VI REGULATION, SUPERVISION AND FINANCIAL STABILITY

Focussed regulation and supervision of the financial system is a key tool for maintenance of financial stability. Taking this into consideration, the Reserve Bank continued to pay significant attention to pro-active regulation and supervision. The commercial banking sector presently remains well-capitalised, although reduced profitability, rising delinquent loans and future capital requirements to comply with Basel III requirements are challenges that need to be addressed. A slew of regulatory and supervisory initiatives have been undertaken to improve the overall functioning of the sector. The legal framework governing banks has also been revamped in line with modern market practices. Reflecting the growing complexity of NBFCs, a new category was created during the year. The Financial Sector Legislative Reforms Commission has made several recommendations on the legal and regulatory architecture governing the financial sector. These will need to be carefully examined.

VI.1 Weaknesses in the regulation and supervision of both banks and non-bank financial entities were identified as a prime cause of the global financial meltdown in 2008. The overt reliance by regulators on market discipline, including the excessive dependence on credit rating agencies, led to 'light touch' regulation. Financial innovations were used to shift some financial practices outside the regulatory perimeter. The culmination of these actions was the build-up of a significant amount of risks that ultimately led to a financial collapse. Taking these lessons into account, regulators have become more proactive by instituting regulatory mechanisms that are macroprudential in scope, forward-looking in nature and analytical in approach.

VI.2 In India, the Reserve Bank has adopted a proactive approach to prudential regulation, which was in place even before the outbreak of the crisis. Taking into account the lessons learnt during the crisis, the Reserve Bank has been fine-tuning its regulatory strategy to ensure that it fosters a stable financial environment where the credit requirements of the productive sectors are adequately met without stifling innovation.

FINANCIAL STABILITY ASSESSMENT

Current Assessment of Risks to Financial Stability in India

VI.3 Risks to the Indian economy from global developments remain elevated especially in the face of domestic vulnerabilities, although the risk of tail events materalising in the advanced economies has reduced on the back of policy action. Newer risks have emerged from prolonged unconventional monetary policies and speculation on the exit from such policies, amidst an environment of uncertain global growth. Financial stability risks are particularly significant from increasing external vulnerabilities and the dependence on volatile capital flows to fund the high CAD. According to the results of the latest Systemic Risk Survey (Financial Stability Report, June 2013) domestic macroeconomic risks and global risks were the most important factors affecting the stability of Indian financial system.

VI.4 The overall risks to the banking sector have increased during 2012-13, owing to the tight liquidity conditions, deteriorating asset quality, and reduced profitability. However, there was marginal improvement in asset quality and soundness as also some sign of easing in 'distress dependencies' among banks in the March 2013 quarter. The macro stress tests show that the credit quality of commercial banks is a concern. However, the comfortable capital adequacy position has provided resilience to most banks as shown by the various stress testing exercises.

Working of the FSDC Sub-Committee

VI.5 The Sub-Committee of the Financial Stability and Development Council (FSDC) continues to coordinate discussions and actions on various issues relating to systemic stability and development of India's financial sector, under the guidance of the FSDC. The Committee made progress in identification of regulatory gaps in areas like wealth management services and collective investment schemes, addressing the conflict of interest in distribution of financial products, among other things. Besides, the Sub-Committee has also been taking stock of implementation of the G20/ FSB post-crisis reforms. It has also been approving the FSR since 2011 and since then, the report reflects the collective views of its members.

VI.6 Based on the IMF Board's decision in September 2010, it was decided to include 25 systemically important economies, including India, under the Financial Stability Assessment Programme (FSAP) for members with systemically important financial sectors. As part of this process, a joint IMF-World Bank team had conducted the FSAP for India in 2011. Subsequently, the Financial Sector Stability Assessment for India, the final report of the FSAP, was released by the IMF in January 2013 (Box VI.1).

Box VI.1
India: Financial Sector Stability Assessment

The assessment report recognised that the India has made remarkable progress towards developing a stable financial system by steady improvements in the legal, regulatory and supervisory framework. Regulatory and supervisory regime for banks, insurance, and securities markets was found to be well developed and largely in compliance with international standards. It added that the Indian financial system's vulnerabilities appeared manageable.

The assessment, however, identified some gaps. The major issues raised in the Report, authorities' response and the progress made in this regard are highlighted below:

Autonomy of regulators: The report suggested enhancing formal statutory basis for the autonomy of regulators in carrying out their regulatory and supervisory functions. The extant position is that financial sector regulators in India operate within statutory frameworks that aim at balancing the role of Government in policymaking with autonomy and independence for regulatory bodies to transparently perform their functions. Steps are underway to accord a statutory basis to the pension regulator as well.

Information sharing and coordination amongst regulators: With regard to the information sharing and co-ordination among domestic regulatory authorities, several arrangements have been made at various levels. The FSDC, under the chairmanship of Finance Minister, serves as an apex forum for effective regulatory co-ordination. A Sub-Committee of the FSDC, under the Chairmanship of the Reserve Bank Governor, provides for the next layer of co-ordination that takes place on a more frequent basis. Under the aegis of the Sub-Committee of the FSDC, a Memorandum of Understanding (MoU) was signed by RBI, SEBI, IRDA and PFRDA in March 2013 to forge greater cooperation in the field of consolidated supervision and monitoring of financial conglomerates.

Information sharing with other jurisdictions: Recognising its importance, information sharing mechanisms with various jurisdictions in which Indian banks are operating have been put in place. Information-sharing MoUs have already been signed by Reserve Bank with 16 jurisdictions and correspondence for the same is in progress with another 28 jurisdictions. Besides, Reserve Bank has carried out overseas inspections of Indian bank branches in five countries covering almost 60 per cent of total overseas assets of Indian banks, while inspection is underway in another six jurisdictions covering another 20 per cent of total overseas assets of Indian banks. The Reserve Bank has also hosted supervisory colleges for State Bank of India and ICICI Bank limited.

Likewise, other regulators are also addressing issues relating to sharing of information at the international level.

Group borrower limits: The report recommended tightening the definition of large and related party concentration and gradually reducing exposure limits to make them more consistent with international practices. However, the authorities' view is that this would severely constrain the availability of bank finance to some of the major corporate groups and hamper growth.

(Contd....)

Nominee on banks' board: The issue of moral hazard posed by a nominee director on the banks' board prompted suggestion for greater clarity regarding their role. This system, however, has served India well and ensured more effective compliance by banks with regulations. Nevertheless, the matter has been taken up with the Government of India for amendment of the enabling legal provisions.

Statutory Liquidity Ratio: The assessment recommends that Statutory Liquidity Ratio (SLR) be gradually reduced in line with evolving international liquidity requirements. This will support deeper capital markets, systemic liquidity management and monetary transmission. The authorities' perspective on this is that the SLR, apart from mandating investments in government securities, has served liquidity, monetary and financial stability needs. SLR requirement has been brought down over time. Government market borrowings are at market-determined interest rates and monetary policy transmission is not impeded by SLR holdings. The holding of government bonds could help banks to better cope with financial stress situations by giving greater access to liquidity.

Securities market regulation: The assessment made certain recommendations regarding securities market regulation in India after employing higher standards than IOSCO principles. In this regard, SEBI has taken several steps to improve the mutual fund regulation. In August 2013, SEBI decided to bring under its ambit fraudulent and unfair trade practices regulations and clamp down on front running practices.

Auditing and accounting standards: The assessment suggested improved mechanisms for ensuring better auditing and accounting standards in the securities market. Several initiatives have been taken recently to strengthen the existing mechanisms. The government has set up Quality Review Board (QRB) for reviewing the quality of auditors, while the SEBI has set up a Qualified Audit Report Review Committee (QARC). The Companies Bill 2012 as passed by *Lok Sabha* contains provisions for establishment of an independent quasi-judicial agency - the National Financial Reporting Authority - to oversee the functions of auditors.

Independent Risk Committee in Central Counterparties (CCPs): Regarding this recommendation in April 2012, SEBI had decided that CCPs will constitute a risk committee comprising independent members which shall report to the Board of the CCP as well as directly to SEBI on relevant issues.

Early Warning Group: The report suggested strengthening early warning mechanisms. Recently, an inter-regulatory Early Warning Group (EWG) for financial markets has been constituted under the FSDC sub-committee.

Regulation of Insurance Industry: In the Report, the IRDA has clarified that there is complete oversight over the Life Insurance Corporation of India (LIC) with regard to both market conduct and prudential regulations. The issues relating to inadequacy of reserves in case of non-life insurance industry have also been addressed with directions to increase the premium in the Motor-Third Party segment. The enforcement powers are being strengthened in the proposed Insurance Laws (Amendment) Bill. Further, the IRDA is also examining various issues relating to moving towards the risk-based approach to solvency.

ASSESSMENT OF THE BANKING SECTOR

Core Financial Soundness Indicators (FSIs) of SCBs

VI.7 The capital position of SCBs remains well in excess of the regulatory requirements, although both the CRAR (13.8 per cent) and the core CRAR (10.3 per cent) are a bit lower than in the previous year (Table VI.1). Driven by a lacklustre domestic environment, the asset quality of SCBs deteriorated further during 2012-13. In terms of magnitude, the gross NPAs of SCBs increased from 2.9 per cent in 2011-12 to 3.4 per cent in 2012-13. The higher provisioning, in turn, meant a lower net profit, which grew by 12.8 per cent during 2012-13 compared with 14.6 per cent a year ago. Accordingly, the RoE and RoA of SCBs also registered declines. The NIM also declined from 3.1 per cent to 3.0 per cent during the same period. SCBs, however, continue to hold around a third of their assets in liquid form, which stood at 28.9 per cent at end-March 2013.

VI.8 Given the drag that NPAs exert on bank profitability, an attempt was made to ascertain the magnitude of the impact (Box VI.2).

Sensitivity Analysis

VI.9 A number of single factor sensitivity stress tests were carried out at the system as well as at the bank level (for the sample of 60 banks comprising 99 per cent of total banking sector assets) to assess their vulnerabilities and resilience under various scenarios. The resilience of the commercial banks in respect of credit, interest rate and liquidity risks were studied through sensitivity analysis by imparting extreme but plausible shocks.

Table VI.1: Select Financial Indicators

(Per cent)

Item	End-March	Scheduled Commercial Banks	Scheduled Urban Co-operative Banks	All India Financial Institutions	Primary Dealers	Non-Banking Financial Companies-D	NBFCs-ND-SI
1	2	3	4	5	6	7	8
CRAR	2012	14.2	12.8	21.0	53.8	20.4	27.5
	2013	13.8	12.7	19.0	39.4	22.3	28.0
Core CRAR	2012	10.4	N.A.	N.A.	N.A.	16.8	24.6
	2013	10.3	N.A.	N.A.	N.A.	19.0	24.3
Gross NPAs to Gross Advances	2012	2.9	5.2	0.4	N.A.	2.7	3.1
	2013	3.4	4.5	0.7	N.A.	2.5	3.5
Net NPAs to Net Advances	2012	1.2	0.9	0.1	N.A.	0.8	1.8
	2013	1.5	0.8	0.2	N.A.	0.8	1.6
Return on Total Assets	2012	1.1	1.0	1.0	0.8	2.8	1.8
	2013	1.0	0.9	1.0	1.5	2.7	2.1
Return on Equity	2012	13.4	N.A.	9.2	4.4	16.7	7.0
	2013	12.8	N.A.	9.6	10.1	15.4	8.6
Efficiency (Cost/Income Ratio)	2012	45.3	50.6	18.1	44.1	73.3	77.7
	2013	46.3	50.4	17.1	27.2	72.2	73.9
Interest Spread (per cent)	2012	3.1	N.A.	2.1	N.A.	3.3	2.3
	2013	3.0	N.A.	2.1	N.A.	3.6	5.3
Liquid Asset to total assets	2012	28.9	N.A.	N.A.	N.A.	16.1	4.9
	2013	28.9	N.A.	N.A.	N.A.	9.1	4.8

N.A.: Not Available.

Note: 1. Data for 2013 is unaudited and provisional.
2. Data for SCBs covers domestic operations, except for CRAR.
3. Data for CRAR of SCBs excludes Local Area Banks and pertains to Basel II norms.
4. Audited data for NABARD, SIDBI, and EXIM Bank for the year ended March 31, 2012 and audited data for NHB for June 30, 2012.
5. Audited data for NABARD, SIDBI and EXIM Bank for the year ended March 31, 2013, unaudited data for NHB for the year ended June 30, 2013.
6. Data on Scheduled UCBs exclude Madhavpura Mercantile Co-operative Bank Ltd.
7. Liquid assets include cash and bank balances and investments in government securities
8. ND-SI = Non deposit Systemically Important (*i.e.*, NBFCs with asset size of ₹1 billion and above

Source: 1. SCBs: Off-site supervisory returns.
2. AIFIs: OSMOS returns and data received from FIs.
3. UCBs: Off-site surveillance returns.

The results based on March 2013 data are available in the Financial Stability Report, June 2013. They indicate that while some banks would fail to maintain CRAR under stress scenarios for credit

Box VI.2
Impact of NPAs on profitability of banks

The quality of assets is an important indicator of banks' financial health. It also reflects the efficacy of banks' credit risk management and the recovery environment. A study of the asset quality of banks was carried out based on data submitted by banks, covering their domestic operations, through off-site returns.

The study indicated that gross non-performing assets, which declined from ₹700 billion at end-March 2003 to ₹500 billion at end-March 2007, recorded an average growth of 24.7 per cent during the last six years to reach to ₹1,839 billion at end-March 2013. Similarly, net NPAs have recorded an average growth of 29.0 per cent since March 2007 and reached ₹883 billion by end-March 2013. The gross NPA and net NPA ratios have been increasing since March 2008, except during 2010-11, and reached 3.42 per cent and 1.46 per cent, respectively, by end-March 2013. The high level of NPAs cost the banks by way of loss of interest income, besides provisioning, recovery and litigation costs.

According to the analysis, the loss to banks due to NPAs has been more than 60 per cent of their net profit since March 2010. In addition, about 18 per cent of banks' net interest income is used for making risk provisions and write-offs of NPAs. Had the NPAs not been there, banks would have improved their yield on advances, on an average, by 124 basis points (considering the position since March 2009).

risk, at the system level, CRAR would remain above the required minimum of 9.0 per cent.

MAJOR DECISIONS TAKEN BY BOARD FOR FINANCIAL SUPERVISION

VI.10 Constituted in 1994, the Board for Financial Supervision (BFS) remains the principal guiding force behind the Reserve Bank's supervisory and regulatory initiatives. The BFS currently has Shri Y.H. Malegam, Ms. Ela Bhatt, Dr. Rajeev Gowda and Shri Kiran Karnik as Director-members.

VI.11 The BFS had ten meetings during the period July 2012 to July 2013. The BFS considered, *inter alia*, the performance and the financial position of banks and financial institutions. The entire process of the inspection cycle for 2011-12 for all banks / LABs / AIFIs programmed for inspection was completed and the relevant Annual Financial Inspection (AFI) memoranda were submitted to the BFS by April 2013. The format of the inspection report has been made more risk-focussed and banks issued with Monitorable Action Plans (MAPs) with a timeline for completion. This has resulted in focussed attention on key supervisory concerns.

VI.12 Based on the issues raised during the 2011-12 inspection cycle, the BFS gave directions on several issues. Some of the major issues pertain to accurate reckoning of pension liabilities, accounting / disclosing commitments/ liabilities under ASBA, deficiencies in compliance with KYC/ AML guidelines, trading of Indian Rupee overseas, governance issues relating to private sector banks, concerns about the increasing number of fraud cases, misclassification of priority sector loans, disparity in pricing of loans, *etc.* Based on the directions / guidance of the BFS, thematic reviews were conducted in certain areas such as the KYC/ AML environment in banks, banks' exposure to real estate/ housing sector, major frauds above a threshold, *etc.* Under directions from the BFS, a revised compensation structure has been issued for private and foreign banks.

VI.13 Regarding the supervision of NBFCs, the BFS dealt with concerns such as the supervisory rating framework, lending against gold and gold ornaments, the fair practices code *etc.* Besides, the BFS considered various proposals based on recommendations of the Working Group to study issues and concerns in the NBFC sector. Inspection report of NBFC-ND-SIs with asset size of ₹1 billion and above were also placed before the BFS.

VI.14 During this period, the BFS also reviewed 49 summaries of inspection reports pertaining to scheduled urban co-operative banks (UCBs), 40 summaries of financial highlights pertaining to scheduled UCBs rated between A+ and B- and 11 summaries of financial highlights pertaining to scheduled UCBs rated between C+ and D. As regards supervision over UCBs, the BFS approved the revised graded supervisory action, financial restructuring of UCBs under directions and made the rating model for UCBs less complex. In addition, the BFS reviewed the regulations over rural credit institutions and approved a proposal to issue directions to unlicenced DCCBs.

COMMERCIAL BANKS

Regulatory Initiatives

Current Status of Implementation of Basel III Guidelines

VI.15 The Reserve Bank issued final guidelines regarding implementation of Basel III capital regulations on May 2, 2012. These guidelines are effective from April 1, 2013 with the exception of Credit Valuation Adjustment (CVA) risk capital charge for OTC derivatives which will become effective from January 1, 2014. This has been done keeping in view the impending introduction of mandatory forex forward guaranteed settlement through a central counterparty.

VI.16 Out of the 27 jurisdictions that comprise Basel Committee on Banking Supervision (BCBS) 25 have issued final Basel III based capital regulations. Further, Basel III capital rules have become effective in 11 member jurisdictions while others have issued final rules but have not yet brought them into force. The remaining two members have issued draft rules.

Status of Implementation of Basel II Advanced Approaches in India

VI.17 Currently, scheduled commercial banks are required to compute capital using simpler approaches available under the Basel II framework. The Standardised Approach for Credit Risk, the Basic Indicator Approach for Operational Risk and the Standardised Measurement Method for Market Risk have been implemented for banks in India. The current status with respect to the implementation of the advanced approaches is detailed below.

VI.18 With regard to credit risk, the guidelines for Internal Rating-Based (IRB) approach to credit risk for regulatory capital calculation were issued in December 2011, in terms of which banks could apply to the Reserve Bank for adoption of either Foundation Internal Rating-Based (FIRB) or Advanced Internal Rating-Based (AIRB) depending on their preparedness, between April and June 2012. Fifteen banks desirous of applying for IRB submitted the letter of intention by June 2012 and subsequently, fourteen banks submitted the gist of self-assessment on their preparedness for the FIRB/AIRB approach by September 2012.

VI.19 Based on the applications received and subsequent information obtained, a preliminary study of the status of preparedness of the banks has been carried out. The applicant banks that are better prepared may be taken for the parallel run under the IRB framework.

VI.20 With regard to market risk, banks in India have been using the Standardised Measurement Method (SMM) since March 2005. The guidelines for the advanced Internal Models Approach (IMA) to market risk assessment for regulatory capital calculation were issued by Reserve Bank in April 2010. Reserve Bank has already undertaken the process of validation of market risk models in respect of two banks. These banks have been suggested to upgrade their market risk management systems and processes before the migration to IMA is allowed. Further, two more banks have submitted their plans for migrating to IMA and Reserve Bank will be undertaking detailed model validation exercise in respect of these banks in due course.

VI.21 With respect to operational risk, the Basel II framework presents three methods to calculate the capital charge for operational risk along continuum of increasing sophistication and risk sensitivity *viz.* the Basic Indicator Approach (BIA), the Standardised Approach (TSA)/ Alternative Standardised Approach (ASA) and Advanced Measurement Approaches (AMA).

VI.22 The guidelines on implementation of The Standardised Approach (TSA) and Alternative Standardised Approach (ASA) for calculating capital charge for operational risk were issued in March 2010. TSA is a more advanced method in comparison to the BIA for determining the capital required for covering operational risk losses. Thirteen banks have submitted applications/ intention to migrate to TSA. Currently, while two banks have been granted permission for migrating to TSA on a parallel run basis with BIA for calculation of operational risk capital charge, three banks have been advised to enhance their operational risk management framework. Applications of the other eight banks are at various stages of assessment.

VI.23 The guidelines on implementation of the AMA were issued in April 2011. Under the AMA, the regulatory capital requirement will equal the risk measure generated by the bank's internal operational risk measurement system (ORMS), using quantitative and qualitative criteria.

VI.24 So far, nine banks have conveyed their intention to apply for AMA, four of which have also submitted a preliminary self-assessment of their preparedness for migration to AMA. The Reserve Bank, after making a preliminary assessment of a bank's risk management system and its modeling process, may allow the bank to make a formal application for migrating to AMA.

Dynamic Provisioning

VI.25 Provisions against loan losses can be broadly divided into two categories: general and specific. The present provisioning policy, consisting of general and specific provisions, has several limitations. First, the rate of provisions on standard assets is not based on any scientific analysis. Second, banks make floating provisions without any pre-determined rules. Third, the provisioning framework does not have cycle smoothening elements built into it. A need was, therefore, recognised for introducing a comprehensive provisioning framework that has dynamic and countercyclical elements.

VI.26 In this regard, a Discussion Paper was released by Reserve Bank on March 30, 2012 for public comments. Based on the analysis in the paper, it was proposed that the dynamic provisioning framework for loan loss provisions for banks in India would consist of two components: a) *Ex-post* Specific Provisions (SP) made during a year as required under Reserve Bank guidelines. These provisions would be debited to the Profit and Loss account; and b) Dynamic Provisions (DP) equal to the difference between the expected loss of the portfolio for one year based on downturn Loss Given Default (LGD) and the incremental specific provisions made during the year.[1] In short, under the proposed framework, banks will accumulate provisioning buffer during the period when the economy is growing and their credit losses are lower than the long-run average. The accumulated buffer would be utilised during the slow /negative growth phase when the banks' credit losses increase.

VI.27 Ideally, calibration of Expected Loss (EL) should be based on forward-looking through-the-cycle probability of default of various asset classes/ rating classes. Further, it should be based on the credit history of individual banks and reflect their own credit risk profile. Banks which have capability to calibrate their own parameters could be allowed, with the prior approval of Reserve Bank, to introduce dynamic provisioning framework based on their own data set. Those banks, which are not able to introduce dynamic provisioning based on their own data set, may use the standardised calibration carried out by the Reserve Bank. The final guidelines, containing the final calibration of EL, are proposed to be issued shortly.

Guidelines on Liquidity Risk Management

VI.28 The Reserve Bank had issued draft guidelines on Liquidity Risk Management (LRM) and Basel III framework on liquidity standards in February 2012 for comments and feedback. After taking into account the feedback received from stakeholders, the guidelines on LRM were issued in November 2012. These included enhanced guidance on liquidity risk governance, and measurement, monitoring and reporting to the Reserve Bank on liquidity positions.

VI.29 The Reserve Bank has indicated in the LRM guidelines that the guidelines on Basel III liquidity standards will be issued once the Basel Committee finalises the relevant framework. The Basel Committee has issued *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* in January 2013 and is in the process of finalising the Liquidity Coverage Ratio (LCR) disclosure requirements and Net Stable Funding Ratio (NSFR). The LCR is to be implemented from January 1, 2015 and the NSFR from January 1,

[1] This will generally ensure that every year the charge to profit and loss on account of specific provisions and DP is maintained at a level of αC_t.
α = Expected Loss Rate based on downturn Loss Given Default (LGD)
= Long Run Average Probability of Default (PD) *x* Downturn LGD
C_t= Gross Loans and Advances

2018. The Reserve Bank will issue the final guidelines on Basel III liquidity standards and liquidity risk monitoring tools, taking into account the revisions by the Basel Committee.

Restructuring of Advances by Banks and Financial Institutions

VI.30 Against the background of an increase in restructured standard advances, a Working Group was constituted (Chairman: Shri B. Mahapatra) to review the prudential guidelines on restructuring of advances by banks/financial institutions and to suggest revisions. The report of the Working Group was submitted in July 2012 and was placed on the website of the Reserve Bank to invite comments from the stakeholders (Box VI.3).

VI.31 Draft guidelines on restructuring of advances were placed on the Reserve Bank website on January 31, 2013 inviting comments from the stakeholders by February 28, 2013. Reserve Bank also issued a circular on the same date, rationalising the disclosure requirements of 'restructured accounts' as per the recommendation of the Working Group. The final guidelines have since been issued on May 30, 2013 taking into account the recommendations of the Working Group and the feedback from stakeholders.

VI.32 The major changes in the guidelines as a consequence are the following. (i) regulatory forbearance regarding asset classification on restructuring will be withdrawn from April 1, 2015; (ii) during the interregnum, standard restructured accounts will attract higher provisioning requirement of 5 per cent – immediately for fresh cases of restructuring (flow) with effect from June 1, 2013 and in a phased manner over three years for stock of standard restructured accounts as at end-May 2013; (iii) asset classification benefit on change of date of commencement of commercial operations (DCCO) of infrastructure and non-infrastructure projects will, however, continue to be available beyond April 1, 2015 until further review; (iv) promoters will have to make a sacrifice of 20 per cent of banks' sacrifice or 2 per cent of the restructured debt, which is higher, as against the earlier requirement of 15 per cent of banks' sacrifice; (v) conversion of debt into preference shares should be done only as a last resort and such conversion of debt into equity/ preference shares should, in any case, be restricted to a cap (say 10 per cent of the restructured debt);

Box VI.3
Review of prudential guidelines on restructuring of advances by banks and financial institutions – Major recommendations of the Working Group

The regulatory forbearance available on asset classification on restructuring presently needs to be withdrawn after two years.

During the interregnum, provision on standard restructured accounts which get the asset classification benefit on restructuring be increased from the present 2 per cent to 5 per cent, in a phased manner in case of existing accounts (stock) and immediately in case of newly restructured accounts (flow).

In view of the importance of infrastructure sector, asset classification benefit on restructuring may however be allowed for a longer period in cases where restructuring is due to change in date of commencement of commercial operation of infrastructure projects.

A cap of, say 10 per cent, to be prescribed on amount of restructured debt which can be converted into preference/ equity shares.

Reserve Bank may prescribe the broad benchmarks for viability parameters based on those used by CDR Cell; and banks may adopt them with suitable adjustments, if any, for specific sectors.

Compulsory promoters stake in the restructured accounts to be increased by way of higher sacrifice and personal guarantee.

Right of recompense may be made mandatory in all cases.

Disclosure requirements to be made comprehensive but to exclude standard restructured accounts which have shown consistent satisfactory performance.

(vi) promoters' personal guarantee should be obtained in all cases of restructuring and corporate guarantee cannot be accepted as a substitute for personal guarantee; (vii) criteria for upgradation of a downgraded restructured account, *i.e.*, an account classified as NPA on restructuring, has been tightened; and (viii) banks would be required to incorporate the 'right to recompense' clause in all cases of restructuring.

Management of Intra-Group Transactions and Exposures

VI.33 As the capital adequacy framework is not sufficient to fully mitigate the microprudential risk of exposures that are larger than a bank's capital resources, various prudential exposure limits are put in place to limit the maximum loss a bank could face in the event of default of a third party or a group of such parties. However, a bank's stability and solvency can also be jeopardised by parties that are related to the bank through organic links, generally termed as group entities. The possibility that large losses could arise due to Intra-Group Transactions and Exposures (ITEs) and threaten the on-going business operations of a banking group motivates supervisory concern that risk concentrations within the Group be identified, monitored and subjected to an adequate management strategy.

VI.34 The Reserve Bank issued draft guidelines in August, 2012 for limiting banks' transactions and exposures to the group entities. The draft guidelines had proposed both quantitative limits for the financial ITEs and prudential measures for the non-financial ITEs to ensure that the banks engage in the ITEs in safe and sound manner.[2] These measures are aimed at ensuring that banks, at all times, maintain an arm's length relationship in their dealings with the Group entities, meet minimum requirements with respect to Group risk management and group-wide oversight, and adhere to prudential limits on intra-group exposures. The comments received on the draft guidelines are being examined and the final guidelines will be issued shortly.

International Financial Reporting Standards (IFRS)

VI.35 The International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) are increasingly being recognised as a global standard for financial reporting. At present, they are followed in more than 100 jurisdictions including the European Union, Canada, Australia, New Zealand and South Korea.

VI.36 The Ministry of Corporate Affairs (MCA), Government of India (GoI) issued a roadmap in January 2010 envisaging a phased convergence from April 1, 2011 for corporates. However, the implementation date was kept in abeyance pending the resolution of various issues including those relating to taxation. Consequently, entities which were to have migrated to IFRS converged Indian Accounting Standards (Ind AS) from April 1, 2011 onwards have not done so.

VI.37 In the Indian banking sector, a delayed convergence schedule of April 1, 2013 was envisaged in the MCA's roadmap taking into account the project of the IASB to replace the existing standard on financial instrument *viz. IAS 39 Financial Instruments: Recognition and Measurement* with a new standard *IFRS 9: Financial Instruments* in order to reduce the complexity in IAS 39 as well as incorporate lessons learned from the financial crisis. However, the process has been substantially delayed due to lack of agreement between the IASB and the Financial Accounting Standards Board (FASB) of the US on certain issues with particular reference

[2] Non-financial ITEs refer to operations arising out of 'matrix' management facilitating control/ effective risk management over a business segment or a line of activity across a number of legally independent entities. Examples are back-office arrangements, IT support, *etc.* Financial ITEs are those whose outcomes can be associated with financial flows manifesting in the form of assets, liabilities and/ or revenue transactions. Examples are fund-based and non-fund based transactions.

to impairment. The uncertainty in the finalisation of IFRS 9 has impeded Indian efforts at convergence.

Licensing of new banks in the private sector

VI.38 In pursuance of the announcement made by the Hon'ble Finance Minister in his Budget Speech for the year 2010-11, the Reserve Bank had placed draft guidelines on the licensing of new banks in the private sector on its website on August 29, 2011 for public comments. The final guidelines were prepared and released on Reserve Bank's website on February 22, 2013, consequent to the amendments to the *Banking Regulation Act* 1949 in December 2012 (Box VI.4). Subsequently, 26 applications for new bank licenses in the private sector have been received till the closing date of July 1, 2013.

Supervisory Initiatives

High Level Steering Committee to Review the Supervisory Policies, Procedures and Processes for Commercial Banks

VI.39 One of the main recommendations of the High-Level Steering Committee (HLSC) to review of supervisory processes (Chairman: Dr. K. C. Chakrabarty) was the adoption of a Risk-Based Approach for supervision of commercial banks from the supervisory cycle beginning April 2013. In this connection, the Board for Financial Supervision (BFS) has recommended migration to Risk Based Supervision (RBS) in a phased manner for scheduled commercial banks from 2012-13. Accordingly, a list of 30 banks has been identified to be taken up under RBS (Phase I). The selected banks account for 52 per cent of the total banking sector assets.

VI.40 To enable banks to gear up to the challenges of a smooth transition to RBS, the Reserve Bank has been endeavouring to sensitise the banks on the changed process of supervision. The Reserve Bank has also conducted sensitisation programs for 180 senior officers and 50 top management officials of the banks under RBS. The Reserve Bank has also initiated the process of collating additional data from banks from April 2013 to facilitate finalisation of the RBS framework.

Bilateral Memorandum of Understanding (MoU) with its Overseas Counterparts for Improved Cross Border Supervision and Cooperation

VI.41 The earlier informal process of sharing of information between "Home" and "Host" supervisors is being formalised though the mechanism of Memorandum of Understanding (MoU). This channel is becoming all the more important since the cross-border operations of Indian banks are increasing at a rapid pace. However, the FSAP team (2011) assessed the Reserve Bank as 'Materially Non compliant' in respect of 3 BCPs (out of a total of 29 BCPs), including BCP 25 (Revised Principle 13) on 'Home- Host relationships'.

VI.42 Against this backdrop, the Reserve Bank has executed MoUs with sixteen overseas supervisors *i.e.*, China Banking Regulatory Commission (CBRC), Dubai Financial Services Regulatory Authority (DFSA), South African Reserve Bank (SARB), Qatar Financial Centre Regulatory Authority (QFCRA), Qatar Central Bank (QCB), Central Bank of Bahrain (CBB), Jersey Financial Services Commission (JFSC), Financial Services Authority (FSA) UK, Finanstilsynet (FSA of Norway), Central Bank of Russian Federation (CBRF), State Bank of Vietnam (SBV), Bank of Mauritius (BoM), Reserve Bank of Fiji (RBF), National Bank of Belgium (NBB), BaFin and ACP and Banque de France. Besides, proposals in respect of 28 other overseas supervisors are in various stages of reaching a mutually agreeable format for a MoU. The MoU provides a formal, yet legally non-binding, gateway of information between supervisors.

MoU with financial sector regulators to monitor Financial Conglomerates

VI.43 One of the mandates assigned to the Financial Stability Development Council (FSDC) is

Box VI.4
Licensing of new banks in private sector

As per the guidelines, entities / groups in the private sector which are owned and controlled by residents and entities in public sector shall be eligible to set up a bank. Non-Banking Financial Companies (NBFCs) shall also be eligible to set up a bank.

The guidelines set out 'fit and proper' criteria for the Promoters/ Promoter Groups. The Promoters/Promoter Groups should be financially sound with a successful track record of 10 years and have a past record of sound credentials and integrity. For this purpose, Reserve Bank may seek feedback from other regulators and enforcement and investigative agencies. Promoters/Promoter Groups' business model and business culture should not be misaligned with the banking model and their business should not potentially put the bank and the banking system at risk on account of group activities such as those which are speculative in nature or subject to high asset price volatility.

The new banks in the private sector would be set up through a wholly-owned Non-Operative Financial Holding Company (NOFHC). NOFHC shall be wholly-owned by the Promoters/ Promoter Group. NOFHC shall hold the bank as well as all the other financial services entities, in which the Promoters/ Promoter Group have significant influence or control. The guidelines stipulate that only the non-financial services companies/entities and non-operative financial holding company in the Group and individuals belonging to Promoter Group will be allowed to hold shares in the NOFHC. Financial services entities whose shares are held by the NOFHC cannot be shareholders of the NOFHC. NOFHC will be registered as an NBFC and comply with the corporate governance standards and prudential norms set out by Reserve Bank.

The aggregate non-resident shareholding from FDI, NRIs and FIIs in the new private sector bank shall not exceed 49 per cent of the paid-up voting equity capital for the first 5 years from the date of licensing of the bank and no non-resident shareholder will be permitted to hold 5 per cent or more of the paid-up voting equity capital of the bank for a period of 5 years from the date of commencement of business of the bank. The non-resident shareholding will be as per the extant FDI policy, after the expiry of the initial five year period.

The bank as well as the financial entities under the NOFHC cannot take credit and investment exposure to Promoters/ Promoter Group entities or individuals associated with the Promoter Group or the NOFHC. Banks promoted by Groups having 40 per cent or more assets income from non-financial business will require Reserve Bank's prior approval for raising paid-up voting equity capital beyond ₹10 billion for every block of ₹5 billion.

The business plan should be realistic and viable and should address how the bank proposes to achieve financial inclusion. The bank shall open at least 25 per cent of its branches in unbanked rural centres (population up to 9,999 as per the latest census). The bank shall comply with the priority sector lending targets and sub-targets as applicable to existing domestic banks. The bank will operate on the core banking system and will have a high powered customer grievances cell to handle complaints.

The eligible applications for the proposed new bank will be referred to a High Level Advisory Committee to be set up by Reserve Bank, comprising of eminent persons with experience in banking, financial sector and other relevant areas.

The High Level Advisory Committee will set up its own procedures for screening the applications and will submit its recommendations to Reserve Bank for consideration. The decision to issue an 'in-principle' approval for setting up of a bank will be taken by Reserve Bank, which would be final.

the macroprudential supervision of large financial conglomerates. In this context, in terms of FSDC sub-Committee directions, an institutional structure for the oversight and monitoring of Financial Conglomerates (FCs) in the form of an Inter Regulatory Forum (IRF) modelled around the "lead regulator" principle has been set up under the aegis of the sub-Committee of the FSDC. The IRF is headed by the Deputy Governor, Reserve Bank (in-Charge of banking supervision) and comprises of senior representatives from the sectoral regulators (Reserve Bank, SEBI, IRDA and PFRDA).

VI.44 As part of formalising the institutional mechanism, a MoU for facilitating data/information sharing and formalising other co-operation arrangements like coordinated inspection, recovery and resolution planning *etc.* has been signed among the regulators. Based on criteria for identification of FC and financials of 2011-12, the IRF for FC monitoring has identified 12 such FCs.

Supervisory College

VI.45 Supervisory Colleges refer to multilateral working groups of relevant supervisors that are constituted for the purpose of enhancing effective consolidated supervision of an international banking group on an ongoing basis. These are permanent, although flexible, structures of coordination that bring together regulatory authorities involved in the supervision of a banking group. In practice, the colleges are a mechanism for the exchange of information between home and host authorities, for the planning and performance of key supervisory tasks in a coordinated manner and also for the preparation and handling of emergency situations. Thus supervisory college is a process for regulatory co-operation.

VI.46 With a view to benchmarking the Indian banking system with the best practices across the globe and in its capacity as the home country supervisor, the Reserve Bank has established supervisory college for two major financial entities in India – State Bank of India and ICICI Bank Ltd. - considering their expanse of overseas operations spreading across several supervisory jurisdictions. The first meeting of the supervisory college was held in December 2012. The meeting brought together a number of host country supervisors/ regulators.[3]

CUSTOMER SERVICE

Complaints received and disposed

VI.47 The Reserve Bank introduced the Banking Ombudsman Scheme 2006, as a cost-free, apex level grievance redressal mechanism for bank customers. During the year 2012-13, fifteen offices of the Banking Ombudsman (OBOs) situated across the country received 70,541 complaints from customers about deficiency in banking services. There were 4,642 complaints pending at the beginning of the year. OBOs disposed of 69,705 complaints during the year clocking a disposal rate of 93 per cent. During the year, 312 awards were passed by the Banking Ombudsmen.

VI.48 The Deputy Governor in-charge of Customer Service Department (CSD), who is the Appellate Authority appointed under the Banking Ombudsman Scheme 2006 receives appeals against the Award issued or decision given by the Banking Ombudsman. During the year 2012-13, the Appellate Authority received 359 appeals. There were 13 appeals pending disposal at the beginning of the year. Of the appeals received, 307 appeals were non-maintainable. Of the remaining 65 maintainable appeals, 29 were disposed in favour of customers and 26 in favour of banks. As on June 30, 2013, 10 maintainable appeals were pending disposal.

VI.49 In addition to the Banking Ombudsman, the Reserve Bank received 6,226 complaints against banks pertaining to deficiency in customer services. All the complaints were disposed of during the year.

VI.50 The Reserve Bank also receives complaints through Centralised Public Grievances Redressal and Monitoring System (CPGRAMS) Portal of the Department of Administrative Reforms and Public Grievances (DARPG), Government of India. During the year, 5,251 such complaints were received through this portal out of which, 4,980 complaints were disposed as on June 30, 2013.

Position of applications and appeals received under RTI Act, 2005

VI.51 The Customer Service Department (CSD) receives applications under RTI Act pertaining to complaints dealt with by BO offices and also

[3] The host country supervisors/ regulators included Bangladesh Bank, Central Bank of Bahrain, National Bank of Belgium, Dubai Financial Services Authority, Bank of Russia, Financial Services Authority (London), Federal Financial Services Authority (BaFin), Bank of Mauritius, Nepal Rastra Bank and Monetary Authority of Singapore.

other activities of the department. During the year 2012-13, the CSD handled 689 RTI applications which were duly disposed. During the year 2012-13, 123 appeals under RTI Act were received of which, 110 were disposed by June 30, 2013.

Damodaran Committee Report

VI.52 Of the 232 recommendations made by the Damodaran Committee on customer service in banks, 155 have been implemented. The important recommendations that have been implemented include abolition of foreclosure charges on floating rate home loans, introduction of basic savings bank deposit account, Unique Identification No. (UID) to be used as KYC for opening basic bank accounts, differential merchant discount/ fee for debit cards, multi-factor authentication for card transactions and blocking of cards through SMS.

Spreading Awareness about Banking Ombudsman Scheme

VI.53 The popularity of the Banking Ombudsman (BO) scheme is evidenced by the large number of complaints received by the offices of the Banking Ombudsman. Spreading awareness about this apex-level grievance redressal mechanism, especially in rural areas, is the key to empowering this segment of the population. In this direction, the Reserve Bank has been organising outreach programmes focussed on financial inclusion and financial literacy in rural areas. The offices of the BO organise awareness campaigns in rural areas within their jurisdiction. Documentary films, publicity through local newspapers and radio, setting up stalls at various *melas*, fairs and live interactive programmes on *Doordarshan* are some of the measures that were initiated by the Reserve Bank and the offices of the Banking Ombudsman during the year.

VI.54 The offices of the Banking Ombudsman also organise Town Hall Events in tier-II cities in co-ordination with the leading banks in the area. Students, bank customers, NGOs, consumers associations and pensioners associations in the area are involved in these events. The events are conducted in local languages to ensure wider reach. The Banking Ombudsman and relevant bank officials respond to the participants' queries during these events.

Working Group for Revision and Updation of the Banking Ombudsman Scheme 2006

VI.55 An internal Working group for revision and updation of the Banking Ombudsman Scheme 2006 was constituted by the Reserve Bank in July 2012. The Working Group was also asked to examine the implementability of the Banking Ombudsman Scheme related recommendations of the Damodaran Committee. The Working Group has submitted its report and its recommendations are being examined for implementation.

BANKING CODES AND STANDARDS BOARD OF INDIA

VI.56 The Banking Codes and Standards Board of India (BCSBI) is an autonomous and independent body set up by the Reserve Bank, which sets minimum standards for banking services in India for individuals and Micro and Small Enterprises (MSEs). Banks register themselves with BCSBI as its member and voluntarily agree to abide by Codes of Commitment of BCSBI. BCSBI monitors and assesses the compliance with the codes and standards. The BCSBI presently has 125 banks as members.

VI.57 During the year, BCSBI continued its efforts to increase awareness about the codes by conducting workshops, Town Hall meets and customer awareness programmes.

URBAN CO-OPERATIVE BANKS

Declaration of Dividend by UCBs

VI.58 UCBs were advised about the revised criteria for declaring dividend without the permission of the Reserve Bank. The criteria included compliance with prescribed CRAR, net NPAs below

5 per cent of net advance, no default in CRR/SLR and the bank having made all provisions as per IRAC norms and statutory provisions. UCBs complying with all parameters except net NPAs and desirous of declaring dividend were advised to approach the respective Regional Office for permission to declare dividend provided the net NPAs is less than 10 per cent.

Intra-bank Deposit Accounts Portability and KYC related advise to UCBs

VI.59 UCBs were advised that once KYC is done by one branch of the bank, it should be valid for transfer of the account within the bank as long as the KYC procedure for the concerned account is complete. UCBs were also advised to complete the process of risk categorisation and compiling/ updating profiles of all of their existing customers in a time-bound manner, and in any case not later than March 31, 2013.

VI.60 Following the announcement in the Monetary Policy Statement 2012-13 on April 17, 2012, UCBs have been granted time up to March 31, 2014 for allotting Unique Customer Identification Code (UCICs) to existing customers.

Know Your Customer (KYC)/ (AML)/ (CFT) / Simplification

VI.61 The existing KYC norms were reviewed and simplified. The salient features of the new norms include the following:

a) *Proof of identity and address:* If address on the document submitted as identity proof is same as that declared by customer, the document may be accepted as valid proof for both identity and address.

b) *Introduction:* Since introduction is not necessary for opening of accounts under PML Act and Rules, banks should not insist on an introduction for opening of accounts.

c) *Acceptance of Aadhaar letter for KYC purposes:* If the address provided by account holder is same as that on the *Aadhaar* letter, it may be accepted as proof of both identity and address

d) *Acceptance of NREGA Job Card as KYC for normal accounts:* Banks may accept the NREGA Job Card as an officially valid document for opening bank accounts without the limitation applicable to 'Small Accounts'.

e) *Small accounts:* Banks were advised to open small accounts for all persons who so desire, subject to limitations applicable to 'Small Accounts'.

KYC /AML / CFT / Obligations of Banks under Prevention of Money Laundering Act (PMLA), 2002 – Identification of beneficial owner

VI.62 The Government of India had specified the procedure for determining beneficial ownership where the client of bank/ financial institution is a person other than an individual or a trust. The procedure as advised by the Government of India for identifying the beneficial owner was advised to UCBs.

Financial Restructuring of UCBs

VI.63 UCBs were advised that the Reserve Bank would, henceforth, consider financial restructuring proposals submitted by UCBs that involve conversion of deposits into equity/IPDI, even if the net worth of the bank does not become positive after such a conversion, provided that the depositors voluntarily agree to the conversion.

Financial Inclusion – Access to Banking Services – Basic Saving Bank Deposit Account

VI.64 In supersession of earlier instructions on financial inclusion, UCBs were advised to offer 'Basic Saving Bank Deposit Account' with the minimum common facilities to their customer at no charge, subject to compliance with Reserve Bank instructions on KYC/AML for opening a bank account. UCBs were also advised to convert the existing 'no frill' accounts of customers into 'Basic Saving Bank Deposit' accounts.

Premature Repayment of Term/Fixed Deposits in banks with "Either or Survivor" or" Former or Survivor" mandate – Clarification

VI.65 It was reiterated that in case of term deposits with 'Either or Survivor' or 'Former or Survivor' mandate, UCBs are permitted to allow premature withdrawal of the term deposits by the surviving joint depositor on the death of the other, only if, there is a joint mandate from the joint depositors to this effect.

Interest Rate on Deposits

VI.66 It was observed that there was wide variation in the interest rates offered by banks on single term deposits of ₹1.5 million and above and those offered on other deposits (*i.e.* less than ₹1.5 million) of corresponding maturities. Further, banks were offering significantly different rates on deposits with very little difference in maturities suggesting inadequate liquidity management systems and pricing methodologies. UCBs were advised to put in place a transparent Board-approved policy on pricing of liabilities and were advised to ensure that the difference in interest rates on single term deposit of ₹1.5 million and other term deposits (*i.e.* deposits less than ₹1.5 million) was minimal for corresponding maturities.

Setting up Central Electronic Registry under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002

VI.67 In connection with the request from the Central Registry of Securitisation Asset Reconstruction and Security Interest Act of India (CERSAI), UCBs were advised to voluntarily file records of equitable mortgages created by them with CERSAI.

Migrating to CTS 2010 Standards – Submission of Compliance Report

VI.68 UCBs were advised to ensure withdrawal of non-CTS -2010 Standard cheques within the extended time limit *i.e.* by March 31, 2013. The date has been extended to July 31, 2013.

Frauds - Classification and Reporting

VI.69 As part of rationalisation of the process and procedures, UCBs have been advised to discontinue the practice of reporting attempted fraud, where likely loss would have been ₹2.5 million or higher, to the Reserve Bank of India. UCBs were also advised to place information relating to frauds on a quarterly basis before the Audit Committee of the Board during the month following the quarter. In addition, UCBs have been advised to conduct an annual review of frauds and place a note before their Board of Directors, for information.

Implementation of Core Banking Solutions (CBS) by Urban Co-operative Banks (UCBs)

VI.70 UCBs were advised to implement CBS in all their branches before December 31, 2013 for better customer service, effective regulatory reporting and generating MIS reports.

Unsecured Exposure Norms for UCBs

VI.71 In order to promote lending to priority sectors and to provide impetus to financial inclusion, UCBs that fulfil certain conditions (such as the entire loan portfolio of the bank is covered under priority sector, all sanctioned loans should be of small value *i.e.*, up to ₹20,000 in a single account, their assessed CRAR should be 9 per cent and their assessed gross NPAs should be less than 10 per cent of gross advances) were permitted to grant unsecured loans (with or without surety) up to 25 per cent of their total assets, with the prior approval of the Reserve Bank.

KYC /AML / CFT / Obligations of Banks under Prevention of Money Laundering Act (PMLA), 2002-Simplifying Norms for Self Help Groups

VI.72 To address the difficulties faced by Self Help Groups (SHGs) in complying with KYC norms when opening savings bank accounts and credit linking their accounts, the norms were simplified and UCBs were advised that (i) KYC verification of all the office bearers would suffice while opening the savings bank account of the SHG and (ii) since KYC would have already been verified when opening the savings bank account and the account to be used for credit linkage would continue to be in operation, separate KYC verification of the members or office bearers was not necessary.

Bank finance for purchase of gold

VI.73 UCBs were advised that they should not grant any advance for purchase of gold in any form, including primary gold, gold bullion, gold jewellery, gold coins, units of gold Exchange Traded Fund and units of gold mutual funds.

Ready forward transactions in corporate debt securities

VI.74 Scheduled UCBs with CRAR of 10 per cent or more, gross NPAs of less than 5 per cent, continuous record of profits for last three years and having in place sound risk management practices and mandatory concurrent audit of its investment portfolio were permitted to undertake ready forward contracts in corporate debt securities with SCBs/PDs, subject to certain conditions.

Consolidation of UCBs through mergers/acquisitions

VI.75 As part of the process of strengthening the sector, a process of consolidation was set in motion through transparent and objective guidelines issued in February 2005. Another set of guidelines was issued by the Reserve Bank in January 2009 for the merger / acquisition of UCBs that have a negative net worth. Guidelines for transfer of assets and liabilities of UCBs to commercial banks were issued in February 2010. Pursuant to the issue of guidelines on merger, the Reserve Bank received 177 proposals for merger up to March 2013 and issued 130 NOC/sanctions of which 111 have been notified for mergers by respective RCS/CRCS (Table VI.2).

Table VI.2 : Year-wise progress in mergers/ acquisitions as on March 31, 2013

Financial year	Proposals received in the Reserve Bank	NOCs issued by the Reserve Bank	Merger effected (Notified by RCS)
1	2	3	4
2005-06	24	13	4
2006-07	32	17	16
2007-08	42	26	26
2008-09	16	26	22
2009-10	26	17	13
2010-11	17	15	13
2011-12	10	11	14
2012-13	10	5	3
Total	**177**	**130**	**111**

VI.76 The maximum number of mergers took place in Maharashtra, followed by Gujarat and Andhra Pradesh (Table VI.3).

Table VI.3 : State-wise progress in mergers/acquisition of UCBs

States	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	**Total**
1	2	3	4	5	6	7	8	9	**10**
Maharashtra	2	12	14	16	6	7	8	1	**66**
Gujarat	2	2	6	2	2	2	4	1	**21**
Andhra Pradesh	-	1	3	1	3	2	1	-	**11**
Karnataka	-	-	2	1	-	-	-	-	**03**
Punjab	-	1	-	-	-	-	-	-	**01**
Uttarakhand	-	-	1	1	-	-	-	-	**02**
Chhattisgarh	-	-	-	1	-	1	-	-	**02**
Rajasthan	-	-	-	-	2	-	1	-	**03**
Madhya Pradesh	-	-	-	-	-	-	-	-	**-**
Uttar Pradesh	**-**	**-**	**-**	**-**	**-**	1	-	1	**02**
Total	**4**	**16**	**26**	**22**	**13**	**13**	**14**	**3**	**111**

RURAL CO-OPERATIVES

Licensing of Rural Co-operatives Banks

Licensing of State and Central Co-operative Banks-Present Status

VI.77 The Committee on Financial Sector Assessment (CFSA) (Chairman: Dr. Rakesh Mohan) had recommended that no unlicensed cooperative bank may be allowed to operate in the cooperative space beyond March 31, 2012. However, this would need to be attained in a non-disruptive manner.

VI.78 As there were a large number of cooperative banks functioning without license [17 out of 31 State Cooperative Banks (StCBs) and 296 out of 371 District Central Cooperative banks (DCCBs)], the Reserve Bank relaxed the licensing norms. Accordingly, only two parameters based on the latest inspection by NABARD were prescribed for licensing *viz.*: (i) CRAR – minimum 4 per cent, and (ii) no default in CRR/SLR for the past one year (default on one/two occasions could be overlooked).

VI.79 The relaxed licensing norms helped in granting licenses to a large number of cooperatives and as at the end of March 31, 2012, only 43 banks (one StCB and 42 DCCBs) remained unlicensed. These banks were issued Directions prohibiting them from acceptance of fresh (new) deposits and advised to draw up a Monitorable Action Plan to achieve the licensing norms by September 30, 2012. Following the infusion of capital by some State Governments, 17 banks (one StCB and 16 DCCBs) became eligible for license, but the remaining 26 banks failed to achieve the licensing norms, even after the extension.

VI.80 Notices were issued on March 7, 2013 to all 26 unlicensed DCCBs for not complying with the licensing criteria to show cause as to why the licence application submitted to the Reserve Bank to carry on banking business should not be rejected. In Maharashtra, two DCCBs attained licensing norms after the State Government released funds and a third DCCB achieved the licensing norms on its own; licenses were issued to these three DCCBs in Maharashtra. Thus, as on date, the number of unlicensed banks remains at 23 in four states (16 in Uttar Pradesh, 3 in Maharashtra, 3 in Jammu & Kashmir and 1 in West Bengal).

Developments in Regional Rural Banks

Amalgamation of RRBs

VI.81 The consolidation of RRBs was initiated in the year 2005. In the first phase of amalgamation of RRBs which took place between September 2005 and March 2010, RRBs of the same sponsor banks within a state were amalgamated bringing down their number to 82 from 196. In the current phase which started from October 1, 2012, the Government of India (GoI) plans to mainly amalgamate geographically contiguous RRBs within a state under different sponsor banks to have just one RRB in medium-sized states and 2 or 3 RRBs in large states. As on date, 36 RRBs have been amalgamated by the GoI to create 15 new RRBs in 10 states bringing down their effective number to 61. The process of scheduling has been initiated in respect of the newly amalgamated RRBs.

Recapitalisation of RRBs

VI.82 The Central Government had, in September 2009, constituted a committee (Chairman: Dr. K.C. Chakrabarty) to study the current level of CRAR of RRBs and to suggest a roadmap for enhancing the same to 9 per cent by March 31, 2012. The committee submitted its report to the Government on April 30, 2010. The committee has assessed that 40 RRBs will require capital infusion to the extent of ₹22 billion. The NABARD has reported that 36 RRBs have been recapitalised fully, whereas in 4 RRBs, the recapitalisation process is yet to be completed. The recapitalisation scheme has been extended up to 2013-14 to complete the process.

DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION

VI.83 The Deposit Insurance and Credit Guarantee Corporation (DICGC) is a wholly-owned subsidiary of Reserve Bank of India. The number of insured banks as on March 31, 2013 stood at 2,167 comprising 89 commercial banks, 67 RRBs, 4 LABs and 2,007 co-operative banks. With the present limit of deposit insurance in India at ₹0.1 million, the number of fully protected accounts at 1,393 million (as on March 31, 2013) constituted 94 per cent of the total number of accounts (1,482 million) as against the international benchmarks of 80 per cent. Amount-wise, insured deposits at ₹21,584 billion constituted 32.6 per cent of assessable deposits at ₹66,211 billion against the international benchmark of 20-40 per cent[4]. At the current level, the insurance cover works out to 1.45 times per capita income as on March 31, 2013.

VI.84 The DICGC builds up its Deposit Insurance Fund (DIF) through transfer of its surplus, *i.e.*, excess of income (mainly comprising premia received from insured banks, interest income from investments and cash recovery out of the assets of failed banks) over expenditure each year, net of taxes. This fund is used to settle the claims of depositors of banks taken into liquidation/ reconstruction/amalgamation, *etc.* During the year 2012-13, the DICGC settled aggregate claims amounting to ₹2.00 billion in respect of 63 co-operative banks as compared with claims aggregating ₹2.87 billion in the previous year. The size of DIF stood at ₹361.20 billion as on March 31, 2013, implying a reserve ratio (DIF/Insured Deposits) of 1.7 per cent.

VI.85 The Financial Stability Board (FSB) undertook a peer review of resolution regimes in order to evaluate the existing regimes in the FSB's jurisdictions and any planned changes to those regimes using Key Attributes (KAs) as a benchmark. The Peer Review Report was released by the FSB in April 2013. The Review report found that, while major legislative reforms have taken place in some jurisdictions, implementation of the KAs remains at an early stage. Further work is needed to implement robust resolution regimes that are capable of addressing failing institutions, including SIFIs.

VI.86 During the global financial crisis, the uncertainty triggered panic and the collapse of banks. Under these circumstances, deposit insurance emerged as an important part of financial safety net in arresting panic (Box VI.5).

NON-BANKING FINANCIAL COMPANIES

New Category of NBFCs

VI.87 During 2012-13, a new category of NBFCs, *viz.*, Non-Banking Financial Company - Factors was created. The guidelines for the new NBFC category are provided in Box VI.6.

Miscellaneous Instructions

VI.88 Revised guidelines on securitisation were introduced for NBFCs which specify *inter alia* that the portfolio can be securitised after a minimum holding period and the originators need to retain a portion of the securitised portfolio. The guidelines also deal with bilateral assignments under which no credit enhancement can be provided by the originators.

VI.89 All NBFCs lending against the collateral of gold were advised to maintain a Loan-to-Value (LTV) ratio not exceeding 60 per cent and disclose in their balance sheet the percentage of such loans to their total assets. Where gold loans comprise 50 per cent or more of the financial assets, the NBFCs shall maintain a minimum Tier I capital of 12 per cent by April 01, 2014. Further, NBFCs should not grant any advances against bullion/primary gold and gold coins or for purchase of gold in any form, including primary gold, gold bullion, gold jewellery,

[4] Accepted as a rule of thumb at the First Annual Conference of the International Association of Deposit Insurers (IADI) in Basel, Switzerland in May 2002.

Box VI.5
Deposit Insurance in the Financial System – Some Observations

The provision of deposit insurance serves several purposes. First, it secures public confidence in the banking system, thereby contributing to financial stability. Second, deposit insurance benefits depositors, particularly small ones, through protection of their deposits, thereby contributing to the social security objective. Third, confidence in the banking system coupled with broad access to safe and affordable small savings accounts promotes financial inclusion and helps households prepare for unexpected expenses and plan for a more secure financial future. Deposit insurance is a very effective tool to attain financial inclusion, given the existing high level of financial exclusion around the globe, especially in the underdeveloped world and emerging and developing economies.

The Financial Stability Board (FSB) undertook a peer review of deposit insurance systems among its member institutions. The report observed that the global financial crisis has illustrated the importance of effective depositor compensation arrangements. The crisis resulted in greater convergence in practices across jurisdictions and emerging consensus about appropriate design features that include higher coverage levels, elimination of co-insurance, improvements in the payout process, greater depositor awareness, adoption of *ex ante* funding by more jurisdictions and strengthening of information sharing and co-ordination with other safety net participants.

In order to play an effective role in the financial system, deposit insurers must comply with the BCBS-IADI 'Core Principles for Effective Deposit Insurance Systems'. In some areas, there are deviations from the 'Core Principles', which need to be addressed. In some countries, including India, non-bank deposit-taking institutions do not have deposit insurance coverage. Second, coverage limits need to be periodically examined so as to achieve a balance between financial stability and market discipline. The deposit insurer would also need to take into consideration the value (of deposits) at risk and the likelihood of failure for determining the sufficiency of funds. In addition, adequacy, timeliness and efficiency in payout are important for the deposit insurance agency, that is contingent on timely access to information. Deposit insurance systems should regularly test the readiness and effectiveness of their payout processes. In this regard, data systems such as the "single customer view" in the US and the UK need to be implemented in India.

The financial crisis led to the expansion of mandates in many systems. The challenge before economies is to ensure proper co-ordination between the deposit insurer and other safety net participants, which would ensure appropriate resolution and expeditious claims settlement. The cross-border information-sharing arrangements between deposit insurance agencies also need to be strengthened.

gold coins, units of gold Exchange Traded Funds (ETF) and units of gold Mutual Funds

VI.90 In light of the operational issues surrounding micro finance and lending against collateral of gold jewellery, the guidelines issued on Fair Practices Code for such NBFCs were revised/amended. As per the guidelines such NBFCs should put in place Board-approved grievance redressal mechanism with the name of the grievance redressal officer prominently displayed at all branches; the Fair Practices Code in vernacular language should be prominently displayed; there should be transparency in loan pricing, besides others. NBFCs lending against gold jewellery have been advised to follow KYC guidelines; have internal policies to establish ownership of gold; have adequate security and insurance on gold collateral and have Board-approved auction policy in place. NBFCs themselves cannot participate in their auctions.

VI.91 The margin cap for all NBFCs irrespective of their size have been revised to 12 per cent until March 31, 2014. However, with effect from April 1, 2014 margin caps may not exceed 10 per cent for large MFIs (loans portfolios exceeding ₹100 crore) and 12 per cent for the others.

VI.92 In view of the unique business model of Core Investment Companies (CICs), it was decided to issue a separate set of guidelines for their entry into insurance business. Eligibility criteria include, *inter alia,* owned funds of ₹ 500 crore, net NPA of not more than 1 per cent of net advances and earning profits for three consecutive years. The CIC will be permitted to invest upto 100 per cent of the equity of the insurance company.

Box VI.6
NBFC-Factors

The *Factoring Regulation Act* 2011, notified by the Central Government in January 2012, aims to regulate factors and assignment of receivables in favour of factors, as also delineate the rights and obligations of parties to assignment of receivables.

Under the Act, factoring companies other than banks, Government companies *etc.* (as provided in Section 5 of the Act) would be registered with the Reserve Bank as NBFCs and would be subject to prudential regulations by the Reserve Bank. Hence, it has been decided to introduce a new category of NBFCs *viz.*, Non-Banking Financial Company-Factors and separate Directions in this regard have been issued.

This Directions states, *inter alia*, that every company intending to undertake factoring business shall make an application for grant of certificate of registration (CoR) as NBFC-factor to the Reserve Bank as provided under Section 3 of the Act. Existing NBFCs that satisfy all the conditions enumerated in these Directions have been advised to approach the Regional Office of the Reserve Bank where it is registered, along with the original CoR issued by the Reserve Bank for change in their classification as NBFC-Factor within six months from the date of this notification. Their request must be supported by their Statutory Auditor's certificate indicating the asset and income pattern. An entity not registered with the Bank may conduct the business of factoring if it is an entity mentioned in Section 5 of the Act *i.e.*, a bank or any corporation established under an Act of Parliament or State Legislature, or a Government Company as defined under section 617 of the Companies Act 1956. A new company that is granted CoR by the Reserve Bank as NBFC-Factor shall commence business within six months from the date of grant of CoR by the Reserve Bank.

For every company seeking registration as NBFC-Factor, the minimum Net Owned Fund (NOF) has been fixed at ₹5 crore. Existing companies seeking registration as NBFC-Factor but do not fulfil the NOF criterion of ₹5 crore have been advised to approach the Reserve Bank for time to comply with the requirement.

Principal Business criteria for NBFC-Factor

(i) An NBFC-Factor shall ensure that its financial assets in the factoring business constitute at least 75 per cent of its total assets and its income derived from factoring business is not less than 75 per cent of its gross income;

(ii) An existing NBFC registered with the Reserve Bank and conducting factoring business that constitute less than 75 per cent of total assets / income shall have to submit to the Reserve Bank within six months from the date of this notification, a letter of its intention either to become a Factor or to unwind the business totally, and a roadmap to this effect. However, such NBFCs shall raise the asset/income percentage as required at 6(i) above or unwind the factoring business within a period of 2 years from the date of this notification. They will be granted CoR as NBFC-Factors only after they reach the required asset/income percentage.

The provisions of Non-Banking Financial (Non-deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 or Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007, as the case may be and as applicable to a loan company shall apply to an NBFC-Factor. The submission of returns to the Reserve Bank will be as specified presently in the case of registered NBFCs.

Export / Import Factoring

The Foreign Exchange Department (FED) of the Reserve Bank gives authorisation to Factors under FEMA, 1999. Therefore, NBFC-Factors, intending to deal in forex through export/import factoring, should make an application to FED for necessary authorisation under FEMA, 1999 to deal in forex and adhere to the terms and conditions prescribed by FED and all the relevant provisions of the FEMA or Rules, Regulations, Notifications, Directions or Orders made thereunder from time to time.

VI.93 A separate set of Directions for CICs was issued with regard to their overseas investments. All CICs investing in joint ventures/subsidiaries/representative offices overseas in financial sector will require prior approval from the Bank. Apart from a minimum eligibility criteria, CIC desiring to invest in the financial sector overseas will need a registration from the Reserve Bank. A ceiling of 400 per cent of owned funds with a minimum of 200 per cent in the financial sector has been prescribed.

VI.94 Based on the Second Quarter Review of Monetary Policy 2012-13, the definition of infrastructure lending for the purpose of financing of infrastructure by banks and financial institutions was harmonised with that in the Master List of Infrastructure sub-sectors' notified by the Government of India on March 27, 2012. Accordingly, it was decided to harmonise the definition of infrastructure lending for NBFCs with that of banks and the extant definition of infrastructure loan in the NBFC Prudential Norms Directions, 2007 stands amended.

VI.95 In line with the increasing size and complexity of the financial sector, the Reserve Bank has taken steps to ensure that the laws governing the sector are in line with modern financial practices. Accordingly, several relevant laws were amended to keep pace with the changing developments (Box VI.7).

Recommendations of the Financial Sector Legislative Reforms Commission

VI.96 Pursuant to the announcement made in the Union Budget 2010-11, the Government of India set up the Financial Sector Legislative Reforms Commission (Chairman: Justice Shri B.N. Srikrishna), on March 24, 2011. The terms of reference were wide in their ambit and included the examination of the architecture of the legislative and regulatory system governing the financial sector, besides reviewing the existing laws that govern the financial sector in India.

VI.97 The comments, suggestions and inputs from the Reserve Bank were submitted to the Commission in April 2012. The submissions focused on the need for a clear and specific mandate to the Reserve Bank for the pursuit of financial stability, monopoly of the Reserve Bank in the regulation of public deposits, the consolidation of banking laws, the need for globally compatible secrecy laws and continuation of the debt management function with the Reserve Bank. The Commission released an Approach Paper in October 2012 and sought feedback from

Box VI.7
Legal developments in the banking sector

Banking Laws (Amendment) Act, 2012

The Banking Laws (Amendment) Act, 2012 came into force from January 18, 2013. This Act has amended the Banking Regulation Act, 1949, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 to make the regulatory powers of Reserve Bank more effective and to increase the access of the nationalised banks to capital market to raise capital required for expansion of banking business. The major features of the Act are as follows:

Reserve Bank has been empowered to supersede the Board of Directors of banking company subject to a total period of twelve months and appoint administrator till alternate arrangements are made.

Banking companies have been enabled to issue preference shares subject to regulatory guidelines by Reserve Bank.

The prior approval of Reserve Bank is required for acquisition of 5 per cent or more of shares or voting rights in a banking company by any person and Reserve Bank is empowered to impose such conditions as it deems fit in this regard.

Provides for the creation of a Depositor Education and Awareness Fund by utilising the inoperative deposit accounts.

The Reserve Bank has been empowered to collect information and inspect associate enterprise of banking companies.

The nationalised banks have been enabled to raise capital through "bonus" and "rights" issue and also to increase or decrease the authorised capital with approval from the Central Government and the Reserve Bank without being limited by the ceiling of ₹3000 crore.

The penalties and fine for violations of the Banking Regulation Act have been substantially increased.

Provides for primary credit societies to stop banking business or to obtain license from Reserve Bank to continue doing banking business.

The Reserve Bank has been empowered to order for additional audit of cooperative banks.

It restricts the meaning of "approved securities" to Government securities and Reserve Bank approved securities.

(Contd....)

The Act enables the Reserve Bank to increase the ceiling on voting rights from ten to 26 per cent in a phased manner.

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

The provisions of this Act (except Sections 8 and 15(b)) have came into effect from January 15, 2013. The provision of sections 8 and 15(b) of the Act came into effect from May 15, 2013. This Act amends the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and the Recovery of Debts Due to Banks and Financial Institutions Act, 1993. The major features of the Act are as follows:

The Act includes 'multi-state cooperative banks' in the existing definition of bank in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 so that the measures for recovery through the Debt Recovery Tribunals are now available to multi-state cooperative banks.

It provides for conversion of any part of debt into shares of a borrower company.

The Act allows secured creditor to accept the immovable property in full or partial satisfaction of the claim against the defaulting borrower in times when they cannot find a buyer for the securities.

It enables the secured creditors or any person to file a caveat so that before granting any stay, the secured creditor or person is heard by the Debt Recovery Tribunal.

It empowers Central Government to require by notification, registration of all transactions of securitisation, reconstruction or creation of security interest on or before the date of establishment of Central Registry, within prescribed time period and on payment of prescribed fee.

The Central Government is enabled to exempt a class or classes of banks or financial institutions from the provisions of this Act on grounds of public interest.

It permits multi state cooperative banks with respect to debts due before or after the commencement of the Act, to opt to initiate proceedings either under the Multi State Cooperative Societies Act, 2002 or under the Recovery of Debts due to Banks and Financial Institutions Act, 1993.

Prevention of Money Laundering (Amendment) Act, 2012

Consequent to the submission of an action plan to the Financial Action Task Force to bring anti money laundering legislation in India at par with international standards and to obviate some of the deficiencies in the Act experienced by the implementing agencies, the Prevention of Money Laundering Act has been amended. The amended Act came into effect from February 15, 2013. The salient features of this amendment Act are as follows:

It introduces the concept of 'corresponding law' to link the provisions of Indian law with the laws of foreign countries and provides for transfer of the proceeds of the foreign predicate offence in any manner in India.

It introduces the concept of 'reporting entity' to include therein a banking company, financial institution, intermediary or a person carrying on a designated business or profession.

The Act enlarges the definition of offence of money-laundering to include therein the activities like concealment, acquisition, possession and use of proceeds of crime as criminal activities.

It provides for attachment and confiscation of the proceeds of crime even if there is no conviction so long as it is proved that offence of money laundering has taken place and property in question is involved in money laundering.

The Act stipulates that in the proceedings relating to money laundering, the funds shall be presumed to be involved in the offence, unless proven otherwise.

It makes the reporting entity, its designated directors on the Board and employees responsible for omissions or commissions in relation to the reporting obligations.

stakeholders. In its Approach Paper, the Commission proposed far-reaching reforms in the financial sector and it was perceived as the blueprint of the legislative reforms contemplated by the Commission.

VI.98 In December 2012, the Reserve Bank submitted its feedback to the Commission on major issues arising out of the Approach Paper, such as the role of the Reserve Bank in pursuing financial stability, autonomy and accountability of the Reserve Bank, an independent Debt Management Office, capital controls, regulation of NBFCs, credit information companies and securitisation and asset reconstruction companies likely to be transferred to unified financial regulatory agency *etc.* The Commission submitted its final report in two volumes in March 2013. Volume I contains the analysis and recommendations of the Commission and Volume II contains the draft Indian Financial

Box VI.8
Major recommendations of the Financial Sector Legislative Reform Commission

The Commission has proposed a financial regulatory architecture comprising of the following agencies:

i) Reserve Bank of India – performing three functions: monetary policy, regulation and supervision of banking and payment systems.

ii) Unified Financial Agency – for implementing consumer protection law and microprudential law for all financial firms other than banking and payment systems.

iii) Financial Sector Appellate Tribunal – as an appellate body that will hear appeals against the Reserve Bank for its regulatory functions, the unified financial agency, decisions of the financial redressal agency and some elements of the work of the resolution corporation.

iv) Resolution Corporation – into which the present DICGC would be subsumed. It would work across the financial system.

v) Financial Redressal Agency – as a one-stop shop where consumers can file complaints against all financial firms.

vi) Public Debt Management Agency – as an independent agency to manage public debt.

vii) Financial Stability Development Council – which will be a statutory agency, and have modified functions in the fields of systemic risk and development.

As regards capital controls, the Commission has envisaged a set up where central government would control inbound capital flows, the Reserve Bank would control outbound capital flows and implementation of all capital controls would vest with the Reserve Bank.

The Commission requires the regulators to frame regulations to achieve their objectives. The detailed procedure for framing regulations have been laid down which includes inviting public comments on the draft regulations and considering the same, cost-benefit analysis of the regulations *etc.* An exception is carved out for regulations that are required to be framed in emergencies. Regulators may issue clarifications on the regulations by framing guidelines. The procedure for framing guidelines is also the same as the procedure for framing regulations. The Indian Financial Code contemplates that only regulations and guidelines will be issued by the regulators and no other form of delegated legislation such as circulars. Contravention of the provisions of the IFC and the regulations only will be actionable and not the contravention of the guidelines.

Code. The Report of the Commission is available on the website of the Ministry of Finance.

VI.99 The Commission identified the following as the nine components for constructing a sound financial legal framework: (i) consumer protection; (ii) microprudential regulation (iii) resolution; (iv) capital controls; (v) systemic risk; (vi) development and redistribution; (vii) monetary policy; (viii) public debt management; and, (ix) contracts, trading and market abuse. The major recommendations of the Commission are highlighted in Box VI.8.

VI.100 The FSLRC Report has opened up several issues that require careful examination in the context of the global practices and what might be suitable or not suitable for implementation in India, as also the best timing for changes that may be finally considered appropriate.