. In particular, it emphasised the importance of collecting relevant data, ensuring robust data quality and integrity and the use of IT infrastructure for carrying out an incisive off-site analysis which, in conjunction with on-site assessment, ensures an effectively continuous supervisory assessment.

Box VI.10

Revised Prompt Corrective Action Framework for Banks

The prompt corrective action (PCA) framework for banks was introduced by the Reserve Bank in December 2002 as an early intervention mechanism. The sub-committee of the Financial Stability and Development Council (FSDC-SC) in its meeting held in December 2014 decided to introduce the PCA framework for all regulated entities. Subsequently, the Reserve Bank reviewed the existing PCA framework keeping in view the recommendations of the working group on resolution regimes for financial institutions in India (January 2014), the Financial Sector Legislative Reforms Commission (FSLRC, March 2013) and international best practices. The Board for Financial Supervision (BFS) decided to implement the provisions of the revised PCA framework with effect from April 1, 2017, based on the financials for March 31, 2017.

Capital, asset quality and profitability continue to be the key areas for monitoring under the revised framework. However, common equity Tier-1(CET 1) ratio will constitute an additional trigger and leverage will also be monitored. The revised PCA defines certain risk thresholds, breach of which would lead to invocation of PCA and invite certain mandatory and discretionary actions. The PCA framework will apply to all banks operating in India including small banks and foreign banks operating through branches or subsidiaries.

under four areas – capital (breach of either CRAR or common equity tier (CET) 1 ratio), asset quality, profitability and leverage (Box VI.10).

VI.56 In line with BCBS principles on cross-border supervisory cooperation, the Reserve Bank has set up supervisory colleges for Indian banks with considerable overseas presence, *viz.*, State Bank of India (SBI), ICICI Bank Ltd., Bank of Baroda, Bank of India, Punjab National Bank and Axis Bank Ltd. The major objectives of supervisory colleges are to enhance information exchange and cooperation among supervisors to improve understanding of the risk profile of the banking group, thereby facilitating more effective supervision of the internationally active banks. The Reserve Bank held meetings of all the supervisory colleges during 2016-17.

VI.57 With a view to assessing banks' cyber security preparedness, the Reserve Bank mandated a baseline cyber security and resilience framework and conducted IT/cyber security examinations/ vulnerability assessments to evaluate their responses to cyber security incidents. It also conducted targeted inspections in the wake of certain cyber security incidents of significant concern. The Reserve Bank conducted trainings on cyber security with hands-on sessions for its IT examiners to build skills in cyber security assessment.

VI.58 In order to improve data quality, a working group was set up with members from major public sector, private and foreign banks to rationalise existing off-site returns. The group submitted its report in September 2016. The various recommendations of the group, after due consideration and approval, are being implemented in a phased manner.

VI.59 Towards enhancing supervisory focus, the department conducted some thematic studies during the year relating to derivatives portfolio and custodial services offered by foreign banks; non-credit related facilities and trade finance; and real estate exposure/housing finance. The studies were shared with the concerned departments for policy action.

VI.60 Migration of supervisory returns, other than off-site monitoring and surveillance (OSMOS) returns, to the eXtensible business reporting language (XBRL) reporting platform is

under progress. Returns relating to fraud reporting and monitoring have been migrated to the XBRL reporting platform.

VI.61 Taking the process of cross-border supervisory cooperation and exchange of supervisory information further, the Reserve Bank signed memoranda of understanding (MoUs) with seven overseas banking supervisory authorities during the year, *viz.*, the Central Bank of Myanmar, the Banking Regulation and Supervision Agency of Turkey, the Central Bank of Nigeria, the Bank of Zambia, the Bank of Guyana, the Bank of Thailand and the Royal Monetary Authority of Bhutan. Further, a letter of cooperation was executed with the Czech National Bank. With this, the Reserve Bank has signed 40 MoUs, two letters of cooperation and one statement of cooperation.

VI.62 The Reserve Bank launched a Central Fraud Registry (CFR), a web-based online searchable database in January 2016. However, usage of CFR by banks, especially PSBs, is yet to pick up on expected lines.

Agenda for 2017-18

VI.63 A joint working group of regulators constituted by IRF-FC will develop a format and structure for a data template for capturing systemic risks arising out of FC activities.

VI.64 As part of capacity building on SPARC, the Reserve Bank will continue to conduct focused workshops and orientation sessions for internal and external stakeholders. Further, specific sessions for board members and top managements of the banks as also for other external stakeholders will be on the agenda for 2017-18.

VI.65 A suitable supervisory framework for small finance banks and payment banks will be developed and implemented. Further, in view of the implementation of Ind AS by banks, its impact on their quantitative and qualitative reporting will be reviewed, aligned and integrated with the supervisory framework.

VI.66 Taking into account concerns arising from examination of IT risks in banks, thematic studies and assessments will be undertaken on specific domains for appropriate policy and supervisory interventions (Box VI.11). Based on the off-site

Box VI.11
Standing Committee on Cyber Security

In the wake of exponential growth of digitalisation in banks, cyber risks have emerged as a major area of concern. Conscious of the rising threats to the cyber infrastructure in its regulated entities, the Reserve Bank has taken a number of measures, particularly over the last two years. Based on the recommendations of the Expert Panel on Cyber Security and Information Technology Examination (Chairperson: Smt. Meena Hemchandra), guidelines were issued to banks in June 2016, mandating cyber security preparedness. Banks' progress in strengthening their cyber resilience and response is being monitored. Recognising the increasing frequency and complexity of cyber security incidents, the monetary policy statement of February 8, 2017 announced that an Inter-disciplinary Standing Committee will be set up to conduct an ongoing review of the cyber security landscape and emerging threats.

The remit of the committee, *inter alia*, includes reviewing the threats inherent in existing/emerging technology; studying adoption of various security standards/protocols; interfacing with stakeholders; and suggesting appropriate policy interventions to strengthen cyber security and resilience.

The committee was constituted on February 28, 2017 (Chairperson: Smt. Meena Hemchandra, Executive Director). Members of the committee include experts on cyber security in the Reserve Bank as well as from outside. The committee is meeting regularly and, as per its recommendations, sub-groups have been formed on certain focus areas for an in-depth examination.

assessment of the key risk indicators in cyber security, IT examinations with a risk based approach will be conducted in 2017-18. The findings will be factored in the overall assessment of risks in banks. Assessment of IT risks in other regulated entities such as major urban cooperative banks will be covered in a phased manner. A back office support system (BOSS) has been established for this. With a view to enabling a more efficient supervisory assessment of banks, BOSS will develop standard data templates on major concern areas under various risk categories.

Cooperative Banks: Department of Cooperative Bank Supervision (DCBS)

VI.67 DCBS is entrusted with the supervisory responsibility of primary (urban) cooperative banks (UCBs) to ensure a safe and well managed cooperative banking sector. The department undertakes supervision of these banks on an on-going basis through periodic on-site inspections and continuous off-site monitoring.

Agenda for 2016-17: Implementation Status

VI.68 The Reserve Bank began focused attention on select weak UCBs by way of intensive hand-holding and periodic training in the identified areas of weakness. It organised a conference on '*Building Banks Co-operatively - Professionalise and Progress*' in Ahmedabad inviting participation from the state government, other stakeholders and the top management of the Reserve Bank. During the year, several training programmes for capacity building were conducted by regional offices for CEOs/directors/officials of UCBs and auditors of UCBs.

Agenda for 2017-18

VI.69 The department will continue to identify select UCBs for hand-holding and impart focused training to them for all round improvement in their functioning. In addition, the Department will take initiatives for capacity building for both supervisors and supervised entities – UCBs – in the coming year. In this direction, conferences on cooperative banking as organised last year will be conducted. As the development of software package for DCBS returns has been completed under XBRL-based reporting platform, the Department will focus on stabilising the package and ensuring submission of timely and reliable data through the platform by all UCBs.

NBFCs: Department of Non-Banking Supervision (DNBS)

VI.70 DNBS supervises the NBFC sector in the country, which is a fast growing sector with significant diversity in terms of size and operational dimensions. The department supervises more than 11,500 NBFCs of which 222 are non-deposit taking systemically important ones.

Agenda for 2016-17: Implementation Status

VI.71 The role of statutory auditors in the certification process was enhanced by enabling on-line filing of statutory auditors certificate (SAC). Further, the Institute of Chartered Accountants of India (ICAI) agreed to digitally authenticate the returns of small NBFCs on the XBRL platform, which will be operationalised soon. The Reserve Bank focused on improving adherence to the fair practices code by NBFCs through levy of penalties. The Bank is in the final stages of incorporating risk factors in the existing CAMELS model of inspection of NBFCs. The project for automation of all regulatory approvals of NBFCs has been initiated and this will be operationalised in 2017-18. The Reserve Bank also operationalised a formal PCA framework for NBFCs.

Agenda for 2017-18

VI.72 The department will put in place a supervisory rating system for ARCs. The *Sachet*

Box VI.12
***Sachet* Portal**

The Reserve Bank launched a mobile friendly portal *Sachet* (sachet.rbi.org.in) on August 4, 2016 to help the public as well as regulators to ensure that only regulated entities accept deposits from the public. The portal can be used by the public to share information including through uploading photographs of advertisements/publicity material, raise queries on any fund raising/investment schemes that they come across and lodge and track complaints. The portal has links to all regulators and the public can easily access information on lists of regulated entities. The portal has a section for a closed user group – the state level coordination committees (SLCCs), inter-regulatory forums for exchange of information and coordinated action on unauthorised deposit collection and financial activities. It will help in enhancing coordination among regulators and state government agencies and will serve as a useful source of information for early detection and curbing of unauthorised acceptance of deposits. The portal is designed to place the entire proceedings of SLCCs on an IT platform. It facilitates comprehensive MIS with respect to complaints received, referred to regulators / law enforcement agencies and for monitoring the progress in redressal of such complaints. Complaints relating to unauthorised deposit collection and financial activities that have been lodged in *Sachet* have been taken up expeditiously with respective regulators for resolution.

portal on NBFCs will be refurbished by improving readability and functionalities (Box VI.12). A detailed standard operating procedure for non-compliant and/or inactive small NBFCs will also be operationalised.

Enforcement Department (EFD)

VI.73 Taking note of the changes in the global and domestic financial sector environment, with a view to separate the function of identification of contravention of respective statutes/guidelines and directives by the regulated entities from imposition of punitive action and to make this process endogenous, formal and structured, a separate Enforcement Department was created within the Reserve Bank with effect from April 3, 2017 (Box VI.13).

VI.74 The core function of the department is to enforce regulations with the objective of ensuring financial system stability and promoting public interest and consumer protection. The department will, *inter alia*, (i) develop a sound policy framework for enforcement consistent with international best practices; (ii) identify actionable violations on the basis of inspections/supervisory reports and market intelligence reports received/generated by it, conduct further investigations/verifications, if required, on the actionable violations thus identified and enforce them in an objective,

Box VI.13
Supervisory Enforcement Framework

An effective system of banking supervision, *inter alia*, depends on effective enforcement of supervisory policies which, in turn, needs a unified and well-articulated supervisory enforcement policy and institutional framework. Taking cognisance of such a need, the Board for Financial Supervision approved a Supervisory Enforcement Framework for action against non-compliant banks. Following a subsequent announcement in the 6th bi-monthly monetary policy statement of February 2017, a separate Enforcement Department was established in April 2017.

Over time, the framework is expected to make the Reserve Bank's enforcement actions more transparent, predictable, standardised, consistent and timely, leading to improvement in the banks' overall compliance with the regulatory framework.

consistent and non-partisan manner; (iii) deal with the complaints referred to it by the Bank's top management for possible enforcement action, and (iv) act as a secretariat to the Executive Directors' Committee constituted for adjudication.

VI.75 To begin with, the department will focus on the enforcement of penalty provisions under the Banking Regulation Act. In the medium-term, the entire enforcement function of the Reserve Bank will be migrated to EFD. In 2017-18, the department will develop a policy framework for enforcement; put in place detailed protocols for information sharing with other regulatory and supervisory departments of the Reserve Bank, other regulators and the government; create channels for generating actionable market intelligence; and initiate enforcement action.

CONSUMER EDUCATION AND PROTECTION

Consumer Education and Protection Department (CEPD)

VI.76 The Reserve Bank has always recognised protection of consumers' interests as a key area and has accorded high priority to providing safe and efficient services to the customers of banks. CEPD is the nodal department in the Bank for monitoring the function of protection of consumer interests.

Agenda for 2016-17: Implementation Status

VI.77 The Reserve Bank operationalised the Charter of Customer Rights in 2014-15 for strengthening customer protection in banks. During the year, the Reserve Bank advised the banks to furnish a certificate in the specified proforma under the signature of the MD or CEO certifying that their customer service policy was fine-tuned to incorporate the principles of the Charter of Customer Rights. All the banks have submitted the certificate.

VI.78 The Reserve Bank's Banking Ombudsman (BO) Scheme – a dispute redressal mechanism notified under Section 35(A) of the Banking Regulation Act, 1949 – has been in existence since 1995. The scheme has been reviewed periodically and its latest comprehensive review was undertaken in 2015-16 covering pecuniary jurisdiction of the BO, compensation and grounds of complaint and rationalisation of certain clauses of the scheme. The scheme was amended accordingly. The government, during the year, conveyed its concurrence to the amended Banking Ombudsman Scheme. The amended scheme came into effect from July 1, 2017. 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. At present, the total number of BO offices has reached 20.

VI.79 The Reserve Bank in consultation with the Indian Banks' Association (IBA) reviewed the forms commonly used by customers in banks and suggested standardisation of these forms. Accordingly, IBA released modified and user friendly specimens of ten commonly used forms during the year to banks for implementation.

VI.80 Aspects and modalities of setting up of an Ombudsman Scheme (OBS) for NBFCs were examined and discussed with concerned regulatory and supervisory departments (Box VI.14).

Agenda for 2017-18

VI.81 The Reserve Bank will formulate an appropriate OBS for NBFCs and operationalise it by establishing the offices of the ombudsman for NBFCs at select centres. It will also conduct surveys on: (i) charges levied by banks for basic banking services; (ii) KYC compliance; and (iii) mis-selling by banks. With a view to creating

Box VI.14
The Ombudsman Scheme for Non-Banking Financial Companies

A pressing need has been felt for setting up a cost effective, expeditious and easily accessible alternative dispute resolution mechanism in the form of the ombudsman scheme (OBS) for customers of NBFCs.

As compared to banks, the NBFCs are relatively larger in number and vary substantially in terms of their activities and size. These aspects need to be weighed carefully before setting up an OBS for the NBFCs.

NBFCs are regulated under Chapter III-B of the RBI Act, 1934. Section 45 L of the RBI Act empowers the Reserve Bank to, *inter alia*, give directions to Financial Institutions. The OBS for NBFCs is proposed to be operationalised by the Reserve Bank under Section 45 L of the RBI Act.

The proposed scheme will initially cover all deposit taking NBFCs and those with customer interface and an asset size of ₹1 billion and above. However, asset reconstruction companies, infrastructure finance companies, infrastructure debt funds, core investment companies, and NBFC factors will not be covered under the scheme for the time being. The coverage of the OBS may be reviewed over time, based on experience.

Complaints relating to non-adherence to the Fair Practices Code, infringement of customer rights, deficiencies in services, use of coercive measures, mis-selling, violation of regulatory guidelines, non-repayment/delayed repayment of deposits and/or interest are some of the categories of complaints that will be covered under the scheme.

awareness about fictitious offers of money, the Reserve Bank will undertake advertisement and publicity campaigns through print and electronic media during 2017-18.

VI.82 All the public sector banks and select private and foreign banks had appointed Internal Ombudsman (IO) in 2015-16 to examine the grievances that are not resolved by the respective bank's internal grievance redressal mechanism. During 2017-18, the Reserve Bank will conduct a review of the IO scheme to make it more effective.

VI.83 The Reserve Bank also redresses the complaints received against regulated entities from their customers through Consumer Education and Protection Cells (CEPCs) set up in every office of the Bank. Customers can also approach the offices of the BOs to lodge their complaints against banks on the grounds of complaints listed in the revised BO scheme. During 2017-18, the Reserve Bank will deploy a complaint management system (CMS) to streamline the processing of complaints (Box VI.15).

Box VI.15
Complaint Management System

The Reserve Bank has initiated the work for setting up a complaint management system (CMS) with a view to harnessing the benefits of information technology (IT) for managing the increasing volume of complaints being received by it.

The web-based CMS will replace the existing complaint tracking system (CTS) which has served for over a decade. CMS will help the Reserve Bank not only to manage the complaints more efficiently but also provide a robust management information system. CMS will also integrate the grievance redressal mechanism in the Bank by bringing the offices of Banking Ombudsman, as well as CEPCs and banks on the CMS platform for facilitating better coordination and effectiveness. The new system will also facilitate data analytics and will help to study the patterns of complaints and, where feasible, pre-empt complaints by addressing the root causes. It will also support the efforts to proactively pursue the complaint-prone areas in banking services to bring about a qualitative change in the resolution process. CMS will also help to monitor the performance of the regulated entities in the area of management and redressal of complaints.

Deposit Insurance and Credit Guarantee Corporation (DICGC)

VI.84 Deposit insurance contributes to the stability of the financial system and protects depositors' interests. In India, DICGC – a wholly-owned subsidiary of the Reserve Bank – provides insurance cover to deposits in all commercial banks including LABs, payment banks, small finance banks, RRBs and cooperative banks. With the present limit of ₹0.1 million, the number of fully protected accounts (1,737 million) as on March 31, 2017 constituted 92.1 per cent of the total number of accounts (1,885 million) as against the international benchmark of 80 per cent. In terms of amount, the total insured deposits at ₹30.5 trillion at end-March 2017 constituted 29.5 per cent of the assessable deposits at ₹103.5 trillion as compared with the international benchmark of 20-30 per cent.

VI.85 The Corporation builds its Deposit Insurance Fund (DIF) through transfer of surplus, that is, excess of income (mainly comprising *premia* received from the insured banks, coupon income from investments and cash recovery out of assets of failed banks) over expenditure (payment of depositors' claims and related expenses) net of taxes. DIF stood at ₹701.5 billion as on March 31, 2017, yielding a higher reserve ratio (DIF to insured deposits) of 2.3 per cent *vis-à-vis* 2.1 per cent at end-March 2016. During 2016-17, the corporation sanctioned total claims of ₹0.6 billion as against ₹0.5 billion during the preceding year.

VI.86 The Corporation has improved the quality of information disseminated through its website by updating FAQs and guidelines for liquidators. It has also published a primer on deposit insurances and placed on the website. With a view to accelerating the resolution of outstanding issues, DICGC held several meetings with liquidators and also requested chief secretaries of states to expedite the appointment of liquidators. The Corporation will continue to focus on adherence to core principles on effective deposit insurance systems in 2017-18.

Resolution Corporation

VI.87 The Financial Resolution and Deposit Insurance Bill, 2017, which was introduced in the Lok Sabha on August 10, 2017, prescribes setting up of a Resolution Corporation (RC) to ensure observance of the Financial Stability Board's Key Attributes on resolution of financial firms by addressing the gaps in the current resolution mechanism in India in terms of legal framework, resolution tools, liquidation, coverage of entities, cross-border cooperation and the oversight framework. The proposed RC will subsume DICGC which at present performs the 'pay box' function, that is, reimbursement of insured amounts to the depositors of failed banks. DICGC also participates in merger schemes approved by the Reserve Bank involving payment to the depositors of transferee bank. RC is being established for protection of consumers of specified service providers and of public funds for ensuring stability and resilience of the financial system.

National Housing Bank (NHB)

VI.88 The primary function of NHB – the apex institution for housing finance – is to register, regulate and supervise housing finance companies (HFCs). It also provides refinance to HFCs, SCBs, RRBs and cooperative sector institutions for housing loans and directly lends (project finance) to borrowers in the public and private sectors for extending financial support to the housing programmes for the unserved and under-served segments of the population. The entire capital of ₹14.5 billion of NHB is subscribed by the Reserve Bank.

VI.89 As on June 30, 2017, 85 HFCs were registered with NHB, out of which 18 HFCs were

eligible for accepting public deposits. Out of the total disbursement made under refinance (₹226.8 billion) in 2016-17 (July-June), 20.1 per cent (₹45.6 billion) was made under the Rural Housing Fund (RHF) and 9.8 per cent (₹22.3 billion) was made under the Urban Housing Fund (UHF). As a nodal agency for implementing the Credit Linked Subsidy Scheme (CLSS) under the 'Housing for All by 2022' mission of the government, NHB had released total subsidy claim (net of refunds) under Pradhan Mantri Awas Yojana (PMAY) CLSS (including economically weaker section (EWS)/ low income group (LIG) Old, EWS/LIG New and middle income group (MIG)) amounting to ₹7.5 billion to 96 primary lending institutions till June 30, 2017, benefitting 39,629 households.

VI.90 It had also disbursed ₹459 million for helping renovation of 1,111 dwelling units through primary lending institutions under the Refinance Assistance for Flood Affected Areas of Tamil Nadu upto June 30, 2017.

VI.91 NHB managed the Credit Risk Guarantee Fund Trust for Low Income Housing with the objective of providing guarantees with respect to low-income housing loans. As at end-June 2017, 79 PLIs had signed MoUs with the trust under the scheme. As on June 30, 2017, the trust has issued guarantee cover for 1,972 loan accounts of 14 member lending institutions (MLIs) involving total loan amount of ₹561 million provided to EWS/LIG households and guarantee cover of ₹476 million to 14 institutions.