



RESERVE BANK STAFF COLLEGE

Functions and Working of RBI

CONTENTS

Foreword	ii	
Acknowledgements	iii	
Chapters	Description	Page No.
1	<u>Evolution of Central Banking Globally and in India</u>	1
2	<u>Legal Framework for Reserve Bank Functions</u>	5
3	<u>Monetary Policy Framework</u>	14
4	<u>Market Operations</u>	22
5	<u>Financial Stability</u>	39
6	<u>Overview of the Indian Financial System</u>	44
7	<u>Regulation of Commercial Banks</u>	47
8	<u>Supervision of Commercial Banks</u>	58
9	<u>Regulation and Supervision of Co-operative Banks in India</u>	70
10	<u>Regulation and Supervision of Non-Banking Financial Companies in India</u>	79
11	<u>Enforcement in RBI</u>	98
12	<u>Development and Regulation of Financial Markets</u>	103
13	<u>Payment and Settlement Systems</u>	122
14	<u>Currency Management</u>	132
15	<u>Banker to Banks and Governments</u>	148
16	<u>Public Debt Management</u>	157
17	<u>Understanding RBI Balance Sheet</u>	162
18	<u>Foreign Exchange Management</u>	175
19	<u>Foreign Exchange (Forex) Reserves</u>	184
20	<u>Consumer Education and Protection</u>	190
21	<u>Financial Inclusion and Development</u>	197
22	<u>Development of Institutions</u>	207
23	<u>Research, Surveys and Data Dissemination</u>	210

Foreword

The importance of central banks has increased manifold in the last decade with such institutions taking a proactive lead in responding to situations and circumstances that have a bearing on financial stability, supporting respective economies during the global financial crisis of 2007-08 and more recently in dealing with the scenario emerging out of Covid-19 pandemic.

The role of Reserve Bank of India (RBI) has also evolved with several dimensions added (recent addition as regulator for HFCs, for example), several reforms and reformation, modification and re-designing of functional domains and creation of new Departments/verticals since its establishment on April 1, 1935. It is in this context that Reserve Bank Staff College as the premier Training Institution of RBI, has constantly tried to document the functions and working of RBI in its most current form. Discerning readers and scholars may recall that the last compilation was brought out in the year 2017, which was an update on the previous publications brought out in the year 2010.

What has necessitated this review and update are several factors which include some very rapid developments in central banking activities and reorganization of departments and divisions within RBI in the intervening period. A case in point are the recent additions/modifications to functional domains in the form of creation of Enforcement Department, the new Supervisory and Regulatory verticals etc. Further, the emphasis in the newer version has shifted more to the functional aspects and thus we have removed references to certain regulations which have since been over-written by new ones(manner of resolution of stressed assets, changing norms on Priority Sector Lending etc) so that the content remains sturdy and stable over longer periods of time. Other significant changes that have been covered in the revised version include introduction of new rupee liquidity management tools by RBI, reconstitution of Financial Stability and Development Council (FSDC), amendments in chapter-III of RBI Act covering changes in provisions related to NBFCs, transfer of regulation of Housing Finance Companies to RBI, introduction of new ombudsman schemes, changes in priority sector guidelines, introduction of National Strategy for Financial Education, etc.

The updated version of this book earlier unveiled by Governor, RBI at RBSC, Chennai on January 3, 2020 and was subsequently modified in June 2020 through a vetting process by concerned CO Department(s). To fulfil the obligations under the bank's Rajbhasha Policy, this book has since been translated in Hindi as well. We hope that the new updated version will make for some valuable read and we shall also look forward to suggestions to bring in more features and updates.

R Kesavan
Principal

ACKNOWLEDGEMENT

Covering a wide range of fully evolved and currently evolving functions and working of Reserve Bank of India most definitely implies that an intense collaborative effort must be involved in producing Training Material of this order. Accordingly, we wish to acknowledge the sincere efforts of all Members of Faculty and all others (more specifically Rajbhasha Officers from RBSC and RO, Chennai, who worked on the Hindi translation) involved in the process, without whose help we would not have been able to bring out an updated version of the book.

2. The meticulous efforts of Members of Faculty of the Reserve Bank Staff College in updating individual chapters is heartily appreciated. The untiring efforts and hard work rendered by the editorial team, consisting of R Sathish, Satish Chandra Rath, M K Subhashree, Edwin Prabu A and Hema Chatterjee are worthy of special mention. But for their determination, hard work and discipline, this version would not have materialised. Smt R Suma, Rajbhasha Officer (RBSC), Smt Mayalakshmi, Shri Pandarinath and Shri Shyam Sunder, Rajbhasha Officers from RO, RBI, Chennai who contributed significantly to the Hindi version, also deserve our gratitude.

3. Needless to mention, there would be changes and updates in the manner we operate and function as a full service Central Bank and there would always scope to update further and improve the effort. We shall, therefore, look forward to reader's suggestions in this regard which may be mailed to principalrbsc@rbi.org.in.

R Kesavan
Principal

Chapter 1: Evolution of Central Banking Globally and in India

"THERE have been three great inventions since the beginning of time: fire, the wheel and central banking" – Will Rogers

The evolution of central banks can be traced back to the seventeenth century when Riksbank, the Swedish Central Bank was set up in 1668. The Bank of England was founded in 1694. The Central Bank of the United States, the Federal Reserve established in 1914, was relatively a late entrant to the Central Banking arena. The Reserve Bank of India, India's central bank started operations in 1935. At the turn of the twentieth century there were only eighteen central banks. Today, most of the countries have a central bank.

Central banks are not regular banks. They are unique both in their functions and their objectives. In the beginning, central banks were established with the primary purpose of providing finance to the government to meet their war expenses and to manage their debt. They were initially known as banks of issue with the term central banking coming into existence only in the nineteenth century. They were founded as "special" commercial banks and would evolve into public-sector institutions much later. The "special" nature of these banks was based on government charters, which made them not only the main bankers to the government but also provided them monopoly privileges to issue notes or currency. Central banks also held accounts of other banks even as they engaged in normal commercial banking activities. Given their "special" status and their size, they soon came to serve as banker to banks facilitating transactions between banks as well as providing them banking services.

The eighteenth and nineteenth century witnessed several financial panics. Panics are a serious problem as failure of one bank may lead to failure of others. Banks are susceptible to panics or "runs" as more popularly known, due to the nature of their balance sheets. Their liabilities are short-term and liquid (banks' major liabilities are demand deposits, which means depositors can ask their money back anytime they want and therefore immediately payable) and the assets are long-term and illiquid (in the sense that it is not easy to sell them and convert into cash quickly). Banks engage in this so-called maturity or liquidity transformation to allocate society's available pool of resources effectively between savers and borrowers. The failure of banks and its potential adverse impact on the real economy was and is a serious concern for all policymakers. In 1873, Walter Bagehot, an editor of the Economist magazine, published a book titled "Lombard Street" where he clearly articulated that to avoid panics, central banks should assume the role of "lender of last resort". The doctrine, which came to be known as Bagehot's dictum states that a central bank, in periods of panics or crisis, should lend freely, against quality collateral and at a penal rate of interest. The idea being, a bank that is facing a "run" by its depositors or other lenders can tide over temporary liquidity problem in the stress period, by borrowing from the central bank against collateral. It can pay off the depositors and buy some time before things calm down. Given bank runs are self-fulfilling prophecies, if the banks can navigate this period without becoming insolvent, a crisis could be averted. The very fact that the bank was able to meet the withdrawal demands would

comfort the other depositors waiting to withdraw and wean them away. Without the ‘lender of last resort’ facility, banks must resort to fire-sale of their assets and that too at a deep discount. Thus, in addition to be a banker to the government and banks, central banks also became lenders of last resort.

The main mission of a central bank is to maintain macroeconomic stability and financial stability. Macroeconomic stability refers to achieving stable and sustainable growth and keeping prices stable, i.e., low and stable inflation. Financial stability on the other hand refers to keeping the financial system resilient and avoiding financial crisis. The relative importance of these objectives has varied over time. While the pursuit of sustainable economic growth and low and stable inflation have been fundamental to central banking activities since the early nineteenth century with the advent of the gold standard, the importance of financial stability became more prominent since the Great Depression of the 1930s when the world economy faced large bank failures and deep recession.

To achieve the objectives of macroeconomic stability and financial stability, central banks have certain tools at their disposal. To achieve economic stability, central banks use monetary policy. By varying short-term interest rates, i.e., either raising or lowering the interest rates, they control the supply of and demand for money in the economy and thereby economic activity and inflation. For example, if the economy is growing fast and inflation is high, central bank may raise the interest rates it charges the banks to lend money. Higher interest rates will permeate into other rates, such as housing loan, consumer loan, etc. As the cost of borrowing increases, it discourages consumption and investment and thus reduces growth and inflation. On the other hand, if the economy is growing too slow or if the inflation is too low, the central bank will lower the interest rate. This will feed into other rates and encourage spending and investment thereby pushing economic growth and inflation. The trick of the trade is to achieve sustainable growth and low and stable inflation. Thus, sometimes, central banking is said to be “neither a science nor an art, but a craft”.

To deal with financial stability, central banks main tool is provision of liquidity. This tool, as explained earlier, is referred to as “lender of last resort”. Some central banks, which are also the banking regulators in their economies employ another tool, viz., regulation and supervision, also to foster financial stability. By setting prudent rules and principles and examining and monitoring banks adherence to these rules and principles, the central banks aim to create a healthy and robust banking and financial system. A resilient and safer banking system will reduce the chances of financial crisis in the first place. In many countries the regulatory and supervisory roles are performed by multiple agencies and therefore may not be a main function of the central bank.

The internationalization of commercial banking activity brought several risks to the fore. The failure of two banks in 1974, the Franklin National Bank in the United States and Bank Herstatt in Germany, which had international implications necessitated international cooperation and coordination among central banks. The Basel Committee for Banking Supervision (BCBS) was thus established. The committee sets international regulatory

standards, known as Basel Standards that forms the bedrock for all national and international banking regulations.

Since the outbreak of the financial crisis in 2007-08, the tool box of central banks has been strengthened. These tools or measures are popularly known as “unconventional policies”, reflecting their use in extraordinary circumstances. Quantitative or credit easing, negative interest rates, forward guidance, etc., are some of the tools employed by central banks to deal with the crisis and its aftermath. The central banks also became “market makers of last resort” during the crisis as the markets became dysfunctional. These concepts will be explained in subsequent chapters.

Evolution of the Reserve Bank of India

The origins of the Reserve Bank of India (RBI) can be traced to 1926, when the Royal Commission on Indian Currency and Finance – also known as the Hilton-Young Commission – recommended the creation of a central bank for India to separate the control of currency and credit from the Government and to augment banking facilities throughout the country. The Reserve Bank of India Act of 1934 established the Reserve Bank and set in motion a series of actions culminating in the start of operations in 1935. Since then, the Reserve Bank’s role and functions have evolved, as the nature of the Indian economy and financial sector changed. Though started as a private shareholders’ bank, the Reserve Bank was nationalised in 1949.

The Preamble to the Reserve Bank of India Act, 1934, under which it was constituted, specifies its objective as “to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage”. The primary role of the RBI, as the Act suggests, is monetary stability, that is, to sustain confidence in the value of the country’s money or preserve the purchasing power of the currency. Ultimately, this means low and stable expectations of inflation, whether that inflation stems from domestic sources or from changes in the value of the currency, from supply constraints or demand pressures. In addition, the RBI has two other important mandates; inclusive growth and development, as well as financial stability.

In a country where a large section of the society is still poor, inclusive growth assumes great significance. Access to finance is essential for poverty alleviation and reducing income inequality. One of the core functions of the RBI, therefore, is to promote financial inclusion that leads to inclusive growth. As the central bank of a developing country, the responsibilities of the RBI also include the development of financial markets and institutions. Broadening and deepening financial markets and increasing their liquidity and resilience so that they can help allocate and absorb the risks entailed in financing India’s growth is a key objective of the RBI.

India’s financial system is dominated by banks. Their regulation and supervision is therefore important both from the viewpoint of protecting the depositors’ interest and preserving financial stability. The RBI, deriving powers from the Banking Regulation Act, 1949, designs and implements the regulatory policy framework for banks operating in India. Over

the years, the purview of regulation and supervision has been expanded to include non-banking entities also.

The global economic uncertainties during and after the Second World War warranted conservation of scarce foreign exchange by sovereign intervention and allocation. Initially, the RBI carried out the regulation of foreign exchange transactions under the Defence of India Rules, 1939 and later, under the Foreign Exchange Regulation Act of 1947. Over the years, as the economy matured, the role shifted from foreign exchange regulation to foreign exchange management.

The 1991 balance of payment and foreign exchange crisis was a watershed event in India's economic history. Being at the centre of country's monetary and financial system, the RBI played a key supporting role in helping the Government manage the crisis and undertake necessary market and regulatory reforms. The approach under the reform era included a thrust towards liberalisation, privatisation, globalisation and concerted efforts at strengthening the existing and emerging institutions and market participants. The Reserve Bank adopted international best practices in areas, such as, prudential regulation, banking technology, variety of monetary policy instruments, external sector management and currency management to make the new policy framework effective.

Central banks are at the heart of a country's payment and settlement system. "One of the principal functions of central banks is to be the guardian of public confidence in money, and this confidence depends crucially on the ability of economic agents to transmit money and financial instruments smoothly and securely through payment and settlement systems"¹. The RBI has, over the years, taken several initiatives in building a robust and state-of-the-art payment and settlement system that not only improves the "plumbing" of the financial system but also its stability.

The last two and a half decades have also seen growing integration of the national economy and financial system with the world. While rising global integration has its advantages in terms of expanding the scope and scale of growth of the Indian economy, it also exposes India to global shocks. The crisis of 2007-08 gave a glimpse of financial instability in other economies posing threat to our financial stability. Hence, preserving financial stability has become an even more important mandate for the RBI.

¹ Bank oversight of payment and settlement systems, BIS, May 2005

Chapter 2: Legal Framework for Reserve Bank Functions

The structure, roles and responsibilities of central banks vary between countries, which is very much evident from their origins and also the variety of functions they perform. The statutes governing the establishment and mandate of central banks are also not uniform even as they play a crucial role in determining the functions of central banks across the world.

In India, the RBI is the central banking authority constituted by the Reserve Bank of India Act, 1934 ('RBI Act'), and its duties and responsibilities flow from that statute. However, the range of functions, which the RBI is undertaking is not only covered under the RBI Act² but is also covered under various other statutes. Thus, the legal backing for the functions of RBI is spread over a number of statutes. In this chapter, we examine in detail the legal provisions vis-à-vis the multifarious functions that are conferred on the RBI.

Reserve Bank of India – Legal Background

Pursuant to the recommendation of the Royal Commission on Indian Currency and Finance, a Bill was introduced in the Legislative Assembly in 1927 to create a central bank for India, which was later withdrawn due to lack of agreement among various sections of people. Subsequently, the White Paper on Indian Constitutional Reforms (1933) recommended for the establishment of a Reserve Bank in India. Accordingly, a fresh Bill was introduced in the Legislative Assembly, which got passed and received the Governor General's assent on March 6, 1934³. Consequently, the RBI Act came into existence and the RBI commenced its operations as the central bank of the country on 1st April 1935 as a private shareholders' bank, with a paid-up capital of Rupees five crore.

Aims and Objectives – The Preamble

The purposes for which the RBI has been established as India's central bank has been spelt out in the preamble to the RBI Act, which states as follows:

- (i) *"to regulate the issue of banknotes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage; and*
- (ii) *(that it is essential to have a modern monetary policy framework to meet the challenge of an increasingly complex economy and the primary objective of the monetary policy is to maintain price stability while keeping in mind the objective of growth"*⁴.

Thus, the Preamble in the RBI Act, as amended by the Finance Act, 2016, provides that the primary objective of the monetary policy is to maintain price stability, while keeping in mind the objective of growth, and to meet the challenge of an increasingly complex economy. However, the functions which the RBI is undertaking is not restricted only within the provisions of the RBI Act, but also extends to various areas, such as, regulation and supervision

² Section 17, RBI Act, 1934

³ Source: RBI Website, 'History of the Reserve Bank of India'

⁴ Please read Indian Finance Act, 2016 wherein amendments to RBI Act, 1934 have been brought to amend the Preamble and also new Chapter III-F

of banks, consumer protection, management of foreign exchange, management of government securities, regulation and supervision of payment systems, etc., for which powers are drawn from various laws, namely, the Banking Regulation Act, 1949, Foreign Exchange Management Act, 1999, Government Securities Act, 2006, Payment and Settlement Systems Act, 2007, etc.

Banking Functions – Legal Background

The general superintendence and direction of the affairs and business of the RBI shall be entrusted to the Central Board⁵ having nominees from the Central Government and Directors appointed under Section 8 of the RBI Act. The Board of the RBI is headed by the Governor and assisted by not more than four Deputy Governors⁶. The Board exercises all powers and do all acts and things which may be exercised by the RBI. Section 17 of the RBI Act enables RBI to do banking business, such as accepting deposits, without interest, from any person. The other business, which the RBI may transact are also mentioned in the said provision. It states that the RBI may transact various businesses such as acceptance of deposits without interest from Central Government and State Governments, purchase, sale and rediscount of Bills of Exchange, making of short term loans and advances to banks and other institutions, providing of annual Contributions to National Rural Credit Funds, dealing in Derivatives, purchase and sale of Government Securities, purchase and sale of shares of State Bank of India, National Housing Bank, Deposit Insurance and Credit Guarantee Corporation, etc., keeping of Deposits with SBI for specific purposes, making and issue of Banknotes, etc⁷.

Section 18 facilitates the RBI to act as a '*Lender of Last Resort*'. Section 19 lists out the kinds of businesses which RBI may not transact. The provisions of the RBI Act enable the RBI to act as banker to Central Government and State Governments. Under Sections 20 and 21 of the RBI Act, RBI has an obligation and right respectively to accept monies for account of the Central Government and to make payments up to the amount standing to the credit of its account, and to carry out its exchange, remittance and other banking operations, including the management of the public debt of the Union. In the case of State Governments, the said banking functions may be undertaken by way of an agreement between the RBI and the State Government concerned, as provided in Section 21-A of the RBI Act. These agreements made between the RBI and the State Governments are statutory as they are required to be laid before the Parliament as soon as they are made.

Issue Functions - Legal Background

Issuance of bank notes is one of the key central banking functions the RBI is authorised and mandated to do⁸. Section 22 of the RBI Act confers on RBI the sole right to issue bank notes in India. The issue of bank notes shall be conducted by a department called the Issue

⁵ Please read Section 7 of the RBI Act, 1934

⁶ Please read Section 8 of the RBI Act, 1934

⁷ Please read Section 17 and other provisions of the RBI Act, 1934 for full details

⁸ See Chapter III of RBI Act, 1934 for detailed reading

Department, which shall be separated and kept wholly distinct from the Banking Department⁹. The RBI Act enables RBI to recommend to Central Government the denomination of bank notes, which can be of two rupees, five rupees, ten rupees, twenty rupees, fifty rupees, one hundred rupees, five hundred rupees, one thousand rupees, five thousand rupees and ten thousand rupees or other denominations not exceeding ten thousand rupees¹⁰. The design, form and material of bank notes shall be approved by the Central Government on the recommendations of Central Board of the RBI¹¹. Every bank note shall be a legal tender at any place in India, however, on recommendation of the Central Board, the Central Government may declare any series of bank notes of any denomination to be not a legal tender¹². Another important function is exchange of mutilated or torn notes, which under the RBI Act is not a matter of right, but of grace¹³. The bank notes that are being issued by the RBI are exempt from payment of stamp duty¹⁴.

Monetary Policy Functions - Legal Background

Chapter III-F¹⁵ of the RBI Act provides for a statutory basis for the Monetary Policy Framework and the Monetary Policy Committee. The Central Government, in consultation with the RBI shall determine the inflation target in terms of the Consumer Price Index, once in every five years, which needs to be notified in the Official Gazette¹⁶. Similarly, it is the Central Government that should constitute a Monetary Policy Committee by notification in the Official Gazette¹⁷. The Monetary Policy Committee shall consist of (a) the Governor of the RBI; (b) Deputy Governor of the RBI in charge of Monetary Policy; (c) one officer of the RBI to be nominated by the Central Board; and (d) three persons to be appointed by the Central Government¹⁸. The Monetary Policy Committee has been entrusted with the statutory duty to determine the Policy Rate required to achieve the inflation target. The decision of the Monetary Policy Committee is binding on the RBI and the RBI shall publish a document explaining the steps to be taken by it to implement the decisions of the Monetary Policy Committee¹⁹. It has been the objective of the statute that a Committee-based approach will add lot of value and transparency to monetary policy decisions. The meetings of the MPC shall be held at least 4 times a year and it shall publicize its decisions after each such meeting²⁰.

Public Debt Functions – Legal Background

The Parliament of India enacted the Government Securities Act, 2006 ('GS Act') with an objective "*to consolidate and amend the law relating to Government securities and its management by the Reserve Bank of India*"²¹. The GS Act applies to Government securities

⁹ Please see Section 23, RBI Act, 1934

¹⁰ Please see Section 24, RBI Act, 1934

¹¹ Please see Section 25, RBI Act, 1934

¹² Section 26, RBI Act, 1934

¹³ Section 28, RBI Act, 1934

¹⁴ Section 29, RBI Act, 1934

¹⁵ Introduced by Finance Act, 2016

¹⁶ Section 45-ZA, RBI Act, 1934

¹⁷ Section 45-ZB, RBI Act, 1934

¹⁸ Section 45-ZB, RBI Act, 1934

¹⁹ Section 45-ZJ, RBI Act, 1934

²⁰ Section 45-ZK, RBI Act, 1934

²¹ Preamble, Government Securities Act, 2006

created and issued by the Central Government or a State Government²². The GS Act prescribes the procedure and modalities to be followed by the RBI in the management of the public debt and also confers various powers on the RBI, including the power to determine the title to a Government security, if there exists any doubt in the opinion of the RBI²³. Further, Section 18 of the GS Act provides that no order made by the RBI under that Act shall be called in question by any Court for the reasons stated therein. Prior to the enactment of the GS Act, the said public debt functions of the RBI have been governed by the provisions of the Public Debt Act, 1944. The enactment of the GS Act has not fully repealed the Public Debt Act, 1944. This is evident from Section 31 of the GS Act which states that the Public Debt Act, 1944, shall cease to apply to the Government securities to which that Act applies and to all matters for which provisions have been made under the GS Act.

Foreign Exchange Management – Legal Background

The powers and responsibilities with respect to external trades and payments, development and maintenance of foreign exchange market in India are conferred on the RBI under the provisions of the Foreign Exchange Management Act, 1999 ("FEMA"). Section 10 of the FEMA empowers the RBI to authorize any person to be known as authorized person to deal in foreign exchange or in foreign securities, as an authorized dealer, money changer or off-shore banking unit or in any other manner as it deems fit. Similarly, it empowers the RBI to revoke an authorization issued to an authorized dealer in public interest, or the authorized person has failed to comply with the conditions subject to which the authorization was granted or has contravened any of the provisions of the FEMA or any rule, regulation, notification, direction or order issued by the RBI. However, the revocation of an authorization may be done by the RBI after following the prescribed procedure in the FEMA or the Regulations made there under. Section 13 of the FEMA details out the contraventions and penalties, and the RBI has been empowered to compound certain contraventions under Section 15 of the FEMA.

Banking Regulation & Supervision – Legal Background

India has a variety of banks viz., banking companies (banks which are companies and regulated by the Banking Regulation Act, 1949), State Bank of India (constituted by the State Bank of India Act, 1955), Nationalised Banks (constituted by the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/ 1980), Regional Rural Banks (constituted under the Regional Rural Banks Act, 1976) and co-operative banks (constituted either under the Multi-State Co-operative Societies Act, 2002 or State Co-operative Societies Acts). Although RBI is entrusted with the task of regulating and supervising all types of banks in the country, the powers exercisable by it towards different banks are not uniform.

The power to regulate and supervise banking companies has been provided by the provisions of the Banking Regulation Act, 1949 (BR Act, 1949) to the RBI. Although, the

²² Please see Section 1 of GS Act, 2006

²³ Please see Section 12 of GS Act, 2006

preamble to the BR Act, 1949, states that it is an Act to consolidate and amend the law relating to banking. The powers of RBI to formulate banking policy²⁴, regulate and supervise banking business etc., are scattered across the BR Act, 1949. Section 5(ca) of the BR Act, 1949, states that banking policy means any policy, which is specified from time to time by the RBI, in the interest of the banking system or in the interest of monetary stability or sound economic growth, having due regard to the interests of the depositors, the volume of deposits and other resources of the bank and the need for equitable allocation and the efficient use of these deposits and resources. The appointment of chairman and whole-time directors of a banking company shall not have effect, unless done with the previous approval of the Reserve Bank²⁵. Similarly, as a part of control over management, Section 36-AB of BR Act, 1949, empowers RBI to appoint additional directors on the boards of banking companies. Section 36-AA of the BR Act, 1949 enables RBI to remove executives, officers and employees of a banking company under certain conditions. Moreover, the RBI has been empowered under BR Act, 1949, to supersede the boards of banking companies.

Though it is not the role of the Reserve Bank to micro-manage the affairs of banks, it has powers to control advances by banking companies²⁶. Section 22 of the BR Act, 1949 confers on RBI the power to issue licenses and also to cancel licenses of banking companies. Another important regulatory power that has been vested in the RBI is the power to issue directions to banking companies. Under Section 35-A of the BR Act, 1949, RBI has the power to issue directions to banking companies in public interest or in the interest of banking policy or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company or to secure the proper management of any banking company.

The Banking Regulation (Amendment) Act, 2017 has provided powers to RBI to issue directions to banking companies in relation to resolution of stressed assets²⁷. As part of the supervisory powers, RBI has been empowered to inspect banking companies on its own or at the instance of Central Government under the provisions of the BR Act, 1949²⁸. *“Thus an overall responsibility to find out the well-being of a banking company, in improving monetary stability and economic growth as well as keeping in view the interests of depositors”*, has been left with the Reserve Bank of India²⁹.

Only a few provisions which are mentioned in section 51 of the BR Act will apply to State Bank of India, Nationalised Banks and Regional Rural Banks. In the case of co-operative banks, the application of the provisions of the BR Act will be subject to the modifications mentioned in section 56 of the very same Act.

²⁴ Please see Section 5(ca) of the BR Act, 1949

²⁵ Section 35B of the BR Act, 1949

²⁶ See section 21 of RBR Act

²⁷ Section 35AB of the BR Act.

²⁸ Please see Section 35 of the BR Act, 1949

²⁹ Janata Sahakari Bank Ltd. V/s. State of Maharashtra (AIR 1993 Bombay 252)

Regulation and Supervision of NBFCs – Legal Background

The regulation and supervision of non-banks is one of the critical functions that the RBI has been entrusted with. Section 45-IA of the RBI Act mandates every non-banking financial company to obtain a certificate of registration from the RBI and to have a net owned fund as may be specified by the RBI in the Official Gazette, before commencing such non-banking financial business.³⁰ Further, as a part of regulation and supervision of non-banks, the RBI has been conferred with the statutory powers to regulate or prohibit issue of prospectus or advertisements soliciting deposits of money by non-banking financial companies,³¹ power to determine policy and issue directions to non-banking financial companies, etc.³² Further, the RBI has been empowered under Section 45-L of the RBI Act to call for information and issue directions to non-banking financial companies for the reasons stated therein. As a part of the supervisory control over the non-banking financial companies, the RBI has the power to inspect them under Section 45-N of the RBI Act, 1934.

Regulation & Supervision of Co-operative banks – Legal Background

In terms of Article 246 of the Constitution of India, the legislative powers of the Union and the State are given in three Lists, viz., the Union List the State List and the Concurrent List respectively of Schedule VII to the Constitution. The entry relating to incorporation, regulation and winding-up of Cooperative Societies fall in State List³³ whereas the entry relating to banking fall in the Union List³⁴. This results in the duality of jurisdiction over cooperative banks - by the Reserve Bank of India and the Registrar of Cooperative Societies. In *Janata Sahakari Bank Ltd. v. State of Maharashtra*³⁵, the Bombay High Court has held that “*though the control over management of Co-operative Society where it is Co-operative Banking Society or otherwise is vested in the Registrar of Co-operative Societies, but insofar as banking is concerned, by virtue of S.56 of the Banking Regulation Act, 1949, read with S.35A of the Banking Regulation Act, 1949, it will be a subject with which the Reserve Bank of India has full power*”.

The Banking Regulation (Amendment) Ordinance, 2020 that was promulgated on June 27, 2020 seeks to amend the Banking Regulation Act, 1949, with regard to cooperative banks. The Ordinance states that the BR Act will not apply to primary agricultural credit societies and cooperative societies whose principal business is long term financing for agricultural development. Further, these societies shall not use the words ‘bank’, ‘banker’ or ‘banking’ in their name or in connection with their business, and act as an entity that clears cheques. The Ordinance provides that a cooperative bank may issue equity shares, preference shares, or special shares on face value or at a premium to its members or to any other person residing within its area of operation. Further, it may issue unsecured debentures or bonds or similar

³⁰ Please read Chapter III-B of RBI Act, 1934 for detailed provisions

³¹ Please see Section 45-J of the RBI Act, 1934

³² Please see Section 45-JA of the RBI Act, 1934

³³ Please see Entry No.32 of List II of the VII Schedule to the Constitution of India

³⁴ Please see Entry No.45 of List I of the VII Schedule to the Constitution of India

³⁵ AIR 1993 Bombay 252

securities with maturity of ten or more years to such persons subject to the prior approval of the Reserve Bank of India (RBI), and any other conditions as may be specified by RBI. The Ordinance adds that in case of a co-operative bank registered with the Registrar of Co-operative Societies of a state, the RBI will supersede the Board of Directors after consultation with the concerned state government, and within such period as specified by it. However, RBI may exempt a cooperative bank or a class of cooperative banks from certain provisions of the Act through notification for such time period and under such conditions as may be specified by the RBI³⁶.

Regulation of Derivatives and Money Market Instruments – Legal Background

Chapter III-D was inserted in the RBI Act with effect from 9th January 2007 by way of an amendment to the RBI Act, 1934. In the said chapter, the Parliament of India thought it as appropriate to introduce provisions relating to regulation of transactions relating to derivatives, money market instruments, securities, etc. by the RBI. Sub-section (a) of Section 45U of the RBI Act defines derivative as an instrument to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called ‘underlying’), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency rupee options or such other instruments as may be specified by the RBI from time to time. Similarly, money market instruments have been defined to include call or notice money, term money, repo, reverse repo, certificate of deposit, commercial usance bill, commercial paper and such other debt instrument of original or initial maturity up to one year as the RBI may specify from time to time. The power of RBI to regulate these money market instruments have been provided under Section 45W of the RBI Act, which states that the RBI may, in public interest or to regulate the financial system of the country to its advantage, determine the policy relating to interest rates or interest rate products and give directions in that behalf to all agencies or any of them, dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature as the RBI may specify from time to time.

Payment and Settlement Functions – Legal Background

The Parliament of India enacted the Payment and Settlement Systems Act, 2007 ('PSS Act, 2007') with an objective to provide for the regulation and supervision of payment systems in India and to designate the Reserve Bank of India as the authority for that purpose and for matters connected therewith or incidental thereto³⁷. Under Section 4 of the PSS Act, 2007, no person shall commence or operate a payment system except with an authorization issued by the RBI. Similarly, under Section 8 of the PSS Act, 2007, RBI has the power to revoke the authorization granted to any person if it contravenes any of the provisions of the PSS Act or does not comply with regulations or fails to comply with the orders or directions issued by the RBI or operates the payment system contrary to the conditions subject to which the

³⁶ www.prsindia.org

³⁷ Preamble to the PSS Act, 2007

authorization was issued. The regulation and supervision of payment systems has been conferred on the RBI by virtue of provisions of Chapter IV of the PSS Act, 2007. The regulatory and supervisory controls include power to determine standards for the functioning of payment systems³⁸, power to call for returns³⁹, documents⁴⁰ or other information⁴¹, power to enter and inspect payment systems⁴², power to carry out audit and inspections⁴³, power to issue directions⁴⁴, etc.

Credit Information Companies Regulation Functions

Reserve Bank has been entrusted with the task of regulation and supervision of Credit Information Companies under the Credit Information Companies (Regulation) Act, 2005. Three institutions form the essential pillars of the Act, viz. the Credit Information Companies, the Credit Institutions and Specified Users. The Act empowers the Reserve Bank to issue directions to Credit Information Companies and also to inspect them. The Reserve Bank is also authorised by the statute to determine policy in relation to functioning of credit information companies.

Consumer Protection and promotion Functions – Legal Background

Protection of the interests of the depositors is one of the vital mandates of the RBI. The various provisions in the RBI Act, 1934, BR Act, 1949, etc., are replete with the phrases like “*in the interests of depositors*” wherever it entrusts powers to the RBI⁴⁵. Apart from depositors, the resolution of grievances of customers who deal with its regulated entities is also important for the Reserve Bank of India. Reserve Bank of India has formulated three Ombudsman Schemes for covering operations of banks, NBFCs and payment systems.

Reserve Bank of India attaches high importance to its promotional and developmental roles. Clause (8AA) of section 17 of the RBI Act states that the promoting, establishing, supporting or aiding in the promotion, establishment and support of any financial institution - whether as its subsidiary or otherwise - is a business which can be transacted by the Reserve Bank. Section 54 of that Act points to the developmental role of RBI in matters of rural development. It provides that the Reserve Bank may maintain expert staff to study various aspects of rural credit and development and in particular it may (i) tender expert guidance and assistance to the National Bank; and (ii) conduct special studies in such areas as it may consider necessary to do so for promoting integrated rural development.

Conclusion

The powers and functions of the RBI have further widened consequent upon the amendments to the Securitisation and Reconstruction of Financial Assets and Enforcement of

³⁸ Please read Section 10 of the PSS Act, 2007

³⁹ Please read Section 12 of the PSS Act, 2007

⁴⁰ Please read Section 12 of the PSS Act, 2007

⁴¹ Please read Section 12 of the PSS Act, 2007

⁴² Please read Section 14 of the PSS Act, 2007

⁴³ Please read Section 16 of the PSS Act, 2007

⁴⁴ Please read Section 17 of the PSS Act, 2007

⁴⁵ Source: RBI Website

Security Interests Act, 2002⁴⁶ and the National Housing Bank Act, 1987⁴⁷. Although, the object and purpose of establishment of the RBI, as could be observed from the preamble to the RBI Act, 1934, is to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability and also to formulate monetary policy with an objective to control inflation,⁴⁸ the multifarious functions which the RBI has been entrusted with through various legislations shows that the central bank of the country has much wider mandates than what have been summarized in the preamble to the RBI Act, 1934. The regulation and supervision of banks, non-banks, co-operative banks, management of currency, management of public debt of the Union and the State, management of foreign exchange, acting as banker to banks, banker to governments, protection of interests of depositors, spreading of financial literacy, etc., are all part of achieving the common goal as enshrined in the preamble to the RBI Act, 1934⁴⁹.

⁴⁶ Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, 2016

⁴⁷ The Finance (No.2) Act, 2019

⁴⁸ Preamble to the Reserve Bank of India Act, 1934

⁴⁹ Report of the Commission on FSLRC in the year 2013 by Shri B.N. Srikrishna, Chairman

Chapter 3: Monetary Policy Framework

I. Monetary Policy Making in India

Definition, objectives and tools

Central banks derive their objectives from their respective mandates. Monetary Policy could have either a single objective of price stability or multiple objectives. In the literature and in practice, price stability is considered as the dominant objective of monetary policy. For countries, which have adopted inflation targeting framework, price stability is the core objective. Monetary policy refers to the use of monetary instruments under the control of the central bank to influence variables, such as interest rates, money supply and availability of credit, with a view to achieving the objectives of the policy.

Before the amendment of the RBI Act in May 2016, the Preamble read as "*to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage*". Accordingly, the objectives of monetary policy evolved as maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy. With progressive liberalization and increasing globalization of the economy, maintaining orderly conditions in financial markets emerged as an additional policy objective. Thus, over time, the role of monetary policy in India evolved to maintain a judicious balance between price stability, economic growth and financial stability. However, pursuant to the amendment to RBI Act, 1934, in May 2016, the primary objective of monetary policy is to maintain price stability while keeping in mind the objective of growth. The amended Preamble to RBI Act reads, *inter alia*, as follows:

"to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage"

"AND WHEREAS it is essential to have a modern monetary policy framework to meet the challenges of an increasing complex economy;

AND WHEREAS the primary objective of the monetary policy is to maintain price stability while keeping in mind the objective of growth".

There are various direct and indirect instruments used for implementing monetary policy including Repo Rate, Reverse Repo Rate, Marginal Standing Facility (MSF) under the Liquidity Adjustment Facility (LAF), Bank Rate, Cash Reserve Ratio (CRR), , Open Market Operations (OMOs) and Market Stabilization Scheme (MSS). They are briefly explained below:

Repo Rate: The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the LAF. It is the policy rate decided by the Monetary Policy Committee (MPC).

Reverse Repo Rate: The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.

Liquidity Adjustment Facility (LAF): The LAF consists of overnight as well as term repo/reverse repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected under variable rate repo auctions across the range of tenors. The aim of term-repo is to help develop the inter-bank term-money market, which in turn can set market-based benchmarks for pricing of loans and deposits, and hence improve transmission of monetary policy. The RBI also conducts variable rate repo/reverse-repo auctions, as necessitated by market conditions.

Marginal Standing Facility (MSF): A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank against their excess SLR securities and also by dipping into their SLR portfolio up to a specified limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system.

Policy Corridor: The MSF rate as the ceiling and the Reverse Repo rate as the floor determines the policy corridor. The objective of liquidity management operations is to keep the WACR closely aligned to the policy repo rate.

Bank Rate: It is the standard rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

Cash Reserve Ratio (CRR): The amount that a bank is required to maintain with the Reserve Bank as a specified proportion (per cent) of its Net Demand and Time Liabilities (NDTL) for a fortnight starting from a Saturday till the next reporting Friday. The proportion required to be maintained is notified by the Reserve Bank from time to time. The maintenance of CRR balances over a fortnight is on an average daily basis with a stipulated minimum daily maintenance notified by the Reserve Bank.

Open Market Operations (OMOs): These include both repurchase (repo or reverse repo) operations and outright purchase and sale of government securities, for injection and absorption of liquidity, respectively.

Market Stabilisation Scheme (MSS): This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. Depending upon the nature of the surplus liquidity (long term/ short term) the securities

under MSS (long term dated securities/ short term CMBs) are issued. The cash so mobilised is held in a separate government account with the Reserve Bank⁵⁰.

II. Evolution of Monetary Policy Framework in India

In order to attain the objectives of monetary policy, it is necessary to have a consistent policy framework. Broadly, monetary policy framework consists of objectives, operating procedure and governance arrangements.

- Objectives are the aims of the monetary policy, which are goal variables or nominal anchors and long-term in scope but are not directly under the control of the central bank. As a result, central banks strive to achieve these objectives only indirectly by targeting intermediate and operating targets, which bear a stable relationship with the ultimate objectives, through instruments which are under their direct control. The choice of the operating target is crucial as this variable is at the beginning of the monetary transmission mechanism. Similarly, the selection of intermediate targets is conditional upon the channels of transmission – the process through which monetary policy actions impact the ultimate objectives.
- Operating procedure essentially deals with how the central bank intends to influence the operating target and thereby the intermediate target through its liquidity management operations. Therefore, the operating procedure is essentially the day-to-day management of liquidity conditions consistent with the overall stance of the monetary policy. In other words, operating procedure is also called the nuts and bolts of monetary policy, the “plumbing in the architecture” (Patra et al., 2016).
- Governance arrangements primarily deal with the process of decision making and focus on responsibilities, powers and accountability of the monetary authority.

From the perspective of global best practices, historically, bank reserves and short-term interest rates have evolved as the two dominant operating targets. However, the focus shifted to short-term interest rates in early 1990s, reflecting greater significance of interest rates in monetary transmission mechanism as markets developed in a deregulated environment. Consequently, the overnight rate emerged as the most commonly pursued operating target in the conduct of monetary policy.

India's monetary policy framework has undergone several transformations reflecting underlying macroeconomic and financial conditions. During 1971-1985, the monetisation of the fiscal deficit exerted a dominant influence on the conduct of monetary policy. The pre-emption of resources by the public sector and the resultant inflationary consequences of high public expenditure necessitated frequent recourse to the CRR to neutralize the secondary

⁵⁰ Key features of the scheme include, *inter alia* (i) under the scheme, the Government issues Treasury Bills and/or dated securities in addition to the normal borrowing requirements, for absorbing liquidity from the system; (ii) the Treasury Bills/dated securities issued under the MSS have all the attributes of regular Treasury Bills and dated securities. These securities are eligible for Statutory Liquidity Ratio (SLR), repo and Liquidity Adjustment Facility (LAF); (iii) the amounts raised under the MSS are held in a separate identifiable cash account titled the Market Stabilisation Scheme Account (MSS Account) maintained and operated by the Reserve Bank; (iv) the amounts credited into the MSS Account are be appropriated only for the purpose of redemption and / or buy back of the Treasury Bills and / or dated securities issued under the MSS.

effects of monetary expansion. Financial repression in the form of interest rate prescriptions, statutory pre-emptions and directed credit partly crowded out the private sector from the credit market. Against this backdrop, the Committee to Review the Working of the Monetary System (Chairman: Dr. Sukhamoy Chakravarty) recommended in 1985 a new monetary policy framework based on monetary targeting with feedback, drawing on empirical evidence of a stable demand function for money.

Monetary Targeting Framework

Under this framework, broad money became the intermediate target while reserve money was one of the main operating instruments for achieving control on broad money growth. Accordingly, monetary (M3) projection was made consistent with the expected real GDP growth and a tolerable level of inflation. Technically, in a simple form, if expected real GDP growth was 6 per cent, the income elasticity of demand for money was 1.5 and a tolerable inflation was 5 per cent, the M3 expansion target was set at 14 per cent [M3 growth = $1.5(6) + 5 = 14$ percent] (Mohanty, 2010). This framework was in operation during mid-1980s to 1997-98. Analysis of the money growth outcomes during the monetary targeting regime indicates that targets were rarely met. The biggest impediment to monetary targeting was lack of control over RBI's credit to the central government, which accounted for the bulk of reserve money creation.

With economic and financial sector reforms in the 1990s, there was shift in financing government and the commercial sector with increasing reliance on market-determined interest rates and exchange rate. RBI was able to move away from direct instruments to indirect market-based instruments. The SLR and CRR were gradually brought down to 25 per cent and 9.5 per cent, respectively by 1997. Further, as the pace of trade and financial liberalization gained momentum in the 1990s, the efficacy of broad money as an intermediate target was re-assessed. Financial innovations and external shocks emanating from swings in capital flows, volatility in the exchange rate and global business cycles imparted instability to the demand for money. There was also increasing evidence of changes in the underlying transmission mechanism of monetary policy with interest rate and the exchange rate gaining importance *vis-à-vis* quantity variables. Against this backdrop, in India, the search for an alternative monetary framework ended in switching over to Multiple Indicator Approach in 1998-99.

Multiple Indicator Approach

The RBI adopted a 'multiple indicator approach' in April 1998 with a greater emphasis on rate channels for monetary policy formulation relative to quantity instruments. Under this approach, a number of quantity variables such as money, credit, output, trade, capital flows and fiscal position as well as rate variables such as rates of return in different markets, inflation rate and exchange rate were analysed for drawing monetary policy perspectives. The multiple indicator approach was informed by forward looking indicators since the early 2000s drawn from the RBI's surveys of industrial outlook, credit conditions, capacity utilization,

professional forecasters, inflation expectations and consumer confidence. The RBI continued to give indicative projections of key monetary aggregates.

The multiple indicator approach seemed to work fairly well from 1998-99 to 2008-09, as reflected in the average real gross domestic product (GDP) growth rate of 7.1 per cent associated with average inflation of about 5.5 per cent in terms of both the wholesale price index (WPI) and the Consumer Price Index (CPI). Subsequently, however, there was a mounting public censure of the efficacy and even the credibility of this framework as persistently high inflation and weakening growth co-existed, i.e., visible signs of stagflation. Use of a large panel of indicators was also not providing a clearly defined nominal anchor for monetary policy. It also left policy analysts unclear about what the RBI looks at while taking policy decisions. Since 2007 several high-level Committees in India have highlighted that the RBI must consider switching over to inflation targeting (RBI, 2014).

Flexible Inflation Targeting

Against this backdrop, the RBI constituted an Expert Committee to Revise and Strengthen Monetary Policy Framework (Chairman: Dr. Urjit R. Patel) on September 12, 2013 to recommend what needed to be done to revise and strengthen the current monetary policy framework with a view to, *inter alia*, making it transparent and predictable. The Expert Committee submitted its report in January 2014 and set the stage for a move towards the adoption of a flexible inflation targeting framework for monetary policy in India. In the flexible inflation targeting framework, the policy (repo) rate is set, based on an assessment of the current and evolving macroeconomic situation, with the aim of achieving the inflation target on an average over the business cycle, while accommodating growth concerns in the short run (RBI, 2014). Once the repo rate is announced, the operating framework designed by the RBI envisages liquidity management on a day-to-day basis through appropriate actions, which aim at anchoring the operating target – WACR – around the repo rate. The details of the operational framework of monetary policy is elaborated in the next chapter “Market Operations”. These changes in money market rates then get transmitted to the entire financial system, which, in turn, influences aggregate demand – a key determinant of inflation and growth.

Prior to the amendment to the RBI Act in May 2016, the flexible inflation targeting framework, as recommended by the above-mentioned Committee, was governed by an Agreement between Government of India and Reserve Bank of India in February, 2015. The amendment of the RBI Act in May 2016 provided the statutory basis for the implementation of the flexible inflation targeting framework. As per the amended Act, the inflation target would be defined in terms of all India Consumer Price Index (CPI) and the inflation target would be set by the Government of India, in consultation with the Reserve Bank, once in every five years. The failure to achieve the inflation target was defined as when: (a) the average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or (b) the average inflation is less than the lower tolerance level for any three consecutive quarters. In the event of a failure to meet the inflation target, the Reserve

Bank has to set out in a report to the Central Government: (a) the reasons for failure to achieve the inflation target; (b) remedial actions proposed to be taken by the Bank; and (c) an estimate of the time-period within which the inflation target shall be achieved pursuant to timely implementation of proposed remedial actions. The amended Act requires the Reserve Bank to publish, once in every six months, a document called the Monetary Policy Report that explains (a) the sources of inflation; and (b) the forecast of inflation for 6-18 months ahead. The amended RBI Act came into effect in June 2016. In pursuance of the amended Act, in August 2016, the Central Government notified in the Official Gazette an inflation target of 4 per cent Consumer Price Index (CPI) inflation for the period from August 5, 2016, to March 31, 2021, with the upper tolerance limit of 6 per cent and the lower tolerance limit of 2 per cent.

Section 45ZB of the amended RBI Act, 1934 also provides for a six-member Monetary Policy Committee (MPC) to be constituted by the Central Government by notification in the Official Gazette. Accordingly, a six-member Monetary Policy Committee (MPC) was constituted on September 29, 2016, with three internal and three external members, to determine the policy rate to achieve the inflation target. Under the amended RBI Act, the six-member committee is required to meet at least four times in a year. Three external MPC members are appointed for a period of 4 years. Each member of the MPC has one vote, and in the event of an equality of votes, the Governor of the RBI has a second or casting vote. The resolution adopted by the MPC is published after conclusion of every meeting of the MPC in accordance with the provisions of Chapter III F of the amended Reserve Bank of India Act, 1934. On the 14th day, the minutes of the proceedings of the MPC meeting are published which include (a) the resolution adopted by the MPC; (b) the vote of each member on the resolution, ascribed to such member; and (c) the statement of each member on the resolution adopted. Till May 2020, the MPC met 23 times since its first meeting in October 2016.

The Reserve Bank's Monetary Policy Department (MPD) assists the MPC in formulating the monetary policy. Views of key stakeholders in the economy, and analytical work of the Reserve Bank contribute to the process for arriving at the decision on the policy repo rate. The Financial Markets Operations Department (FMOD) operationalises the monetary policy, mainly through day-to-day liquidity management operations. The Financial Markets Committee (FMC) meets daily to review the liquidity conditions so as to ensure close alignment of the operating target - the weighted average call money rate (WACR) – with the policy repo rate.

During the global financial crisis, advanced economies suffered steep and persistent fall in the real GDP. The advanced economies' central banks couldn't rely solely on conventional monetary policy, *i.e.*, reduction in policy rate due the zero-lower bound (ZLB) constraint of the policy rate leading them to introduce unconventional monetary policies to revive the economy. Unconventional monetary policy broadly consists of quantitative easing (QE) and forward guidance (FG) measures. Quantitative easing measures refer to the asset purchase programs of the advanced central banks', which drastically increased the total assets

as well as altered the composition of assets in the central banks' balance sheet unlike the conventional monetary policies, which had negligible impact on the central banks' balance sheet. Forward guidance refers to the use of central bank communication to manage expectations about the future course of policy, thereby attempting to influence the financial decisions of the household and firms.

The RBI has started implementing some of the unconventional monetary policy measures from December 2019 onwards to arrest the economic slowdown and improve the investment cycle in India. The reliance on unconventional monetary policy measures increased in February 2020 to reduce the impact of Corona virus outbreak on economic activity. Operation twist is one of the unconventional monetary policy measures adopted by the RBI since December 2019 under which the RBI simultaneously sells short-term securities and buys long-term securities through open market operations (OMO). This measure is aimed at bringing down the long-term benchmark yield rate. RBI has also introduced measures aimed at durable liquidity injections to the banking system through long-term repo operations (LTRO) with the tenor of one year and three year at reasonable cost, *i.e.*, the repo rate. RBI has also implemented sector-specific measures such as exemptions from the cash reserve ratio (CRR) for the equivalent of incremental credit disbursed by banks as loans in certain select areas/segments and targeted LTROs (TLTROs) to provide liquidity to sectors and entities which are experiencing liquidity constraints and/or hindrances to market access⁵¹.

As explained above, monetary policy making in India has evolved over the years. In the last three decades, key changes related to the adoption of monetary targeting framework, transition to multiple indicator approach and adoption of inflation targeting.

III. Monetary Policy Transmission

Monetary transmission is the process through which monetary policy impulses in the form of policy rate changes by a central bank are transmitted to the entire spectrum of interest rates such as money market rates, bond yields, bank deposit and lending rates and asset prices such as stock prices and house prices. Various economic agents such as households, firms and the government respond to these interest rate changes by adjusting their spending behaviour. This alters aggregate demand of households and firms and by aligning it with aggregate supply conditions, the broader macroeconomic policy objectives such as price stability and sustainable growth of the economy are achieved. The whole process takes months, sometimes, more than a year.

The empirical evidence for India suggests that monetary policy actions are felt with a lag of 2-3 quarters on output and with a lag of 3-4 quarters on inflation, and the impact persists for 8-12 quarters. Transmission takes place through various 'channels', namely (i) interest rate channel, (ii) credit channel, (iii) exchange rate channel, and (iv) asset price channel⁵². According to many studies, the interest rate channel has been found to be the

⁵¹ Detailed changes in the liquidity management of RBI is provided in the next chapter "Market Operations".

⁵² See RBI (2014)

strongest in India. The efficacy of monetary policy depends on the magnitude and the speed with which policy rate changes are transmitted to the ultimate objectives of monetary policy, *viz.*, growth and inflation. In a bank dominated system like India, the transmission to banks' lending rates is the key to the successful implementation of monetary policy. Hence, it has been the endeavour of the Reserve Bank to strengthen the monetary transmission by focusing on the design of the lending interest rates of the banking system. However, the issue of transmission from the policy rate to banks' lending rates has all along been a matter of concern. The transmission to banks' lending rates has been impeded by a variety of factors and thus the impact of policy change on economic activity and inflation remained muted.

To address this concern, the Reserve Bank has refined the interest rate setting methodology of banks from time to time. Effective October 1, 2019, in pursuance of the recommendations of the Internal Study Group (RBI, 2017), the Reserve Bank, mandated that all scheduled commercial banks (excluding regional rural banks) should link all new floating rate personal or retail loans and floating rate loans to Micro and Small Enterprises (MSEs) to the policy repo rate or 3-month T-bill rate or 6-month T-bill rate or any other benchmark market interest rate published by Financial Benchmarks India Private Ltd. (FBIL). With a view to further strengthening monetary transmission, Reserve Bank directed the banks to link their pricing of loans for the medium enterprises also to an external benchmark effective April 1, 2020. Under this benchmarking system, banks are free to choose the spread over the benchmark rate, subject to the condition that the credit risk premium may undergo change only when the borrower's credit assessment undergoes a substantial change, as agreed upon in the loan contract. External benchmarks are transparent as they are available in the public domain and hence easily accessible to the borrowers. Subsequent to the introduction of an external benchmark system, monetary transmission has improved to the sectors where new floating rate loans have been linked to the external benchmark.

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Chapter 4: Market Operations

The objective, framework and implementation of the market operations of the RBI are discussed in this Chapter, which is divided into two sections. The first section deals with Monetary Policy Operations and the second section deals with the Foreign Exchange Operations of RBI.

I. Monetary Policy Operations

The objective of monetary policy operations is to enable the transmission of monetary policy to the financial system. The MPC determines the policy interest rate, and the policy stance to achieve the inflation target. The operating target of monetary policy is the weighted average call rate (WACR), which is a volume weighted rate of overnight transactions undertaken in Call money market (uncollateralized segment of the money market with banks and primary dealers as participants). By conducting market operations as per the liquidity management framework designed by it, the RBI endeavours to ensure that the operating target, i.e., the WACR is aligned to policy rate on a daily basis.

The liquidity management framework of RBI comprises of Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) for management of transient liquidity, i.e., liquidity surplus or deficit of temporary nature. LAF includes repos and reverse repos of various tenors conducted by the RBI. MSF is an additional facility in which banks can borrow rupee funds from RBI at a higher rate against eligible collateral including by dipping below the statutory SLR up to a specified limit. For managing liquidity of enduring nature, i.e., liquidity surplus or deficit, which is persisting in the banking system for a longer period, due to various factors, instruments like Long Term Repo/Reverse Repo Operations (LTROs/LTRROs), Open Market Operations (OMOs) by outright purchase and sale of government securities, changes in required Cash Reserve Ratio (CRR), Market Stabilisation Scheme (MSS), USD/INR swaps auctions (Forex Swap Auctions) are used.

The CRR is a direct instrument which immediately impacts the system liquidity. If CRR is increased, banks must maintain higher balances in their current account with RBI, thereby creating liquidity deficit in the banking system. Similarly decrease in CRR has the immediate impact of creating liquidity surplus in the banking system. Other instruments of liquidity management are detailed in the ensuing paragraphs.

Liquidity Management Framework

An RBI Internal Working Group has reviewed the liquidity management framework and published its report in September 2019. The Group has continued with the existing objectives of maintaining the call money rate close and consistent to the policy rate and not undermining the price discovery in the inter-bank money market. The Group recommended the continuance of a corridor system with the call money rate as the target rate but with greater flexibility in deciding about the appropriate level of liquidity deficit or surplus required in the banking system based on financial conditions. Other recommendations were regarding

minimizing the number of operations for greater efficiency, discontinuance of assured liquidity of up to 1% of NDTL, inclusion of longer term repo operations in addition to existing tools for durable liquidity management and dissemination of more information on liquidity management.

Based on the recommendations of the above report, RBI has updated its Liquidity Management Framework vide RBI notification dated February 6, 2020, as tabulated below.

Sl. No.	Instrument	Quantum	Periodicity/Timing
A. Instruments under LAF framework to manage short-term/transient liquidity			
1.	14-day variable-rate repo/ reverse repo auction <i>(Main operation)</i>	Auction amount is decided by RBI and a single auction (either repo or reverse repo) is conducted based on the assessment of liquidity conditions by RBI.	On reporting Friday (2.30 p.m. to 3.00 p.m.)
2.	Variable Rate Term Repo/ Reverse Repo auction (Tenor: overnight and up to 13 days) <i>(Fine-tuning operations)</i>	The auction amount is decided by RBI based on an assessment of the liquidity conditions.	Discretionary
3.	Fixed Rate Reverse Repo	No restriction on amount	Daily between 5.30 p.m. and 11.59 p.m.*
4.	Marginal Standing Facility (MSF)	Individual banks can draw funds up to Excess SLR + 2 per cent below SLR.	
5.	FX Swaps	The amount is decided by RBI, based on the assessment of the liquidity conditions.	Discretionary

Sl. No.	Instrument	Quantum	Periodicity/Timing
6.	Standing Deposit Facility (SDF)	The operational details are awaited.	
B. Instruments to manage durable liquidity			
7.	Long Term Variable Rate Repo Operation (LTRO) Tenor: beyond 14 days	The auction amount is decided by RBI, based on an assessment of the liquidity conditions.	
8.	Long Term Variable Rate Reverse Repo Operation (LTRRO) Tenor: beyond 14 days	The auction amount is decided by RBI, based on an assessment of the liquidity conditions.	Discretionary
9.	FX Swap Auctions	The auction amount is decided by RBI, based on an assessment of the liquidity conditions.	Discretionary

* The window was extended from 09:00 hrs to 23:59 hrs daily w.e.f. March 31, 2020 as an interim and temporary measure to provide greater flexibility in liquidity management by market participants in the wake of the disruptions caused by COVID-19.

Key features of repo/reverse repo/MSF conducted under LAF are summarised below:

Discretion with RBI

While the main operation is a 14-day variable rate repo or reverse repo (depending upon the prevailing liquidity conditions) at the start of the reporting fortnight under the revised liquidity framework, RBI has the discretion to conduct overnight/ longer term, repo/ reverse repo auctions at variable/fixed rates depending on market conditions and other relevant factors. For using this discretion, RBI considers its assessment of the prevailing liquidity conditions based on available data and forecast of liquidity. The details of this mechanism are elaborated later in this chapter.

Rate of interest

The rate of interest applicable for repo is the policy rate decided by the MPC from time to time. The reverse repo rates and the MSF rates are linked to the policy rate and are decided by RBI from time to time. For variable-rate repo and reverse repo auctions, the applicable rate of interest will be the cut-off as decided by RBI, based on the bids/offers

received.

Securities eligible for collateral

SLR-eligible and unencumbered Government of India dated securities (including oil bonds)/Treasury Bills and State Development Loans (rated and unrated) are considered as eligible securities for repo/ MSF and reverse repo operations. The market value of securities on the day of operation is reckoned to calculate collateral requirement for repo/MSF/reverse repo operations. The RBI also has the option to revalue securities held as collateral at pre-determined intervals as is currently done for LTROs & TLTROs to ensure that lending remains adequately collateralised.

Margin Requirement

A margin is applied in respect of the eligible securities, which effectively ensures that the borrower using the repo or MSF window to borrow Rupee funds has to provide extra collateral. For example; if the margin is 5 percent and the market participant borrowing from repo window would have to provide ₹105 crore worth of eligible securities to borrow ₹100 crore Rupees.

Mechanics of operations

- The bid/offer is submitted electronically in the Core Banking System (e- Kuber) of RBI by the members within the stipulated time. Settlement of reverse repo/MSF transactions is automatic and immediate after the placement of the bid/offer in the CBS.
- For variable rate operations, settlement is done after announcement of results of the auction. Results of the operations are announced through Press Release on RBI website.

Decision regarding cut-off for Variable-Rate auctions

- Variable-rate repo: There is no restriction on the number of bids by banks. Banks can bid up to the notified amount. Once the bidding time is over, all the bids are arranged in descending order of the quoted rates and the cut-off rate is arrived corresponding to the notified amount of the auction. Successful bidders would be those who have placed their bids at or above the cut-off rate. If there is more than one successful bid at the cut-off rate, then pro-rata allotment is done. No bids are accepted at or below the prevailing repo rate.
- Variable-rate reverse repo: The mechanics of a variable-rate reverse-repo auction is opposite of the mechanics for repo auctions. In this case, no offers are accepted at or above the prevailing repo rate.

How does the LAF corridor work?

To ensure that the WACR does not deviate too much from the policy repo rate, a corridor system with the reverse repo as floor and MSF as ceiling is maintained. By accessing the MSF window, banks can borrow Rupee funds from RBI by providing acceptable securities

as collateral. By accessing the reverse repo window, banks can lend Rupee funds to RBI, in exchange for collateral securities. The important point to note here is that both MSF and reverse repo rates are linked to the policy repo rate set by the MPC with MSF rate being upper bound of the corridor and reverse repo rate being the lower bound of the corridor. The RBI has the discretion to decide the width of the corridor. For the current policy rates please refer to the RBI website.

Banks can also borrow and lend Rupee funds from other market participants in the money market. Therefore, before availing the RBI facility, banks would consider the available options for borrowing and lending in other segments of the money market such as call money, tri-party repo⁵³, market repo, etc. An important factor, which will influence the decision of the individual banks to borrow or lend short term funds from/to RBI or other segments of the money market would be the interest rate. While, banks also consider various aspects such as the requirement of collateral securities, ease of operations, availability, tenor, etc., interest rate level is the most important factor which enables alignment of WACR with the policy repo rate.

Let us understand this with an example. XYZ bank needs to lend its surplus funds. The bank would try to lend to other participants in money market. In a situation of system level liquidity surplus (more lenders than borrowers), the rate in the money market will fall. However, given that banks have the option of deploying their excess funds in the RBI's reverse repo facility without any limit, the reverse-repo rate sets a floor to the interbank rates as a bank will not lend it to another market participant at a rate below the reverse-repo rate.

Similarly, let us suppose XYZ bank needs to borrow overnight Rupee funds. The bank would try to borrow from other participants in money market. In a situation of system level liquidity deficit (more borrowers than lenders), the rates could increase in the market. However, given that banks have the option of borrowing funds under MSF window of RBI, the MSF rate sets the ceiling as banks typically would not borrow from other market participants at a rate higher than the MSF rate. However, the amount of borrowing from MSF window is restricted by the availability of free collateral securities with the bank i.e. eligible securities held in excess of SLR requirements plus allowance given to banks to let their SLR holdings fall below the statutory requirement to the extent permitted by RBI. Therefore, in a scenario of huge system level liquidity deficit, it is possible that the money market rates can breach the ceiling and go beyond the MSF rate. However, such a scenario is only expected in extraordinary circumstances.

A narrow corridor limits the possibility of huge deviations of the money market rates from the policy Repo rate and helps in anchoring the WACR to the policy repo rate, while a wider corridor allows greater room for rates to fluctuate and incentivises market development.

⁵³ Tri-Party Repo is a money market instrument provided by CCIL in which market participants can borrow and lend short term rupee funds against eligible collateral securities. CBLO segment of the money market has been discontinued and replaced with Triparty Repo with effect from November 05, 2018

How is the WACR aligned to the policy repo rate?

In periods of huge surplus liquidity, the call rates will trend towards lower bound of the LAF corridor, the reverse repo rate. Similarly, in periods of huge liquidity deficit, the call rates will be biased towards the upper bound, *i.e.*, MSF rate. To ensure that the WACR is anchored to the repo rate, RBI uses fine tuning operations, *i.e.*, the discretionary variable-rate repo and reverse repo auctions. The amount and timing is decided by RBI depending upon its assessment of the liquidity conditions. RBI also continuously monitors the money market rates during the market hours and conducts fine-tuning operations, as and when needed, to achieve the objective of keeping the WACR close to the policy rate. For example, if the WACR is close to the reverse-repo rate, it means that there is surplus in the system liquidity. Let us assume that liquidity estimation including feedback from the market participants suggests that about ₹50000 crore has come into the system due to unanticipated government spending. In such a scenario, the announcement of an additional variable rate reverse repo auction for about ₹50000 crore, will help in supporting the market rates and pushing them higher, bringing it closer to the policy repo rate. Similarly, in a situation of a large deficit in the system, when the WACR is trending towards the MSF Rate, an announcement of an additional variable-rate-repo auction for sufficient amount will pull the WACR lower and align it with the repo rate. To ascertain the amount, tenor and timing of operations, the assessment of the system-level liquidity on an ongoing basis is very important.

How is the System level liquidity assessed by RBI?

The important factors considered for assessment of the system level liquidity can be classified into known factors and unknown factors. On a day-to-day basis, information about the amount and impact of known factors is readily available with certainty. Some examples of known factors are reversal of outstanding RBI operations under LAF, settlement of OMOs, settlement of forex operations of RBI, government bond redemptions, coupon payments, primary auctions, etc. Information about the amount and impact of unknown factors is not readily available and it needs to be assessed or forecasted. Some examples of unknown factors are the extent of banks maintenance of reserves on any given day, changes in currency in circulation and expenses by the Central Government. Forecasting, therefore, relies on past data as well as information gathered from informal communications with government/banks. For arriving at the net impact on system liquidity, both known and unknown factors must be considered.

The liquidity management framework in India stands on two broad mutually reinforcing pillars of forward looking assessment⁵⁴.

- Pillar-I is an assessment of the likely evolution of system-level liquidity demand based on near-term (four to six weeks) projections of autonomous drivers of liquidity. The core of Pillar I is near-term forecasts of autonomous drivers of liquidity, particularly demand for

⁵⁴ Dr. Urjit R. Patel. (2014). Expert Committee to Revise and Strengthen the Monetary Policy Framework. Mumbai: Reserve Bank of India

currency (which reflects behaviour of households), demand for excess reserves (which reflects behaviour of the banking system), and the central government's balances with the RBI (which depends on cash flows of the Government). For liquidity management, forex market intervention is also an autonomous driver of liquidity, but since there cannot be any near-term forecasts for these interventions, they are considered as and when the information is available. Using a combination of forward looking information and a backward-looking assessment of the time series evolution of the determinants of liquidity, projections are generated on a regular basis to inform the RBI's decisions on discretionary liquidity management.

- Pillar-II is an assessment of system-level liquidity over a relatively longer time horizon, focusing on the likely growth in broad money, bank credit and deposits, the corresponding order of base money expansion and this assessment is then juxtaposed with a breakdown into autonomous and discretionary drivers of liquidity derived under Pillar I. Thus, Pillar II becomes the broader information set within which decisions relating to discretionary liquidity management measures are taken based on Pillar I assessment.

Decision regarding discretionary liquidity management operations by RBI

The RBI's discretionary liquidity management operations (primarily in the form of variable- rate repos/reverse repos and OMOs) are guided by the extent of LAF deficit that is 'reasonable' at any point of time (measured by amount of net outstanding repo, reverse repo, MSF and standing liquidity facility for primary dealers), and the assessment of the nature of deficit/surplus, i.e., whether it is transient or durable. For managing liquidity of transient nature, LAF/MSF windows are used. However, for managing the liquidity condition of enduring or persistent nature, instruments like LTROs, OMOs, MSS & CRR are used. MSS is used in situations when use of OMOs may not be desirable and/or RBI's own portfolio of securities is not adequate to absorb the surplus system liquidity. The mechanics is explained in the MSS subsection in later paragraph.

Calculation of System Liquidity⁵⁵

We can determine whether and by how much, the system is in deficit or surplus by arriving at the net borrowing/lending from RBI from various windows i.e. LAF/ MSF/ standing liquidity facility (for Primary Dealers) or any other windows/schemes. If the net amount so derived is positive it means banks have borrowed from RBI and system is in deficit, and vice versa. However, excess reserves maintained by banks must be adjusted to the net LAF/MSF/SLF to arrive at the system liquidity. The summarised version of system liquidity is furnished below:

System liquidity = Net borrowing under LAF - Excess reserves maintained by banks

Net borrowing under LAF = Total of all Repo/MSF/SLF borrowings (-) Total of all Reverse repo deposits

⁵⁵ Report of the Internal Working Group to Review the Liquidity Management Framework dated September 26, 2019

Excess reserves maintained by banks = Actual reserves maintained by banks (–) Required reserves

Note: If the system liquidity derived above is positive it would indicate that system liquidity is in deficit and vice-versa.

How to determine whether the liquidity condition is enduring or not?

Persistent high levels of outstanding RBI Repos or Reverse Repos indicate that the deficit/surplus is of an enduring nature. Durable liquidity or permanent demand for reserves arises from permanent or long-term changes in the liabilities of the Reserve Bank viz., expansion/contraction in currency in circulation, unsterilised Fx intervention operations and decrease/increase of banking system reserves due to changes in net demand and time liabilities of the banking system (NDTL). However, reversible changes in demand/supply of reserves arising from frictional factors such as tax outflows or government expenditure generate temporary mismatches in the banking system liquidity. For example, if the government balances have come down from positive balance of ₹10,000 crore to around Nil, then this would increase the banking system surplus by that amount till such amount flows back to government account in the form of tax collections and other revenues. Similar kind of impact can be observed for the deficit also. Considering all the factors, RBI decides on the nature of the liquidity surplus or deficit and, accordingly, the appropriate instruments are used.

Instruments of durable liquidity

Traditionally, OMO and MSS operations are used to deal with durable liquidity. The mechanics of these operations are given in following paragraphs. However, recently, the RBI has augmented its liquidity management toolkit to meet the durable liquidity needs of the system through usage of long-term foreign exchange Buy/Sell USDINR swap auctions and introduction of Long Term Repo Operations (LTROs)/Targeted Long Term Repo Operations (TLTROs). The first Buy/Sell auction was conducted for USD 5 billion for a tenor of 3 years on March 26, 2019.

LTROs were introduced in February 2020 to augment the liquidity management toolkit. The mechanism of LTROs is similar to repos but they are of longer duration from one to three years. A variant of the same, TLTROs were introduced in March 2020 to provide longer duration money to specific sectors/instruments. Liquidity availed by banks under TLTROs had to be deployed in investment grade corporate bonds, commercial paper, and non-convertible debentures in both primary and secondary markets. In April 2020, RBI announced a Targeted Long-Term Repo Operations 2.0 (TLTRO 2.0) to channel liquidity to small and mid-sized corporates, including non-banking financial companies (NBFCs) and micro finance institutions (MFIs) that had been impacted by COVID-19 disruptions. The funds availed under TLTRO 2.0 had to be deployed in investment grade bonds, commercial paper (CPs) and non-convertible debentures (NCDs) of Non-Banking Financial Companies (NBFCs). At least 50 percent of the total funds availed has to be apportioned as given below:

- i. 10 per cent in securities/instruments issued by Micro Finance Institutions (MFIs);
- ii. 15 per cent in securities/instruments issued by NBFCs with asset size of ₹ 500 crore and below; and
- iii. 25 per cent in securities/instruments issued by NBFCs with assets size between ₹ 500 crore and ₹ 5,000 crore.

Mechanics of OMO operations

An OMO sale of government securities by the Reserve Bank has the impact of reducing the system liquidity. An OMO purchase of government securities, on the other hand, has the impact of increasing the system liquidity. OMO purchases will lead to increase in RBI investments in the government securities while OMO sales lead to a decrease.

OMOs are conducted by RBI through auction mechanism or by directly undertaking transactions in the secondary market. Such direct secondary market transactions are undertaken on NDS-OM (Negotiated Dealing System – Order Matching) platform which is an anonymous order matching platform for Government securities. The data on total amount of OMO purchase or sale transactions by the RBI in the secondary market is published with a lag. For conducting OMO through auction mechanism, announcement is made by RBI through press releases giving details of the amount, date and time of auction and the choice of securities. On the day of auction, after the cut-off time for bidding, the bids are processed and the OMO auction committee in RBI decides on the cut-off yield. The decision is announced by way of press release. The frequency of auctions is generally not pre-determined or pre-announced, unlike the primary auctions conducted as part of Government's market borrowing programme. It depends on the evolving liquidity conditions.

One important issue regarding OMOs is the impact on G-Sec yields. Announcement regarding OMO sales may have a hardening impact on yield due to higher supply of securities in the system. The selection of securities for OMO auction is an important factor in the success of the auction. The cut-off yield of the OMO auctions are keenly watched by the markets as it may indicate RBI's comfort levels for the yields.

Recently, the RBI has conducted special OMOs involving simultaneous sale and purchase of Government securities, also known as 'Operation Twist'. These operations are liquidity neutral at the inception and can be used to have a desired impact on the long-term and short-term interest rates without altering the liquidity conditions.

Mechanics of MSS operations

Market Stabilisation Scheme (MSS) is another tool used by the RBI to manage the surplus liquidity in the system. MSS was used in periods when large capital inflows had necessitated RBI intervention in the forex market to contain volatility. The purchase of significant amount of dollars and consequent increase in liquidity required sterilisation operations to prevent inflationary effects of the excessive capital flows. Also, post demonetization, MSS had been used to deal with huge surplus liquidity condition resulting

from increase in deposits by public with the banks. To conduct OMO sales and reverse repos, the RBI needs sufficient government securities. As OMO sales and Reverse Repos can only be conducted to the extent of such securities being available with RBI⁵⁶, the MSS comes handy in a situation where OMO sales are not desirable or the available quantum of government securities with RBI is inadequate to handle the liquidity surplus in the system.

Under MSS, Government securities (including Cash Management Bills (CMB), T- Bills and Dated Securities) are auctioned. Unlike normal market borrowing by the government, the amount raised under MSS is kept in a sequestered account and not available for spending by the Government. This is essential as government spending would have resulted in rupee liquidity again getting transferred back to the banking system, thereby defeating the purpose for which the instrument was used.

In consultation with RBI, the government decides the ceiling and the threshold limit of MSS for each financial year. After receiving confirmation from the government, the RBI issues a press release with information regarding the ceiling for gross issuances and the threshold amount. Once the gross issuances under MSS reach the threshold limit, or there is an additional requirement, the RBI informs the government of the same, which reviews and advises the revised ceiling and threshold limit.

The choice of securities under MSS depends, *inter alia*, on the estimate regarding the nature of the surplus liquidity conditions. If the surplus is forecasted to linger for a much longer duration, then government securities of longer tenor would be issued, while if the surplus is forecasted to be for a shorter tenor, T-Bills or CMBs would be issued. Press release for conducting the auction is issued by the RBI. During the auction window, the market participants can place their bids electronically in the core banking system of RBI. Like auction of other government securities, an internal auction committee decides the cut-off and the same is communicated by way of press release.

The effectiveness of the RBI's operations in the money markets is regularly analysed and published in the bi-annual Monetary Policy Report (MPR), MPC statements and the annual report. The operating framework and its components have also been fine-tuned and revised to support the financial markets, monetary conditions and to fulfil the needs of a modern economy while ensuring consistency with the monetary policy stance. Regular efforts have also been taken to improve the accuracy of forecasting through improved market intelligence for effective liquidity management.

Special operations

Conducting special operations in money markets is necessitated for financial stability considerations and in view of RBI's role as lender of last resort. Select special operations are mentioned below:

⁵⁶ The Urjit Patel committee of 2014 had recommended the introduction of a Standing Deposit Facility (SDF) which would obviate the requirement of providing collateral securities by RBI in reverse Repo operations and thus the balance of securities would not come in the way of liquidity management in such situations. The RBI Act has since been amended for introduction of a SDF.

- From October 2008 to October 2009, RBI had conducted special repo auctions with a view to enabling banks to meet the liquidity requirements of Mutual Funds (MFs), Non-Banking Financial Companies (NBFCs) and Housing Finance Companies (HFCs).
- In April 2020, to deal with liquidity strains on mutual funds (MFs) in the wake of redemption pressures related to closure of some debt MFs and potential contagious effects because of COVID-19 related disruptions, RBI announced a ₹ 50,000 crore Special Liquidity Facility for Mutual Funds (SLF-MF). Under this scheme, RBI conducted repo operations of 90 days tenor at the fixed repo rate. The SLF-MF was on-tap and open-ended. Funds availed under the SLF-MF had to be used by banks exclusively for meeting the liquidity requirements of MFs by (1) extending loans, and (2) undertaking outright purchase of and/or repos against the collateral of investment grade corporate bonds, commercial papers (CPs), debentures and certificates of Deposit (CDs) held by MFs.

II. Foreign Exchange Operations of India

Objective⁵⁷

The Rupee exchange rate is determined by the forces of market demand and supply. The objective and purpose of exchange rate management is to ensure that economic fundamentals are reflected in the external value of the rupee. Subject to this general objective, the conduct of exchange rate policy is guided by three major objectives: first, to reduce excess volatility in exchange rates, while ensuring that the market functions in an orderly fashion; second, to help maintain an adequate level of foreign exchange reserves, and; third, to facilitate the development of a healthy foreign exchange market. To ensure orderly conditions, RBI closely monitors the developments in the financial markets at home and abroad.

Due to India's significant reliance on capital flows, which can be often large and lumpy and are subject to sudden stops and reversals, *viz.*, bulk demand for oil imports and bunching up of government payments, the forex market becomes susceptible to bouts of volatility. Of late, geopolitical events of significant nature such as trade war fears, tensions in the middle-east and severe exogenous shocks (e.g. volatility in markets caused by Covid-19 in the year 2020) have caused disruptions in the global and domestic forex markets. The sharp growth in the offshore trading volumes in the Rupee NDF market abroad in recent years, likely even exceeding the volumes in the onshore markets, have raised concerns around the forces that are determining the value of the rupee, price discovery in onshore market and the ability of the RBI to ensure currency stability.

An important aspect of the policy response in India to the various episodes of volatility has been market intervention combined with monetary and administrative measures to

⁵⁷ India's Foreign Exchange Reserves : Policy, Status and Issues (Speech by Dr. Y.V. Reddy, at National Council of Applied Economic Research, New Delhi on May 10, 2002)

address the threats to financial and market stability, while complementary or parallel recourse has been taken by way of communications through speeches and press releases. Based on the preparedness and maturity of the foreign exchange market and India's position on the external front (in terms of reserves, debt, current account deficit, etc.), reform measures have been progressively undertaken to put in place a liberalized exchange and payments system for current and capital account transactions with a view to further develop the foreign exchange market.

While regulatory measures may produce the desired outcomes with a lag, the RBI's forex intervention has the immediate impact on the prevailing demand and supply of foreign currency in the market. With the objective of curbing volatility in exchange rate, RBI conducts sales or purchases of foreign currency in the forex market, to contain the excessive volatility and/or to smoothen out lumpy outflows/inflows. Such sales and purchases are not governed by a predetermined target or band around the exchange rate.

Impact of RBI's intervention

RBI's intervention impacts the demand and supply of the foreign currency in the domestic forex market and helps in curbing volatility of the USDINR currency pair. For example, consider a scenario of huge capital inflows causing spurt in volatility in dollar-rupee movement with sharp appreciating pressure on Rupee *vis-à-vis* dollar. Such flows lead to appreciation of Rupee because of increase in supply of dollars in the forex market as foreign investors sell dollars to invest in Rupee bonds and equity shares. However, most times, the price adjustment is not smooth. It rather gyrates up and down. In such a scenario, RBI intervention through buying dollars neutralises the impact of temporary oversupply of dollars. But the amount of dollars purchased by RBI intervention does not have a one-to-one relationship with the dollar oversupply. The very hint of RBI intervention impacts the market sentiments, altering the market dynamics and forcing market players to rebalance themselves to the new situation.

For example, if Rupee is appreciating sharply against the dollar, the participants (e.g. importers) who are looking for opportunity to buy dollars at the best possible price would like to wait to benefit by buying dollars at lower price. If such an importer anticipates reversal in Rupee appreciation, then he would immediately like to buy the dollars in the market at current price. Similarly, the Authorised Dealers⁵⁸ (ADs) can undertake proprietary positions within acceptable limits. The AD banks also take position by buying and selling dollars to benefit from the price movement. Because the AD banks have superior information about supply and demand of foreign currency in the market, they swiftly change their position from dollar overbought to oversold position⁵⁹ in foreign currency and vice-versa. Thus, RBI's intervention influences the market participants' behaviour, thereby impacting the short- term supply and demand of dollars in the domestic forex market and bringing stability in the

⁵⁸ Authorised Dealers are the banks licensed and authorized by RBI to deal in foreign exchange.

⁵⁹ When an entity buys and holds dollars, it is considered as long position and when an entity sells dollars it is considered as a short position.

market.

Similarly, to deal with increased volatility during episodes of huge capital outflows with depreciating pressure on Rupee, RBI sells dollars in the market. This causes the supply of dollars to go up, thereby stemming the depreciation of Rupee against the dollar. The market sentiments and behaviour of the market participants are impacted, which ultimately lead to stability in the market.

One important aspect of RBI intervention in FX market is that it has a concurrent and commensurate impact on rupee liquidity conditions. If RBI sells foreign currency, it receives INR from the market participants and thus the banking system liquidity reduces to that extent. Similarly, when RBI purchases foreign currency in the forex market, the INR liquidity goes up in the banking system. To mitigate this impact of forex intervention on the INR liquidity, the RBI undertakes offsetting transaction via its liquidity management tools. This process is known as 'sterilisation' and such forex intervention sometimes is referred as 'sterilised intervention.' However, there is no one to one relationship between both.

Instruments used by RBI for forex intervention

RBI intervenes in the spot, forwards, swaps and futures market. Rupee exchange rate is determined from transactions in the spot market (T+2 settlement). Rates for forex forwards (other than spot) are derived from a combination of spot and swap transactions. The forward transactions impact both spot rate and forward premium, whereas swaps only impacts the forward premium. The spot, forwards and swaps are traded in over the counter (OTC) market. One important factor for operating in the forward market is that it provides manoeuvrability to RBI to modulate the domestic rupee liquidity conditions in consonance with the prevailing monetary policy stance. For example, when RBI purchases foreign currency from the forex market and wants to postpone the injection of INR liquidity due to its forex operation, it can undertake a sell/buy swap to postpone the delivery of foreign currency to a future date thereby shifting the impact on INR liquidity to a future date.

Currency futures are traded on authorised exchanges such as NSE, BSE, etc., and are a part of the exchange traded segment of the forex market. An important difference between the OTC and exchange traded segment is that, while the transactions in the OTC segment is delivery based (both rupee and dollar legs are settled on due dates), transactions on the ETCD (Exchange Traded Currency Derivative) segment is cash settled in Rupee terms (only the profit or loss converted into Rupee terms are settled on due date). Another important advantage of using the ETCD market is that it does not alter the level of forex reserves, as only net amount in Rupee terms is settled and there is no requirement of delivering or taking delivery of dollars.

The market operations can be undertaken either directly or through select agency banks, though the general preference is for indirect intervention through selected banks. Both approaches have merits and drawbacks. But the indirect approach has the advantage of maintaining confidentiality of the intervention operations, thereby enhancing their

effectiveness⁶⁰. The data regarding RBI's forex intervention operations is published with some lag in the RBI Monthly Bulletin and the Special Data Dissemination Standards of the International Monetary Fund (both are available on RBI website).

Why excessive volatility is bad in forex market?

Exchange rate volatility represents the movement in exchange rate over time. The larger the magnitude of its change, or the more quickly it changes over time, the more volatile it is. Standard deviation is a popular measure to determine volatility. Historical standard deviation is a backward-looking measure of volatility, while implied volatility can be derived from options traded in the derivative market. Market players use several other models for forecasting volatility such as ARCH (Autoregressive Conditionally Heteroscedasticity), Generalized Autoregressive Conditionally Heteroscedasticity (GARCH), etc. Volatile exchange rates make international trade and investment decisions more difficult as it increases risks. Exchange rate risk refers to the potential to lose money because of a change in the exchange rate. Some examples of how traders and investors may lose money when the exchange rate changes sharply are as follows.

Let us consider that an Indian garment manufacturer had received an order to export 1000 pieces of a particular type of garment to a retailer in USA at 10 dollar per item. The cost of the garment was ₹600 per item for the exporter, and the dollar-rupee was trading at ₹65 per dollar. Accordingly, the exporter was expecting to make a profit of ₹50 per item. Suppose the shipment is expected to occur in 3 months' time and that the payment for the shipment need not be made until that time. Three months have elapsed and 10,000 dollars are received in lieu of shipment of the garments. Now, at the end of this three-month period, suppose Rupee rate has fallen to ₹60 per dollar. On conversion at this rate, Rupee amount comes to only ₹600 per item. This amount is less than the originally expected amount of ₹650 per item. Therefore, the movement in exchange rate has led to a loss of ₹50 per item worth of expected profit. This is an example of the risk an exporter faces due to change in the currency value.

Let us consider another example in which an Indian corporate had borrowed one-million-dollar last year from an overseas bank in USA for a one year period to take advantage of the lower interest rate prevailing abroad at the dollar-rupee exchange rate of ₹65 per dollar. Consider that the one-year cost of borrowing in USA was 3% for that borrower, while the borrowing rate in India was 10%. The Indian corporate had converted the dollar proceeds to ₹65,000,000 and used the same in his business. The investor did not hedge the currency risk. The dollar unexpectedly appreciated against the Rupee and at the time of repayment it was trading at ₹70 per dollar. So, to refund the borrowed amount with interest, the Indian corporate needs to buy 1.03 million dollar by spending ₹72,100,000 which translates into borrowing costs higher than the rate if he had borrowed in India.

⁶⁰ BIS Paper no. 73 on 'Intervention in foreign exchange markets: the approach of the Reserve Bank of India. by Mr. Rakesh Tripathy of the Reserve Bank of India under the guidance of Mr. G. Mahalingam and Mr. Harun R. Khan for the Emerging Markets Deputy Governors' Meeting hosted by the Bank for International Settlements on 21 and 22 February 2013 at Basel.

On the flip side, favourable currency movements in both the examples cited, would have led to gains. In the first example, had the rupee value changed to ₹70, the shipment value would have increased in Rupee terms, generating a profit of ₹100 per item. Similarly, in the second example, had the exchange rate moved to ₹60, it would have further reduced the cost of his borrowing. Thus, a volatile exchange rate will either lead to unexpected losses or gains.

There are several methods to hedge and protect oneself from this type of exchange rate movement (also called currency risk). Some important derivative instruments are forwards, futures and options, etc. In any case, exchange rate fluctuations lead to either increase in risk of losses or additional cost to protect against those risks.

Adequacy of foreign exchange reserves

Purchase of dollars by RBI through forex market intervention operation has the impact of increase in forex reserves whereas sale of dollars decreases the forex reserves. The adequacy of forex reserves is assessed based on several parameters, which take into account the import cover; quantum, composition and risk profile of various types of capital inflows; as well as the external shocks to which the economy is vulnerable. Unlike many other countries, India has not accumulated its reserves by having a surplus current account, but through large capital inflows. Therefore, one can argue that reserves held by India are not truly "earned", but rather "borrowed" in nature, and that they may be required to be "returned" should the capital flows reverse, as it did during 2008–09. Forex reserves entail a cost because of low returns on investments as compared to returns on Rupee investments.

RBI intervention data

The data related to RBI intervention data is published in the RBI monthly bulletin on trade settlement basis with a lag of one month. The data on purchase, sale and forward outstanding is given for intervention in OTC markets. A separate table on intervention in ETCD Market is also provided. In addition, net drains on foreign currency assets related data with a lag is published in the IMF Special Data Dissemination Standards Template on International Reserves/Foreign Currency Liquidity.

Special operations in the forex market

With a view to maintaining stable conditions and to restore confidence during periods of liquidity stress, RBI has undertaken special measures in the past to augment both rupee and foreign exchange liquidity. Some important special operations taken in the past are mentioned below.

- Post Lehman collapse in 2008, there was global crisis resulting in dollar liquidity shortage in the international market. In order to give comfort to the Indian banks having overseas branches or subsidiaries in managing their short-term foreign funding requirements, a rupee-dollar temporary swap facility was introduced in November 2008. Under this facility, banks were allowed to swap their rupee funds for dollar funds for a maximum period of three months.

Further, for funding the swaps, banks were also allowed to borrow under the Liquidity Adjustment Facility (LAF) for the corresponding tenor at the prevailing repo rate. This facility was subsequently extended to EXIM Bank, for meeting their disbursals under lines of credit already committed by them. This facility had the net impact of lending dollars for temporary periods to the eligible entities against the collateral of LAF eligible securities.

- A swap facility for expansion of Export Credit in Foreign Currency was announced on January 14, 2013 to support the incremental Pre-shipment Export Credit in Foreign Currency (PCFC) extended by the banks. The swap facility was available to scheduled banks (excluding RRBs) from January 21, 2013 till June 28, 2013 for fixed tenor of 3/6 months. Banks had the option to enter into rupee-dollar swaps with RBI and also access rupee refinance to the extent of the swap under PCFC. During any particular month, the maximum amount of dollars that banks were eligible to avail of from RBI through swaps was equal to the incremental PCFC disbursed with reference to November 30, 2012.

- A Forex Swap Window for Public Sector Oil Marketing Companies was announced on August 28, 2013 to meet the entire daily dollar requirements of three public sector oil marketing companies (IOC, HPCL and BPCL). Under the swap facility, RBI entered into sell/buy USD- INR forex swaps for fixed tenor with the oil marketing companies through designated banks. This facility had the impact of temporarily supplying dollars against rupees to the oil companies and thereby taking out a big chunk of demand from the forex market. This helped in managing the increased volatility of Rupee by taking off the depreciating pressure from it.

- A swap window for attracting FCNR (B) dollar funds was announced on September 6, 2013 for scheduled commercial banks (excluding RRBs). The facility remained open till November 30, 2013. Under the facility, a US Dollar- Rupee swap window for fresh FCNR (B) deposits in permitted currencies was allowed for a tenor of 3 to 5 years, in line with the tenor of the underlying FCNR deposits. The swap facility with RBI was available in US Dollars only and was undertaken at a fixed rate of 3.5 per cent per annum. In the first leg of the transaction, the bank sold US Dollars to RBI at RBI Reference Rate. In the reverse leg of the swap transaction, Rupee funds would have to be returned to RBI along with the swap premium to get the US Dollars back. The facility had the impact of increasing the dollar availability with RBI for the swap period. Bulk of the swaps was for the 3-year period, which was extinguished in 2016.

- A facility of US Dollar-Rupee swap window was announced for Authorised Dealer Banks on September 10, 2013. Under the scheme, the Category-I banks were permitted to borrow funds from their Head Office, overseas branches and correspondents and by overdrafts in Nostro accounts up to a limit of 100 per cent of their unimpaired Tier I capital (as against the prevailing limit of 50 per cent) as at the close of the previous quarter or USD 10 million (or its equivalent), whichever is higher. The banks were then permitted to enter into a swap transaction with RBI in respect of the fresh borrowings raised with a minimum tenor of one year and a maximum tenor of three years covering the entire tenor of the borrowing. The swaps were available at a concessional rate of a 100 bps below the market rate. The swap rate was

reset after everyone year from the date of the swap at 100 bps lower than the market rate prevailing on the date of reset. The swaps were available only for conversion of USD equivalent into Rupees. The concessional swap window was available till November 30, 2013. The facility had the impact of increasing the dollar availability with RBI for the swap period. As the facility was for a maximum period of 3 years, the swaps were extinguished by 2016.

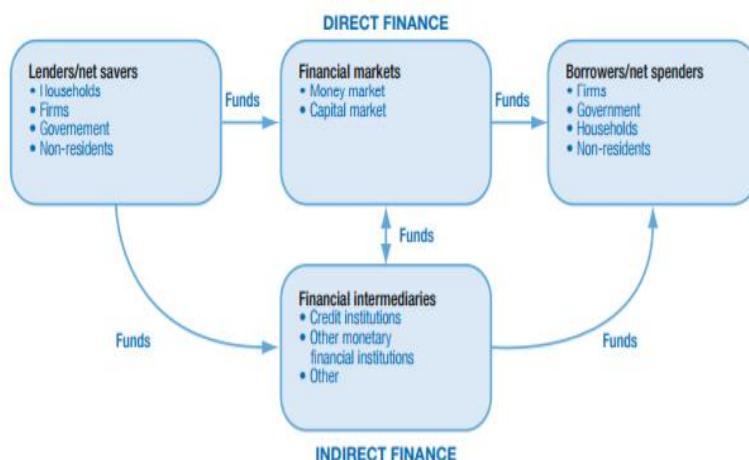
- The two swap windows (against fresh FCNR (B) deposits and Banks' overseas borrowings) mobilized about USD 34 billion that helped in augmenting dollar funds with RBI.
- In March 2019, the RBI has inducted forex swap auctions (buy-sell or sell-buy Rupee-Dollar swaps) in its liquidity management toolkit. The first such buy/sell auction (thus injecting INR liquidity) was conducted for USD 5 billion for tenor of 3 years on March 26, 2019. The US Dollar amount mobilized through this auction was reflected in RBI's foreign exchange reserves for the tenor of the swap while also reflecting in RBI's forward liabilities. In 2020, the RBI used forex swap auctions to provide USD liquidity (via a sell/buy swap) to the market. This is a very versatile tool and can be used to inject/absorb both USD and INR liquidity for a desired long or short-term period.

Chapter 5: Financial Stability

A well-functioning financial system – comprising financial markets, financial intermediaries (such as, banks, insurance companies, non-banking finance companies, etc.) and financial infrastructure (responsible for payment, clearing and settlement) – is critical for economic growth, as it ensures the efficient transfer of resources from lenders to borrowers. If anyone who wants to start a business – a restaurant, a software firm, a consumer electronics shop – and had to do so only with their hard-earned savings or with the help of their parents, relatives or friends, many bright ideas would go unrealized. At the same time, in the absence of avenues for investment, savings will remain idle or be wasted. Similarly, if you invest in a company and you cannot sell your shares or bonds and invest somewhere else, you remain invested forever and it would be very hard for promising enterprises to raise capital and grow. Thus, stable financial systems, by allocating society's accumulated savings to the most productive available uses, not only provides access to finance, which is essential for economic development, but also plays a key role in managing risk and promoting entrepreneurship.

Finance can be obtained through two channels: directly by issuing securities (shares or bonds) or indirectly through financial intermediaries such as banks and non-bank finance companies. This is depicted below:

Functions of financial systems



Source: European Central Bank

The two channels are mostly complementary. However, depending upon the nature of development of financial systems in a country, one channel may play a greater role than the other. For example, in countries such as the United States or the United Kingdom where financial markets are more developed, direct or market-based finance is more popular. On the other hand, in European countries like France and Germany, banks play a dominant role in the financing of the economy. In India, banks not only are the main source of financing for households and corporates, but also are the main saving vehicle. In the absence of a healthy

financial system, the intermediation process will not happen, and economic development will stutter.

Financial systems, most of the time, performs its role efficiently. However, when they do not, it leads to financial instability and episodes of financial crisis. A financial crisis in itself, if it does not transmit to the real economy, though a cause for concern, is not catastrophic. If the financial system can absorb the shocks and thereby keep the real economy immune from the distortions, it is said to be resilient and is well-functioning. However, there have been many episodes of financial crisis in the modern economy, when the shocks in the financial system spilled over to the real economy resulting in massive unemployment and recession. In particular, banks may stop lending or stop rolling over maturing loans either due to losses in its balance sheet or due to low levels of capital. It could also be due to sudden liquidity crunch as assets in bank's balance sheet are generally long-term and illiquid. In a market-based economy, the lenders may lose trust in the borrower's ability to repay and would not be willing to invest in their securities or provide any short-term finance. As a consequence, financing declines with attendant adverse implications for consumption and investment and ultimately economic growth. The financial literature categorises such an event as Systemic risk – the risk wherein "*the provision of necessary financial products and services by the financial system will be impaired to a point where economic growth and welfare may be materially affected*"⁶¹. A build-up of systemic risk leads to financial instability. Therefore, financial stability is a state whereby the build-up of systemic risk is prevented.

The financial crisis of 2007-09 is a manifestation of systemic risk as many economies fell into recession following the bursting of the housing bubble and failure of large financial institutions. The crisis brought to light several new risks that must be addressed to prevent systemic risk. These include, but not limited to, the build-up of leverage, the complexity of new financial instruments, the opacity of markets and interconnectedness among institutions. Financial intermediation outside the regulatory perimeter, the so-called Shadow Banking, and its linkages with the regulated banking system, was also a major catalyst for the financial crisis.

The build-up of systemic risk has been identified with two dimensions, viz., Time and Cross-sectional dimensions. Therefore, the objective of financial stability should be to address the build-up of systemic risk as also to limit the spill over of the consequences of materialisation of such systemic risk. Spill over of risks arise from interconnectedness of various segments of the financial sectors. One way of limiting the spill over could be to restrict the interconnectedness among the various sectors. However, this will come at a cost of reduced efficiency of the market and substantially enhanced cost of intermediation as well as a high level of inconvenience to the market entities and ultimate consumers of financial services. Therefore, the objective of financial stability should be to identify, monitor and minimise the build-up of systemic risks in financial system and reduce the spill over effects in

⁶¹ European Central Bank

the most efficient and effective way. This involves a fine dovetailing between the objectives of maximum market efficiency, highest consumer protection and minimum systemic risks.

Objectives of financial stability can be achieved by establishing a framework broadly divided under three categories, viz., (1) establishing an institutional and governance structure for financial stability (2) measuring and monitoring systemic risk; and, (3) implementing macroprudential policies to mitigate identified systemic risks.

Institutional and governance structure for financial stability

Post financial crisis of 2007-09, there is recognition of the need to pursue financial stability as an explicit policy objective by many central banks. However, given that the financial system is comprised of several financial intermediaries and market segments, increasingly the responsibility for financial stability is vested with the Government in most of the countries with the central banks playing a pivotal supporting role. In India, the Government set up Financial Stability and Development Council (FSDC) in December 2010 as the apex level forum for strengthening and institutionalizing the mechanism for maintaining financial stability, enhancing inter-regulatory coordination and promoting financial sector development. The Chairman of the Council is the Finance Minister and its members include the heads of financial sector Regulators, viz., Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority of India (IRDAI), Pension Fund Regulatory and Development Authority (PFRDA), Finance Secretary and/or Secretary, Department of Economic Affairs (DEA), Secretary, Department of Financial Services, and Chief Economic Adviser. Later, FSDC was reconstituted in May 2018 to include additional members such as Minister of State responsible for DEA, Secretary of Department of Electronics and Information Technology given the importance of digital transactions and data privacy, Revenue Secretary subsequent of rollout of Goods and Services Tax (GST) and the Chairperson of the Insolvency and Bankruptcy Board of India (IBBI). The Council can invite experts to its meeting if required. Without prejudice to the autonomy of regulators, the Council monitors macro prudential supervision of the economy, including functioning of large financial conglomerates and addresses inter-regulatory coordination and financial sector development issues. It also focuses on financial literacy and financial inclusion.

A sub-committee of the FSDC was formed to assist the FSDC, which replaced the previous High-Level Coordination Committee on Financial Markets. The sub-committee is headed by the Governor, RBI and has representation from all the members of FSDC. In addition, Deputy Governors and an Executive Director from RBI are also members of this sub-committee. The sub-committee meets regularly to review the developments in the macro economy and financial markets to maintain financial stability and monitor macro-prudential regulation in the country.

Maintaining financial stability has been the main objective of the RBI even prior to the crisis. The RBI over the years has been pursuing macroprudential policies, without explicitly labelling them as such, to address systemic risk. The Board for Financial Supervision and the

Board for Payment and Settlement Systems, both committees of the Central Board of Directors, were constituted to aggregate information pertaining to the financial system as a whole and take informed decisions to deal with any signs of instability, both at the individual institution level and at the system level. Prior to the formation of the FSDC, RBI had a record of using time varying LTV ratios to dampen credit growth in commercial and residential real estate segment. In addition, the cross-sectional spillovers of financial markets are contained by imposing a strict exposure limit on equity market participation, tracking of unhedged foreign currency exposures of counterparties as well as directing banks to have an aggregate exposure limit on real estate. Similarly, RBI, during times of foreign exchange pressure has resorted to implementing strict open position limits of banks and has also in co-ordination with capital markets regulator imposed higher margining norms as well as position limits on exchange traded currency derivatives. The lender of last resort facility as well as Central Bank experience in ensuring price and exchange rate stability makes the Central Banks' role in maintaining financial stability even more significant.

The financial crisis of 2007-09 reinforced the importance of financial stability for macroeconomic stability and to strengthen the existing architecture, the RBI set up an operationally independent Financial Stability Unit (FSU) in August 2009. The FSU prepares half-yearly financial stability reports, which reflect the collective assessment of the sub-committee of the FSDC on risks to India's financial stability. The other major functions of the FSU include, but not limited to, conduct of macro-prudential surveillance of the financial system on an ongoing basis, carry out periodic systemic stress tests to assess resilience of the banking system and development of models for assessing financial stability.

Measuring and Monitoring Systemic Risk

Monitoring of systemic risk on an ongoing basis has become a mandate for most of the Central Banks and Financial Sector regulators. These monitoring are done with the help of various tools, such as stress tests at micro and macro level, analysis of interconnectedness among various financial market entities and sectors, use of various indicators such as banking stability indicator, systemic liquidity indicator, credit-GDP growth trends for the whole economy as well as for different economic sectors. In most of the jurisdictions, these indicators and instruments are published in periodic reports called Financial Stability Reports or Financial Stability Reviews.

Implementing policies to mitigate identified systemic risks

Once the systemic risk has been identified, the next task is to implement the policies to mitigate such risks. In many modern economies, the regulation and supervision of financial institutions are distributed among a host of agencies. This made it difficult to coordinate the supervision of the activities of these institutions and share information that could pose risk to the system. Therefore, even though financial stability is one of the key objectives of central banking, the role of Central Bank was limited to provision of liquidity, i.e., lender of last resort. The financial crisis brought to recognition that the policies and tools to deal with financial

stability issues were inadequate. Focus on micro prudential policies, which are aimed at safety of individual institutions, was found to be insufficient and macroprudential policies aimed at safeguarding the stability of the financial system and preventing the build-up of systemic risk gained prominence.

The objectives of macroprudential policies are twofold:

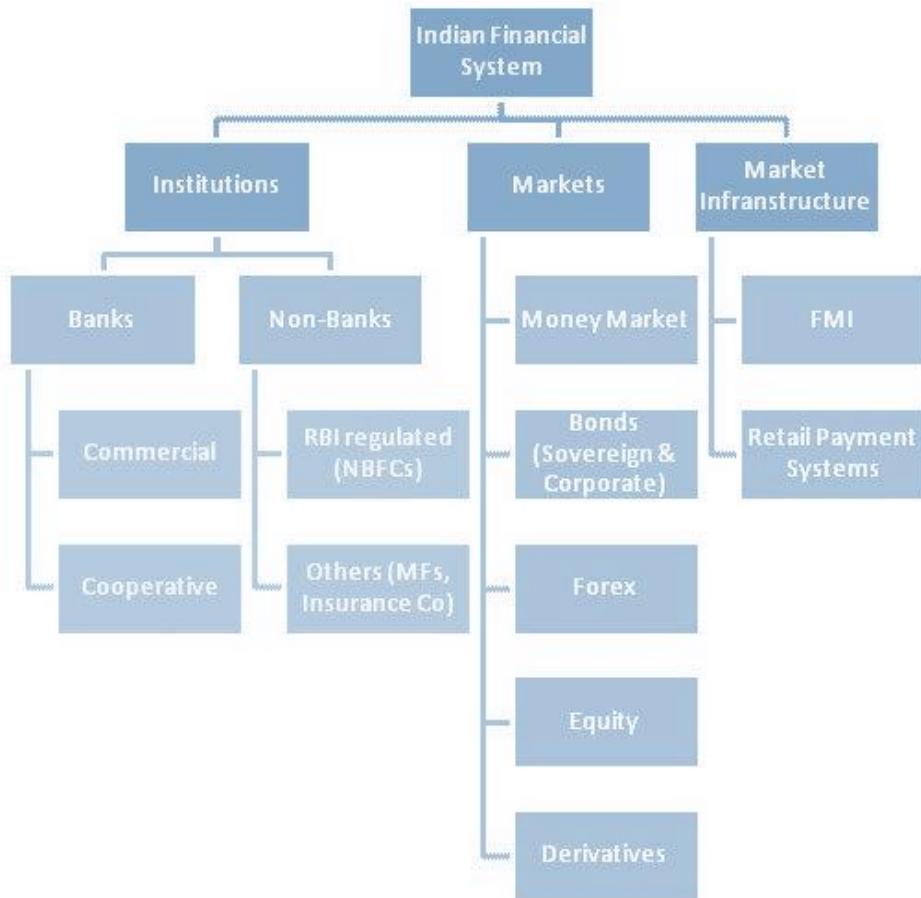
- To mitigate procyclicality, i.e., prevent the excessive build-up of risk through debt and leverage, which amplifies boom and bust cycles (time dimension)
- To improve the resilience of the financial system, i.e., its ability to absorb shocks without major disruptions to the real economy, by limiting contagion (cross-sectional dimension) and targeting systemically important financial institutions (higher capital levels for example)

To achieve the above objectives, many instruments are identified. These instruments sometimes are standalone macroprudential tools or they can be an overlay on the existing micro prudential instrument. To achieve the first objective, i.e., to mitigate procyclicality, leverage ratio (to reduce leverage and thereby curb lending of banks), limiting loan-to-value ratios (home buyers for example must bring in more of their money), dynamic provisioning, higher risk-weights on bank loans, etc., are employed. Similarly, long term institutional investors can be precluded from investing in certain sectors or prescribed not to invest in instruments below a certain credit rating. At the system level, regulators can prescribe some across the sector measures such as countercyclical capital buffer when a pre-decided threshold, say credit to GDP gap, is breached. To enhance the resilience of the financial system, capital buffers (accumulation of capital as precautionary reserves during economic upturns to use them in economic downturns), liquidity buffers (presence of significant high-quality liquid assets in the balance sheet), higher capital requirements for systemically important institutions, stress tests to assess the strength of the balance sheet, etc., are used.

Chapter 6: Overview of the Indian Financial System

Indian financial system comprises of institutions (banks, non-banking financial companies, insurance companies, mutual funds, etc.), financial markets (money market, Government Securities market, foreign exchange market, etc.) and financial market infrastructure ably supported by the legal and institutional framework (Fig.1). A well-functioning financial system supports efficient financial intermediation, bringing savers and borrowers together, facilitates efficient allocation of risk and resources and contributes to overall economic growth.

Figure 1



Rationale for Financial Regulation

The financial system performs several vital functions: intermediating between savers and investors, facilitating payments, risk-sharing, providing liquidity, alleviating information asymmetry between borrowers and lenders, etc. A well-functioning financial system contributes to economic welfare, whereas a dysfunctional or unstable financial system leads to economic hardship. The objective of regulation is to ensure that the financial system performs these vital functions without any adverse impact on the real economy.

The traditional approach of prudential regulation has been to safeguard the stability of individual institutions. In addition to prudential regulation, regulations aimed at consumer protection are also in place. Regulations, which examine how individual institutions respond

to exogenous shocks and ensure their soundness are called micro prudential regulations. The focus of regulation has taken a macroprudential character in the aftermath of the global financial crisis, as it showed that the existing regulatory architecture was inadequate to deal with the build-up of systemic risk where the financial system as a whole was impaired and was not in a position to perform intermediation. The current approach therefore is to use a combination of both micro prudential and macroprudential regulations to make the financial system resilient and maintain financial stability.

Regulatory and Supervisory structure in India

The regulation and supervision of the financial system in India is carried out by different regulatory and supervisory authorities. The regulatory role of Reserve Bank covers commercial banks, co-operative banks and certain categories of Non-Banking Financial Companies (NBFCs) registered with it. The Ministry of Corporate Affairs (MCA) regulates other financial companies registered with it. Further, the Finance (No.2) Act, 2019 (23 of 2019) has amended the National Housing Bank Act, 1987 that conferred certain powers for regulation of Housing Finance Companies (HFCs) with Reserve Bank. In respect of co-operative sector, there exists a system of dual regulation, wherein the Registrar of Co-operative Societies (RCS) of the respective States in respect of Single State Co-operative Banks and the Central Registrar of Co-operative Societies (CRCS) in respect of Multi-State Co-operative Banks jointly regulates these entities with Reserve Bank. While Reserve Bank is concerned with the banking function of the co-operative banks, the management control rests with the RCS/CRCS. This dual control impacts both the regulation and supervision of the co-operative banks. The Insurance Regulatory and Development Authority of India (IRDAI) regulates the insurance sector and the capital market, credit rating agencies, etc., are regulated by Securities and Exchange Board of India (SEBI).

The supervisory role of the Reserve Bank covers commercial banks, urban co-operative banks (UCBs), some Financial Institutions (FIs) and Non-Banking Financial Companies (NBFCs) registered with it. The Regional Rural Banks (RRBs), State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs) are supervised by National Bank for Agriculture and Rural Development (NABARD), while the Housing Finance Companies (HFCs) are supervised by National Housing Bank (NHB).

In addition to regulating and supervising financial institutions, RBI also regulates certain segments of the financial markets and the financial market infrastructure which would be discussed in the subsequent chapters.

Reorganisation of Regulation and Supervision Departments of RBI

The Central Board of the Reserve Bank of India had in its meeting on May 21, 2019, approved the creation of the separate supervisory and regulatory cadre. This decision was taken with a view to having a holistic approach to supervision and regulation of the regulated entities to address growing complexities, size and inter-connectedness as also to deal more effectively with potential systemic risk that could arise due to possible supervisory arbitrage

and information asymmetry. Accordingly, the RBI decided to integrate the supervision function into a unified Department of Supervision and regulatory functions into a unified Department of Regulation with effect from November 01, 2019.

Prior to that, the supervision of financial sector entities was undertaken through three separate departments, viz., Department of Banking Supervision, Department of Non-Banking Supervision and Department of Co-operative Bank Supervision. Similarly, the regulatory functions relating to financial sector entities were carried out through three separate departments, viz., Department of Banking Regulation, Department of Non-Banking Regulation and Department of Cooperative Banking Regulation.

This restructuring will:

- i. make supervisory and regulatory process more activity based rather than being segmented purely based on the organizational structure of regulated entities;
- ii. bestow graded supervisory approach to all the RBI supervised entities linked to their size and complexity;
- iii. facilitate more effective consolidated supervision of financial conglomerates among the RBI supervised entities;
- iv. result in more efficient allocation of human resources attending to regulation and supervision of financial sector entities under the Bank's purview; and
- v. help build an experienced and skilled human resources in regulation and supervision of financial sector entities.

Chapter 7: Regulation of Commercial Banks

The prime rationale for bank regulation can be traced to the special role that banks play in an economy. The core act of banking – acceptance of deposits which are withdrawable on demand and using such funds for lending and investing – helps the economic growth by mobilising savings and encouraging investment and consumption. In the discharge of their role of financial intermediaries, banks perform transformation functions – of size, risk, liquidity and maturity, which expose them to significant risks. As liquidity and maturity transformers, banks fund long term illiquid assets (mortgages, for example) using short term and liquid instruments such as demand deposits. The resultant asset-liability mismatch, while being central to banking business, makes banks fragile by design. Inability, or even the perceived inability, to refund the deposits on demand could lead to erosion of public confidence resulting in a ‘run’, which can bring down any bank. The mechanisms put in place to repose public confidence in the banking system - depositor insurance and provision of liquidity support by the Central Bank - could themselves lead to other regulatory concerns such as moral hazard. Considering these risks faced by banks, a well-designed regulatory framework is a sine qua non for ensuring the safety and well-functioning of the banking system.

Banks are highly leveraged institutions as they mobilise huge quantum of deposits and borrowings against a relatively very low quantum of their own equity capital. Since banks build-up huge leverage using depositors’ funds, protection of depositors’ interests becomes one of the central reasons for bank regulation. Unsophisticated depositors of banks may not be able to monitor banks effectively due to asymmetric information. Asymmetric information arises when one party to the economic transaction has greater material information than the other party. Even if a depositor could assess the current value of a bank’s assets *vis-à-vis* its liabilities, the condition could change as the banking business is dynamic with banks continuously altering their asset holdings and taking on new depositors and creditors. For a developing economy like India, there is also much less tolerance for downside risk among depositors many of whom place their life savings with the banks. Hence, from a moral, social, political and humane angle, it is imperative that the banking system is well regulated.

The central role banks occupy in the financial system in facilitation of payment and settlement services and in the transmission of monetary policy also make the stability of banking system an uncompromising objective of regulators. Banking crises can adversely impact the economy by disrupting the payment and settlement systems and making monetary policy transmission less effective, thus resulting in huge social costs in terms of output losses and unemployment.

All the above reasons call for a well-designed banking regulation.

What Regulation does not intend to accomplish

While the depositor protection, systemic stability and fostering of competition, etc., are goals of regulation, there are several aspects that banking regulation is not intended to

accomplish⁶². Firstly, preventing the failure of individual banks is not the primary focus of banking regulation, subject to the condition that depositors are protected, financial stability is not affected, and adequate banking services are maintained. Secondly, banking regulation should not substitute banker's commercial decisions about its operations. Finally, banking regulation should not favour certain groups over others. Banks also should not be protected from competition from other institutions.

Legal framework for banking regulation

Prior to the enactment of the Banking Regulation Act, 1949, the provisions of law relating to banking companies were contained in the Indian Companies Act. Company law was introduced in India with the Companies Act 43 of 1850, which was based on the English Companies Act, 1844. When the Reserve Bank of India Act, 1934 came into effect, an important function of the Reserve Bank was to hold the custody of the cash reserves of banks, granting them accommodation in a discretionary way and regulating their operations in accordance with the needs of the economy through instruments of credit control. With regard to the banking system of the country, the primary role of the Reserve Bank was conceived as that of the lender-of-last-resort for the purpose of ensuring the liquidity of the short-term assets of banks. The Banking Regulation (BR) Act was passed on February 17, 1949, which comprehensively deals with several aspects of the banks ranging from setting up of a bank to amalgamation besides several operational issues.

In addition, the functioning of banks is also covered under various statutes, depending on their category, e.g., SBI Act 1955, Banking Companies (ATU) Act 1970 and 1980, RRB Act 1976. Further in 1965, Section 56 was inserted in Banking Regulation Act to regulate functioning of Co-operative banks.

Evolution of Banking Regulation in India

As functions of the Reserve Bank evolved over the years, the regulatory and supervisory approaches were modified as and when deemed necessary. In tune with the developments that have taken place from time to time in the Indian economy in general and the banking system in particular, the objectives and approaches of regulation and supervision have also changed, while retaining the basic purpose of maintaining the soundness and stability of the banking system. The focus of the Reserve Bank's role as a regulator and supervisor has shifted gradually from micro regulation of banks' day to day activities with a view to ensuring that the regulations are adhered to in an environment where banks' management are given freedom to take commercial decisions based on their own judgment.

As the Indian banking system gradually started acquiring global character in recent years, the regulation and supervision have focused on preventing systemic instability, fostering competition and improving market practices. While the fundamental objective of regulation and supervision continued to be "maintaining the soundness and stability of the

⁶² Report on Currency and Finance (Chapter X), Reserve Bank of India Sep 4, 2008 under Para 10.11 of Chapter X. Regulatory And Supervisory Challenges in Banking.

financial system" all along, regulation and supervision has simultaneously focused on other objectives such as transparency of balance sheet, protection of depositor interest, meeting social needs and improving the efficiency, reducing information asymmetries and preventing money-laundering activities. In sum, with constant changes in the domestic and external financial environment, the Reserve Bank responded appropriately from time to time, and in a proactive manner, by fine tuning the focus of its regulatory and supervisory function as the situation evolved.

Indian Banking System

Commercial Banks

The commercial banking sector in India is quite diverse. Based on the ownership pattern, banks can be broadly categorised into public sector banks, private sector banks and foreign banks. While the State Bank of India, nationalised banks and Regional Rural Banks (RRBs) are constituted under respective enactments of the Parliament, the private sector banks and foreign banks are considered as banking companies as defined in the Banking Regulation Act, 1949. Till 2015, only universal banking licenses were being issued. However, since 2015, licenses for differentiated banks (niche banks) are also being issued alongside licenses for universal banks.

Regional Rural Banks

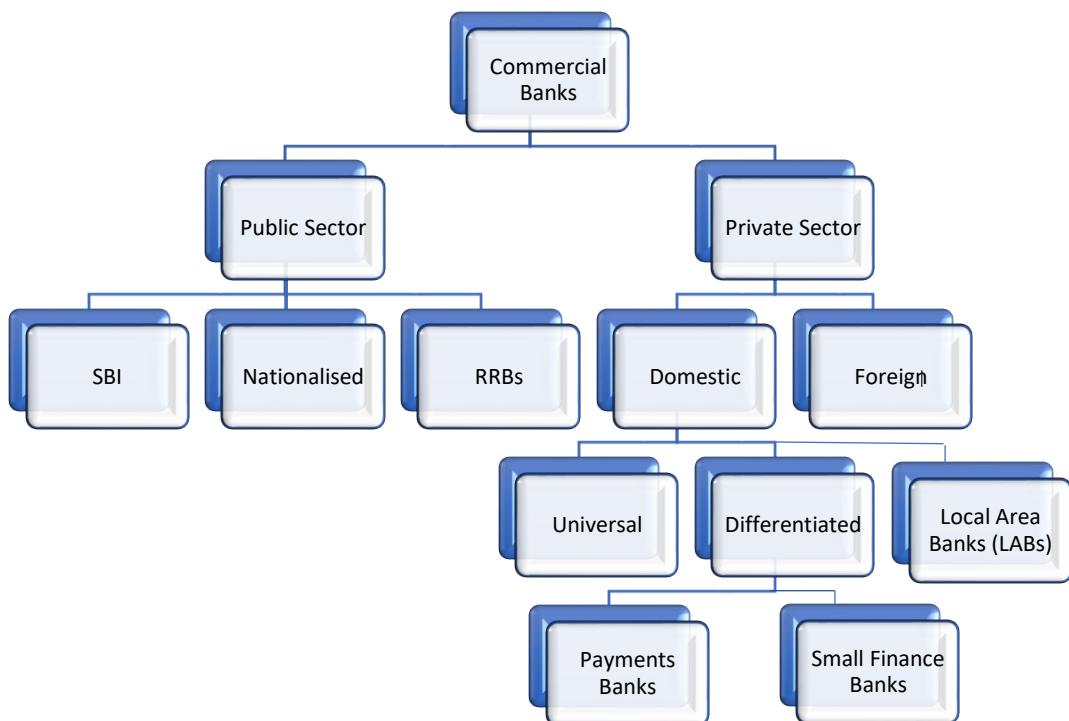
Regional Rural Banks (RRBs) were setup with a view to developing the rural economy by providing credit and other facilities, particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs. Being local level institutions, RRBs together with commercial and co-operative banks, were assigned a critical role to play in the delivery of agriculture and rural credit. The equity of the RRBs was contributed by the Central Government, State Government concerned and the sponsor bank in the proportion of 50:15:35. The function of financial regulation over RRBs is exercised by Reserve Bank and the supervisory powers have been vested with NABARD.

Local Area Banks

Local Area Banks (LABs) were conceived as low-cost structures and for providing efficient and competitive financial intermediation services in their areas of operation in the rural and semi-urban areas. The Scheme envisaged a Local Area Bank with a minimum capital of INR 5 Crore and an area of operation comprising three contiguous districts. Further, to provide LABs an opportunity to grow, in December 2012, they were permitted to expand their area of operation to two more districts.

Foreign Banks

Foreign banks are permitted to operate in India either as branches or Wholly Owned Subsidiaries (WOS). Permission for opening of branches by foreign banks in India is guided by India's commitment to WTO.



Salient banking regulations

Given the special risks faced by banks and, at the same time, the deleterious impact their failure has on the economy, it is imperative that the banking regulation is comprehensive and robust. The banking regulation seeks to regulate the entire gamut of bank's functions starting from their inception to winding up. Broadly the banking regulation strategies relate to ex-ante strategies such as entry regulations, activity regulations, prudential regulations, governance regulations, conduct regulations and information regulations and ex-post regulations such as resolution policies.

Bank licensing

For commencing banking operations in India, whether by an Indian or a foreign bank, a licence from the Reserve Bank is required. The Banking Regulation Act, 1949 provides that a company intending to carry on banking business must obtain a license from RBI except such of the banks (public sector banks and RRBs), which are established under specific enactments. The RBI issues licence only after 'tests of entry' are fulfilled.

The minimum statutory requirements for setting up new banks in India are stipulated in the Banking Regulation Act, 1949. Ownership in private banks is also regulated in terms of threshold limits and 'lock in' period with a view to address conflicts of interest and for ensuring more diversified ownership.

In the past, bank licenses for setting up universal banks were given on a 'Stop and Go' basis. Accordingly, 10 licenses were issued based on Guidelines on Entry of New Private Sector banks issued in 1993 and 2 licences were issued each based on licensing guidelines issued in 2001 and 2013. The licensing policy was reviewed and has been replaced with a 'continuous

authorisation' policy in 2016, with a view to increasing the level of competition and bringing new ideas into the system. Accordingly, a framework for 'on tap' licensing was established.

With a view to furthering the cause of financial inclusion using the functional building blocks of payments, deposits and credits, guidelines for licensing of small finance banks and payments banks were issued in 2014. The objectives of setting up of payments banks are to further financial inclusion by providing (i) small savings accounts and (ii) payments/remittance services to migrant labour workforce, low income households, small businesses, unorganised sector entities and other users. The objectives of setting up of small finance banks are to further financial inclusion by (i) provision of savings vehicles, and (ii) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities, through high technology-low cost operations. Accordingly, ten licences were issued to small finance banks and seven licences were issued to payments banks. After a review of the performance of the existing small finance banks and to encourage competition, licensing of these banks was made 'on-tap' in 2019.

Branch Expansion - Opening of new place of business (banking outlets)

The opening of new place of business and shifting of existing places of business of banks is governed by the provisions of the Banking Regulation Act, 1949. In terms of these provisions, banks cannot, without the prior approval of the Reserve Bank of India (RBI), open a new place of business in India or abroad or change, otherwise than within the same city, town or village, the location of the existing place of business. However, to cater to the financial needs of a larger number of underprivileged and unbanked population, RBI liberalised the branch licensing norms wherein all domestic commercial banks (other than RRBs, Local Area Banks and Payments Banks) are permitted to open, unless otherwise specifically restricted, Banking Outlets⁶³ in Tier 1 to Tier 6 centres without having the need to take permission from RBI in each case. Domestic commercial banks have been advised to open at least 25% of such 'banking outlets' in unbanked rural centres.

Maintenance of Statutory Reserves

Commercial banks are required to maintain a certain portion of their Net Demand and Time Liabilities (NDTL) in the form of cash with the Reserve Bank, called Cash Reserve Ratio (CRR). In addition to the cash reserves, every bank shall also maintain assets in India, the value of which shall not be less than the prescribed percentage of its NDTL in the form of investment in unencumbered approved securities, Cash, Gold and any other instrument notified by RBI. This is called Statutory Liquidity Ratio (SLR).

⁶³A Banking outlet is a fixed-point service delivery unit, manned by either bank's staff or its Business Correspondent where services of acceptance of deposits, encashment of cheques/ cash withdrawal or lending of money are provided for a minimum of 4 hours per day for at least five days a week. For more details refer to

<https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI3062319C9C94C33494794C2B5271CF92878.PDF>.

Prudential Norms

Prudential norms are the guidelines issued by the banking regulator to ensure safety and soundness of banks. Prominent prudential norms relate to Income Recognition and Asset Classification, Capital Adequacy, Exposures, etc.

- Income Recognition and Asset Classification and Provisioning (IRAC) Norms- Asset Quality: In the course of their business, banks lend and invest in various classes of assets, some of which may turn non-performing either due to the systemic factors such as economic downturn or idiosyncratic factors specific to the borrower. Banks are required to objectively identify such stressed assets and take corrective action. In line with the international norms in this regard, Reserve Bank issued prudential guidelines on Income Recognition, Asset Classification and Provisioning to ensure greater consistency and transparency in the financial statements of banks.

In line with the international guidelines in this regard, Indian banks are required to classify assets as non-performing once they cease to generate income for the bank. Illustratively, if the interest and/or instalment of principal of a term loan remains overdue for a period of 90 days, the banks are required to classify them as non-performing loans. Banks are required not to recognise income on such assets on accrual basis and are also required to make provisions out of their profits as a portion of such non-performing assets. The classification of non-performing assets is graded based on the age of the non-performing assets and provisions are prescribed depending upon the availability of security, with higher provisioning requirements for higher grades of NPAs.

- Basel guidelines on Capital and Liquidity: Bank's capital (common equity and other permitted classes of capital) acts as loss absorbing buffer protecting depositors in the event of losses faced by the bank. Further, capital also limits leverage of the bank, ensuring its safety. Under the Basel Capital Adequacy framework, banks' capital requirements have been linked to the risk profile of their asset classes, requiring riskier banks to keep larger buffers. The Basel framework evolved over a period since the introduction of Basel I framework in 1988, which required the banks to hold capital as a percentage of their credit risk exposures. Gradually the framework was expanded to include other risks on the banks' balance sheet such as market risk and operational risk. The comprehensive Basel II guidelines issued in 2006 provided banks with a flexibility to assess risks using their internal models in addition to the standardised models.

- The global financial crisis which witnessed the failure of well capitalised banks, triggered an overhaul of the capital framework and led to the introduction of Basel III. It addresses shortcomings of the pre-crisis regulatory framework and provides a regulatory foundation for a resilient banking system that supports the real economy. It seeks to increase the quantity and quality of capital, enhance the risk coverage and introduce macro prudential elements such as leverage ratio, countercyclical capital buffers and liquidity ratios (Liquidity Coverage Ratio and Net Stable Funding Ratio). While LCR has already been implemented in

India, the implementation of NSFR was scheduled to be adopted from April 1, 2020 but has been differed briefly.

- Exposure Norms: A bank's exposures to its counterparties may result in concentration of its assets to a single counterparty or a group of connected counterparties. As a prudential measure aimed at better risk management and avoidance of concentration of credit risks, the Reserve Bank of India has fixed limits on bank's exposures to an individual business concern and to business concerns of a group. Apart from limiting the exposures to a single or a Group of borrowers, banks have also been advised to consider fixing internal limits for aggregate commitments to specific industry or sectors, so that the exposures are evenly spread over various sectors. In addition, banks are also required to observe certain statutory limits on shareholdings in companies and other regulatory exposure limits in respect of capital market exposures and intra-group exposures.

- Investment Guidelines: Banks can invest in a variety of instruments such as government securities, other approved securities, shares, debentures and bonds, subsidiaries/joint ventures and other instruments like commercial paper and mutual fund units, among others. The Reserve Bank of India issues guidelines for the investment portfolio of the banks, keeping in view the developments in the financial markets and taking into consideration the evolving international practices. Banks are required to follow the prudential norms for the classification, valuation and operation of investment portfolios as laid down by the Reserve Bank from time to time. In terms of these guidelines, the entire investment portfolio of the banks should be classified under three categories, viz, Held to Maturity (HTM), Available for Sale (AFS) and Held for Trading (HFT). The guidelines stipulate the norms relating to initial recognition, valuation, transfer among categories, etc.

- Resolution of Stressed Assets: Swift, time-bound resolution of stressed assets is critical for de-clogging bank balance sheets and for efficient reallocation of capital. The Banking Regulation (Amendment) Act, 2017, and the subsequent authorisation given by the Government of India therein, empowered the Reserve Bank to issue directions to the banks for resolution of stressed assets, including referring assets to the Insolvency and Bankruptcy Code 2016 (IBC). The action taken by the Reserve Bank under the said provisions and issuance of the Prudential Framework for Resolution of Stressed Assets on June 7, 2019 reflect a paradigm shift in the regulatory approach towards resolution of stressed assets in India. The Framework is aimed at ensuring early resolution of stressed assets in a transparent and time-bound manner, with collective action clauses, so that maximum value could be realised by the lenders while also recognising the potential going concern value of stressed assets. Unlike previous schemes for restructuring, complete discretion and flexibility has been given to banks to formulate their own ground rules in dealing with borrowers who have exposures with multiple banks. The lenders can implement resolution plans that are tailored to their internal policies and risk appetites.

Risk Management

Banks in the process of financial intermediation are confronted with various kinds of financial and non-financial risks, viz., credit, interest rate, foreign exchange rate, liquidity, equity price, commodity price, legal, regulatory, reputational, operational, etc. These risks are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. Reserve Bank issues guidelines from time to time to banks to ensure that the banks' management gives considerable importance to improve the ability to identify, measure, monitor and control the overall level of risks undertaken. The guidelines relate to aspects such as banks' risk management structure, mechanism to assess and manage various risks, risk aggregation and capital allocation.

Further, banks are also required to operationalise formal stress testing framework to help them in building a sound and forward-looking risk management framework. Banks are required to assess their resilience to withstand shocks of all levels of severity indicated by the regulator, and should be able to survive, at least the baseline shocks.

Regulation of Interest Rates

The interest rates on deposits have been progressively deregulated providing banks greater flexibility in resource mobilisation. However, keeping the customer service under consideration, the deposit rates are required to be uniform across all branches and for all customers and no discrimination is permitted in the matter of interest paid on the deposits, between one deposit and another of similar amount and tenor, accepted on the same date, at any of its offices by the banks. Banks can allow higher interest in respect of deposits of senior citizens, and additional interest in respect of deposits of bank's own staff and executives, including retired staff (subject to conditions) and associations of staff (except associations of retired staff). Further, the interest rates offered are required to be reasonable, consistent, transparent and available for supervisory review/scrutiny as and when required. In respect of interest rates on advances, while banks have been provided flexibility to offer all categories of advances on fixed or floating interest rates, the regulations require that such rates are fair and transparent and are determined on the basis of an internal or external benchmark rate. The banks have been mandated to link all new floating rate personal or retail loans and floating rate loans extended to MSMEs to external benchmarks such as Repo Rate, Treasury Bill Rate, etc. Banks can offer such external benchmark linked loans to other types of borrowers as well. External benchmarks, being publicly known, ensure greater transparency in determination of interest rates. To avert the delays in transmission of monetary policy, banks have been advised to reset the interest rates under external benchmark system at least once in three months. In order to ensure transparency, standardisation, and ease of understanding of loan products by borrowers, banks have been advised to adopt a uniform external benchmark within a loan category; in other words, adoption of multiple benchmarks by the same bank is not allowed within a loan category.

Know Your Customer Norms

Sound 'Know Your Customer' (KYC) policies and procedures are critical for protecting the safety and soundness of banks and the integrity of banking system in the country. To prevent money laundering through the banking system, the Reserve Bank has issued 'Know Your Customer' (KYC), Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT) guidelines. These instructions are based on the provisions of Prevention of Money Laundering (PML) Act, 2002 and Prevention of Money Laundering (Maintenance of Records) Rules, 2005. The Reserve Bank's regulatory stance on KYC is with the aim to safeguard banks from being used by criminal elements for money laundering activities and to enable banks to understand the risk posed by customers, products and services, delivery channels and helping them assess and manage their risks prudently. Banks are required to carry out KYC exercise for all their customers to establish their identity and report suspicious transactions to the Financial Intelligence Unit.

Corporate Governance

Corporate Governance is the key to protecting the interests of all the stakeholders and the need for good corporate governance has been gaining increased emphasis over the years. Banking regulation in India shifted from prescriptive mode to prudential mode in 1990s, which implied a shift in balance away from regulation and towards corporate governance. Banks are accorded greater freedom and flexibility to draw up their own business plans and implementation strategies consistent with their comparative advantage. This freedom necessitated tighter governance standards requiring bank boards to assume the primary responsibility and the directors to be more knowledgeable and exercise informed judgement on various strategies and policy choices. With a view to strengthening corporate governance, over a period of time, various guidelines have been issued in matters relating to the role to be played by the Board, fit and proper criteria for the directors of banks in general and for elected directors of Public Sector Banks in particular, calendar of reviews to be undertaken by the Board, broadening the fields of specialisation for directors against the backdrop of innovations in banking and technology, qualifications and experience for Chief Financial Officer and Chief Technology Officer, bifurcation of the post of Chairman and Managing Director (CMD), etc. Further, with an objective to better align the compensation policy with evolving international best practices over the past few years, and for an objective assessment of remuneration sought by the banks for their whole-time directors, the guidelines related to compensation have been revised.

Disclosure Norms

Public disclosure of relevant information is an important tool for enforcing market discipline. Hence, over the years, the Reserve Bank has strengthened the disclosure norms for banks. Banks are now required to make disclosures in their annual report, among others, about capital adequacy, asset quality, liquidity, earnings and penalties, if any, imposed on them by the regulator, etc.

Deposit Insurance

Deposit Insurance protects depositors against the loss of their deposits in case a deposit institution is not able to meet its obligation to the insured depositors. All commercial banks, including the branches of foreign banks functioning in India, local area banks and regional rural banks are covered under the Deposit Insurance Scheme.

Under the Scheme the insurance cover is limited to ₹5,00,000/- per depositor for deposits held in ‘the same capacity and in the same right’ at all the branches of the bank taken together. The premium paid by the insured banks to the DICGC is required to be borne by the banks themselves and not passed on to the depositors.

Para banking Activities

Deregulation of the banking sector and the development of the financial sector encouraged many banks to undertake non-traditional banking activities, also known as para-banking. The Reserve Bank has permitted banks to undertake diversified activities, such as, mutual funds business, insurance business, merchant banking activities, factoring services, card business, pension fund management, investment advisory services, agency business, membership of SEBI approved stock exchanges, etc. While some of the activities are permitted to be undertaken departmentally, some other activities are to be undertaken through subsidiary/Joint Venture route by way of equity participation in line with Prudential regulations for banks’ investments. Banks are also permitted to invest in equity/unit capital of financial/non-financial companies, Alternative Investment Funds and Real Estate Investment Trust/Infrastructure Investment Trust in line with the Prudential regulations for banks’ investments.

Regulation of All India Financial Institutions

All India Financial institutions (AIFIs) are an important part of the Indian financial system as they provide medium to long term finance to different sectors of the economy, through refinance and direct lending. These institutions have been set up to meet the growing demands of particular segments, such as, export, rural and agricultural sector, housing and small-scale industries, and have been playing a crucial role in channelizing credit to these sectors and addressing the challenges / issues faced by them.

The four AIFIs, viz. Export-Import (EXIM) Bank of India, National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI) are under regulation and supervision of the Reserve Bank. These AIFIs have been constituted under their own statutes which, along with the provisions of the Reserve Bank of India Act, 1934, provide the legal framework for their regulation. As in the case of commercial banks, prudential norms relating to income recognition, asset classification and provisioning, exposures, investments, capital adequacy and disclosures are applicable to the AIFIs as well. AIFIs are also subject to on-site inspection and off-site surveillance.

Credit Information Companies

Credit reporting addresses a fundamental problem of credit markets: asymmetric information between borrowers and lenders, which may lead to adverse selection, credit rationing and moral hazard problems. Credit reporting system consists of the institutions, individuals, statutes, procedures, standards and technology that enable information flows relevant to making decision relating to credit and loan agreements.

Credit Reporting System in India currently consists of four credit Information companies (CICs) viz., TransUnion CIBIL limited, Experian Credit Information Company of India Private Ltd, Equifax Credit Information Services Private Limited and CRIF High Mark Credit Information Services Pvt. Ltd. and credit institutions – Banks, All India Financial Institutions, NBFCs, Housing Finance companies, State Financial Corporations, Credit Card Companies etc., are governed by the provisions of Credit Information Companies (Regulation) Act, 2005, Credit Information Companies Rules 2006 and Credit Information Companies Regulation, 2006.

The credit information reports (CIR) of borrowers can be obtained from the CICs by specified users listed under CIC regulations which include credit institutions, telecom companies, other regulators, insurance companies, stockbrokers, credit rating agencies, resolution professionals, etc.

Credit Institutions have been advised to include CIR from at least one CIC as one of the inputs for credit appraisal. CICs also offer value added products like credit scores. Individual borrowers can also obtain credit report from CICs. RBI has directed CICs to furnish Free Full Credit Report (FFCR) which includes credit score to individual borrowers once in a calendar year.

Chapter 8: Supervision of Commercial Banks

Commercial Banking Supervision – Concepts and Evolution

Supervision, in simple terms, is the enforcement of rules and regulations that are formulated by the regulator to govern the behaviour of regulated institutions and at the same time spot loopholes or grey areas where regulatory reinforcement may be due. RBI undertakes supervision of the commercial banks located in India as well as branches of Indian banks located outside India under various provisions of the Banking Regulation Act, 1949. The Department of Supervision (DoS) is responsible for supervision of all RBI regulated entities, viz., commercial banks, non-banking finance companies, urban co-operative banks, small-finance banks and payments banks.

One of the fundamental questions that arise is how supervision is different from regulation. In common parlance they are often used interchangeably as they serve the same objective – protecting the interest of the depositors and preserving financial stability. However, there is a difference between the two functions. ‘Regulation’ is synonymous with laying down the rules and norms for doing business by all the market players and, therefore, is uniformly applicable to all market participants. ‘Supervision’, on the other hand, is the process through which the rules and norms are enforced at individual entity level. Thus, while regulation is applicable to the system as a whole, supervision is entity-specific, with the intensity of supervision being proportional to the perceived risk levels⁶⁴.

The rationale for supervision of banks is identical to that of regulation of these entities. The overarching objective of preserving financial stability by promoting a resilient banking system is the foundation for effective supervision. Notably, banks occupy a pre-eminent place in the financial system and spur economic activity by undertaking maturity and liquidity transformation and supporting the critical payment systems. However, the business of banking has several attributes (leverage, asset-liability mismatch, etc.), which have the potential to generate instability. Moreover, banks also enjoy backing from Government/Regulator in terms of liquidity support and depositor guarantee. This in turn can potentially lead to moral hazard issues, such as excessive risk taking and consequent impairment of balance sheet. From a systemic perspective, failure of banks can cause immense damage to the real economy as an impaired banking system cannot perform the essential function of financial intermediation between savers and borrowers. Therefore, effective supervision of banks is essential to ensure that banks adhere to the rules and regulations in letter and in spirit as well as their risk culture and risk governance does not pose threat to its solvency.

Until the early 1990s, supervision function was serving as an adjunct to the existing regulatory framework that primarily focused on licensing, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset

⁶⁴ Strengthening the Banking Supervision through Risk Based Approach: Laying the Stepping Stones, Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India, May, 2013

requirements. The evolution of Basel accord in 1988 and the economic liberalization post the 1991 balance of payment crisis, which resulted in banking sector reforms, lead to a shift in supervisory approach. Supervision shifted from intrusive micro-level intervention to a more broad-based approach that reflected the prudential nature of regulation, deregulation of interest rates, and private ownership of banks. The adoption of Basel standards realigned the supervisory and regulatory practices to international best practices. However, this was and is done in a phased manner taking into consideration the stage of development of Indian financial system and overall economic condition. Over the years, many expert groups were formed to review the processes and practices to improve the supervisory approach. The important ones include, but not limited to, Working Group to Review the System of On-site Supervision of Banks (Chairman: S. Padmanabhan, 1995), Working Group on Consolidated Accounting and Other Quantitative Methods to Facilitate Consolidated Supervision (Chairman: Vipin Malik, 2001), Working Group on Monitoring of Systemically Important Financial Intermediaries (Financial Conglomerates) (Convener: Smt. Shyamala Gopinath, 2004), and the High Level Steering Committee for Review of Supervisory Processes for Commercial Banks (Chairman: K C Chakrabarty, 2012).

The Basel Committee on Banking Supervision (BCBS) has identified Core Principles for Effective Banking Supervision originally published in September 1997. This has been used as a benchmark by many countries, including India, for assessing the quality of their supervisory systems and for identifying future work to be done. Since 1997, however, significant changes have taken place in banking regulation and supervision, necessitating a review of these principles. The latest such revision was carried out in September 2012 and there are currently 29 core principles covering supervisory powers and responsibilities, supervisory expectations of banks, emphasising the importance of good corporate governance and risk management, as well as compliance with supervisory standards.

What are the attributes of good supervision? An IMF Staff Position note titled “The Making of Good Supervision: Learning to Say ‘No’”, provides some insight. It identifies five key attributes that are essential for a good supervisory framework. First, Good supervision is intrusive, i.e., the supervisor should have a thorough understanding of the supervised entity’s business model, its risk culture and governance structure. A hands-off approach is not advisable when it comes to bank supervision. Second, Good supervision is sceptical but proactive. Supervisors should not take things for granted and question bank’s actions even in good times. Third, Good supervision is comprehensive. Supervision should not be restricted to only the bank and its core activities. It should encompass subsidiaries, off-balance sheet vehicles or structures, etc. Often the risk may emanate from the periphery rather than from the core and the supervisor must be vigilant. Fourth, Good supervision is adaptive. Given the high level of innovation in financial industry, the supervisors should continuously upgrade their skills to stay in touch to identify emerging risks. Finally, Good supervision is conclusive. Supervisors must follow-through and ensure that supervisory findings are taken to a logical conclusion. In order to bring about good supervision, according to the IMF note, two

supporting pillars are necessary: the ability to act and the will to act. The ability to act is dependent on the legal authority, the necessary resources, clear strategy, a robust internal setup and effective working relationship with other regulators and supervisors. The will to act is judged in terms of having a clear and unambiguous mandate, operational independence, accountability, skilled staff, healthy relationship with the industry, and an effective partnership with boards of directors.

Legal and Institutional Structure in RBI

RBI has been entrusted with the responsibility of supervising the Indian banking system under various provisions of the Banking Regulation Act (BR Act), 1949 and RBI Act, 1934. In particular, the inspection of banks under section 35 of B.R. Act is undertaken as a follow up of the bank licensing regulation and objectives as laid down in Section 22 of the Act. The substantive objective of the statutory inspections is to verify whether the conditions subject to which the bank has been issued license to undertake banking business [vide sub-section 3, and for foreign banks also 3A of Sec.22] continue to be fulfilled by them.

RBI set up the Board for Financial Supervision (BFS), a sub-committee of the Central Board of RBI, in November 1994, with the objective of dedicated and integrated supervision of all credit institutions, i.e., banks, development financial institutions and non-banking financial companies. The BFS is the responsible for Consolidated Supervision of the financial sector under the jurisdiction of RBI (scheduled commercial banks and urban co-operative banks, financial institutions and non-banking finance companies). The Governor, RBI is the Chairman of the BFS, and the Deputy Governor in charge of banking supervision, is nominated as the Vice Chairman. The other deputy governors of the Reserve Bank are ex-officio members and four external directors from the Central Board of the RBI are co-opted as members for a term of two years. DoS acts as the Secretariat of the BFS, which normally meets once every month to deliberate various supervisory issues and approve the rating of banks.

Prior to 1993, the Department of Banking Operations & Development (DBOD) was responsible for the supervision and regulation of commercial banks. In December 1993, the Department of Supervision (DoS) was carved out of the DBOD, with the objective of segregating the supervisory role from the regulatory functions of RBI. As the financial system developed and complexity grew, it was felt that dedicated and focused supervision of different financial entities was the need of the hour. Accordingly, DoS was split into Department of Banking Supervision (DBS), Department of Non-Banking Supervision (DNBS) and Department of Co-operative Bank Supervision (DCBS). The latter two were created for supervision of non-banking finance companies and urban co-operative banks.

In November 2019, with a view to having a holistic approach to supervision and regulation of the regulated entities so as to address growing complexities, size and interconnectedness as also to deal more effectively with potential systemic risk that could arise due to possible supervisory arbitrage and information asymmetry, it was decided to integrate the supervision function into a unified Department of Supervision (DoS). This restructuring is

aimed at adopting a graded supervisory approach to all the RBI supervised entities linked to their size and complexity; to facilitate more effective consolidated supervision of financial conglomerates among the RBI supervised entities; and to help build experienced and skilled human resources that also results in its efficient allocation. Furthermore, to train, develop, and improve the skills of personnel in the supervisory departments, a ‘College of Supervisors’ was set up. The ‘College of Supervisors’ will provide extensive training to the officers on a wide array of subjects and functions related to supervision of all regulated entities.

Approach / Models used for Supervision

It is well acknowledged that there is no single optimal structure or process for supervising banks. Accordingly, supervisory approach adopted by a country is a function of stage of development of its financial system and size and complexity of the banking system. Some of the other factors, which influence the supervisory approach include, but not limited to, the business models of banks and the availability of technological and human resources for conducting supervision. The Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision (BCBS) provides the broad framework for supervision. Principle 8 states that “*An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.*”

Prior to the global financial crisis, in most jurisdictions, a rule-based or compliance-based supervisory approach was in place. Banks were supervised under what is known as the CAMELS model, an abbreviation for Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risk. In the Indian context, S in the CAMELS acronym stood for Systems and Control. This approach focused on the monitoring and examination of financial condition of banks and their compliance with the rules and regulations. Under this model, onsite examination is carried out on an annual basis supported by offsite surveillance. The CAMELS approach was focused on solvency and liquidity of the banks and primarily aimed at limiting the risk of loss to depositors. This approach has the drawback of being a ‘Single-Size Fit’ approach and is found to be behind the curve when it comes to keeping pace with innovation in the financial sector.

The global financial crisis revealed that though many countries had similar financial systems and operated under similar set of rules (Basel Standards), some of them were less affected. One of the reasons attributed to this upshot is “better supervision”. Given the inherent weaknesses in the CAMELS model, which may have contributed to the lax supervision in existence before the crisis, a move towards a risk-based or risk-focused approach to supervision gained momentum in many countries. There were primarily two reasons for this shift towards risk-based supervision. First, there is a growing recognition that banking in the

traditional sense of accepting deposits for the purpose of lending is no longer in vogue and banks and banking are becoming complex. Second and equally important is the realisation that supervisory resources are scarce and need to be optimally deployed to meet supervisory goals.

Thus, there was a need for a robust supervisory framework, which proactively identifies incipient risks and takes measures to address them. Recognizing this, the Reserve Bank of India constituted a High-Level Steering Committee under the Chairmanship of former Deputy Governor, Shri K C Chakrabarty, in August 2011, to review the supervisory processes for commercial banks. The regulator, industry and academics had representation in the Committee. The Committee, inter alia, recommended a shift to a risk-based approach to supervision from the existing compliance-based approach. Based on the recommendations of the committee, a risk-based approach to supervision was implemented from 2013 onwards in a phased manner. All the scheduled commercial banks in India are now under the Risk Based Supervisory (RBS) framework and the erstwhile CAMELS framework is no longer in vogue.

Risk-based Supervision (RBS)

RBS may be defined as "*an ongoing process wherein risks of a bank are assessed and appropriate supervisory plans designed and implemented by the supervisor*". RBS can thus be seen as a structured process, which identifies material and critical risks that a bank may potentially face, and through a focused supervisory review process, assesses the bank's ability to manage the potential risks along with its financial vulnerability to adverse outcomes.

The substantive objectives of supervision, risk-based or otherwise, are two-fold:

- Ensuring safety and soundness of the individual banks and thereby protecting the interest of depositors; and
- Safeguarding the stability of the financial system

The risk-based approach to supervision aims to achieve the above overarching objectives through a supervisory process of comprehensive and structured assessment of the major risks faced by banks. The risk-based approach marks a considerable shift from the earlier predominantly compliance-based CAMELS/ CALCS⁶⁵ methodology, but it continues to involve assessing the level of compliance in banks with an objective of assessing the compliance culture and attendant risks.

At a broad level, the risk-based and compliance-based approaches have much in common. They both involve a combination of on-site examination and off-site data analysis. The critical difference is that under risk-based approach a more organised structure is in place to identify and quantify those activities of a bank that carry greater risk and also assess the risk management practices and controls in place to mitigate the risk. Risk-based supervisory approach is intended to result in a supervisory system that, on an ongoing and dynamic basis,

⁶⁵ CALCS (Capital Adequacy, Asset Quality, Liquidity, Compliance, Systems and Control) was the supervisory rating model used for foreign banks

assesses the safety and soundness of banks. It seeks to achieve an accurate assessment of a bank's risks in order to ascertain the extent of capital commensurate to the level of risks a bank is exposed to. In doing so, the risk-based supervision targets early identification and timely response to emerging risks. This would enable the supervisor to optimally use the scarce supervisory resources to deal with the identified risks. Moreover, unlike in a compliance-based CAMELS model where individual risks are examined in isolation, in a risk-based framework, interaction between risks is examined. Thus, improving proportionality and economic efficiency of supervision through the optimal use of supervisory resources and developing specialised expertise is the cornerstone of RBS.

The RBS framework as adopted by RBI is called SPARC (Supervisory Program for Assessment of Risk and Capital). While, the supervisory approach under CAMELS is performance based, reactive and is a point-in-time assessment, SPARC is risk-based, forward-looking, proactive and dynamic in identifying incipient risks and prompting early response. The three key objectives of SPARC are: (1) to apply differentiated supervision based on risk profile of the bank. i.e., different banks will be subjected to varying degrees of supervision; (ii) focus on areas deemed as higher risk for the bank. i.e., within a bank the focus will be given to areas that are identified to have significant material risks; and (iii) to help banks in improving their risk management systems, oversight and controls. The focus of SPARC is on the unexpected losses (say, exposure as opposed to outstanding) for which more capital may be required.

A risk-based supervisory framework has two dimensions: First, the risk of failure, which is based on the assessment of the inherent risks, the controls in place at the entity level, the governance & oversight at the bank and available capital; second, the impact of failure, which takes into account the relative significance of the entity or the group in the overall financial system. The risk of failure determines the overall supervisory rating and the extent of supervisory capital. In arriving at supervisory stance (i.e. intensity of supervision) the SPARC framework considers both the risk of failure and the impact of failure of a banking entity. This is achieved through a proprietary risk scoring and aggregation model called "Integrated Risk and Impact Scoring (IRISc)" model.

To assess the risk of failure, both onsite and offsite risk discovery is carried out. The offsite risk discovery process involves collection of data, documents, etc., as well as discussions with the management personnel of the banks. The offsite risk discovery process provides information about the key risk areas (the universe of risk measures includes, credit risk, market risk, operational risk, liquidity risk, etc.) pertaining to a bank. The offsite risk discovery process will determine the areas, which need further clarity and necessitate an onsite visit, the length of on-site visit and the supervisory resources required to conduct such visit. The offsite surveillance is a key component of the supervisory framework, even more so in RBS. The offsite surveillance enables the RBI to monitor continuously the health of the banks, which act as input for remedial actions, if any. Since optimal utilisation of scarce supervisory resources is one of the key objectives of the RBS, offsite monitoring assumes

greater importance as onsite examination is carried out in a targeted fashion with the most critical areas receiving supervisory attention.

The onsite risk discovery process involves further investigation into identified risk areas including obtaining additional information. In this step, a dedicated team of supervisors conduct onsite inspection of the identified areas/ aspects at the premises of the banking entity. The severity of risk and the volume of business determines periodicity, length and intrusiveness of on-site examination. A major part of the on-site examination involves:(i) discussion with the key functionaries of the bank regarding processes, products, policies, procedures, etc., (ii) verification of the accuracy of information submitted by the bank as part of regulatory reporting, including any additional data/ information received, (iii) review of the effectiveness of the controls in place to deal with the material risks the bank is exposed to, (iv) review of overall board and management oversight and the role played by risk management and internal audit function in the bank, and (v) review of compliance with regulatory guidelines and accounting standards including testing of transactions based on a pre-determined sample size to ascertain if they are in compliance with the guidelines. Thus, the RBS framework incorporates both elements of leading indicators that is aimed at risk discovery and lagging indicators such as capital and compliance review.

Even though the risk-based approaches applied by different supervisors are broadly similar, they vary depending on several factors, including the mandates of the supervisory agencies. An important dimension that many supervisory agencies have incorporated into their risk-based system is determining the systemic importance of each firm. Systemically important firms, all other things being equal, attract greater supervisory attention (and resources) than non-systemically important firms.

The creation of a Senior Supervisory Manager (SSM) is one of the key features of SPARC. The creation of SSM is primarily aimed at having a single point of supervisory contact for banks within RBI. This is expected to improve the efficiency and effectiveness of the supervisory processes by removing multiple points of contact for the banks within the Department of Supervision and more broadly within RBI, which at times could undermine an effective and continuous supervision. The SSM for a bank is supported by a dedicated team of officers. The SSM is expected to develop a strong understanding of the bank and its operations through off-site and on-site examination and continuous monitoring.

To summarise, the key benefits of a risk-based framework for supervision are: (i) optimal use of scarce supervisory resources, which in turn results in better use of organisation's resources (ii) a dynamic and ongoing assessment of risks faced by regulated entities; (iii) early identification and recognition of emerging risks; (iv) a structured and consistent framework for evaluating risks based on separate assessment of both inherent risks and risk management controls. This also enables in a system-wide assessment of banking sector risks as all the entities are evaluated under the same model with less subjectivity; and (v) a better understanding of a bank's business, systems, processes, human resource, etc.

Typology of Supervisory Approaches

Considering the differentiated approach to supervision and the proportionality paradigm, variant RBS models are developed in addition to the main model for regular banks and the others for small or niche banks, based on certain benchmarks. To achieve the right balance between onsite and off-site supervisory processes, the following classification is adopted in the supervision of different categories of banks.

- (a) **Full Scope Supervision (FS):** Involves the most detailed and intrusive supervisory approach, both on-site and off-site, covering all the material risks of a bank
- (b) **Select Scope Supervision (SS):** Off-site supervision plays the major role in this approach with on-site examination a function of concerns emerging from off-site analysis. Moreover, on-site examination shall be centred around operations that are critical to the functioning of the bank, such as IT/Cyber risks in respect of private banks, compliance in the case of small finance banks, etc.
- (c) **Thematic Assessment (TA):** This approach is aimed at assessing topical themes, such as asset quality, cyber risk, etc., with the assessment covering a group of banks or all banks.
- (d) **Targeted Scrutiny (TS):** Under this approach, scrutiny is undertaken to examine specific aspects of a bank based on supervisory or market intelligence inputs.

Grouping of banks for differentiated supervisory approach

The proportionality paradigm demands differentiated approach to supervision. Accordingly, banks are classified into groups/sub groups for deciding the appropriate supervisory approach. The principle criteria used to categorize banks is market share of their reported assets. The supervisory intrusion is linked to the category of the bank under normal circumstances though the same can be reviewed based on risks emanating in case of any entity.

Various Tools of Supervision

To conduct meaningful supervision of regulated entities, both off-site surveillance and onsite examination are equally important. RBI uses a judicious mix of off-site and on-site tools to conduct a ‘close and continuous’ supervision of banks.

Off-site Supervision

Off-site supervision is a key supervisory tool used by authorities to analyse a bank's profile, culture, risk tolerance, operations and environment on a dynamic basis.

It provides the specific inputs that shape on-site examination. The objective of off-site supervision is to make a preliminary risk assessment of the bank and discover key risk areas. This involves assessment of their business plan/ strategies, group structure, financial statements, compliance and internal audit/plans and reports, observations of external auditors, etc. This along with assessment of macroeconomic factors and market intelligence

inputs aid in deciding the scope, focus, resources and time required for onsite examination. In this context, an Off-site Monitoring and Surveillance (OSMOS) system was set up as a complementary tool to on-site inspection. Under OSMOS, various returns are collected at different periodicities, viz., fortnightly, monthly, quarterly, half yearly and annual.

Central Repository of Information on Large Credits (CRILC) has been introduced in 2014 as part of Framework for Revitalising Distressed Assets in the economy. Credit information on large borrowers⁶⁶ are collected from the banks under this system with effect from quarter ended June 2014. Information collected under the OSMOS (along with CRILC) system cover balance sheet, income, expenditure and profitability, capital, assets quality, ownership, off-balance sheet exposures, liquidity and several other areas with significant details. All users concerned access off-site data through the Database on Indian Economy (DBIE) site⁶⁷.

Borrower level credit information reported in the CRILC system and sharing relevant information among the banks has eliminated information asymmetry and brought in much needed transparency. It is expected to enhance the credit appraisal mechanism in banks providing hitherto missing requisite information about the borrower. Thus, CRILC has been found very useful for the banks, SSMs as well as for policy making. The OSMOS Division primarily strives for (i) timely collection of data from the banks, (ii) to maintain reasonable degree of data quality and (iii) to facilitate making sense of the data by providing useful and meaningful readily available standard reports in DBIE apart from need-based analysis and supply of voluminous data.

Onsite Examination

Onsite examination complements off-site surveillance by focusing on conducting validation checks of data gathered under off-site surveillance, assessing the risk areas identified, including capital assessment, and following-up on issues identified from previous assessments. Onsite examination demands not just high levels of technical skills but also interpersonal skills to both understand and assess the risk as well as draw information that may be material to a bank's ability to continue as a going concern.

Para-supervisory Activities

Central Fraud Registry

As Frederick William Robertson eloquently said, "There are three things in the world that deserve no mercy - hypocrisy, fraud, and tyranny". Fraud - there is no universal definition of what it means - is a generic term used to describe human ingenuity that engage in unscrupulous activities with the aim to gain an unfair advantage either through suppression of truth or falsehood of wrong. Frauds in banking are a serious matter as banks deal with large amounts of public money in their role as financial intermediaries. While there can be many causes for fraud, it is important to detect them at an early stage to contain the losses and

⁶⁶ A large borrower is defined as one who has aggregate fund-based and non-fund based exposure of ₹5 crore and above

⁶⁷ DBIE can be accessed from www.rbi.org.in

prevent their recurrence. Keeping this objective in mind, a Central Fraud Registry (CFR) has been operationalised with effect from January 20, 2016. The CFR will provide “a searchable centralised database for use by banks”, which in turn can alert banks to take necessary steps to develop a sound and robust fraud risk management system.

Cyber Security Framework

Information technology has become an integral part of the operational aspects of a bank and the use of technology has grown exponentially in the recent past. While the use of technology has many advantages, it also exposes banks to cyber-attacks.

In the wake of rising concerns on cyber security incidents in banks, the BFS directed that the RBI should have a thorough supervisory insight into the IT systems of the banks. Accordingly, an Expert Panel on Cyber Security and IT Examination was constituted with Executive Director In-Charge of Department of Banking Supervision as the Chairperson. A dedicated Cyber Security & IT Examination Cell (CSITE Cell) was also established in June 2015 within the RBI.

Under the aegis of the Expert Panel, a comprehensive circular, “Cyber Security Framework in Banks”, covering the best practices pertaining to various aspects of cyber security was issued. In terms of the circular, banks are required, inter-alia, to put in place a Cyber Security Policy distinct from Information Security Policy, report unusual cyber incidents to RBI within stipulated time frame, carry out & submit the gap assessment with respect to the best practices mentioned in the circular, etc.

Early Warning System and Action

Early warning indicators are critical to detect the build-up of vulnerabilities in the banking system. At a macro level, this involves looking at aggregate indicators such as credit-to-GDP ratio, economy-wide debt service ratios (DSRs), etc., to identify systemic risk. At a micro level, banks are subject to stress testing, capital planning, asset quality review, liquidity monitoring, etc. These are aimed at alerting the bank management and supervisory authorities about the potential adverse shocks that could arise from a wide range of risks as well as provide an estimate to banks and supervisory authorities of the financial resources that might be needed to absorb losses should risks materialise.

Prompt Corrective Action (PCA)

The "Core Principles for Effective Banking Supervision" drawn up by the Basel Committee in 1997, which were in the nature of minimum requirements intended to guide supervisory authorities in strengthening their current supervisory regime, stressed upon the necessity of supervisors having at their disposal adequate supervisory measures, backed by legal sanctions, to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations or the depositors' interest is threatened in any other way. Accordingly, a system of Prompt Corrective Action (PCA), based on pre-determined rule-based structured early intervention, was put in place in December 2002 to strengthen the existing supervisory

framework. As per the original scheme of PCA the RBI will initiate certain structured actions, such as, restrictions on dividend payments, entry into new lines of business, acceptance of fresh deposits, etc., on those banks that have hit the trigger points in terms of capital adequacy, asset quality and profitability.

As per the directions of the Sub-Committee of the Financial Stability and Development Council (FSDC-SC) the RBI decided to review and upgrade the existing PCA framework for banks. The revised PCA framework was notified in April 2017 and applies without exception to all banks operating in India including small banks and foreign banks operating through branches or subsidiaries based on breach of risk thresholds of identified indicators. The key areas for monitoring banks under the revised framework continue to be capital, asset quality and profitability, while leverage is monitored additionally as part of PCA framework. The indicators tracked for capital, asset quality and profitability are CRAR/Common equity Tier 1 ratio, Net NPA ratio and Return on Assets respectively. Certain risk thresholds have been defined, breach of which result in invocation of PCA and result in certain mandatory and discretionary actions. Mandatory actions include restriction on dividend distribution, branch expansion, higher provisions, etc. There is a common menu for selection of discretionary actions such as, Special Supervisory Interactions (for example, special audit of the bank), Strategy related actions (instruct bank to undertake business process reengineering), Governance related actions (actively engage with the bank's Board on various aspects as considered appropriate), Capital related (reduction in exposure to high risk sectors to conserve capital), Credit risk related (strengthening of loan review mechanism), Market risk related (restrictions on derivative activities), HR related (review of specialized training needs of existing staff), Profitability related (restrictions on certain forms of capital expenditure) and Operations related (restrictions on branch expansion plans). In addition, the PCA framework does not preclude the RBI from taking any other action as it deems fit in addition to the corrective actions prescribed in the framework.

A bank is placed under PCA framework based on the audited financial results and supervisory assessment made by RBI. However, RBI may impose PCA on any bank during the year, in case the circumstances so warrant.

Stress Testing

The role of stress testing has rapidly evolved and grown in importance since the Global Financial Crisis of 2007-09. Many jurisdictions are using stress testing to decide the appropriate level of 'supervisory capital'. In December 2013, RBI issued guidelines on stress testing and made it mandatory for all banks to carry out stress tests involving shocks prescribed in the guidelines at a minimum. The guidelines stated that banks should be able to survive at least the base line shocks and adopt stress testing programmes that is commensurate with the degree of sophistication.

Red Flagged Accounts (RFA)

To prevent the incidence of financial frauds, the concept of a Red Flagged Account (RFA) was introduced in 2015 as part of the early warning system. “A RFA is one where a suspicion of fraudulent activity is thrown up by the presence of one or more early warning signals (EWS).”. Accordingly, banks must set up systems for identifying EWS and flagging the accounts as RFA for exposures of ₹50 crore and above.

Presenting Supervisory Outcomes

With experience gained and in order to have a modular approach to the components of comprehensive supervisory processes, the supervisory outcomes are broken down to (i) Risk Assessment Reports (RAR) taking care of unexpected losses of the banks; (ii) Inspection Report (IR) covering the expected losses of the banks through (a) Assessment of Regulatory Operations i.e compliance review and (b) Capital Review involving assessment of available capital; and (iii) Assessment of Conduct of Business covering issues relating to bank's customer and market conduct.

Supervision in cross-national context

Internationally active banks can be a source of risk both for the jurisdiction in which it operates as well as for the home country where its major operations are carried out. Therefore, it is important for countries to cooperate in supervising these entities. Since regulation and supervision of banks is mostly at national level rather than supranational level, such cooperation among the authorities is vital in preserving financial stability across borders. RBI periodically conducts onsite examination of Indian bank branches located abroad to ensure that they adhere to both home and host country regulations as well as to understand the risks posed by branch balance sheets to the bank balance sheet.

Supervisory College

The Reserve Bank of India has set up, as part of supervision of cross border operations of Indian banks abroad, Supervisory Colleges for six major banks (State Bank of India, Bank of Baroda, Bank of India, ICICI Bank Ltd., Axis Bank Ltd. and Punjab National Bank) which have significant international presence. The main objectives of Supervisory College are to enhance information exchange and cooperation among supervisors to improve understanding of the risk profile of the banking group. This, in turn would facilitate more effective supervision of internationally active banks. Further, DoS has entered into MoU with a large number of global institutions in the matter of supervisory cooperation and exchanges.

References - RBI (2012). Report of the High Level Steering Committee for Review of Supervisory Processes for Commercial Banks, RBI, June 2012.

Chapter 9: Regulation and Supervision of Co-operative Banks in India

"Cooperatives are a reminder to the international community that it is possible to pursue both economic viability and social responsibility" – former UN Secretary General - Ban Ki-moon

Introduction

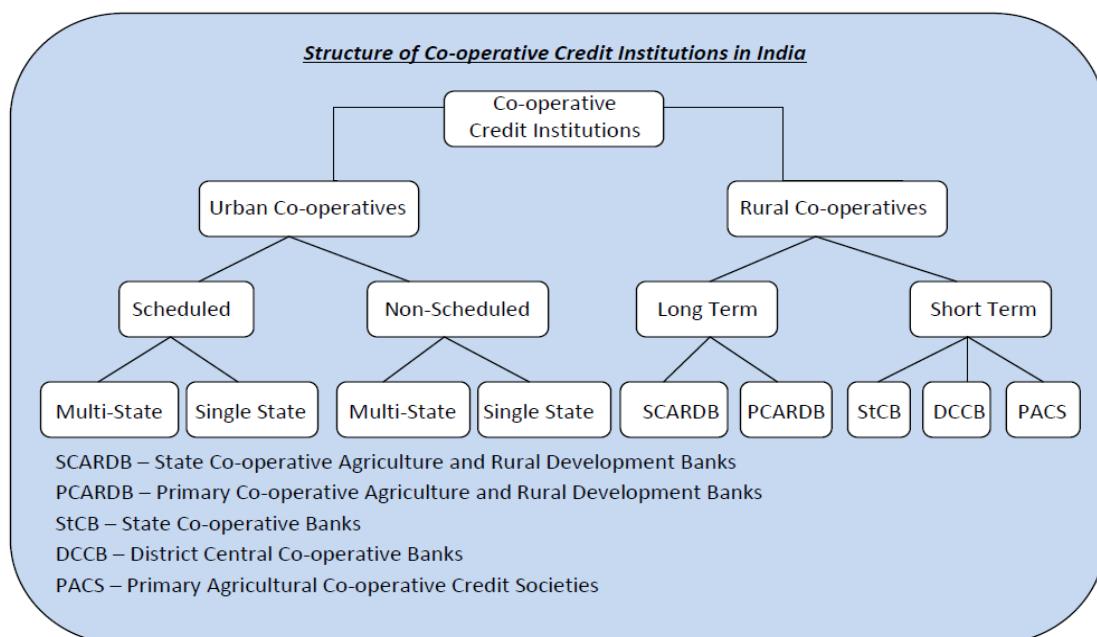
Mahatma Gandhi once said: "*Suppose I have come by a fair amount of wealth - either by way of legacy, or by means of trade and industry - I must know that all that wealth does not belong to me; what belongs to me is the right to an honourable livelihood, no better than that enjoyed by millions of others. The rest of my wealth belongs to the community and must be used for the welfare of the community*". This forms the essence of the co-operative movement, which is based on the same principles of community camaraderie, mutual help, democratic decision making and open membership, etc. commonly known as "***Co-operative Principles***" as detailed below:

1. **Voluntary and Open Membership** - Co-operatives are voluntary organisations, open to all persons capable of using their services and willing to accept the responsibilities of membership, without discrimination on basis of gender, social inequality, racial, political ideologies or religious consideration.
2. **Democratic Member Control** - Co-operatives are democratic organisations controlled by their members, who actively participate in setting their policies and decision making. Elected representative of these co-operatives are responsible and accountable to their members.
3. **Member's Economic Participation** - Members contribute equally and control the capital of their Co-operative democratically. At least a part of the surplus arising out of the economic results would be the common property of the co-operatives. The remaining surplus could be utilised benefiting the members in proportion to their share in the Co-operative.
4. **Autonomy and Independence** - Co-operatives are autonomous, self-help organisations controlled by their members. If co-operatives enter into agreement with other organisations including Government or raise capital from external sources, they do so on terms that ensure their democratic control by members and maintenance of Co-operative autonomy.
5. **Education, Training and Information** - Co-operatives provide education and training to their members, elected representatives and employees so that they can contribute effectively to the development of their co-operatives. They also make the general public, particularly young people and leaders aware of the nature and benefits of co-operation.

6. *Co-operation among Co-operatives* - Co-operatives serve their members most effectively and strengthen the co-operative movement, by working together through available local, regional, national and international structures-
7. *Concern for Community* - While focusing on the needs of their members, co-operatives work for the sustainable development of communities through policies accepted by their members.

The co-operative movement in India is more than one century old. The organisation of co-operative institutions in India dates back to 19th century, when the first mutual aid society 'Anyonya Sahakari Mandali' was formed in Gujarat at Baroda on February 05, 1889. The first major impetus was provided to these institutions by the passage of the Co-operative Society Act in 1904 and the Kancheepuram Co-operative Credit Society in Tamil Nadu became the first credit society to get registered under this Act. Later in 1919, the subject of co-operation was transferred from Central Government to Provincial States.

Co-operative credit institutions are an important segment of the banking system, as they play a vital role in mobilising deposits and purveying credit to people of small means. They form an important vehicle for financial inclusion and facilitate transactions. Traditionally, the co-operative institutional structure in India is divided into two categories viz. 'Rural' and 'Urban' with the rural cooperatives having a federal structure. The present structure is graphically represented below.



Characteristics of Co-operative Institutions

- They have focussed area of operation
- The Board of Directors is elected by shareholders in a democratic manner
- The borrowing from these institutions is restricted only to its members

- There is share linking to borrowing, viz., the borrowing member is required to hold share capital in the co-operative bank, the amount of which should not be less than a certain specified percentage of the amount borrowed from the bank
- Members can cast only one vote irrespective of the number of shares held
- The shares of these institutions cannot be listed and traded

Difference between Co-operative Credit Societies and Co-operative Banks

‘Co-operative societies’ appear at Entry 32 in the State List, whereas ‘Banking’ appear at Entry 45 in the Union List under the Seventh Schedule to the Constitution of India. Hence, Co-operative Societies in India are a State subject and they do not fall under the regulatory purview of RBI. Co-operative Credit Societies primarily cater to the credit needs of its members by mobilizing deposits from their own members.

Co-operative Credit Societies, which are licensed to carry out banking activities function as a co-operative bank and are eligible to accept deposits from the public. Urban Co-operative Banks (UCBs) are primarily registered as Co-operative Societies under the provisions of either the State Co-operative Societies Act of the respective State or the Multi-State Co-operative Societies Act, 2002, if the area of operation of the bank extends beyond the boundaries of one State.

The UCBs are divided into Tier-I and Tier-II UCBs depending upon the size of deposits and area of operation. UCBs satisfying the following criteria are defined as Tier-I UCBs:

- Deposit base below ₹100 crore and operating in a single district.
- Deposit base below ₹100 crore and operating in more than one district, provided that the branches are in contiguous districts, and deposits and advances of branches in one district separately constitute at least 95 per cent of the total deposits and advances, respectively, of the bank.
- Deposit base below ₹100 crore, with branches originally in a single district, which subsequently became multi-district due to a re-organisation of the district.

All other UCBs are defined as Tier-II UCBs.

Legal framework for regulating Co-operative banks

Though the Banking Regulation Act came into force in 1949, the banking laws were made applicable to co-operative societies only in March 1966 through an amendment to the Banking Regulation Act, 1949 by insertion of section 56 (Part V) of the Act, which is colloquially known as Banking Regulation Act, 1949 (AACS)⁶⁸.

With this, co-operative banks came under the dual control of respective State Governments / Central Government and the Reserve Bank, which make these institutions distinctly different from commercial banks. While administrative aspects like registration,

⁶⁸ AACS – As Applicable to Co-operative Societies

management, recruitment, audit, write-offs, amalgamation and liquidation are regulated by the State/Central Governments, matters related to banking are regulated by the Reserve Bank under the Banking Regulation Act, 1949 (AACS).

With a view to bring in uniformity for protecting the interests of depositors across all banks, the Banking Regulation (Amendment) Ordinance, 2020⁶⁹ was promulgated on June 27, 2020. The Ordinance that seeks to amend the Banking Regulation Act, 1949 (AACS) provides for augmenting capital by Urban Co-operative Banks through issues of shares, debentures and other similar securities with the approval and conditions that may be stipulated by RBI. The Ordinance adds that in case of a co-operative bank registered with the Registrar of Co-operative Societies of a State, the RBI may supersede the Board of Directors after consultation with the concerned State Government, and within such period as specified by it. However, RBI may exempt a cooperative bank or a class of co-operative banks from certain provisions of the Act through notification for such time period and under such conditions as may be specified by the RBI.

While UCBs are regulated and-supervised by RBI, Rural Co-operative Banks, viz., the State Co-operative Banks (StCBs) and the District Central Co-operative Banks (DCCBs) are regulated by RBI but-supervised by NABARD⁷⁰. The Long Term Rural Co-operatives, viz., State Co-operative Agriculture and Rural Development Bank (SCARDB) and Primary Co-operative Agriculture and Rural Development Bank (PCARDB) do not fall under the regulatory or supervisory purview of RBI.

Definition of an Urban Co-operative Bank

Sec. 5(ccv) of Banking Regulation Act, 1949 (AACS) defines Urban Co-operative Banks (UCBs) as a co-operative society, other than a primary agricultural credit society and satisfying the following conditions:

- The primary object or principal business of which is the transaction of banking business;
- The paid-up share capital and reserves of which are not less than one lakh of rupees; and
- The bye-laws of which do not permit admission of any other co-operative society as a member.

Growth and Consolidation of Urban Co-operative Banks (UCBs)

When the provisions of Banking Regulation Act, 1949 were made applicable to these UCBs in 1966, making it mandatory to obtain a licence from RBI to do banking business, there were about 1100 UCBs with deposits and advances of ₹167 crore and ₹153 crore respectively. Thereafter, Reserve Bank pursued a liberal licensing policy, especially pursuant to the recommendations of the Marathe Committee. Accordingly, from 1311 UCBs in the year 1993, the number increased to 1926 UCBs by 2004. However, nearly one-third of the newly licensed

⁶⁹ The Ordinance has to be passed as an Act by the Parliament within 6 months

⁷⁰ NABARD – National Bank for Agriculture and Rural Development

UCBs became financially unsound within a short period. In the light of the experience and the prevailing financial health of the UCB sector, it was decided in 2004-05 that the Reserve Bank would consider issuance of fresh licenses only after a comprehensive policy on UCBs, including an appropriate legal and regulatory framework for the sector, was put in place. No fresh licences have been issued since then for setting up of new UCBs. However, due to mergers/amalgamations, conversion to credit societies and cancellation of licences of UCBs over the years, the number of UCBs in the country has come down to 1538 as on May 31, 2020. In terms of total assets, UCBs contributed 3.2% of total banking system assets as at March 2019.

Initiatives taken by RBI

The Reserve Bank undertook several steps to strengthen the sector during this period. To improve the financial soundness of the UCB sector, through better coordination between the co-regulators, the Reserve Bank of India entered into Memoranda of Understanding (MoU) with all State Governments and the Central Government since 2005. As part of the arrangements under MoU, the Reserve Bank constituted, in each State, a State-level Task Force for Co-operative Urban Banks (TAFCUB) for UCBs which operate only in one State. A Central TAFCUB was constituted for the Multi-State UCBs. TAFCUBs identify potentially viable and non-viable UCBs in the states and suggest revival path for the viable and non-disruptive exit route for the non-viable ones. The exit of non-viable banks could be through merger/amalgamation with stronger banks, conversion into societies or liquidation as the last option.

To give direction and impetus to the resolution processes for weak banks (banks with precarious financial position), Reserve Bank has issued guidelines for financial restructuring to aid revival of weak banks including various financial instruments that can be used for the purpose and also on merger of UCBs with other UCBs including with and without DICGC support, acquisition of UCBs with commercial banks.

Reserve Bank has recently also brought out guidelines for voluntary transition of UCBs into Small Finance Banks (SFBs) subject to certain conditions and for constitution of Board of Management (BOM), in addition to Board of directors, for bringing about improvement in the governance and banking functions of UCBs.

Apart from this, RBI has recently brought in norms for UCBs to adhere to stringent and higher Priority Sector Target (in a graded approach to reach a target level of 75%) with penalty of placement of shortfalls in RIDF at lower interest rates and tightened Exposure norms linking the ratio to the robust Tier I capital instead of total capital and also mandating 50% of loans to be extended towards small borrowers. Nonetheless, they continue to remain outside the Lead Bank Scheme of RBI and not represented in various fora of SLBC.

To ensure technological soundness of the UCBs basic cyber security norms have been put in place for all banks along with additional requirements based on their digital depth.

Regulation of UCBs

The Reserve Bank of India derives its powers to regulate UCBs mainly from the Banking Regulation Act, 1949 (AACS) and Reserve Bank of India Act, 1934. The regulations include issue of branch licences, authorization for extending their area of operation, prescribing CRR and SLR requirements and prudential norms for capital adequacy, income recognition, asset classification and provisioning norms, exposure norms, targets for priority sector lending, inclusion of UCBs into second Schedule of RBI Act, 1934, etc.

Approach to Regulation of Co-operative Banks

With a view to enabling UCBs to offer banking services on par with commercial banks, RBI has permitted them to open specialized branches, currency chests, on-site/off-site/mobile ATMs, undertake intra-day short selling in government securities and ready forward contracts in corporate debt securities, access Centralised Payment System/RTGS/NEFT/NDS-OM, open Current Account and SGL accounts with RBI, sell insurance products/mutual fund units, act as PAN service agents, undertake Point of Presence services for PFRDA, engage Business Correspondents/Business Facilitators, offer mobile banking /internet banking facility and trading facilities to Demat account holders, issue prepaid instruments, etc. Scheduled UCBs have been permitted access to Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) of RBI. Thus, these co-operatives provide universal banking services in a niche geographical area, whereas commercial banks are mandated to provide niche services throughout India.

Financial Assistance for implementation of Core Banking Solution in UCBs

Keeping in view the difficulties encountered by several small UCBs in implementing Core Banking Solution (CBS), the Reserve Bank announced a scheme of financial assistance in April 2016, whereby the initial set up cost of up to ₹4 lakh would be borne by RBI and technical support for implementation of CBS would be provided by the Indian Financial Technology and Allies Services (IFTAS), a wholly owned subsidiary of RBI. This initiative has been taken to bring the co-operative banks into a technology platform on par with commercial banks.

Supervision of UCBs

To ensure that UCBs function on sound lines and their methods of operation are consistent with statutory provisions and are not detrimental to the interests of depositors, they are subject to both (i) on-site inspection and (ii) off-site surveillance.

- i. **On-site Inspection:** The statutory inspections conducted under Section 35 of the Banking Regulation Act, 1949 (AACS) follows the CAMELS pattern to assess the Capital Adequacy (C), Asset Quality (A), Management (M), Earnings (E), Liquidity (L) and Systems & Control (S) of the UCBs. These inspections basically make a core assessment and brings out specific review of:
 - a. Financial condition and performance,
 - b. Management, systems and controls and

- c. Compliance with regulatory and other guidelines.
- ii. Off-site surveillance: In order to have continuous supervision over the UCBs, the Reserve Bank has supplemented the system of periodic on-site inspections with off-site surveillance (OSS) through a set of periodical prudential returns that will be submitted by UCBs to RBI. These returns are analysed at RBI for identifying incipient indicators that may cause deterioration in the health of the banks. Sometimes, the analysis may also act as a trigger to take up an UCB for inspection before it is scheduled.

Supervisory Action Framework (SAF)

RBI has put in place a Supervisory Action Framework (SAF) under Sec.36(1) of BR Act, 1949 (AACS) for UCBs experiencing financial stress. The framework, that was revised on January 6, 2020 aims at bringing about the desired improvement in such UCBs as also an expeditious resolution. Financial triggers are based on the required level of Net NPA (Asset Quality), Profitability and Capital to Risk-Weighted Assets Ratio (CRAR). Depending on area and extent of weakness and financial triggers⁷¹, actions may include restriction on opening new branches, capital expenses, declaring/disbursing dividend, reducing exposure norms for loans or freezing the limit of total advances to the level existing on a particular day, etc. Such supervisory action will normally be initiated on the basis of assessed financial position of UCBs by the RBI inspection. However, action may also be taken on the basis of the reported/audited financial position which may be subsequently reviewed, if necessary, on the basis of the statutory inspection findings. Although supervisory action taken will primarily be based on the criteria specified under SAF, Reserve Bank will not be precluded from taking appropriate supervisory action in case stress is noticed in other important indicators/parameters or in case of serious governance issues or any such issues based on merits of each case.

The banks whose financial conditions continue to severely deteriorate are brought under All Inclusive Directions (AID) under Section 35A of the Act ibid, which entails, inter-alia complete prohibition on accepting fresh deposits and grant of fresh loans, besides restricting repayment of deposits to a specified ceiling. The banks under AID are monitored closely with an advise to either have robust revival plan or explore possibilities of merger/conversion to a Society. The Action Plan for revival consists of action in one or more of the following areas:

- a) NPA recovery
- b) Capital augmentation through contribution from existing members or by making new members
- c) Capital infusion by Central/State government
- d) Cost cutting measures like rationalising branch network, reducing staff expenses and other overheads, implementing VRS, etc.

⁷¹ The financial triggers are specified in the Supervisory Action Framework (SAF) issued to UCBs vide DOR (PCB).BPD. Cir No. 9/12.05.001/2019-20 dated January 6, 2020.

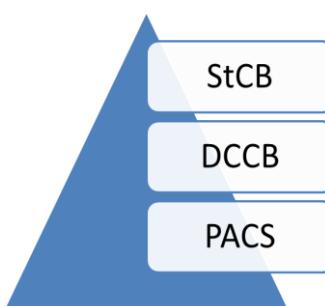
In the absence of any significant development on revival/merger front and in the event of the financials continuing to deteriorate/be precarious, the bank's licence is cancelled to arrest further worsening, in the interest of the bank's depositors.

However, notwithstanding the above, a bank is placed under direction only when there are clear indications of failure on the part of bank to quickly respond to the deterioration faced due to financial stress and there is a serious concern of deposits likely to be favourably withdrawn thereby putting common public at loss.

Rural Co-operatives

Rural credit co-operatives came into existence essentially as an institutional mechanism to provide credit to farmers at affordable cost and address the twin issues of rural indebtedness and poverty. With its phenomenal growth in outreach and volume of business, rural credit co-operatives have a unique position in the rural credit delivery system. Through the short-term and long-term structures, they continue to play a crucial role in dispensation of credit for increasing productivity, providing food security, generating employment opportunities in rural areas and ensuring social and economic justice to the poor and vulnerable.

- The **long-term co-operative credit structure** has the State Co-operative Agriculture and Rural Development Banks (SCARDBs) at the apex level and the Primary Co-operative Agriculture and Rural Development Banks (PCARDBs) at the district or block level. These institutions were conceived with the objective of meeting long-term credit needs in agriculture and they are not under the regulatory purview of Reserve Bank of India.
- The **short term co-operative 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.



At the apex level is the State Co-operative Bank (StCB) at the state, at the district level there are District Central Co-operative banks (DCCBs) and at the village level, there are Primary Agricultural Credit Societies (PACS). Across India, there are more than 95000 PACS. PACS are outside the purview of the Banking Regulation Act, 1949(AACs) and hence not regulated by the Reserve Bank of India. They are regulated and monitored by the respective State Governments. While regulation of State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs) vests with Reserve Bank, their supervision is carried out by National

Bank for Agriculture and Rural Development (NABARD) under Section 35 (6) of the Banking Regulation Act, 1949 (AACS). As part of regulation of StCBs and DCCBs, RBI prescribes CRR and SLR requirement in addition to prescribing prudential norms on capital adequacy, income recognition, asset classification and provisioning norms, exposure norms, etc.

Moving towards a 2-tier structure for STCCS

STCCS has considerable outreach and volume of operations. However, the structure of STCCS is not uniform across the States. It has a 3-tier structure in some States and 2-tier structure in some. Based on the tier structure PACS are affiliated to DCCBs or StCBs. In a 3-tier credit structure, each tier adds to the cost and margins leading to an escalation in the cost of credit for the ultimate borrowers. The relevance of the 3-tier credit structure has been examined by several committees in the past (notably, those headed by Prof V S Vyas, Shri Jagdish Kapoor, Prof 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 decision for amalgamation of DCCBs into StCB leading to conversion of a 3 tier structure into a 2 tier structure has to be initiated by the respective State Governments. The request of the State Government will be examined by RBI in consultation with NABARD and the approval for amalgamation would be conveyed. Accordingly, based on RBI approval, 7 DCCBs in the State of Jharkhand amalgamated with the Jharkhand State Co-operative Bank in March 2017 and 13 DCCBs in the State of Kerala amalgamated with the Kerala State Co-operative Bank in November 2019.

Conclusion

Co-operative banks are unique in terms of their structure, clientele and credit delivery. They are at the base level of the banking system in India, providing basic banking facilities to the middle and lower income groups of society in urban and semi urban areas. The resilience and stability shown by these banks during the global financial crisis has underscored their importance in the financial system of both developed and emerging market economies. RBI has initiated several policy measures to strengthen and consolidate the co-operative banking sector and will continue to do so in future.

Chapter 10: Regulation and Supervision of Non-Banking Financial Companies in India

India has financial institutions, which are not banks but perform bank like functions, especially the financial intermediation of mobilisation of funds and extending credit. These are called Non-Banking Financial Companies (NBFCs) and they play a critical role in the financial system by providing last mile credit intermediation, while absorbing and diversifying risks by catering to segments not serviced by banks and pioneering innovative financial products. In regulating these entities, the challenge is to maintain a fine balance between maintaining the innovativeness and dynamism of the sector while also promoting its resilience. Their sheer number (over 9,000) and heterogeneity makes supervising them a daunting task with onsite supervision needing to be reinforced by offsite monitoring, market intelligence, statutory auditors reports and stakeholder interaction. This Chapter attempts to give an insight into the NBFC sector by delving into the definition of an NBFC, explicating the heterogeneity of the sector and giving an overview of the regulatory and supervisory framework.

Definition of NBFC

An NBFC is defined under section 45 I(f) of the Reserve Bank of India Act, 1934 ('RBI Act') as a:

- i. a financial institution, which is a company;
- ii. a non-banking institution which is a company, and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
- iii. such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify

Thus, a 'financial institution' that is a company is an NBFC. The term 'financial institution', is defined under Section 45I(c) of the RBI Act. Briefly, a financial institution means any non-banking institution that carries on as its business (or part of its business) any of the following activities ('financial activities'):

- i. Lending or financing for activities other than its own
- ii. Acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority
- iii. Leasing or hire-purchase
- iv. Insurance business
- v. Chit business
- vi. Collection of monies
- vii. Acceptance of deposits

but does not include any institution, which carries on its principal business in

- i. Agriculture operations
- ii. Industrial activity
- iii. Purchase or sale of any goods (other than securities)
- iv. Providing any services and
- v. Sale/purchase/construction of immovable property

Sometimes, non-banking institutions that do not carry out the activities of a financial institution are still categorised as NBFCs. They are designated as NBFCs through a notification in the Gazette⁷² as in the case of Account Aggregators and Peer-to-Peer Lending Platforms, explained later. Another aspect is that a company need not be fully engaged in financial activities to be classified as an NBFC as long as it does not undertake as its principal business, non-financial activities such as agriculture, industrial activity, trading in goods, etc. The issue is how does one define principal business?

Principal Business Criteria (PBC):

As explained above only a company that carries on the business of a financial institution ('financial activity') as its principal business can be called an NBFC. On the other hand, if a company undertakes agriculture, manufacturing, trading in goods, etc. as its principal activity, it cannot be called an NBFC, even if carries out some financial activity. The term "principal business" is not defined in the RBI Act. Therefore, to give clarity and consistency to the interpretation of the term 'principal business', the Bank explained the term vide its press release dated April 8, 1999. As per this press release, to identify a company as an NBFC, the Bank will consider both, the assets and the income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. A company is treated as an NBFC, if its financial assets are more than 50 per cent (excluding fixed deposits⁷³) of its total assets (netted off by intangible assets) and income from financial assets should be more than 50 per cent of the gross income. Both these tests are required to be satisfied as the determinant factor for principal business of a company. If a company meets the PBC it is an NBFC and is required to be registered with the RBI unless specifically exempted from doing so.

⁷² Notified in the Official Gazette by the RBI, with the previous approval of the Central Government, under Section 45 I (f)(iii) of the RBI Act, 1934

⁷³ Vide circular dated March 15, 2012, it was clarified that investments in fixed deposits shall not be treated as financial assets and receipt of interest income on fixed deposits with banks shall not be treated as income from financial assets as these are not covered under the activities mentioned in the definition of "financial Institution" in section 45I(c) of the Act. Besides, bank deposits constitute near money and can be used only for temporary parking of idle funds, and/or in cases where the funds are parked in fixed deposits initially to fulfil the requirement of registration as NBFC, till commencement of NBFI business.

Are NBFCs shadow banks?

In response to the request by leaders of the Group of 20 (G20) to strengthen oversight and regulation of shadow banking in November 2010, the Financial Stability Board (FSB)⁷⁴ defined shadow banking as “*credit intermediation involving entities and activities (fully or partly) outside the regular banking system*” and adopted a two-pronged strategy to address financial stability risks from shadow banking, including a system-wide oversight framework and the coordination and development of policies to address such risks. However, on October 22, 2018, the FSB announced its decision to replace the term “shadow banking” with the term “non-bank financial intermediation” (NBFI) in future communications. This change in terminology is intended to emphasise the forward-looking aspect of the FSB’s work to enhance the resilience of non-bank financial intermediation and clarify the use of the technical terms. Every year the FSB publishes a Global Monitoring Report on Non-Bank Financial Intermediation. The following monitoring aggregates are used in the report to categorise NBFI:

- (i) MUNFI (monitoring universe of non-bank financial intermediation), also referred to as non-bank financial intermediation, is a broad measure of all NBFI, comprising insurance corporations, pension funds, Other Financial institutions (OFIs) and financial auxiliaries.
- (ii) OFIs comprise all financial institutions that are not central banks, banks, insurance corporations, pension funds, public financial institutions or financial auxiliaries. The largest OFI sub-sectors are investment funds, captive⁷⁵ financial institutions and money lenders (CFIMLs) and broker-dealers.
- (iii) Narrow measure of non-bank financial intermediation (or “narrow measure”) includes non-bank financial entity types that authorities have assessed as being involved in credit intermediation activities that may pose bank-like financial stability risks, based on the FSB’s methodology and classification guidance.

Exemptions from RBI regulation

As may have been observed from the definition of NBFC in the RBI Act, even entities such as insurance companies and stock broking companies are NBFCs. However, these entities are regulated by other regulators as part of their statutory function. Therefore, to avoid dual regulation, the RBI has exempted⁷⁶ various categories of NBFCs which are regulated by other regulators/ government from registration and/or other requirements. The table

⁷⁴ The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system. It was established after the 2009 G20 London summit in April 2009 as a successor to the Financial Stability Forum (FSF). The Board includes all G20 major economies including India, FSF members, and the European Commission. It is based in Basel, Switzerland.

⁷⁵ As per the FSB report Captive Financial Institutions are institutional units that provide financial services, including entities transacting with subsidiaries of the same holding corporation or entities that provide loans from own funds provided by only one sponsor. In simpler terms, captive financial institutions are those that provide finance for purchase of products of group companies from own funds.

⁷⁶ In exercise of its powers under section 45NC of the RBI Act

below lists various exempted categories and their regulators. Until August 9, 2019, Housing Finance Companies (HFCs) were regulated by the National Housing Bank (NHB). However, the same has now been transferred to the RBI through an amendment to the National Housing Bank Act, 1987.

Types of NBFCs/Activities	Regulated by
Venture Capital Fund, Merchant Banking Companies, Stock Broking Companies, Mutual Funds, Collective Investment Schemes (CIS)	Securities and Exchange Board of India (SEBI)
Insurance Companies	Insurance Regulatory and Development Authority (IRDA)
Pension Funds	Pension Fund Regulatory and Development Authority (PFRDA)
Mutual Benefit Companies, Nidhi Companies	Ministry of Corporate Affairs (MCA)
Chit Funds	State Governments

Types of NBFCs

Broadly, NBFCs can be categorised in the following ways:

- i. Based on acceptance of public funds and customer interface
- ii. Based on deposit acceptance and size
- iii. Based on activity its regulatory framework

Based on acceptance of public funds and customer interface

As mentioned previously, applications for registration of deposit accepting NBFCs (NBFC-D) are not considered since 1997. Further, in June 2016, the RBI issued a press release simplifying and rationalising the process for registration of new NBFCs. In respect of non-deposit accepting NBFCs (NBFC-NDs), there are two types of applications based on sources of funds and customer interface.

- i. **Type I** - NBFC-NDs not accepting public funds / not intending to accept public funds in the future and not having customer interface / not intending to have customer interface in the future. The term "Public funds" shall include funds raised either directly or indirectly through public deposits, commercial paper, debentures, inter-corporate deposits and bank finance but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue. The processing of cases for Type I - NBFC-ND applicants are subjected to less intensive scrutiny and due-diligence. However, in case these companies intend to avail public funds or have customer

interface in future, they are required to seek approval from the Department of Regulation (DoR).

- ii. **Type II - NBFC-ND** accepting public funds/intending to accept public funds in the future and/or having customer interface/intending to have customer interface in the future.

Even the regulatory framework provides certain relaxations for companies that do not access public funds and/ or have customer interface.

Based on size

An NBFCs-ND is categorised as systemically important (i.e. NBFC-ND-SI) if its asset size is ₹ 500 crore or more. Given the sensitivity towards public deposits, deposit taking NBFCs (i.e. NBFC-Ds) are clubbed along with NBFC-ND-SIs irrespective of their size. Indeed, some regulations for NBFC-Ds are restrictive and stringent as compared to NBFC-ND-SIs.

Based on activity

NBFCs are heterogeneous in their activities. While some engage primarily in micro finance and dealing with the underserved sections of society, others specialise in long term project and infrastructure finance. Consequently, it is difficult to have a ‘one size fits all’ regulatory framework and NBFCs need to be categorised based on their principal activities. This does make the regulatory framework complex and attempts have been made to harmonise regulations and reduce the number of categories. Today almost 99 per cent of NBFCs by number fall under the Investment and Credit Category (ICC) explained below.

Sl. No.	Type of NBFC	Nature of activity / Principal Business	Key Qualifying Criteria
1.	Investment and Credit Company (ICC)	<ul style="list-style-type: none"> i) Lending (erstwhile Loan companies) ii) Financing of physical assets including automobiles, tractors and generators (erstwhile Asset Finance Companies) iii) Acquisition of securities (erstwhile Investment Companies) <p>Includes Gold Loan companies which are NBFCs primarily engaged (i.e. 50 per</p>	Does not qualify (or has not registered) to be in any other category

Sl. No.	Type of NBFC	Nature of activity / Principal Business	Key Qualifying Criteria
		cent or more of financial assets) in lending against gold jewellery ⁷⁷ .	
2.	Infrastructure Finance Company (IFC)	Providing long term loans for Infrastructure development	<ul style="list-style-type: none"> (i) Infrastructure loans should be at least 75 per cent of total assets. (ii) Minimum NOF of ₹ 300 crore (iii) Minimum credit rating of 'A' (iv) CRAR of 15 per cent with min. Tier 1 of 10 per cent
3.	Core Investment Company (CIC)	Investing in / lending to group companies	<ul style="list-style-type: none"> (i) 90 per cent of total assets to be investments in group companies and 60 per cent of investments in group companies to be in equity shares of group companies (ii) Does not trade in its investments in shares, bonds, debentures, debt/loans of group companies except through block sale for dilution/disinvestment. (iii) Does not carry out any other financial activity
4.	Infrastructure Debt Fund (IDF)	Refinancing existing debt of infrastructure companies	<ul style="list-style-type: none"> (i) Minimum NOF of ₹ 300 crore (ii) Invests only in Public Private Partnerships (PPP) and post commencement of operations date (COD) in infrastructure projects which have completed

⁷⁷ Lending against the bullion, primary gold or gold coins is prohibited.

Sl. No.	Type of NBFC	Nature of activity / Principal Business	Key Qualifying Criteria
			at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.
5.	Micro Finance Institutions (MFI)	Collateral free loans to small borrowers	(i) Minimum NOF of ₹5 crore (for North East: ₹ 2 crore) (ii) Invests only in Public 85 per cent of assets to be in qualifying assets criteria ⁷⁸
6.	NBFC – Factors	Factoring business i.e. financing of receivables. Registered under section 3 of the Factoring Act	(i) Minimum NOF of ₹5 crore (ii) Financial assets in factoring business at least 50 per cent of total assets and income derived there from not less than 50 per cent of total income.
7.	Mortgage Guarantee Companies (MGC)	Providing mortgage guarantees for loans	90 per cent of business turnover in principal business and 90 per cent of gross income from this business
8.	Non-Operative Financial Holding Company (NOFHC)	For setting up new banks in private sector through its promoter/promoter groups	Should have first received an in-principle approval for setting up a commercial bank from RBI.
9.	Account Aggregators (AA)	Providing under contract the service of retrieving,	Can only provide account aggregation services. Only those

⁷⁸ The assets which qualify certain criteria stipulated by RBI with regard to maximum amount of loans linked to income of the borrower, total indebtedness of the borrower, tenor of loan, loans for income generation, etc. would be treated as 'qualifying assets'.

Sl. No.	Type of NBFC	Nature of activity / Principal Business	Key Qualifying Criteria
	[notified under section 45I(f)(iii)]	consolidating, organising and presenting financial information of its customer (with explicit consent).	financial assets that are under the regulatory ambit of financial sector regulators can be aggregated. These aggregators cannot support the transactions of customers and cannot take services of third-party service providers.
10.	Peer-to-Peer (P2P) Lending Platforms [notified under section 45I(f)(iii)]	Carries on the business of a P2P lending platform i.e. providing loan facilitation services to participants on the platform.	Can only provide platform. No lending from its own books.
11.	Housing Finance Company (HFC)	Registered under section 29A the NHB Act to carry on the business of providing finance for housing and housing projects.	Minimum NOF is ₹ 10 crore.
12.	Standalone Primary Dealers (SPD)	Primary Dealers are expected to play an active role in the G-Sec market, both in its primary and secondary market segments through various obligations like participating in Primary auction, market making in G-Secs, predominance of investment in G-Secs, achieving minimum secondary market turnover ratio, etc.	Minimum NOF of ₹150 crore for undertaking core activities and ₹250 crore for undertaking diversified activities.

In addition to the above categories there is a class of NBFCs called Residuary Non-Banking Companies (RNBCs). The principal business of such companies is receiving deposits under any scheme or arrangement or in any other manner. However, no fresh registrations

for this category are being issued. Miscellaneous Non-Banking Companies (MNBCs) are NBFCs that manage chit fund⁷⁹ business. Chit funds are primarily regulated by State Governments and NBFCs carrying on chit fund business are exempt from registration requirements. Further, MNBCs have been barred from accepting fresh public deposits since July 1, 1977 and the extant RBI regulatory framework deals with protecting the interest of depositors of the existing depositors of such companies.

Apart from the above, there are also Asset Reconstruction Companies (ARC) that are registered and regulated under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 for acquiring and dealing in financial assets sold by banks and financial institutions. ARCs play a crucial role in resolution of non-performing assets (NPAs). ARCs have been exempted by the RBI from registration under the RBI Act and are instead registered by RBI under section 3 of the SARFAESI Act. The minimum NOF stipulated for these companies was increased from ₹.2 crore to ₹.100 crore in April 2017. Prudential guidelines on maintenance of capital adequacy, deployment of funds, asset reconstruction, asset classification norms, disclosure norms, etc., have been stipulated for these companies also by RBI.

Another way to distinguish NBFCs is based on ownership i.e. Government owned and others. The regulatory framework has endeavoured to remove this distinction by making the prudential framework applicable to Government owned NBFCs in a phased manner. However, there is a distinction in the statutory framework with the RBI not having the powers to remove directors or supersede the Board of Directors of a Government owned Company.

Regulation of NBFCs - Genesis and Legal Framework

RBI acquired regulatory and supervisory powers over NBFCs with the insertion of Chapter III-B in the RBI Act in 1963. An extract of the Statement of Objects and Reasons to the Banking Laws (Miscellaneous Provisions) Bill, 1963 that inserted Chapter III B into the RBI Act is given below.

"The existing enactments relating to banks do not provide for any control over companies or institutions, which, although they are not treated as banks, accept deposits from the general public or carry on other business which is allied to banking. For ensuring more effective supervision and management of the monetary and credit system by the Reserve Bank, it is desirable that the Reserve Bank should be enabled to regulate the conditions on which deposits may be accepted by these non-banking companies or institutions. The Reserve Bank should also be empowered to give to any financial institution or institutions directions in respect of matters, in which the

⁷⁹ A chit fund is a rotating savings and credit scheme. Generally, a group of persons come together to contribute a fixed sum to a chit fund monthly for several months (equaling the number of members). The fund is managed by a foreman. Every month an auction is held for the chit fund and the member bidding the lowest amount wins the auction. Originally, the winner was selected drawing a chit from a box (hence the term "chit fund") and this practice continues in some chit funds instead of the auction. The balance amount after adjusting for the foreman's commission is distributed amongst the rest of the members. A member who wins an auction is not allowed to participate in future auctions, but has to continue to contribute the monthly subscription.

Reserve Bank, as the central banking institution of the country, may be interested from the point of view of the control of credit policy.”

While regulation of NBFCs by RBI started in 1963 with Parliament's recognition of the need to regulate the deposit taking activity of NBFCs, 1996 marked a watershed year for NBFCs with the failure of a large NBFC (CRB Capital). Based on the recommendations of the Shah Committee (1992), which had highlighted the need to expand the regulatory and supervisory focus of NBFCs, RBI's regulatory and supervisory powers were strengthened with amendments to Chapter III B of the RBI Act. Some of the important amendments carried out in 1997 included:

- Compulsory registration with RBI and maintenance of minimum Net Owned Fund (NOF)
⁸⁰ for companies satisfying the ‘principal business’ criteria (Sec.45-IA)
- Maintenance of liquid assets by NBFCs accepting public deposits (Sec.45-IB)
- Creation of a Reserve Fund by all NBFCs by transfer of 20 per cent of their net profit every year (Sec.45-IC)
- Powers of RBI to determine Policy and issue directions to NBFCs (Sec.45JA)
- Conduct of Special Audit of the accounts of NBFCs, if necessary (Sec.45MA)
- Power of RBI to prohibit acceptance of deposits and alienation of assets (Sec.45MB)
- Power of RBI to file winding up petition under Companies Act, 1956 (Sec.45MC)
- Introduction of nomination facility for depositors of NBFCs (Sec.45QB)
- Prohibition of deposit acceptance by unincorporated bodies engaged in financial business (Sec.45S)
- Power of RBI to impose fine on NBFCs for violations / contraventions of guidelines (Sec.58G)

The Reserve Bank tightened the regulatory structure over the NBFCs, with rigorous registration requirements, enhanced reporting, and supervision. The Bank also took a policy stance to not register new public deposit accepting NBFCs and encourage the existing ones to convert to non-deposit taking NBFCs. Further, in 1999 capital requirement for fresh registration was enhanced from ₹.25 lakh to ₹.2 crore.

In view of the rapid strides made by NBFCs in terms of their size, nature of operations with entry into newer areas of financial services and products, adoption of newer technologies, etc., the regulatory framework for the sector was reviewed again in 2014⁸¹. The review was also necessary as this sector was increasingly getting inter-connected with other

⁸⁰ Net Owned Fund = Owned Fund (-) investments and other exposure of the NBFC in its group companies and subsidiaries to the extent the amount exceeds 10% of the Owned Fund. Owned Fund = Capital + Reserves – accumulated losses and deferred revenue expenditure – other intangible assets.

⁸¹ Refer Revised Regulatory Framework for NBFCs issued vide DNBR(PD) CC.No.002/03.10.001/ 2014-15 dated November 10, 2014

segments of the financial sector with changes observed in both sides of the balance sheet. The key changes in the revised regulatory framework were as follows:

- i. Requirement of minimum NOF of ₹2 crore for legacy NBFCs.
- ii. Harmonisation of deposit acceptance requirements across categories and introduction of minimum investment grade rating requirement for deposit acceptance.
- iii. Revision of the threshold of systemic significance from ₹100 crore to ₹ 500 crore and inclusion of multiple NBFCs within the same group for reckoning systemic significance threshold.
- iv. Differentiated regulatory approach based on customer interface and source of funds. At one end of the spectrum, entities with asset size less than ₹500 crore and not accessing public funds with no customer interface were exempted from prudential and business conduct regulations. At the other end, entities accessing public funds with customer interface were subjected to full slew of regulations.
- v. Harmonisation of asset classification norms for NBFC-D and NBFC-ND-SIs with banks.
- vi. Review of corporate governance and disclosure norms leading to constitution of Board Committees (Audit Committee, Nomination Committee, and Risk Management Committee) and rotation of audit partners every three years applicable for NBFC-Ds and NBFC-ND-SIs.

In 2019, certain amendments enumerated below were again carried out to Chapter III-B of the RBI Act, which has *inter-alia* strengthened RBI's supervisory powers.

- Reserve Bank may notify different amount of NOF to different categories of NBFCs with minimum NOF between ₹.25 lakh and ₹.100 crore (Sec.45-IA)
- RBI can remove Directors of NBFC (other than Government owned NBFCs) – (Sec.45-ID)
- RBI can supersede the BOD of NBFC (other than Government owned NBFCs) – (Sec.45-IE)
- RBI can remove or debar an auditor of NBFC for a max. period of 3 years at a time (Sec.45MAA)
- Resolution of NBFCs through amalgamation, reconstruction, splitting into various activities, etc. (Sec.45MBA)
- Power to call for information of Group Companies and inspection of Group Companies (Sec.45NAA)

Further, the Finance (No.2) Act, 2019 (23 of 2019) has amended the National Housing Bank Act, 1987 transferring the registration and regulation of HFCs to RBI. With the notification of the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 by the Government of India, the Bank is also entrusted with insolvency resolution process of NBFCs

(including HFCs) under the Insolvency and Bankruptcy Code (IBC) from November 2019 onwards.

Overview of the regulatory framework

NBFCs being financial service intermediaries are exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movements and risks pertaining to liquidity and solvency. Further, the inter-connectedness of NBFCs with other participants in financial markets has increased over time with greater access to public funds through NCDs, CPs, borrowings from banks and financial institutions. Consequently, risks of the NBFC sector can easily be transmitted to the rest of the financial system and vice-versa. While regulations for NBFCs are simpler and lighter as compared to banks, there is a continuous evaluation to ensure that NBFC regulations are commensurate with the systemic impact that NBFCs can cause and certain financial market activities do not remain out of the regulatory perimeter.

As explained earlier, NBFCs are categorised into deposit taking (NBFC-D) and non-deposit taking (NBFC-ND), with the latter being further categorised based on total assets as systemically important (NBFC-ND-SI) if the total assets are ₹. 500 crore or more. The regulatory framework for NBFC-NDs is lighter as compared to NBFC-ND-SI and NBFC-Ds. Illustratively, instead of capital to risk weighted assets ratio (CRAR), NBFC-NDs are required to adhere to a simpler to compute leverage ratio⁸². Similarly, a six-month overdue norm is followed for classification of an asset as non-performing for NBFC-NDs as compared to a three-month overdue norm for NBFC-ND-SIs and NBFC-Ds. Further, credit concentration norms as applicable to NBFC-ND and NBFC-D have not been made applicable for NBFC-NDs.

Broadly regulatory objectives are twin fold i.e. (i) fostering financial system stability and (ii) consumer protection. Based on these objectives, regulations applicable to NBFCs may be classified as Prudential (i.e. those that foster financial system stability) and Conduct of Business (i.e. those that provide for consumer protection). While Prudential Regulations include prescribing of capital adequacy requirements, single/group borrower exposure norms, income recognition, asset classification and provisioning norms, prescribing Loan-To-Value (LTV) ratios, Leverage Ratio, regulations governing acceptance of public deposits, etc., the Conduct of Business Regulations mainly relate to the Fair Practices Code (FPC) to be adhered to by lenders and adherence to Know Your Customer (KYC) norms by NBFCs. The regulatory framework also takes cognizance of whether an NBFC has accessed public funds or has customer interface. NBFCs that do not access public funds are exempted from most prudential regulations, while NBFCs that do not have customer interface are exempted from most business conduct regulations.

A comparison of the key elements of the regulatory framework for NBFCs vis-à-vis banks is summarised in the table below:

⁸² Leverage Ratio for NBFCs is defined as Total Outside Liabilities / Owned Funds. As per extant regulations, the Leverage Ratio should not exceed 7 for NBFC-NDs (excluding NBFC-MFIs and NBFC-IFCs).

	NBFC-ND	NBFC-ND-SI and NBFC-D	Banks
Legal Basis	Chapter IIIB of the RBI Act		Banking Regulation Act, 1949
Capital Adequacy	No CRAR. Leverage Ratio of 7 times	Min. CRAR of 15 per cent (akin to Basel 1 i.e. uniform risk weights and no capital charge for market or operating risks)	Min CRAR of 9 per cent + Capital Conservation Buffer +Counter cyclical Buffer (Basel 3 based)
NPA classification norms	6 months overdue (except NBFC-MFI)	3 months overdue (90 days for NBFC-MFI)	90 days
Credit concentration	No specific norms	Limits reckoned as percentage of owned funds Single Borrower Limit: 25 per cent (Lending:15 per cent, Investment: 15 per cent) Group Borrower Limit: 40 per cent (Lending:25 per cent, Investment: 25 per cent)	Large exposure framework –Limit reckoned as per centage of Tier I capital Single counterparty: 20 per cent Groups of connected counterparties: 25 per cent
Liquidity Coverage Ratio (LCR)	Not applicable	Applicable for all NBFC-D and those NBFC-ND-SI with asset size of ₹5,000 crore or more.	Applicable for all Commercial Banks (excluding Regional Rural Banks, Local Area Banks and Commercial Banks)
Net Stable Funding Ratio	Not applicable	Not applicable	Guidelines issued and will be applicable to all Scheduled Commercial Banks (excluding Regional

	NBFC-ND	NBFC-ND-SI and NBFC-D	Banks
			Rural Banks) when effective.
KYC/AML-CFT	Same norms uniformly applicable to banks and NBFCs.		
Accounting Norms	Based primarily on Companies Act, 2013. Listed NBFCs and other NBFCs with net worth of ₹ 250 crore or more are required to prepare financial statements as per IFRS converged Indian Accounting Standards (Ind AS)	Melange of statutory requirements, accounting standards, RBI instructions and guidance notes issued by self-regulatory organisations.	

Regulatory Guidance on Implementation of Ind AS

In accordance with the roadmap for transition to IFRS converged Indian Accounting Standards (Ind AS) drawn up by the Ministry of Corporate Affairs, NBFCs with a net worth of ₹500 crore or above have already transitioned to Ind AS from April 1, 2018 followed by NBFCs with a net worth of ₹ 250 crore or above and other listed NBFCs transitioning from April 1, 2019.

Ind AS represents a paradigm shift in accounting by *inter-alia* introducing concepts of expected credit loss (ECL) framework, other comprehensive income, symmetric fair value accounting, etc. which also impacts the interaction of the accounting framework with regulatory capital computation. Being “principle based” rather than “rule based” Ind AS also brings in a significant increase in subjectivity and management discretion resulting in a concomitant loss of comparability. To promote a high quality and consistent implementation as well as to facilitate comparability and better supervision, the RBI vide circular dated March 13, 2020 issued regulatory guidance to NBFCs implementing Ind AS. The salient features of the proposed guidance are as under:

- a) A governance framework is prescribed for critical assumptions and management judgment entailed in Ind AS through Board approved documentation of business model objectives, ECL model, definition of default, etc. While placing responsibility on the Board, this would also facilitate verifiability by auditors and supervisors.
- b) Ind AS 109 does not explicitly define default but requires entities to define default in a manner consistent with that used for internal credit risk management. The circular recommends that the definition of default adopted for accounting purposes be guided by the definition used for regulatory purposes. Further, it requires ACB to approve the classification of accounts that are overdue for more than 90 days but

- have not been classified as impaired. The number and total amount outstanding against such accounts also needs to be disclosed.
- c) Under Ind AS, when a significant increase in credit risk is assessed, the ECL allowances move from 12 month to lifetime ECL. Ind AS provides a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. In limited circumstances where NBFCs/ARCs rebut this presumption, they should place the justification before the ACB. Further, the recognition of significant increase in credit risk should not be deferred for accounts that are overdue beyond 60 days.
 - d) To address concerns pertaining to inadequate provisioning under Ind AS, a prudential floor based on the current norms (IRACP) has been prescribed. In case provisioning under Ind AS is below IRACP norms, the difference would not be available for payment of dividend and instead need to be transferred to an 'Impairment Reserve'. The Impairment Reserve shall not be reckoned for regulatory capital. Any withdrawal from this reserve would be subject to approval from RBI. Further, in order to provide a benchmark for comparison for stakeholders, a disclosure template comparing Ind AS and IRACP classification and provisioning has been prescribed.
 - e) In order to minimise the disruption to the regulatory capital computation, the guidelines provide for ignoring net unrealised fair value gains, while providing for net unrealised fair value losses. They also prescribe treatment for 12 month ECL (on the same lines as general provisions), discount on revaluation of fixed assets, derecognition of unrealised gains and losses due to cash flow hedge reserve and own credit risk and adjustments in net owned funds due to fair valuation of group entities. It is also clarified that regulatory capital would be required on financial instruments that do not qualify for derecognition. Further regulatory ratios, limits and disclosures would be based on Ind AS figures.

Fintech developments in the NBFC sector

In India, banks and NBFCs are increasingly using technology to adopt financial innovation. As the financial sector regulator, the Reserve Bank of India has been on the forefront of creating an enabling environment for growth of digital technology for new financial products and services. In fact in the non-banking and the payment and system space, the Bank has been ahead of the curve and has come out with regulations for new products and services when the industry itself was at nascent stage. Peer to peer (P2P) lending, Account Aggregator (AA) and credit intermediation over only digital platforms are cases in point where the regulation has helped the industry to grow in a systematic and robust manner.

Digital-only lending platform- Though Digital-only lending platform are not a new category of NBFC, they have adopted a business model wherein the NBFI activity is carried out only over a digital platform without any brick and mortar presence. There are around 20 such platforms which are catering primarily to retail individuals and small entrepreneurs with small ticket

loans but with high frequency. This enables them to have a shorter turnaround time and increase the number of cycles. It also caters to such customers who do not have credit history, but their creditworthiness can be ascertained through their spending pattern, which in turn would bring more customers in the formal financial fold.

P2P Lending Platform- An intermediary bringing the borrowers and lenders over an electronic platform. The platform itself does not take any credit risk, transactions are reported over credit information companies and prudential limits have been placed on the borrowers and lenders on the platform. There are around 21 P2P platforms which are functional.

Account Aggregator - It retrieves or collects information related to financial assets of a customer from the holders of such information and aggregates the same before presenting it to the customers or users specified by customers. The larger goal of AA is to attain data empowerment or data democratization in an emerging market economy like India where access to financial services (qualitative and quantitative) is still limited to a large extent.

Technical Specifications for AA- In the AA ecosystem, the data is supposed to move in a standardised and encrypted format across different financial sector regulated entities. In order to ensure that movement of data is seamless across systems in a safe and secured environment, technical specifications for AA have been prescribed. These are Application Programme Interface (API) based specifications framed for movement of data and in the core is the consent architecture which will go a long way in realising the full potential of the AA ecosystem.

The highlight of these regulations is that these not only give a fillip to adoption of newer, faster and efficient technology/business models but also alleviate the concerns arising out of adopting fintech led financial services. In particular, regulatory features like, explicit consent for data sharing, domestic location of servers, electronic consent artefact, audit trails, CISA audit, data blind AA platform etc are progressive and pre-emptive in nature.

Supervision of NBFCs

The RBI has instituted a strong and comprehensive supervisory mechanism for NBFCs. The focus of the RBI is on prudential supervision to ensure that NBFCs function on sound and healthy lines and avoid excessive risk taking. The RBI has put in place a five-pronged supervisory framework based on:

(I) On-site Inspections: The system of on-site examination put in place during 1997 is structured on the basis of CAMELS (Capital, Assets, Management, Earnings, Liquidity, and Systems and Controls) approach. The Reserve Bank derives its powers under Section 45N of the RBI Act, 1934 to cause an inspection of an NBFC for the purpose of verifying the correctness or completeness of any statement or information or for obtaining any information or particulars or if the Bank feels that such an inspection is warranted. Powers to inspect the books of an NBFC have also been vested with the Bank under Section 45-IA(4) of the RBI Act, 1934, primarily to verify as to whether the financial company complies with the conditions

laid down for grant of Certificate of Registration (CoR). The overall objectives of on-site inspection of an NBFC are to:-

- Assess the adequacy of capital and earnings prospects and assign a supervisory rating on the basis of CAMELS.
- Evaluate the solvency of the financial company.
- Evaluate the position of compliance with provisions of the RBI Act and the directions/notifications issued from time to time, and any other guidelines/regulations which may be prescribed by the Bank under the extant Act.
- Identify the areas where corrective actions are needed to strengthen the company.

The supervisory framework takes into account the statutory prescriptions, directions and prudential regulations. Within this framework, companies are expected to manage themselves prudently to meet the risks emanating from their business and ensure that they are in a position to meet their obligations, particularly (public) deposit liabilities and other creditors and also ensure that they do not function in a manner detrimental to the interests of their depositors or the overall financial system. The periodicity of such inspections will be based on the category and asset-size of NBFCs.

(II) Off-site monitoring: In order to supplement information gathered from on-site inspections, several returns have been prescribed for NBFCs as part of the off-site surveillance system. The information provided is analysed to identify potential supervisory concerns and in certain cases serves as a trigger for on-site inspection. The returns being submitted by the NBFCs are reviewed and examined at intervals to widen the scope of information, so as to address the requirements either for supervisory objectives or for furnishing the same to various interest groups on the important aspects of the working of these companies.

(III) Market Intelligence: Market Intelligence is an important component of monitoring financial sector. While off-site surveillance system and on-site inspections are effective tools in assessing the financial position and overall regulatory compliance of the registered companies, pro-active market intelligence can help pick up early warning signals about the health of a particular NBFC and trigger supervisory action to protect the interest of the depositors/avoid systemic risks. In the recent past, there has been a spurt in the activities of the entities which accept money under various garbs by violating the directions of the Regulators and structure their scheme in a manner which escapes the apparent meaning of 'Deposits' and the attention of the Regulators. With the objective to control the incidents of unauthorized acceptance of deposits by unscrupulous entities, State Level Coordination Committees (SLCC) are formed in all States to facilitate information sharing among the Regulators viz. RBI, SEBI, IRDA, NHB, PFRDA, Registrar of Companies (RoCs) etc., and Enforcement Agencies of the States viz., Home Department, Finance Department, Law Department, Economic Offences Wing (EOW) etc. SLCCs were reconstituted in May 2014 with renewed focus on the illegal activities of the unauthorised entities. In the last few years, the regular discussions among the Regulators and Enforcement Authorities has led to increased

awareness & co-ordination and Standard Operating Procedures are being evolved for effective handling of such matter.

The 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 wherein they can also upload photographs of advertisements/publicity material, raise queries on any fund raising/investment schemes that they come across and lodge complaints. The portal has links to all the regulators and the public can easily access information on lists of regulated entities. The portal has a section for a closed user group – the SLCC inter-regulatory forum for exchange of information and coordinated action on unauthorised deposit collection and financial activities. It helps in enhancing coordination among regulators and State Government agencies, which serves as a useful source of information for early detection and curbing of unauthorised acceptance of deposits. On October 24, 2019 Sachet portal was made available in 11 more prominent regional languages besides Hindi and English to further its penetration in general public.

(IV) Exception Reports of Statutory Auditors: In addition to all the above types of supervision, the responsibility of ensuring compliance with the directions issued by the Reserve Bank, as well as adherence to the provisions of the RBI Act has also been entrusted to the Statutory Auditors of NBFCs. The Statutory Auditors are required to report to the Reserve Bank about any irregularity or violation of regulations concerning acceptance of public deposits, credit rating, prudential norms and exposure limits, capital adequacy, maintenance of liquid assets and regularisation of excess deposits held by the companies.

(V) Interaction with stakeholders: In order to develop a closer understanding of the emerging risks and developments in the sector to facilitate prompt action Supervision department interacts with various stakeholders like Management of NBFCs, Statutory Auditors, Credit Rating Agencies, Credit Information Companies, Mutual funds etc. In addition to the above, the actions of the supervised entity in the market and the approach of the investors in the bonds/ CPs of NBFCs is discussed with market department to understand the position of the supervised entity from the perspective of investors.

Conclusion

Over the last decade, non-banking financial companies (NBFCs) have witnessed phenomenal growth. From being around 10 per cent of the balance sheet size of banks in 2009, they are now more than a quarter of the size of banks. While the development of a robust non-bank intermediation channel provides a good ‘spare tyre’ to the economy, unbridled growth fuelled by a lighter regulatory framework can also lead to systemic risks. Therefore, it is a constant endeavour of the Reserve Bank to enable prudential growth of the sector, keeping in view the multiple objectives of financial stability, consumer and depositor

protection, the need for more players in the financial market and addressing regulatory arbitrage concerns while not forgetting the uniqueness of the NBFC sector.

Chapter 11: Enforcement in RBI

The Reserve Bank has powers to impose penalties under various laws affecting the banking and financial sector, viz., Banking Regulation Act, 1949 [BR Act]; Reserve Bank of India Act, 1934 [RBI Act]; Payments and Settlement Systems Act, 2007 [PSS Act]; Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 [SARFAESI Act]; Factoring Regulation Act, 2011 [FR Act]; Credit Information Companies (Regulation) Act, 2005 [CIC (R) Act]; etc. While the Reserve Bank has been taking penal action under these statutes, the process was spread across various supervisory/regulatory departments and was also not in line with the international best practice of separating enforcement action from the supervisory process.

Regulation, surveillance and enforcement are three pillars of financial sector oversight mechanism. Regulations determine the framework in which financial entities function so that prudence, transparency, and comparability are ensured on the one hand and customer and public interests are protected on the other. Surveillance is the process through which adherence to the regulations is monitored. Ascertainment of cases of non-compliance with regulations noticed either through the surveillance process or otherwise, and taking appropriate penal action falls within the domain of enforcement. An effective system of banking supervision depends, *inter alia*, on effective enforcement of supervisory policies which, in turn, needs a unified and well-articulated enforcement policy and institutional framework. Taking cognisance of such a need and in line with the international best practices, in furtherance to the announcement made in the 1st Bi-monthly Policy Statement, 2016-17 on April 5, 2016, the Board for Financial Supervision approved a Supervisory Enforcement Framework for action against non-compliant banks, with an intent to meet the principles of natural justice and global standards of transparency, predictability, standardisation, consistency, severity and timeliness of action. While the said framework was originally intended for undertaking enforcement action, against scheduled commercial banks, following a subsequent announcement in the 6th bi-monthly monetary policy statement on February 8, 2017, a separate Enforcement Department (EFD) was established in Reserve Bank on April 3, 2017, with a view to put in place a structured, rule based approach to identify and process the violations committed by all the regulated entities, and enforce the same consistently across entities. A comparative enforcement framework/s prevalent in other jurisdictions is given in Box-1 below.

Box-1

International Experience

In the **United States**, the Federal Deposit Insurance (FDI) Act and Federal Deposit Insurance Corporation (FDIC) Rules and Regulations, Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), 1989 and US Civil Code are some of the laws that regulate the financial sector. Supervisory and enforcement powers are divided between various agencies at the federal and state level and four agencies, viz., Board of Governors of the Federal

Reserve System (Federal Reserve), FDIC, Office of the Comptroller of the Currency (OCC) and the Consumer Financial Protection Bureau (CFPB). In addition, the Department of Justice (DoJ) enforces misconduct related to criminal offences and anti-competitive conduct. On the basis of gravity, the violations are classified as Tier 1, Tier 2 and Tier 3 and enforcement action may include non-monetary action like public statements, cease and desist orders, withdrawal of authorisation and temporary bans on the management, monetary fine and criminal penalties.

In the **European Union (EU)**, banking supervision is carried out by a Single Supervisory Mechanism, one of the two pillars of the EU Banking Union, the other being Single Resolution Mechanism, and comprises the European Central Bank (ECB) and the national competent authorities (NCAs) of participating Member States. The supervisory domain of ECB and NCAs is determined on the basis of classification of an institution, viz., significant institutions are supervised by ECB and the less significant institutions by the NCAs. Monetary penalties can be imposed on significant institutions and less significant institutions by ECB or by the NCAs depending on the nature of breach (of EU Law, ECB regulation and decisions or national law), up to twice the amount of the profits gained or losses avoided because of the breach, or up to 10 per cent of the significant institution's total annual turnover in the preceding business year, based on the principles of effectiveness, proportionality and dissuasiveness, taking into account severity of the infringement and also any aggravating and mitigating circumstances of the case. The period of limitation (from the date of infringement) within which the decision to impose penalty is to be taken as well as the period within which the penalty is to be recovered is also provided by the Regulation.

Core Function and Mandate of EFD

The core function of EFD is to enforce regulations with an objective of promoting financial system stability, public interest and consumer protection. Accordingly, the mandate of EFD is to identify the actionable violations based on:

- i. Inspection/supervisory/scrutiny reports received from supervisory departments and references from regulatory departments;
- ii. Market intelligence reports received from other departments ; and
- iii. References by Reserve Bank's Top Management;

and undertake enforcement action in an objective, consistent and non-partisan manner;

Initially, taking into account the systemic importance of commercial banks, EFD was tasked with the responsibility of imposing monetary penalties for violations by the Scheduled Commercial Banks (SCBs) under Section 47A of the BR Act, rules framed and directions/regulations issued thereunder and violations falling under the Prevention of Money Laundering Act, 2002 where directions have been issued by RBI. Subsequently, enforcement work pertaining to Co-operative Banks and Non-banking Financial Companies (NBFCs) was also brought under the purview of EFD, with effect from October 3, 2018. Thereafter, the National Housing Bank Act, 1987 [NHB Act] was amended vide Finance (No. 2)

Act, 2019 and with effect from August 9, 2019, regulation of housing finance companies under the NHB Act, and the consequent enforcement actions, were transferred to Reserve Bank. With this, EFD was mandated to undertake enforcement action against commercial banks, cooperative banks and NBFCs under the provisions of BR Act, RBI Act, PSS Act, FR Act, CIC (R) Act and SARFAESI Act, and against housing finance institutions which are companies under the NHB Act.

In view of the requirement to undertake enforcement action against a large number of entities comprising of cooperative banks and NBFCs, for operational efficiency and focussed enforcement, Regional Offices of EFD were set up at Ahmedabad, Chennai, Kolkata, Mumbai, Nagpur and New Delhi. While the Department at Central Office undertakes enforcement action against commercial banks, scheduled cooperative banks, deposit-taking NBFCs, systemically important NBFCs and ARCs, the Regional Offices of the Department undertake enforcement action against non-scheduled cooperative banks, non-deposit taking and non-systemically important NBFCs. Enforcement action under the provisions of Foreign Exchange Management Act, 1999 [FEM Act] and Government Securities Act, 2006 [GS Act] for violations attracting monetary penalties, and other regulatory or supervisory action, including action to compound violations would continue to be undertaken by the respective regulatory/supervisory departments.

Enforcement Policy and Objective

The primary role envisaged for EFD was to develop a broad policy for enforcement. Accordingly, an ‘Enforcement Policy and Framework’ was drafted and placed before the BFS in its 255th Meeting held on October 9, 2017. Thereafter, with the extension (to cooperative banks and NBFCs) and expansion (to include other Acts) of the mandate of EFD, the Policy was revised and updated. The same was approved by BFS in its 276th meeting held on September 25, 2019 and subsequently placed before the Central Board, for information, in its meeting held on December 13, 2019,

The objective of the policy is to ensure greater compliance with statutes and regulations/directions issued by the Reserve Bank thereunder, within the overarching principle of ensuring financial stability, public interest and consumer protection. It envisages enforcement action to be initiated on the basis of inspection reports and scrutiny reports finalised by the supervisory departments (evidence based), based on well-defined principles of materiality, proportionality and intent applied uniformly across all entities to minimise arbitrariness and discretion (objective, consistent and predictable) with violations of higher incidence and greater systemic impact attracting sterner action (responsive, risk focussed and proportionate).

Scope of Enforcement

While various statutes empower the Reserve Bank to take penal action, both monetary and non-monetary, Enforcement Policy addresses violations attracting imposition of monetary penalty. Violations inviting non-monetary penalties or imposition of penal interest

would be enforced by the respective regulatory and supervisory departments. The Policy neither envisages dealing with individual consumer grievances nor is intended to be a mechanism for grievance redressal. Enforcement action is also not a substitute for the supervisory compliance process.

Basis of Enforcement

Actionable violations are determined on the basis of:

- i. fact of violation, and
- ii. materiality of the violation.

Fact of the violation is determined on the basis of the existence of statutory provision and directive/guideline issued thereunder and violation thereof. Materiality of the violation is determined on the basis of:

- i. the extent (i.e., by what degree or percentage a regulatory limit has been breached; or how widespread (geographically), even if by smaller percentage/degree, the violation is, etc.),
- ii. frequency (multiple instances of the same violation in a given sample) and
- iii. seriousness of the violation.

Seriousness of the violation is determined on the basis of the amount involved in the violation in an absolute number or as a proportion to business size. Aggravating factors like repeat/persisting violations, false compliance, violation of a specific direction, and seriousness of consequences of commission/omission, if any, are also factored in to determine materiality.

Adjudication Process

The process of enforcement action entails issuance of a show cause notice to the Regulated Entity (RE) and providing it with a reasonable opportunity of being heard, in writing, and also, if requested, orally. A three member Adjudication Committee consisting of three Executive Directors at Central Office (with ED in-charge of EFD as chairman), and Regional Director with two Senior Officers at Regional Office adjudicate the matter and issues to the RE a reasoned speaking order, indicating therein the enforcement action being taken and the reasons therefor. While the maximum amount that can be levied as penalty for a violation has been stipulated in respective statutes, the amount of penalty to be imposed in each case within that limit is assessed on its merits based on the principle of proportionality, intent and mitigating factors, if any. The penalty imposed is payable by the RE within the period specified in the respective statutes. At present, statutes enable the Reserve Bank to impose penalty only on the RE and not on the individual in charge of the entity or those apparently responsible for the violation. The Reserve Bank is not empowered to entertain any appeal against or review the order of the Adjudication Committee, except in cases where monetary penalty has been imposed under the SARFAESI Act. The details of the enforcement action are provided through Press Releases and in various publications of RBI.

Conclusion

An effective, consistent and predictable enforcement framework is a *sine qua non* for a credible banking/financial regulatory and supervisory framework. Enforcement action has a deterrent effect in terms of money and reputation for the RE and the demonstration effect of an enforcement action has been well documented. Studies have suggested that enforcement action leads to better behaviour not only in case of sanctioned banks but also modifies the behaviour of non-sanctioned banks favourably. (*Delis, Staikouras and Tsoumas, 2016*). Enforcement can be formal, *ex post* in the form of obtaining compliance as part of the supervisory process or imposing penalty on the banks/ individuals; or, informal, *ex ante* in terms of clarifications/cautionary advices issued by the regulator. A balanced approach to enforcement involves elements of both, with persisting / recurring non-compliance attracting exemplary action. Currently, the laws enabling RBI to undertake enforcement action empower it to impose monetary penalty only on the regulated entities and not on the individuals in-charge of the entities or responsible for the violations. It also needs to be noted that the enforcement process is not a mechanism for customer grievance redressal nor an alternative for supervisory compliance process.

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GAD Manual

Chapter 12: Development and Regulation of Financial Markets

Financial markets in India have evolved in the context of a primarily bank-dominated financial system. It was only after the financial reform process was initiated in the early nineties and the regulation of banks started getting aligned to the international best practices that different market elements were introduced gradually as part of the market development agenda. The agenda primarily focused on putting in place the requisite market microstructure in terms of institutions, technology, market participants and appropriate regulations.

The Money market, Government Securities market, Foreign Exchange market, certain elements of the Corporate Debt market and derivatives relating to interest rate, credit and foreign exchange fall under the regulatory domain of the Reserve Bank. The Bank has been discharging both the developmental as well as regulatory roles for these markets. While the developmental role aims at aiding orderly growth of the markets, the regulatory role focusses on framing appropriate prudential regulations for ensuring market integrity and stability.

Reserve Bank has followed a gradual path in introducing new financial products both in the cash and derivative markets based on the needs of the real sector and the broader objectives of development of the financial markets. The OTC products were supplemented with exchange-traded products during the recent period with an objective to enhance the market transparency, improve the price discovery process and to provide a wider access to market participants particularly the retail customers. The exchange traded products are jointly regulated by RBI and SEBI. The RBI-SEBI Technical Committee facilitates formulation of regulations for exchange-traded products.

Over the years, Reserve Bank has vested greater responsibilities with the market representative bodies, viz. Fixed Income, Money Market and Derivatives Association of India (FIMMDA), Foreign Exchange Dealers' Association of India (FEDAI), Primary Dealers' Association of India (PDAI), for development of various market segments and instituting self-regulatory mechanisms such as code of conduct, oversight of brokers, arbitration of trading disputes, etc. The Bank has facilitated setting up of an independent Benchmark Administrator, viz. Financial Benchmark India Limited (FBIL), jointly formed by FIMMDA, FEDAI and IBA, for administration of major financial benchmarks relating to Money, G-sec and Foreign Exchange markets.

The Bank has taken many initiatives over past several years to put in place robust financial market infrastructures. The first landmark initiative goes back to 2001 when the Clearing Corporation of India Limited (CCIL) was set up (operations started in February 2002) to provide an institutional mechanism for clearing and settlement of G-Sec, Money Market and Foreign exchange transactions. The institution has since expanded its operations to cover CCP based settlement in several cash market and derivative products and has set up a Trade Repository for all OTC foreign exchange, interest rate and credit derivatives.

In order to have a more focused approach towards market development and regulation, a new department called Financial Markets Regulation Department (FMRD) has

been set up carving out functions from various other departments. The Financial Market Consultative Committee (FMCC) guides the future agenda of the department. The important developmental and regulatory functions relating to financial markets performed by the Reserve Bank are described hereunder:

Money Market

The money market is a market for short-term financial assets that are close substitutes of money. It facilitates managing short-term surplus funds by lenders and the short-term funding deficits by borrowers. A deep and liquid Money Market enhances robustness of the yield curve. More importantly, Money Market provides an avenue for central bank intervention in influencing both quantum and cost of liquidity in the financial system, thereby transmitting monetary policy signals to the real economy.

The important developmental and regulatory roles performed by RBI in the Money Market are mentioned below:

Developmental Roles

The Chakravarty Committee (1985) was the first to make comprehensive recommendations for the development of the Indian money market. This was followed by the Vaghul Committee set up by the Reserve Bank to specifically examine various aspects for widening and deepening of the money market. Several new initiatives were taken based on the recommendations of the above committees. Instruments such as the Certificates of Deposit (CD), Commercial Paper (CP) and Inter-bank participation certificate (IBPC) were introduced. The Discount and Finance House of India (DFHI) was set up in 1988 to impart liquidity to money market instruments and help the development of secondary markets in such instruments. Based on the recommendations of the Narasimham Committee (1998) and the Reserve Bank's Internal Working Group to Examine the Development of Call Money Market (1997), steps were initiated to reform the call money market and make it a pure inter-bank market, in a phased manner starting in 1999 and was completed in August 2005.

The Interest Rate Swaps (IRS)/ Forward Rate Agreements (FRA) were introduced in 1999 to further deepen the money market and enable market participants to hedge their interest rate risks. Market infrastructure for trading, reporting, clearing and settlement of money market transactions has been strengthened keeping in pace with the development of the market. State-of-the-art electronic trading systems (viz. NDS-CALL, CROMS, TREPS), straight-through-processing (STP) of transactions, Real Time Gross Settlement (RTGS), and a separate Central Counter Party (CCP) in the Clearing Corporation of India Ltd (CCIL) for guaranteed settlement are among the steps that were taken by the Reserve Bank over the years. Apart from financial institutions such as Commercial banks, Co-operative banks, Primary Dealers (PDs), Insurance companies, Mutual Funds, Non-banking financial companies (NBFCs), etc., Reserve Bank has permitted corporates to participate in certain collateralized segments of the Money Market.

The important developmental measures undertaken during the recent period are: (i) Introduction of Re-Repo and Tri-party Repo, (ii) Strengthening the determination process for Mumbai Inter-bank Offered Rate (MIBOR), (iii) Setting up of trading platform for Rupee IRS trades referenced to the MIBOR (Overnight) at CCIL with guaranteed settlement facility, (iv) consolidating and simplifying the interest rate derivative framework. (v) allowing participation of new entrants such as payment banks and small finance banks in Call money market both as borrower and lender

Regulatory Roles

Reserve Bank has laid down prudential norms for various money market instruments, viz. Call/Notice Money, Repurchase Agreement (Repo), Commercial Paper (CP), Certificates of Deposit (CD), Non-Convertible Debentures (NCDs) of original or initial maturity up to one year and derivative products linked to Money Market interest rate/benchmark.

Call/Notice Money

Call/Notice Money refers to lending/borrowing of funds on uncollateralized basis among scheduled commercial banks, cooperative banks and the PDs. Payments Banks and Small Finance Banks have been permitted to participate in the call money market both as borrowers and lenders, which would expand the participation base in the call money market and provide an avenue for liquidity management for these entities. The lending/borrowing is for one day in case of Call Money, while it is for a period between two days to fourteen days in case of Notice Money. Prudential limits have been set in respect of both outstanding borrowing and lending transactions in Call/Notice money market for scheduled commercial banks, cooperative banks and PDs. The Call/Notice Money transactions take place over the counter (OTC), and on NDS-Call, a screen-based, negotiated, quote-driven electronic trading system managed by the Clearing Corporation of India (CCIL). The OTC trades are to be reported on the NDS-Call platform within the specified timeframe after execution of the trades.

Repurchase Agreement (Repo)

Repo is an instrument for borrowing (lending) funds by selling (purchasing) securities with an agreement to repurchase (resell) the securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed (lent). The transaction is called Repo from the point of view of the borrower of funds (seller of securities) and Reverse Repo from the point of view of the lender of funds (buyer of securities). The Repos undertaken with RBI are categorized as ‘Liquidity Adjustment Facility (LAF)-Repo’, while the Repos undertaken among the market participants in India are known as ‘Market Repo’. Currently Government securities, Treasury Bills, Commercial Papers, Certificates of Deposits, Units of Debt Exchange Traded Funds (Debt ETFs) and Corporate debt securities specified by RBI are permitted as eligible securities for Market Repo. Bonds issued by multilateral financial institutions like the World Bank Group (e.g., IBRD, IFC), the Asian Development Bank or the African Development Bank and other such entities as notified by RBI from time to time, and carrying minimum

ratings as specified by RBI, are also considered as eligible securities for Market repo. Permitted participants in market repo include Scheduled Banks, Primary Dealers, NBFCs, HFCs, Insurance companies, listed and unlisted companies etc. with some conditionalities. The Repo transactions can take place either on CCIL's anonymous Repo Order Matching System (CROMS) or bilaterally through OTC. The OTC Repo transactions are required to be reported on CROMS within the specified timeframe after execution of the trades. Securities purchased under the repo cannot be sold during the period of the contract except by entities permitted to undertake short selling. Re-repo is permitted in government securities, including state development loans and Treasury Bills, acquired under reverse repo, subject to certain conditions. In case of the Tri-party Repo permitted in July 2018, RBI has specified various aspects of the product including the eligibility criteria and roles and obligations of the Tri-party agent. In July 2018, comprehensive directions for repo in G-sec and corporate debt were issued to simplify and harmonise the regulations across different types of collateral and to encourage wider participation, especially for corporate debt repos.

Commercial Paper (CP)

CP is an unsecured money market instrument issued in the form of promissory note. This was introduced in 1990 with an objective to enable highly rated corporate borrowers to diversify their sources of short-term borrowings and provide an additional instrument to the investors. Companies including Non-Banking Finance Companies (NBFCs) and All India Financial Institutions (AIFIs); other entities like co-operative societies/unions, government entities, trusts, limited liability partnerships and any other body corporate having presence in India with a net worth of ₹100 crore or higher are eligible to issue CPs subject to the condition that any fund-based facility availed by them from bank(s) and/or financial institutions is classified as a standard asset by all financing banks/institutions at the time of issue. The end use of the issue proceeds has to be disclosed in the offer document at the time of issue of a CP. Eligible issuers, whose total CP issuance during a calendar year is above the threshold prescribed by RBI, have to obtain necessary credit rating from Credit Rating Agencies registered with SEBI. All OTC trades in CP are required to be reported within the specified timeframe after execution of the trades to the Financial Market Trade Reporting and Confirmation Platform ("F-TRAC") of Clearcorp Dealing System (India) Ltd. (CDSL). The duties and obligations of the Issuer, Issuing and Paying Agent (IPA) and Credit Rating Agency (CRA) have been spelt out in RBI's guidelines.

Certificate of Deposits (CD)

Certificate of Deposit (CD) is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note against funds deposited at a bank or other eligible financial institution for a specified time period. CDs can be issued by (i) scheduled commercial banks (excluding Regional Rural Banks and Local Area Banks), and (ii) select All-India Financial Institutions (FIs) that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year, while FIs can issue CDs for a period

not less than 1 year and not exceeding 3 years. Banks / FIs cannot grant loans against CDs. Furthermore, they cannot buy-back their own CDs before maturity. However, the RBI may relax these restrictions for temporary periods through a separate notification. All OTC trades in CD are required to be reported within the specified timeframe after execution of the trades to the Financial Market Trade Reporting and Confirmation Platform ("F-TRAC") of Clearcorp Dealing System (India) Ltd. (CDSL).

Non-Convertible Debentures (NCDs) of original maturity up to one year

Non-Convertible Debenture (NCD) means a debt instrument issued by a corporate (including NBFCs) with original or initial maturity up to one year and issued by way of private placement. A corporate shall be eligible to issue NCDs if it fulfils certain criteria laid down by RBI in terms of its tangible net worth, sanctioned working capital limit or term loan facility from bank/s or all-India financial institution/s, and the status of its borrowing account with the financing bank/s or institution/s. An eligible corporate intending to issue NCDs should obtain necessary credit rating for issuance of the NCDs from one of the rating agencies registered with SEBI or such other credit rating agencies as may be specified by RBI from time to time. NCDs should not be issued for maturities of less than 90 days. The exercise date of option (put/call), if any, attached to the NCDs should not fall within 90 days from the date of issue. Every corporate issuing NCDs should appoint a registered Debenture Trustee (DT) for each issuance of the NCDs. The role and responsibilities of issuers, DTs and the credit rating agencies (CRAs) have been spelt out in RBI's guidelines.

Interest rate derivatives (IRDs)

The FRA/IRS were introduced in July 1999 to help banks and PDs to better manage their interest rate risk in the wake of deregulated interest rate regime. RBI permitted futures on 91-day T-Bill on March 7, 2011. The futures based on other money market instrument or money market interest rate was permitted on October 28, 2016. Rupee interest rate options (IROs) were introduced in December 2016. Initially, only plain vanilla IROs were allowed but, in June 2018, directions on rupee interest rate options were reviewed resulting in the introduction of rupee interest rate swaptions.

RBI on June 26, 2019, released the Rupee Interest Rate Derivatives (Reserve Bank) Directions, 2019 to consolidate regulations on individual products and to permit flexibility for exchanges and market-makers in the design and innovation of products while ensuring that relatively less informed participants using these derivatives markets are adequately protected. The interest rate derivatives currently allowed in India are Forward Rate Agreement (FRA), Interest Rate Swaps (IRS) and European Interest Rate Options (IRO) (including caps, floors, collars and reverse collars), swaptions and structured derivative products (excluding leveraged derivatives).

Both residents and non-residents can undertake transactions in IRD. Indian or non-resident parent company or any group company or centralised treasury can transact in IRDs on behalf of their wholly owned subsidiaries or group companies. Transactions have been

permitted for both hedging and otherwise. IRD transactions can be carried out both in OTC markets (including transactions on Electronic Trading Platforms) and recognized exchanges.

Exchanges have been permitted to offer any standardized Interest Rate Derivatives product. The product design, eligible participants and other details of the IRD product can be finalized by the exchanges but prior approval of RBI is required to introduce any new IRD product or before carrying out modifications to an existing product.

Any floating interest rate or price or index used in IRDs in the OTC market shall be a benchmark published by an FBA or approved by The Fixed Income Money Market and Derivatives Association of India (FIMMDA) after ensuring that the floating rate approved by them is determined transparently, objectively and in arm's length transactions. IRD transactions can be settled bilaterally or through any clearing arrangement approved by the RBI. Market-makers of IRDs in OTC markets have to comply with the 'suitability and appropriateness' requirements stipulated by RBI. All OTC transactions including client trades must be reported by Market Makers within stipulated time to the Trade Repository of Clearing Corporation of India Ltd. (CCIL), clearly indicating whether the trade is for hedging or other purposes.

Government Securities Market

Government Securities market is an extremely critical segment of any financial system. It deals with tradeable debt instruments issued by the Government for meeting its financing requirements. The development of the primary segment of this market enables the managers of public debt to raise resources from the market in a cost-effective manner with due recognition of associated risks. A vibrant secondary segment of the government securities market helps in the effective operation of monetary policy through application of indirect instruments such as open market operations, for which government securities act as collateral. The government securities market is also regarded as the backbone of fixed income securities markets as it provides the benchmark yield curve and imparts liquidity to other financial markets. The existence of an efficient government securities market is seen as an essential precursor, in particular, for development of the corporate debt market.

In India, the Central Government issues both, treasury bills and bonds (or dated securities) while the State Governments issue only bonds (or dated securities) called as State Development Loans (SDLs). Dated Government securities are long term securities (longer than 1 year of original maturity) and carry a fixed or floating coupon (interest rate) which is paid on the face value, payable at fixed time periods (usually half-yearly). The tenor of dated securities can be very long (up to 40 years in India as of September 2019).

The important developmental and regulatory roles performed by RBI in the Government Securities Market are mentioned below:

Developmental Roles

Since the onset of financial sector reforms in India, RBI has taken several important measures for development of the Indian Government securities market. Introduction of auction based primary issuances has helped better price discovery and improved participation and depth of the primary market. When Issued (WI) trading in the G-Secs was permitted in 2006 with an objective to facilitate the distribution process of G-Secs by stretching the actual distribution period for each issue, allowing the market more time to absorb large issues of G-Secs without disruption and facilitating the price discovery by reducing uncertainties surrounding auctions. Over the years, the Bank has facilitated introduction of new instruments such as Floating rate bonds, Capital indexed bonds, Inflation indexed bonds, STRIPS (Separate Trading of Registered Interest and Principal of Securities), etc. The Bank has taken a lot of measures to boost liquidity in Repo in G-Secs which includes introduction of electronic trading platform, revision in accounting guidelines in alignment with international standards, introduction of Re-Repo, etc.

RBI introduced short selling in Government securities in Feb 2006 and has brought in lot of improvements in the instrument over the years keeping in view the market developments and demands from market participants. With a view to improving liquidity in the G-sec market and to address short squeeze, notional short sales were permitted in November 2017, allowing market participants not to compulsorily borrow securities in repo market. In exceptional situations of market stress, entities undertaking notional short sale are permitted to deliver securities from their own held to maturity (HTM)/available for sale (AFS)/held for trading (HFT) portfolios.

Market infrastructure for trading, reporting, clearing and settlement of bond market transactions has been strengthened keeping in pace with the development of the market. The upgraded primary issuance process with electronic bidding and straight-through-processing capabilities, completely dematerialized depository system within RBI, Delivery-versus-Payment (DvP) mode of settlement, Real Time Gross Settlement (RTGS), electronic trading platform (Negotiated Dealing Systems - Order Matching) (NDS-OM) and a separate Central Counter Party (CCP) in the Clearing Corporation of India Ltd (CCIL) for guaranteed settlement of government securities transactions are among the initiatives that were taken by the Bank over the years. The Bond Turnover Ratio, a measure of bond market liquidity which shows the extent of trading in the secondary market relative to the amount of bonds outstanding, compares well with many developed countries. The bid-ask spread of the on-the-run securities remains narrow with increased liquidity in these securities. The sovereign yield curve now spans up to 40 years with some well-developed benchmark points.

The NDS-OM trading platform is an anonymous screen-based order matching platform owned by RBI and operated by CCIL. The system facilitates secondary market trading in all kinds of Central Government Securities, State Government Securities, Special Securities and Treasury Bills. Permitted participants can log into the system and place their bids/offers or accept the quotes already available in the order book. The settlement is on a Straight Through

Processing basis and the deal information flows directly to CCIL for guaranteed settlement. Direct access to the NDS-OM system is currently available only to select financial institutions like Commercial Banks, Primary Dealers, Insurance Companies, Mutual Funds, NBFCs etc. Other participants can access this system through their custodians, i.e., with whom they maintain Gilt Accounts. The system ensures complete anonymity among participants as counterparty information is not available to any of the system participants either pre or post trade, thus facilitating transparency without impeding fair pricing. The anonymity offered by the system enables large ticket execution without distorting market sentiment and/or price equilibrium which would normally be prevalent in a bilateral market.

NDS-OM Web Based System is an internet access-based utility for use by the various Gilt Account Holders (GAH) for directly accessing NDS-OM. Even FPIs have been given direct access to NDS-OM through this web module. While the GAH can access and trade on the NDS-OM, such activities would be within the permitted threshold of their custodians (primary members). This gives a greater operational freedom for marginal players to trade directly on the NDS-OM. Individual investors having demat accounts with depositories have also been allowed to trade directly on NDS-OM.

Regulatory Roles

Regulation of Government securities market has evolved over the years keeping in view the systemic imperatives and institutional prudence at the center. Large sovereign borrowings impact the yield curve through the expectation channel. Apart from direct balance sheet effects on the financial sector, interest rate volatility has a critical bearing on sovereign balance sheet which could translate onto financial sector balance sheets. It, therefore, becomes imperative to be watchful of volatility in interest rates on account of activities of various market players. In order to ensure orderly condition in the Government securities market, RBI has prescribed regulations on various aspects of the market. Some of the major aspects are listed below.

- *Short Selling:* The regulation on short selling specifies the eligible participants, limits for short sale, maximum time period for holding short sale position, etc. Short sale in G-secs was introduced in February 2006 to provide participants with a tool to express two-way views on interest rates and thereby enhance price discovery. For smoother settlement of short sale transactions which is necessary for orderly functioning of the market, RBI stipulated in October 2017 that (i) a short seller need not borrow securities for ‘notional short sales’, wherein it is required to borrow the security even when the security is held in the held-for-trading/available-for-sale/held-to-maturity portfolios of banks; and, (ii) over-the-counter (OTC) G-sec transactions by FPIs may be contracted for settlement on a T+1 or T+2 basis. In July 2018, the participants’ base was liberalised and entity-wise and security category-wise limits for short selling in G-secs were relaxed to further develop and deepen the G-sec and repo market.

- *Investment by FPIs:* The foreign portfolio investors (FPIs) have been allowed greater access to the government securities market. Pursuant to the Monetary Policy announcement of Sept 29, 2015, the Medium-Term Framework (MTF) for FPI investment limits in rupee debt securities was announced to provide a more predictable regime. With the objective of having a more predictable regime for investment by FPIs, the FPI limits are revised on a half yearly basis under the MTF. In terms of the MTF, the limit for FPI investment in government securities is linked to the outstanding stock of government securities and the limit has been increased in phases. The limit is specified in Indian Rupee (in place of USD) which eliminates the complication arising out of exchange rate fluctuations. The FPI investment in government securities is subject to various macro-prudential and other regulatory prescriptions as notified by RBI from time to time.

The regulatory regime for FPIs' debt investments was reviewed in June 2018 to provide FPIs greater latitude in managing their portfolios in terms of increased investment limits, eligible instruments, tenor and duration management, etc. The limits for FPI investment in debts was linked to the outstanding stock - 6 per cent for central government securities, 2 per cent for SDLs and 9 per cent for corporate bonds in 2019-20. Investment in corporate bonds was rationalised by discontinuing its various sub-categories and prescribing a single limit for FPI investment in all types of corporate bonds. The cap on aggregate FPI investments in any central government security was revised upward from 20 per cent to 30 per cent of the outstanding stock of that security. The minimum residual maturity requirement of three years for investment in debt has been withdrawn, subject to certain conditions. Other macro-prudential measures put in place include: concentration limits for FPI investment as a percentage of overall investment limit in each debt category, short-term investment limits, and single as well as group investor-wise limit in corporate bonds. Subsequently incremental changes were made periodically in this regime.

A separate channel called the Voluntary Retention Route (VRR) was introduced in May 2019 with more operational flexibility in terms of both instrument choices as well as exemptions from regulatory limits to encourage FPIs to undertake long-term debt investment in India.

In March 2020, a separate channel, called the 'Fully Accessible Route' (FAR) for Investment by non-residents was introduced by RBI to enable non-residents to invest in specified Government of India dated securities. Eligible investors can invest in specified Government securities without being subject to any investment ceilings. This scheme would operate along with the two existing routes, viz., the Medium-Term Framework (MTF) and the Voluntary Retention Route (VRR).

When Issued Trading: As part of restructuring the debt issuance framework in light of Fiscal Responsibility and Budget Management (FRBM) Act, 2003, and based on the recommendations of Internal Technical Group on Central Government Securities 'When Issued' markets in Central Government Securities was introduced in May 2006 on NDS platform. 'When Issued' market has facilitated the distribution process for Government

securities by stretching the actual distribution period for each issue and allowing the market more time to absorb large issues without disruption. It also facilitates price discovery process by reducing uncertainties surrounding auctions. Later, the application of when issued guidelines was expanded to non-NDS trades and eligible participants and limits on short and long positions by various categories of participants were increased to increase trading in this segment. With the objective to further deepen the G-sec market, the ‘When Issued’ directions were revised in July 2018 to liberalise eligible participants’ base and to relax entity-wise limits for taking positions.

Separate Trading of Registered Interest and Principal of Securities (STRIPS): The Reserve Bank introduced the Separate Trading of Registered Interest and Principal Securities (STRIPS) in Government Securities in April, 2010. The securities that are eligible for stripping/reconstitution, the minimum amount of securities that needs to be submitted for stripping/reconstitution, the discount rates to be used for valuation of STRIPS, etc. was specified by RBI. After some initial interest, the product did not find much favour with the market. With a view to encouraging trading in STRIPS by making it more aligned with market requirements and to meet the diverse needs of the investors, revised directions were issued in April 2018 in terms of which all fixed coupon securities issued by Government of India, irrespective of the year of maturity, are eligible for Stripping/ Reconstitution, if such securities are eligible for Statutory Liquidity Ratio (SLR) and transferable.

Corporate Bond Market

A well-developed corporate bond market complements a sound banking system in providing an alternative source of finance to the real sector for its long-term investment needs. An active corporate bond market also provides institutional investors such as insurance companies, provident funds, pension funds with quality long term financial assets, helping them in matching their assets and liabilities. There has been substantial growth in both primary and secondary corporate bond markets during the recent years though it still lags in comparison with global peers. There has been a number of Expert Committees which have made in-depth study on development of corporate bond markets in India and have made useful recommendations, viz. Report of High Level Expert Committee on Corporate Bonds and Securitisation in 2005 (R. H. Patil Committee), Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre in 2007 (Percy Mistry Committee), A Hundred Small Steps [Report of the Committee on Financial Sector Reforms (CFSR)] in 2009 (Dr. Raghuram Rajan Committee), Reports of the City of London, and RBI’s Working Group Report in August 2016 (Chairman: Shri H.R.Khan). Based on the recommendations of various committees, several measures have been taken by the Government of India, RBI and SEBI for the development of corporate bond market in India.

RBI regulates only certain aspects of the Corporate Bond Market, viz. participation of banks and other RBI regulated entities in Corporate Bond market, FPI investments in Corporate Bonds, Repo in Corporate Bonds and Credit Derivatives on Corporate Bonds. The

important developmental and regulatory roles played by RBI with respect to Corporate Bond Market in India are described below:

Developmental Roles

- *Increasing Participation:* RBI has permitted banks to issue long-term bonds with minimum maturity of seven years for funding their loans for long term projects in various infrastructure sub-sectors, and affordable housing. Further, funds mobilised through these bonds have been exempted from CRR/SLR requirements. Banks and PDs have been allowed to become members of stock exchanges to trade in corporate bonds. The investment norms for them were relaxed to facilitate investment in corporate bonds. FPIs have been provided greater access to the secondary market with increased investment limits and simplified limit allocation methodology.
- *Increasing market liquidity:* Repo in corporate bonds was introduced to enable the institutional buyers to fund their long positions. The brokers authorized as market makers in the corporate bond market have been allowed to participate in the corporate bond repo. RBI's guidelines on enhancing credit supply for large borrowers through bond market route are envisaged to augment the market liquidity.
- *Market Infrastructure:* Delivery versus Payment (DvP) mode of settlement was introduced for OTC corporate bond trades to eliminate settlement risk. RBI has mandated banks, PDs and other entities regulated by it to report corporate bond trades to the designated reporting platform for improving market transparency.
- *Risk Management:* RBI permitted introduction of Credit Default Swaps (CDS) in December 2011 to facilitate hedging of credit risk by the holders of corporate bonds. Banks were permitted to provide partial credit enhancements on corporate bonds subject to limits.

Regulatory Roles

- *Repo in Corporate Bond:* RBI has laid down guidelines on eligible securities, hair-cut and valuation methods, etc. for Repo transactions in corporate bonds.
- *Credit Derivatives:* CDS is allowed on listed corporate bonds, Commercial Papers, Certificates of Deposit and Non-convertible debentures with original maturity less than one year issued by resident entities, as reference obligations. However, CDS can also be written on unlisted but rated bonds. Besides, unlisted/unrated bonds issued by the SPVs set up by infrastructure companies are also eligible as reference obligation. The scheduled commercial banks, stand-alone primary dealers (PDs), non-banking financial companies (NBFCs) having sound financials and good track record in providing credit facilities and any other institution specifically permitted by the Reserve Bank are eligible to act as market makers in CDS. Insurance companies and Mutual Funds would also be permitted as market-makers as and when permitted by the respective regulatory authorities. Users cannot purchase CDS without having the underlying exposure.

- *Credit Enhancement by Banks:* Banks have been allowed to provide partial credit enhancement (PCE) to a project as a non-funded subordinated facility in the form of an irrevocable contingent line of credit which will be drawn in case of shortfall in cash flows for servicing the bonds. PCE improves credit rating of the bond issue. RBI has prescribed limits for PCE by individual banks as well as the aggregate PCE that can be provided by all banks for any particular bond issue
- *FPI Investments:* RBI prescribes the limit for FPI investment in Corporate bonds. The MTF and VRR for FPI investment in rupee debt securities, as discussed earlier, covers FPI investment limit in corporate bonds.

Other regulations for financial markets

- *Market abuse regulations:* This regulation was introduced in March 2019, in line with the best global practices with the objective of putting in place a fair, open and transparent market underpinned by high ethical standards. The regulations cover market manipulation, benchmark manipulation, misuse of information or any other similar practice under its ambit.
- *Authorization of Electronic Trading Platform (ETP):* In October 2018, RBI introduced Authorization of ETP Directions to put in place a framework for authorisation of ETPs for financial market instruments regulated by RBI, with the objective to improving transparency, reducing transaction time and costs, facilitating efficient audit trails, improving risk controls and enhancing market monitoring. It also includes detailed eligibility criteria, technology requirements and reporting standards. All new ETPs as well as existing ones are required to obtain authorisation from the Reserve Bank under this framework.
- *Legal Entity Identifier (LEI):* The Legal Entity Identifier (LEI) code is conceived as a key measure to improve the quality and accuracy of financial data systems for better risk management post the Global Financial Crisis. LEI is a 20-digit unique code to identify parties to financial transactions worldwide. The LEI system was implemented in June 2017 for non-individual participants in OTC markets for rupee interest rate derivatives, foreign currency derivatives and credit derivatives. The LEI mechanism was expanded to financial market transactions undertaken by non-individuals, including non-resident entities, in money, G-sec and forex markets regulated by the Reserve Bank in November 2018. A phased approach to have smooth implementation has been adopted.
- *Financial Benchmark Administration:* Based on recommendations of the Committee on Financial Benchmarks set up by Reserve Bank of India (February 2014) to review the systems governing major financial benchmarks in India, Fixed Income Money Market & Derivative Association of India (FIMMDA) and Foreign Exchange Dealers' Association of India (FEDAI) were identified as benchmark administrators for the Indian rupee interest rate benchmarks and Foreign exchange benchmarks respectively and measures were taken to strengthen the governance framework. Later, Financial Benchmark India Private Ltd (FBIL) was jointly promoted by FIMMDA, FEDAI and Indian Banks' Association (IBA) and was recognised by RBI as an independent Benchmark administrator on July 2, 2015. On June 26, 2019, RBI

issued the Financial Benchmark Administrators (Reserve Bank) Directions, 2019 a regulatory framework for financial benchmarks, to improve the governance of the benchmark processes, ensure transparency in benchmark administration and prevent misuse of benchmarks. On January 01, 2020 RBI has notified the following benchmarks administered by Financial Benchmarks India Pvt. Ltd. (FBIL) as ‘significant benchmark’:

- i) Overnight Mumbai Interbank Outright Rate (MIBOR)
- ii) Mumbai Interbank Forward Outright Rate (MIFOR)
- iii) USD/INR Reference Rate
- iv) Treasury Bill Rates
- v) Valuation of Government Securities
- vi) Valuation of State Development Loans (SDL).
- vii) Market Repo Overnight Rate (MROR)
- viii) USDINR Option volatility

Foreign Exchange Market

The evolution of India’s foreign exchange market may be viewed in line with the shifts in India’s exchange rate policies over the last few decades from a par value system to a basket-peg and further to a managed float exchange rate system. During the period from 1947 to 1971, India followed the par value system of exchange rate. Initially the rupee’s external par value was fixed at 4.15 grains of fine gold. The Reserve Bank maintained the par value of the rupee within the permitted margin of ±1 per cent using pound sterling as the intervention currency. Since the sterling-dollar exchange rate was kept stable by the US monetary authority, the exchange rates of rupee in terms of gold as well as the dollar and other currencies were indirectly kept stable. The devaluation of rupee in September 1949 and in June 1966 in terms of gold resulted in the reduction of the par value of rupee in terms of gold to 2.88 and 1.83 grains of fine gold, respectively. With the breakdown of the Bretton Woods System in 1971, the rupee was linked with pound sterling in December 1971. Since sterling was fixed in terms of US dollar under the Smithsonian Agreement of 1971, the rupee also remained stable against dollar. In order to overcome the weaknesses associated with a single currency peg and to ensure stability of the exchange rate, the rupee, with effect from September 1975, was pegged to a basket of currencies. The currency selection and weights assigned were left to the discretion of the Reserve Bank.

The origin of the foreign exchange market in India could be traced to the year 1978 when banks in India were permitted to undertake intra-day trade in foreign exchange. The exchange rate of the rupee during this period was officially determined by the Reserve Bank in terms of a weighted basket of currencies of India’s major trading partners and the exchange rate regime was characterised by daily announcement by the Reserve Bank of its buying and selling rates to the Authorised Dealers (ADs) for undertaking merchant transactions. The

spread between the buying and the selling rates was 0.5 per cent and the market began to trade actively within this range.

However, it was in the 1990s that the Indian foreign exchange market witnessed far reaching changes along with the shifts in the exchange rate regime in India. A two-step adjustment of exchange rate in July 1991 effectively brought to close the regime of a pegged exchange rate. After the Gulf crisis in 1990-91, the broad framework for reforms in the external sector was laid out in the Report of the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan). Following the recommendations of the Committee to move towards the market-determined exchange rate, the Liberalised Exchange Rate Management System (LERMS) was put in place in March 1992 involving a dual exchange rate system. Under the LERMS, all foreign exchange receipts on current account transactions (exports, remittances, etc.) were required to be surrendered to the Authorised Dealers (ADs) in full. The rate of exchange for conversion of 60 per cent of the proceeds of these transactions was the market rate quoted by the ADs, while the remaining 40 per cent of the proceeds were converted at the Reserve Bank's official rate. The ADs, in turn, were required to surrender these 40 per cent of their purchase of foreign currencies to the Reserve Bank. They were free to retain the balance 60 per cent of foreign exchange for selling in the free market for permissible transactions.

The LERMS was essentially a transitional mechanism and a downward adjustment in the official exchange rate took place in early December 1992 and ultimate convergence of the dual rates was made effective from March 1, 1993, leading to the introduction of a market-determined exchange rate regime. The dual exchange rate system was replaced by a unified exchange rate system in March 1993, whereby all foreign exchange receipts could be converted at market determined exchange rates. The unification of the exchange rate was instrumental in developing a market-determined exchange rate of the rupee and an important step in the progress towards current account convertibility, which was achieved in August 1994.

A further impetus to the development of the foreign exchange market in India was provided with the setting up of an Expert Group on Foreign Exchange Markets in India (Chairman: Shri O.P. Sodhani), which submitted its report in June 1995. The Group made several recommendations for deepening and widening of the Indian foreign exchange market which was required as the risk-bearing capacity of banks increased, and foreign exchange trading volumes started rising after the rupee became fully convertible on all current account transactions. Consequently, beginning from January 1996, wide-ranging reforms have been undertaken in the Indian foreign exchange market. After almost a decade, an Internal Technical Group on the Foreign Exchange Market (2005) was constituted to undertake a comprehensive review of the measures initiated by the Reserve Bank and identify areas for further liberalisation or relaxation of restrictions in a medium-term framework. Important recommendations of the Group such as freedom to cancel and rebook forward contracts of any tenor, delegation of powers to ADs for grant of permission to corporates to hedge their

exposure to commodity price risk in the international commodity exchanges/markets and extension of the trading hours of the inter-bank foreign exchange market were implemented.

The Indian foreign exchange market has witnessed phenomenal growth since last two decades with the average daily turnover recording a quantum jump from about USD 6 billion in 2000 to USD 60 billion in recent times. RBI has taken several regulatory initiatives which aided orderly development of the Indian foreign exchange market.

The offshore Indian Rupee (INR) derivative market has grown rapidly over a period. The dominant segment of this market is the Non-Deliverable Forward (NDF) market – wherein foreign exchange forward contracts are traded in the OTC market at offshore locations, generally the International Finance Centres (IFCs) like Singapore, Hong Kong, London, Dubai and New York. There are also a few exchange-traded offshore rupee markets dealing in rupee futures and options in Chicago, Singapore and Dubai. Volumes in these markets have typically been far smaller in comparison to the offshore NDF OTC market.

Important developmental and regulatory roles of RBI with respect to foreign exchange market are mentioned below:

Developmental Roles

Institutional Framework: With the replacement of the Foreign Exchange Regulation Act (FERA), 1973 with Foreign Exchange Management Act (FEMA), 1999, Reserve Bank delegated powers to Authorised Dealers (ADs) to release foreign exchange for a variety of purposes. The Bank has vested greater authority and responsibilities with Foreign Exchange Dealers' Association of India (FEDAI), the market representative body, for instituting self-regulatory mechanisms to ensure ethical conduct by the market participants and development of various segments of the foreign exchange market.

Expanding the basket of Instruments: Reserve Bank has facilitated introduction of many new instruments over the years to facilitate effective hedging of currency risks by diverse economic agents. Foreign currency-rupee options, cross currency options, foreign currency-rupee swaps, cross currency swaps, interest rate swaps & options in foreign currency were introduced at various points of time. The OTC basket was supplemented with introduction of exchange traded currency futures and options in phases starting from 2008. Currently, the following instruments are available in the Indian forex market:

- Spot, Cash and Tom
- Forwards
- FX swaps
- Currency Swaps
- FX options (includes Cost Reduction structures and Covered Calls & Puts)
- Exchange Traded Currency Futures and Options

Market Infrastructure: In pursuance of the recommendations of the Sodhani Committee, Reserve Bank had set up the Clearing Corporation of India Ltd. (CCIL) in 2001 to reduce settlement risks in the Indian financial markets. The CCIL commenced settlement of foreign exchange operations for inter-bank USD-INR spot and forward trades from November 8, 2002 and for inter-bank USD-INR cash and tom trades from February 5, 2004. The CCIL undertakes settlement of foreign exchange trades on a multilateral netting basis through a process of novation and all spot, cash, tom and forwards transactions are guaranteed for settlement from the trade date.

Foreign exchange trading platform for retail participants: To deal with the issue of transparent and fair pricing for retail users (individuals and Micro, Small and Medium Enterprises) in the foreign exchange market, RBI has allowed the rollout of FX-Retail, by the Clearing Corporation of India Limited (CCIL) on June 20, 2019. The FX-Retail platform provides for an anonymous and order driven dealing in the USD/INR currency pair for the Customers of banks. This mechanism provides transparency while enhancing competition and lead to better pricing for retail customers. Banks may charge their retail customers a pre-agreed flat fee towards administrative expenses, which should be publicly declared. Overall, this is expected bring down the total cost faced by the retail customer in the foreign exchange market. Facilitating direct access of retail customers to the market, rather than through price-setting by their banks, is also expected to bring down the risk that banks face in warehousing transactions.

Regulatory Roles

Maintaining Exchange Rate Stability: The exchange rate is a key macro-economic variable. It shapes a country's balance of payments and engagement with the rest of the world. It affects a country's export competitiveness, in conjunction with other factors and the country's income and employment to the extent that export sector is important for the economy. It determines the cost of import and to the extent that import constitutes articles essential for investment and growth, can act as a retarding factor. It affects the price level through the linkages provided by the tradeable sector. Exchange rate fluctuations also affect the value of international investment portfolios, international reserves, currency value of debt payments, and the cost to tourists in terms of the value of their currency. Movements in exchange rates thus have important implications for the country's business cycle, trade and capital flows. Since introduction of market-determined exchange rate system in 1993, the rupee's exchange rate against other currencies is determined largely by market demand and supply. The Reserve Bank intervenes in the foreign exchange market with an objective to curb excessive volatility and maintain orderly conditions in the market. The Bank intervenes in different segments of the foreign exchange market, viz. spot, forward and futures through a panel of banks.

Access to OTC derivatives market: The access to the OTC foreign exchange derivatives has been subject to production of documentary evidence in support of the underlying exposure except for hedging of probable exposures and special dispensations offered to SMEs, individuals and firms. The primary objective of this regulation was to restrict the use of OTC foreign exchange derivatives by the corporate clients for hedging their exchange rate risks and not for trading in the instruments. The exchange rate being an important macroeconomic variable, unregulated trading in it has potential adverse consequences for macroeconomic and financial stability.

However, the Bank has taken several measures in the recent past to simplify the documentation requirements for facilitating easy access to foreign exchange derivatives. The facility of hedging the probable exposures based on past performance in respect of trades in merchandise goods and services has provided flexibility in hedging in the absence of underlying documents. A Simplified Hedging Facility for residents and non-residents which permits dynamic hedging of currency risk and simplifies the procedure involved in booking hedge contract was introduced.

In April 2020, RBI issued Hedging of Foreign Exchange Risk –Directions in terms of which, facilities for residents and non-residents have been merged into a single unified facility for all users. This direction allows hedging of both contracted and anticipated exposures and permits cancellation and rebooking of contracts freely. Users are permitted to hedge their valid exposures using any available instrument. Simplified procedures have been introduced for authorised dealers to offer foreign exchange derivatives. RBI has allowed users to undertake currency derivative transactions up to USD 10 million in over the counter (OTC) market, without the need to evidence underlying exposure. Banks have been provided with discretion in exceptional circumstances, to pass on net gains on hedge transactions booked on anticipated exposures. Besides, safeguards have been introduced to ensure, that complex derivatives are sold only to users that are capable of managing the risks.

Exchange Traded Currency Derivatives: The position limits for various classes of participants in the currency futures market have been prescribed in the guidelines issued by the SEBI. Reserve Bank has permitted AD Category - I banks to act as trading and clearing members in the currency derivatives market of the recognized stock exchanges, on their own account as well as on behalf of their clients, subject to fulfilling the prudential requirements. The trading in exchange traded currency derivatives is subject to maintaining various margins as specified in the guidelines issued by SEBI from time to time. In February 2018, persons resident in India and foreign portfolio investors (FPIs) were permitted to take positions (long or short), without having to establish existence of underlying exposure, upto a single limit of USD 100 million equivalent across all currency pairs involving INR, put together, and combined across all exchanges. Earlier this limit was USD 15 million per exchange for position in USD-INR and USD 5 million equivalent per exchange for position in EUR (i.e., euro)-INR, GBP (i.e., Great Britain pound)-INR and JPY (i.e., Japanese yen)- INR pairs, all put together. The limit of USD 100

million without the need to establish existence of underlying exposure has been retained in the Hedging of Foreign Exchange Risk –Directions dated April 7, 2020

Access to Persons Resident Outside India: RBI has gradually relaxed the restrictions and provided greater access to FPIs, FDIs, NRIs, Non-resident exporter/importer (for trade exposures invoiced in Indian Rupee), Non-resident lenders (for external commercial borrowings designated in Indian Rupee) for hedging their currency risks linked to Indian Rupee, in the Indian foreign exchange market. The Simplified Hedging Facility mentioned in the previous paragraph is also available to the non-residents.

Market making/Trading: Only the Authorised Dealer Category-I banks are permitted to act as market makers in the foreign exchange market. They are licensed by Reserve Bank under Section 10(1) of the Foreign Exchange Management Act, 1999. The Board of Directors of the AD banks is required to fix the net overnight open exchange position limit (NOOPL) and the aggregate gap limit (AGL) within which the banks have to operate in the foreign exchange market.

Customer and Inter-Bank Transactions beyond Onshore Market Hours: Based on the recommendations of Task Force on Offshore Rupee Market, RBI on January 06, 2020 permitted AD Category-I banks to voluntarily undertake customer (persons resident in India and persons resident outside India) and Inter-Bank transactions beyond onshore market hours. Transactions with persons resident outside India, through their foreign branches and subsidiaries may also be undertaken beyond onshore market hours.

Commodity Hedging: Residents in India, engaged in import and export trade or as otherwise approved by the Reserve Bank from time to time, are permitted to hedge the price risk of permitted commodities in the international commodity exchanges/markets. The role of AD banks is primarily to provide facilities for remitting foreign currency amounts towards margin requirements from time to time, subject to compliance with the applicable guidelines.

Rupee Derivatives at IFSCs: With effect from March 27, 2020, RBI has allowed AD Category I banks in India which are operating International Financial Services Centre (IFSC) Banking Units (IBUs), to offer non-deliverable derivative contracts involving the Rupee to non-residents. Banks can undertake such transactions through their branches in India, through their IBUs or through their foreign branches (in case of foreign banks operating in India, through any branch of the parent bank). The Report of the Task Force on Offshore Rupee Markets chaired by Smt. Usha Thorat had recommended this measure. Prior to this notification, Indian banks were not allowed to offer non-deliverable forward (NDF) products involving Rupee.

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Chapter 13: Payment and Settlement Systems

Central banks have always been closely associated with payment and settlement systems. Central banks throughout the world seek strong economies and stable financial markets. These goals, in turn, rest to a considerable degree on well-functioning payment systems. Payment systems, especially retail systems, are evolving rapidly across the globe. Electronic payments are becoming the norm. New technologies, new participants, and new market structures continue to arise.

Long before central banks became responsible for monetary policy, they were the banks designated to issue banknotes: the means of payment protected by legal tender status. The origin of central banking lies precisely in this revolution in payment technology: from metal to paper, from commodity money with intrinsic value to fiduciary money. From the Latin “fiducia”, the value of this kind of money lies in the trust it generates. However, trust is not something that can be left simply for the invisible hand to generate. Trust needs institutions to maintain it. The central bank was the institution designed to maintain trust in money.⁸³

A payment is a transfer of money from the payer to the payee. In most cases, the payment is a discharge of an obligation assumed by an economic agent whenever it acquires real or financial resources. Central Banks Play three main roles in the Payment and Settlement Systems viz. service provider, regulator and user.

System Provider

Operator Owner: Central Banks have traditionally performed the development role of starting payment systems in most countries. Where central banks have not run the systems, they have provided various services for payment systems to develop and still in most countries the large value payment systems (LVPS) is run by Central Banks.

Settlement Systems: Most central banks allow for settlement of LVPS in the central bank books. Even when the payment system is run by private operators, the settlement finally happens in the books of the Central Bank. There are compelling arguments why finality of settlements is achieved best through settling in central bank money, the most important of which is the ability of the central bank to provide liquidity against collateral as a lender of last resort to enable the smooth functioning of the systems.

Regulator

Overseer/supervisor: Central bank oversight is a key central bank activity. Central banks monitor and oversee payment systems by setting the rules (generally backed by a legal framework).

⁸³ Tommaso Padoa-Schioppa, *Shaping the payment system: a central bank's role*, Seoul, 13 May 2004.

Catalyst and Facilitator: Payment systems develop internationally as a common good. The availability of an efficient payment system allows not only for efficient economic transmission but also facilitates the seamless transmission of monetary policy and mitigation of systemic risk.

User

As the banker to the banks and the Government, the central banks operate in a unique role as a part of the payment and settlement systems. This role enables the central banks to perform the role of the oversight and act as a counter-balance in case of disruptions.

Payment and Settlement Systems in India

Payment instruments and mechanisms have a very long history in India. The earliest payment instruments known to have been used in India were coins, which were either punch-marked or cast in silver and copper. While coins represented a physical equivalent, credit systems involving bills of exchange facilitated inter-spatial transfers. In the Mauryan period, an instrument called *adesha* was in use, which was an order on a banker desiring him to pay the money of the note to a third person, which corresponds to the definition of a bill of exchange as we understand it today. The most important class of credit Instruments that evolved in India were termed *Hundis*. Their use was most widespread in the twelfth century and has continued till today. In a sense, they represent the oldest surviving form of credit instrument. Hundis were used as remittance instruments (to transfer funds from one place to another), as credit instruments (to borrow money [IOUs]) and for trade transactions (as bills of exchange).

Paper money, in the modern sense, has its origin in the late 18th century with the note issues of private banks as well as semi-government banks. Amongst the earliest issues were those by the Bank of Hindoostan, the General Bank in Bengal and Behar, and the Bengal Bank. Later, with the establishment of three Presidency Banks, the job of issuing notes was taken over by them. Each Presidency Bank had the right to issue notes within certain limits. The Paper Currency Act of 1861 conferred upon the Government of India the monopoly of Note Issue bringing to an end note issues of private and Presidency Banks.

The private banks and the Presidency Banks introduced other payment instruments in the Indian money market. Cheques were introduced by the Bank of Hindoostan, the first joint stock bank established in 1770. In 1833, cash credit accounts were added to the Bank of Bengal's array of credit instruments. Buying and selling bills of exchange became one of the items of business to be conducted by the Bank of Bengal from 1839.

In 1881, the **Negotiable Instruments Act (NI Act)** was enacted, formalising the usage and characteristics of instruments like the cheque, the bill of exchange and promissory note. The NI Act provided a legal framework for non-cash paper payment instruments in India. With the development of the banking system and higher turnover in the volume of cheques, the need for an organised cheque clearing process emerged amongst the banks. With the setting up of the Imperial Bank in 1921, settlement was done through cheques drawn on that bank.

After the setting up of Reserve Bank of India under the RBI Act 1935, the Clearing Houses in the Presidency towns were taken over by Reserve Bank of India.

Evolution of Payment Systems and role of RBI

RBI has always played a significant role in the development and nurture of payment and settlement systems in our country. As per Section 3 of the Payment and Settlements Act 2007, RBI is the designated authority for the regulation and supervision of payment systems under the Act. The PSS Act, 2007 provides for the regulation and supervision of payment systems in India and designates the Reserve Bank of India (Reserve Bank) as the authority for that purpose and all related matters. The Reserve Bank is authorized under the Act to constitute a Committee of its Central Board known as the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS), to exercise its powers and perform its functions and discharge its duties under this statute. The Act also provides the legal basis for “netting” and “settlement finality”. This is of great importance, as in India, other than the Real Time Gross Settlement (RTGS) system all other payment systems function on a net settlement basis. The Department of Payment and Settlement Systems assists the Board in performing its functions.

From 1998 onwards, the Reserve Bank has been continuously bringing out a Payment System Vision document for every three years, enlisting the road map for implementation.

Computerisation of clearing operations was the first major step towards modernisation of the payments system. The rapid growth of cheque volumes in the eighties made the task of manual sorting and listing a very difficult task. Banks were unable to cope with the huge volume of cheques which had to be physically handled prior to their presentation in the clearing house.

The solution was the introduction of Magnetic Ink Character Recognition (MICR) based mechanised cheque processing technology. The existing cheques were redesigned incorporating a MICR code line which could be read by document processing machines called reader-sorters. These were installed in Mumbai (1986) followed by Chennai, New Delhi (1987) and Calcutta (1989). Soon after other MICR processing centres at the main metros and other major centres were started. These MICR centres were run by banks. After nearly twenty odd years of MICR clearing, the cheque truncation system (CTS) was introduced first in New Delhi in 2008 and now all the MICR centres have been subsumed into three grid-CTS systems at New Delhi, Chennai and Mumbai. Further, standardisation of cheque features with built-in fraud prevention measures have also been brought in the form of CTS-2010 cheque standards.

Meanwhile electronic payment systems developed rapidly in the early 90s. The Electronic Clearing Service (ECS) was introduced in early 1990s, ECS Credit to facilitate one-to-many payments such as dividend, salary, interest payments, etc. and ECS Debit to facilitate many-to-one payments such as utility payments. ECS in itself has undergone many changes from being a local system to a regional system and then a national level system. These changes have been facilitated by the adoption of CBS in banks which has enabled straight-through-

processing of payments. Further efficiency has been brought in this sphere with the operationalisation of the National Automated Clearing House (NACH) by National Payments Corporation of India (NPCI). The earlier EFT system also launched in the 90s has evolved into a state of the art NEFT. In the year 2004, the first RTGS was introduced in the country which has been upgraded into a new system dedicated to the nation in 2013.

National Payments Corporation of India (NPCI)

In 2008, National Payments Corporation of India (NPCI), an umbrella organisation for operating retail payments and settlement systems in India, was established as an initiative of Reserve Bank of India (RBI) and Indian Banks' Association (IBA) under the provisions of the Payment and Settlement Systems Act, 2007, for creating a robust Payment & Settlement Infrastructure in India. NPCI, has been incorporated as a "Not for Profit" Company under the provisions of Section 25 of Companies Act 1956 (now Section 8 of Companies Act 2013), with an intention to provide infrastructure to the entire Banking system in India for physical as well as electronic payment and settlement systems. NPCI is focused on bringing innovations in the retail payment systems through the use of technology for achieving greater efficiency in operations and widening the reach of payment systems

Classification of Payment Systems

While all payment and settlement systems are equally important to the nation's financial infrastructure, the monitoring of these systems can be classified into the systemically important systems, which are large in terms of value and are called Financial Market Infrastructure (FMIs) and other systems collectively known as Retail Payment Systems.

Financial Market Infrastructures

Financial Market Infrastructure (FMI) is defined as a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions. The term FMI generally refers to systemically important payment systems, Central Securities Depositories (CSDs), Securities Settlement Systems (SSSs), Central Counter Parties (CCPs), and Trade Repositories (TRs) that facilitate the clearing, settlement, and recording of financial transactions. FMIs play a critical role in the financial system and the broader economy and contribute to maintaining and promoting financial stability and economic growth. At the same time, the FMIs also concentrate the risk and, if not properly managed, FMIs can be sources of financial shocks or a major channel through which these shocks are transmitted across financial markets. To address these risks, the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) have issued a comprehensive set of 24 principles titled "Principles for Financial Market Infrastructure" (PFMI) published in April 2012. These principles have strengthened the existing standards, introduced new standards, and enhanced the responsibilities of authorities.

RBI has identified and regulates the following entities related to payment and settlement infrastructure as FMI:

Real Time Gross Settlement System (RTGS) – RTGS system was implemented in March 2004. RTGS system is owned and operated by the RBI. It is a Systemically Important Payment System (SIPS) where the inter-bank payments settle on a 'real' time and on gross basis in the books of the RBI. RTGS system also settles Multilateral Net Settlement Batch (MNSB) files emanating from other ancillary payment systems including the systems operated by the Clearing Corporation of India Limited and National Payment Corporation of India. RBI implemented the Next Generation RTGS (NG-RTGS) in 2013 which is built on ISO20022 standards with advance liquidity management functions, future date functionality, scalability, etc.

Securities Settlement Systems (SSS) – The Public Debt Office (PDO) of the RBI, Mumbai manages and operates the Securities Settlement Systems for the Government securities, both for outright and repo transactions conducted in the secondary market. Government securities (outright) are settled using DVP model 3 mechanism on a T+1 basis. Repos are settled on T+0 or T+1 basis. Additionally, the PDO system also acts as depository for dematerialized government securities. With implementation of the Core Banking Solution (CBS) in the RBI, the securities settlement system has been migrated to the CBS platform.

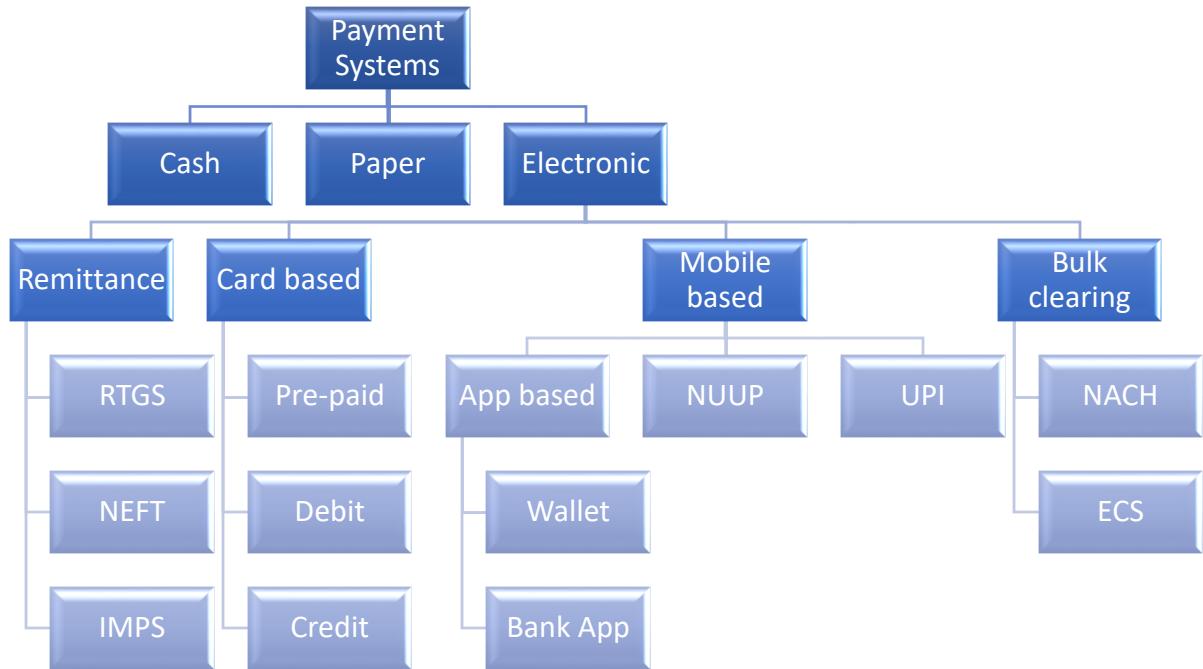
Clearing Corporation of India Ltd (CCIL) systems – CCIL is a **Central Counterparty (CCP)** which was set up in April 2001 to provide clearing and settlement for transactions in Government securities, foreign exchange and money markets in the country. CCIL acts as a central counterparty in various segments of the financial markets regulated by the RBI viz. the government securities segment, collateralised borrowing and lending obligations (CBLO) - a money market instrument, USD-INR and forex forward segments. Moreover, CCIL provides non-guaranteed settlement in the rupee denominated interest rate derivatives like Interest Rate Swaps/Forward Rate Agreement market. It also provides non-guaranteed settlement of cross currency trades to banks in India through Continuous Linked Settlement (CLS) bank by acting as a third party member of a CLS Bank settlement member. CCIL also acts as a **Trade Repository (TR)** for OTC interest rate and forex derivative transactions

Retail Payment Systems

Retail payment systems can be broadly classified based on the medium of transactions, i.e. Paper based systems, electronic systems, mobile based systems and card based systems though the lines are blurring due to innovation.

Paper based systems like cheques, demand drafts and payment orders are largely cleared through the **Cheque Truncation System (CTS)** run in three grids, Mumbai (for Western region), New Delhi (for the Northern region) and Chennai (covering the Southern and Eastern regions) by NPCI. In the smaller centres (1093 MICR centres as of April, 2019) run a magnetic media based cheque clearing system called **Express Cheque Clearing System (ECCS)**.

The following figure depicts the retail electronic payment systems:



In retail electronic payment systems, **National Electronic Funds Transfer (NEFT)** system run by RBI is the most prominent. National Electronic Funds Transfer is a nation-wide payment system facilitating one-to-one funds transfer. Under this Scheme, individuals, firms and corporates can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme. Individuals, firms or corporates maintaining accounts with a bank branch can transfer funds using NEFT. Even such individuals who do not have a bank account (walk-in customers) can also deposit cash up to a permitted limit at the NEFT enabled branches with instructions to transfer funds using NEFT. However, such cash remittances are subject to a limit. The system currently runs 24*7 with settlement done every half hour in batches.

The National Payment Corporation of India (NPCI) has a suite of payment products. The **National Financial Switch (NFS)** which was taken over by NPCI from IDRBT in 2009 connects all **ATMs** all over the country for card transactions. In addition to allowing switching seamless, the NFS network allows sub-membership model which enables smaller, regional banks including RRBs and local co-operative banks to participate in the ATM network. NPCI has also tied up with International card schemes like Discover Financial Service (DFS), Japan Credit Bureau (JCB) and China UnionPay International (CUPI) which allows their cardholders to use ATMs connected to NFS network.

For bulk and repetitive payments such as collection of utility payments, payment of dividends, etc. RBI was running the **Electronic Clearing System (ECS)**. Further efficiency has been brought in this sphere with the operationalisation of the **National Automated Clearing House (NACH)** by NPCI. This is a pan-India system for processing bulk and repetitive payments and the ECS has gradually been subsumed into NACH. The NACH system provides a robust, secure and scalable platform to the participants with both transaction and file based transaction processing capabilities. It has best in class security features, cost efficiency &

payment performance (STP) coupled with multi-level data validation facility accessible to all participants across the country.

Based on NFS and its IMPS platform, NPCI has come up with many innovative electronic retail payment systems. Some of these innovative new payment systems are given below:

Immediate Payment System (IMPS) – The Immediate Payment System (IMPS) operated by NPCI provides 24x7 convenience to small remittances. IMPS provides robust & real time fund transfer which offers an instant, 24X7, interbank electronic fund transfer service that could be accessed on multiple channels like Mobile, Internet, ATM, SMS, Branch and USSD (*99#). IMPS is an emphatic service which allows transferring of funds instantly within banks across India in a safe and economical way. The stabilization of the IMPS platform has allowed NPCI to come up with other innovations.

Unified Payments Interface (UPI) – UPI is a system that powers multiple bank accounts into a single mobile application (of any participating bank), merging several banking features, seamless fund routing & merchant payments into one hood. It also caters to the “Peer to Peer” collect request which can be scheduled and paid as per requirement and convenience. Being a digital payment system it is available 24*7 and across public holidays. Unlike traditional mobile wallets, which keep customer’s money up to permitted limits in their wallets, UPI withdraws and deposits funds directly from the bank account whenever a transaction is requested. It uses Virtual Payment Address (a unique ID provided by the bank), Account Number with IFSC Code, Mobile Number with MMID (Mobile Money Identifier), Aadhaar Number, or a one-time use Virtual ID. An MPIN (Mobile banking Personal Identification Number) is required to confirm each payment. Many banks have built Apps based on the UPI. NPCI have launched their own UPI based app called **Bharat Interface for Money (BHIM)**.

National Electronic Toll Collection (NETC) – National Payments Corporation of India (NPCI) has developed the National Electronic Toll Collection (NETC) program to meet the electronic tolling requirements of the Indian market. It offers an interoperable nationwide toll payment solution including clearing house services for settlement and dispute management. Interoperability, as it applies to National Electronic Toll Collection (NETC) system, encompasses a common set of processes, business rules and technical specifications which enable a customer to use their FASTag as payment mode on any of the toll plazas irrespective of who has acquired the toll plaza.⁸⁴

FASTag is a device that employs Radio Frequency Identification (RFID) technology for making toll payments directly while the vehicle is in motion. FASTag (RFID Tag) is affixed on the windscreen of the vehicle and enables a customer to make the toll payments directly from the account which is linked to FASTag. FASTag offers the convenience of cashless payment

⁸⁴ Source - NPCI

along with benefits like - savings on fuel and time as the customer does not have to stop at the toll plaza.

Bharat QR Code – At the instance of RBI, the major card networks, MasterCard, VISA and NPCI have developed the interoperable, Bharat QR Code. The QR code or Quick Response code is a two-dimensional machine-readable code, which is made up of black and white squares and is used for storing URLs or other information. These can easily be read by the camera of a smartphone. Merchants need to display QR codes in their premises. User can scan these QR via BQR enabled mobile banking app and pay using Card linked account / VPA / IFSC + Account / Aadhaar.

Aadhar enabled Payment System (AePS) – AePS is a bank led model which allows online interoperable financial inclusion transactions (cash deposit, cash withdrawal, intrabank or interbank fund transfer, balance enquiry and get a mini statement) at Micro ATMs through the Business correspondent of any bank using the Aadhaar authentication.

USSD (*99#) - While bank App based models are widely prevalent for not only payments but to do all forms of mobile banking, NPCI has launched the National Unified USSD Platform (NUUP) to make mobile banking more accessible by providing basic banking services to all non-smart phone users as well. *99# service has been launched to take the banking services to every common man across the country. Banking customers can avail this service by dialling *99#, a “Common number across all Telecom Service Providers (TSPs) on their mobile phone and transact through an interactive menu displayed on the mobile screen. Key services offered under *99# service include, Sending and Receiving interbank account to account funds, balance enquiry, setting / changing UPI PIN besides host of other services. *99# service is a unique interoperable direct to consumer service that brings together the diverse ecosystem partners such as Banks & TSPs (Telecom Service Providers). It is available in several regional languages to facilitate interaction in vernacular for common person.

Aadhaar Payment Bridge (APB) - NACH's APB system, developed by NPCI has been helping the Government and Government Agencies in making the Direct Benefit Transfer scheme a success. APB System has been successfully channelizing the Government subsidies and benefits to the intended beneficiaries using the Aadhaar numbers. The APB System links the Government Departments and their sponsor banks on one side with beneficiary banks and beneficiary on the other hand.

RuPay card network – The Indian banks issue a wide variety of **cards** of all major international card networks including MasterCard, VISA and American Express. NPCI has launched its indigenous card network called **Rupay**. RuPay card payment scheme launched by the NPCI, has been conceived to offer a domestic, open-loop, multilateral system which will allow all Indian banks and financial institutions in India to participate in electronic payments. RuPay cards are accepted at all automated teller machines (ATMs) across India under National Financial Switch, and under NPCI's agreement with DFS, RuPay Cards are accepted on the international Discover network. The banks issue RuPay's prepaid, debit and credit cards with

largest issuance of debit cards among the three. Recent liberalizations allowing tokenization of cards will allow cards to be used safely from the device of the user where they can be tokenised in a secure manner and enabled for transactions through the Near Field Communication (NFC) technology. The cards are used extensively in online transactions, ATMs and Point of Sale terminals.

National Common Mobility Card (NCMC) – National Common Mobility Card (NCMC), is an inter-operable transport card conceived by the Ministry of Housing and Urban Affairs of the Government of India. It was launched on 4th March 2019. The transport card enables the user to pay for travel, toll duties (toll tax), retail shopping, and withdraw money. It is enabled through the RuPay card mechanism. The NCMC card, which is powered by qSPARC (Quick Specification for Payment Application of RuPay Chip) specification, is issuable by partner banks as a combo of an account linked prepaid, debit, or credit RuPay card usable for regular online payments with another prepaid component having on card balance that can be used for small value offline payments in transit.. qSPARC is a Dual Interface Open loop payment specification, with the option of loading multiple payment applications on a single card.

Other Retail Payment & Settlement Initiatives

White Level ATMs (WLAs) - ATMs set up, owned and operated by non-banks are called WLAs. The rationale to allow non-bank entities to set up WLAs has been to increase the geographical spread of ATMs for increased / enhanced customer service, especially in semi-urban / rural areas. All services available in a normal bank ATM are also available in WLAs.

Pre-paid instruments (PPIs) – PPIs are a specific category of payment products which have gained prominence in recent times, particularly due to the use of mobile wallets. PPIs can be issued in closed, semi-closed and open systems. PPIs are issued by both banks and non-banks after obtaining licence from RBI. The open PPIs which allow for cash withdrawal can be issued only by banks. The PPI guidelines allow for two kinds of PPI, one with minimum KYC and the other with full KYC with different limits. PPI issuers have the option of becoming interoperable wherein PPI card issuers can do so through card networks while the mobile wallet issuers can do so through UPI.

Bharat Bill Payment System (BBPS) - Bharat Bill Payment System (BBPS) is an integrated bill payment system which offers interoperable bill payment service to customers online as well as through a network of agents on the ground. The system provides multiple payment modes and instant confirmation of payment. The BBPS operates as a tiered structure with a single Bharat Bill Payment Central Unit (BBPCU) and multiple Bharat Bill Payment Operating Units (BBPOUs). The National Payment Corporation of India has been identified to be the BBPCU. The system is a one-stop payment platform for all bills providing an interoperable and accessible “Anytime Anywhere” bill payment service to all customers across India with certainty, reliability and safety of transactions.

Trade Receivables Discounting System (TReDS) is an electronic mechanism for financing trade receivables. The TReDS will facilitate discounting of both invoices as well as bills of

exchange. The objective of the TReDS is to facilitate financing of invoices / bills of MSMEs drawn on corporate buyers by way of discounting by financiers. To enable this, the TReDS has to put in place suitable mechanism whereby the invoice / bill is converted into “factoring units” which are then traded on the TReDS platform where financiers can bid and the seller can select the best bid.

Global Outreach of Indian Payment Systems: The Way Ahead

The Unified Payments Interface (UPI) has been a huge success in India. In less than 4 years since launch in 2016, its growth, in volume terms, has eclipsed all other payment products. The UPI model allows it to have unique features like open and interoperable platform, two factor authentication, facility for Payment Service Providers to build on top of existing infrastructure, multiple bank accounts in a single application, e-mandate feature, compatibility with bank account, wallets, etc., that have a potential to make it appealing to other nations also. Similarly, the growth of domestic card network – RuPay also provides an opportunity for its global expansion. The Reserve Bank’s Payment and Settlement System Vision envisaged enhancing global outreach of our payment systems, including remittance services, through active participation and co-operation in international and regional fora by collaborating and contributing to standard setting. Reserve Bank in close collaboration with the Government and NPCI is working in the direction of expanding the reach of UPI and RuPay globally. While RuPay cards are being accepted the world over, the issuance of RuPay cards in Bhutan has also been facilitated. To give impetus to global outreach through undivided attention, NPCI has, on direction of RBI, created a subsidiary solely for international business.

Chapter 14: Currency Management

Currency Management is one of the core functions of the RBI by virtue of the statutory responsibility conferred on the central bank in the Preamble of the Reserve Bank of India Act, 1934, which mandates it to *regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage; to have a modern monetary policy framework to meet the challenge of an increasingly complex economy, to maintain price stability while keeping in mind the objective of growth.*

Under Section 22 of the RBI Act, 1934 "Right to Issue Bank notes", RBI has the sole right to issue bank notes of various denominations except one rupee notes, which is issued by the Government of India. As per the Coinage Act, 2011, the Government of India has the sole right to produce / mint coins. Although the responsibility for minting coins vests with the Government of India, the coins are issued for circulation only through the Reserve Bank of India under the provisions of Section 38 and Section 39 of RBI Act, 1934.

Currency includes the bank notes issued by RBI in various denominations from time to time ranging between ₹2 to ₹10000 (Section 24 of RBI Act) and Rupee coins in the denominations of 1 (including ₹1 notes), 2, 5 ,10 and 20 issued by the Government of India through RBI. At present 50 paise coins are the only denomination of small coins in circulation as the Government of India, vide its gazette notification S.O. 2978 € dated December 20, 2010, withdrew the coins of denomination of 25 paise and below from circulation with effect from June 30, 2011.

Though there has been a considerable increase in the use of digital payment systems for settlement of various transactions on account of speed, convenience and competition, paper currency continues to be the most favoured means of settlement of daily transactions as evidenced by the growing demand for bank notes and coins. With the Currency in Circulation (CIC) across the country increasing at a Compounded Annual Growth Rate (CAGR) of 10.2% over the past 5 years, i.e., between the financial years (FY) 2014-15 and 2018-19, and the Notes in Circulation (CIC minus coins in circulation) as on May 19, 2020 at 25.73 trillion / lakh crore '**Cash continues to remain the King**'.

The Cash to GDP ratios of India and the G20 countries also signify the importance of cash which is exhibited in the tables below:

Cash to GDP Ratio for India					
Type of Estimate	Financial Year	Nominal GDP (₹ Cr)	Currency in Circulation (CIC) (₹ Cr)	CIC/GDP Ratio (%)	
	2011-12	87,36,329	10,66,100	12.2	
	2012-13	99,44,013	11,80,100	11.9	
	2013-14	1,12,33,522	13,00,200	11.6	
	2014-15	1,24,67,959	14,48,300	11.6	
	2015-16	1,37,71,874	16,63,300	12.1	
3rd Revised	2016-17	1,53,91,669	13,35,200	8.7	
2nd Revised	2017-18	1,70,98,304	18,29,300	10.7	
1st Revised	2018-19	1,89,71,237	21,36,700	11.3	
Provisional	2019-20	2,03,39,849	24,47,275	12.0	

Currency to GDP ratio for G-20 Countries														
Sr . n o	Currency to GDP Ratio (%)	200 5	200 6	200 7	200 8	200 9	201 0	201 1	201 2	201 3	201 4	201 5	201 6	
1	Argentina	7.5	7.5	7.5	6.4	6.9	6.8	6.9	8.0	7.7	6.9	7.3	6.6	

2	Australia	3.8	3.8	4.0	4.2	4.1	3.9	3.8	3.9	4.0	4.2	4.4	4.5
3	Brazil	3.2	3.6	3.8	3.7	4.0	3.9	3.7	3.9	3.8	3.8	3.8	3.7
4	Canada	3.3	3.3	3.2	3.3	3.5	3.5	3.4	3.5	3.5	3.5	3.8	4.0
5	China	12. 5	12. 2	11. 2	10. 7	10. 9	10. 9	10. 4	10. 1	9.8	9.3	9.0	9.2
6	France	6.2	6.6	6.7	7.4	7.9	8.0	8.2	8.3	8.6	9.0	9.3	9.5
7	Germany	6.9	7.4	7.5	8.3	8.4	8.4	8.4	8.5	8.7	8.5	8.7	8.7
8	India #	11. 6	11. 7	11. 8	12. 3	12. 3	12. 2	12. 2	12. 0	11. 6	11. 6	12. 2	8.8
9	Indonesia	4.8	4.9	5.1	4.9	4.6	4.6	4.8	5.1	5.2	5.0	5.1	4.9
10	Italy	6.6	7.0	7.2	8.0	8.7	8.9	9.2	9.6	10. 1	10. 4	10. 9	11. 1
11	Japan	16. 0	16. 0	16. 1	16. 5	17. 5	17. 4	18. 0	18. 4	18. 8	19. 0	19. 5	20. 0
12	Republic of Korea	2.8	2.9	2.8	2.8	3.2	3.4	3.6	3.9	4.4	5.0	5.5	5.9
13	Mexico	4.0	4.3	4.3	4.7	5.2	5.2	5.2	5.4	5.7	6.2	6.8	7.3
14	Russia	9.5	10. 6	11. 5	9.9	11. 1	11. 6	11. 4	11. 2	11. 4	11. 2	10. 2	
15	Saudi Arabia	5.2	4.9	4.6	4.3	5.5	4.8	4.8	5.9	5.1	5.4	6.9	7.0
16	South Africa	3.3	3.5	3.2	3.1	3.1	3.0	3.4	3.4	3.4	3.4	3.4	3.4
17	Turkey	2.9	3.4	3.1	3.2	3.8	4.2	4.0	3.9	4.1	4.2	4.4	4.7
18	United Kingdom	2.2	2.2	2.4	2.5	2.8	2.8	2.9	3.0	3.0	3.0	3.1	3.3

1 9	United States	5.8	5.6	5.5	5.8	6.2	6.3	6.7	7.0	7.2	7.4	7.6	7.9
<i>#: Except for India, all countries data refer to the end of calendar year position; For India, the ratio refers to the end of financial year.</i>													
<i>Source: IFS yearbook, 2017 (IMF) for Currency in Circulation data and IMF WEO October 2017 for Nominal GDP data.</i>													

Basic Glossary

Currency in Circulation: Currency in Circulation includes notes in circulation, rupee coins and small coins. Rupee coins and small coins in the balance sheet of RBI include ten-rupee coins issued since October 1969, two rupee-coins issued since November 1982 and five rupee coins issued since November 1985.

Notes in Circulation: The notes in circulation comprise the notes issued by the Government of India up to 1935, and by RBI since then, less notes held in the Banking Department, i.e. notes held outside the RBI by the public, banks treasuries etc. The Government of India one rupee notes issued since July 1940 are treated as rupee coins and hence are not included under this head.

Being the sole authority to issue bank notes, it is obligatory on the RBI to ensure adequate and timely supply of clean notes in the system to cater to this ever-increasing demand.

Evolution of Paper Currency in the Country

In India, coins of various design, form and material, have been used as a medium of exchange since ages. Paper currency made its appearance in the later part of the 18th century, when it was introduced in the form of promissory notes by the royal Treasuries / banks. These paper currencies / notes were issued by Bank of Hindostan (1770-1832), General Bank of Bengal and Bihar (1773-75), Bengal Bank (1784-91), the Commercial Bank (1819-1828), etc.

The responsibility of issuance of currency notes, which was dispersed amongst the private and the Presidency banks, was conferred solely upon the Government of India by the Paper Currency Act, 1861. From then on, the monopoly for the issue of bank notes remained with the Government of India. After the consolidation of the issue function at the Currency Department of the Government, several currency circles were created to cater to the currency needs of the entire geographical area of the country. The Presidency banks were appointed as agents for issue and redemption. In 1913, the Office of Controller of Currency was established replacing the Currency Department in the Government. With the enactment of the RBI Act, 1934, the function of issue of notes was taken over by the RBI from the Controller of Currency in 1935. Since then the RBI is the nation's sole Note Issuing authority and responsible for the country's currency management.

The initial notes were printed in England and the production of currency notes in India started with the establishment of the currency printing press at Nashik in Maharashtra in 1928. The same was augmented with the setting up of another government press at Dewas in Madhya Pradesh (MP) in 1974. Meanwhile, in 1968, Security Paper Mill with a capacity of 1500 metric tonne per year was established at Hoshangabad in MP. To bridge the gap in demand and supply of currency notes necessitated by the increasing currency requirements of growing economy, the RBI, in 1995 established a wholly owned subsidiary **Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL)**. In 1996, BRBNMPL established two currency presses - one in Mysuru in Karnataka and the other at Salboni in West Bengal to augment the country's bank note production capacity. Currently, these two presses account for the supply of nearly two third of the bank notes received by RBI. With the full capacity utilization of these two presses of BRBNMPL, the country has become self-reliant in bank note printing.

BRBNMPL has contributed immensely to achieving strategic objectives in the field of currency management by indigenously designing the Mahatma Gandhi (New) Series banknotes and continuing with extensive automation and Enterprise Resource Planning.

Along with SPMCIL, BRBNMPL has set up the Bank Note Paper Mill India Private Limited (BNPMIPL), an entity producing Cylinder Watermarked Bank Note (CWB) paper required for banknote production.

Similarly, BRBNMPL has also set up an ink factory at Mysuru with an annual production capacity of 1,500 metric tonnes, which has started its commercial production from August 2018. Consequently, dry offset, intaglio, numbering and colour shifting inks used in the printing of banknotes are being manufactured at the Mysuru ink factory. The BNPMIPL and the BRBNMPL ink factory are significant milestones achieved in the efforts towards 'Make in India' programme and indigenisation of production of new bank notes.

Currency Management Architecture

Currency Management is the process of managing the life cycle of the notes, which includes assessing the printing requirement of various denominations of notes, placing indents with the note printing presses, supplying and distributing adequate quantity of currency throughout the country and ensuring the quality of banknotes in circulation by continuous supply of clean notes and timely withdrawal of soiled notes.

Section 23 of the RBI Act, 1934, mandated that the function of issuance of bank notes is to be conducted by the RBI through a separate department called the Issue Department. Hence, the RBI has separate Issue Departments at its Regional Offices to manage the operational part of the currency management function, while the overall management is carried out by the Department of Currency Management (DCM) located at its Central Office in Mumbai. In addition to the 19 Issue Offices (located at Ahmedabad, Bengaluru, Bhopal, Belapur, Bhubaneswar, Chandigarh, Chennai, Guwahati, Hyderabad, Jaipur, Jammu, Kanpur, Kolkata, Lucknow, Mumbai, Nagpur, New Delhi, Patna and Thiruvananthapuram), the RBI is supported in this function by a network of Currency Chests (CCs) and Small Coin Depots

(SCDs), bank branches and ATMs spread over the country.

Currency Chests / Small Coin Depots are storehouses of bank notes and rupee coins / small coins located at branches, mostly of commercial banks, though there are a few currency chests established at State Co-operative banks, Regional Rural Banks, and one even at RBI (Kochi). The CCs are extended arms of RBI that help in the distribution as well as retrieval of currency from the system and they are responsible for meeting the currency requirements of their respective regions.

Designing of Notes

The design, form and material of bank notes are decided by the Government of India based on the recommendations of the Central Board of RBI, as specified in Section 25 of the RBI Act, 1934. Special care is taken in the choice of the size, colour and design of the notes to enable the public to distinguish the notes of different denominations at a glance. At the same time, care is taken to incorporate improved security features in the notes thereby rendering it difficult to counterfeit them. Currently, bank notes of various denominations are issued in the Mahatma Gandhi (New) series.

Mahatma Gandhi (New) Series Bank Notes

In line with the international practice of periodically reviewing and upgrading the design and security features of banknotes, a new series (Mahatma Gandhi New Series) of bank notes in new design, dimensions and denominations, highlighting the cultural heritage and scientific achievements of the country, was introduced during the year 2016-17. Bank notes in the denominations of ₹10, ₹20, ₹50, ₹100, ₹200, ₹500 and ₹2000 have since been introduced.

A few other elements added in these notes are numerals in Devanagari and the logo of Swachh Bharat. The new notes also have design elements in myriad and intricate forms and shapes. While the security features in the current series of bank notes, continue to remain, their relative positions have changed in the new design notes.

Denomination	Colour	Size	Motif	Identification mark	Bleed Lines
2000	Magenta	66mm x 166mm	Mangalyaan	Horizontal Rectangle	Seven angular bleed lines
500	Stone Grey	66mm x 150mm	Red Fort	Circle	Five angular bleed lines
200	Bright Yellow	66mm x 146mm	Sanchi Stupa	H	Four angular bleed lines with two circles in between
100	Lavender	66mm x 142mm	Rani ki Vav	Triangle	Four angular bleed lines
50	Fluorescent Blue	66mm x 135mm	Hampi with Chariot	-	-
20	Greenish Yellow	63mm x 129mm	Ellora Caves	-	-
10	Chocolate Brown	63mm x 123mm	Sun Temple, Konark	-	-

Planning the Annual Requirement

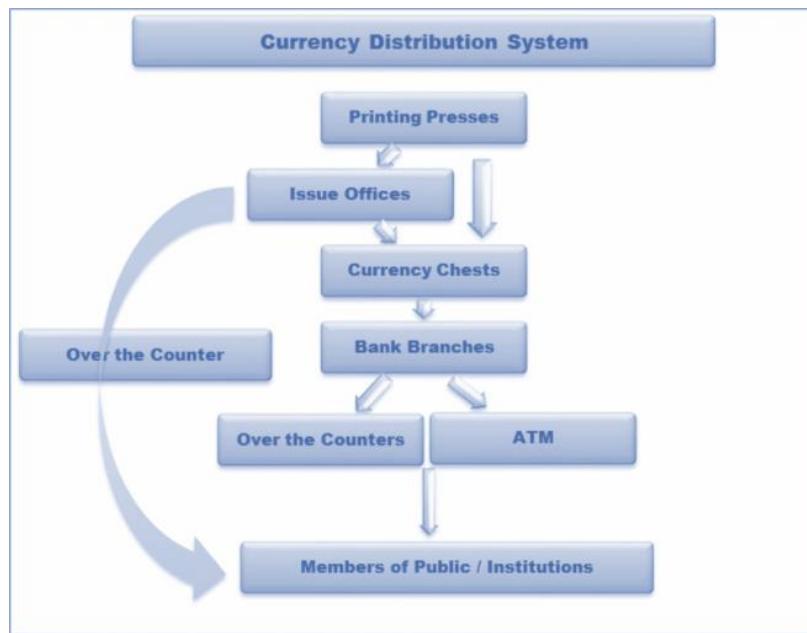
The quantity of notes that is required to be printed is decided by the RBI in consultation with GOI. The major drivers of currency demand are economic activity as proxied by the real GDP growth, Inflation, interest rate, growth of digital payment etc. The projection of banknotes and coins are carried out to finalize the annual indent. As regard to the banknotes, the total demand is arrived at after consolidating two components viz., **incremental demand (or transactional demand) and replacement demand**. Incremental demand is estimated by combining different econometric models viz., Time Varying Parameter- Auto Regressive Distributed Lag (TVP-ARDL) model, Seemingly Unrelated Regression Equation (SURE) model and Autoregressive Integrated Moving Average (ARIMA) model assuming exogenous variables viz. real GDP growth, CPI inflation rate, call rate, digital/alternate payment growth etc. However, the replacement demand is projected based on the denomination-wise estimated lifespan of banknotes. Replacement rates of banknotes are computed as reciprocal of average lifespan in years. Finally, the total demand projection is arrived at by adjusting for contingency demand (in case of emergency) keeping view of the existing stock of currency at RBI and CC. The demand for coins is forecasted separately using Autoregressive Integrated Moving Average (ARIMA) model. In case of coins, only incremental demand is required to be considered.

Distribution of Currency

For distribution of currency, there are three currency distribution models prevalent in different countries of the world:

- i. Wholesale model – Under the wholesale model, as prevalent in Australia, the commercial banks purchase bank notes directly from the central bank. These banknotes are transported and stored by the banks at approved cash centres located throughout Australia.
- ii. Retail model – Under the retail model, as practised in China and France, the central bank opens its own stocking points to take care of the currency needs of the public and other institutions.
- iii. Semi-retail model – Like most central banks, India has adopted the semi-retail model under which its currency notes are made available to currency chest branches of banks at their doorsteps. The transportation and other moving costs are borne by the central bank. The banks are required to bear only the static cost of maintaining the currency chest.

The notes and coins are distributed, in the semi-retail model, by the network of the RBI Issue Offices, CCs/SCDs, bank branches and ATMs in the following manner:



To facilitate the distribution of notes and rupee coins across the country, the RBI has authorised selected banks/branches of banks to establish currency chests. Currency chests, as mentioned earlier, are storehouses where bank notes and rupee coins are stocked on behalf of the RBI. It is ensured that the currency chests at bank branches, contain adequate quantity of notes and coins so that currency is accessible to the members of the public in all parts of the country. These currency chests are supplied with periodical remittances of fresh / re-issuable banknotes and rupee coins from Reserve Bank's Issue Offices. The Agency banks / linked bank branches freely draw upon them for meeting local requirements. Surplus and non-issuable notes (including Re1 notes and coins) are deposited into the currency chests. The notes and coins are pushed into or taken out of circulation through the Issue Offices of RBI and the various currency chests.

RBI is slowly withdrawing from the retail distribution of currency by ensuring easier access to exchange facilities to the customers through nearby bank branches. Banks have been advised to strengthen their distribution systems and procedures so as to cater to the growing needs of the currency for the general public.

Clean Note Policy

RBI has put in a mechanism wherein, notes that have become dirty / soiled / torn due to excessive usage, are taken out of circulation. RBI has a mandate as per the Section 27 of the RBI Act, 1934, to ensure that only clean notes are in circulation and to fulfil this mandate the soiled notes are taken out of circulation and are sent back to Issue Offices for further verification and processing before destruction.

RBI uses the Currency Verification and Processing System (CVPS) for mechanised on-line examination, authentication, counting, sorting and destruction of notes received. After processing, the non-issuable notes are automatically sent from the CVPS to the Shredding and Briquetting System (SBS). The SBS after shredding the notes, converts them into

briquettes.

The mechanism in which the dirty or soiled notes are retrieved and processed from the system is as shown below:



Exchange of Notes

As a part of its mandate to ensure that only clean notes are in circulation, RBI undertakes the responsibility of exchanging the soiled and torn banknotes both at its Issue Offices as well as at the bank branches. Basically, there are two categories of notes which are exchanged by banks and the RBI – soiled notes and mutilated notes. While soiled notes are notes that have become dirty and limp due to excessive use, a mutilated note means a note of which a portion is missing or which is composed of more than two pieces. Soiled notes can be tendered and exchanged at all bank branches. Similarly, the facility of exchanging mutilated / imperfect notes (a note which is wholly or partially obliterated, altered or undecipherable but does not include a mutilated note) under Note Refund Rules (NRR), (as amended by Reserve Bank of India (Note Refund) Amendment Rules, 2018) is available at all the bank branches from January 2013 onwards. All branches of banks have been delegated powers under Rule 2(j) of Reserve Bank of India (Note Refund) Rules, 2009 for exchange of mutilated / defective notes. Small Finance Banks and Payment Banks may exchange mutilated and defective notes at their discretion. The procedure for such exchange has been amended in 2018. After adjudication as per the NRR, 2009, either full or no value is paid for notes of denominations up to ₹20, while notes of ₹50 and above would get full, half, or no value, depending on the area of the single largest undivided portion of the tendered note. Additionally, special adjudication procedures exist at the RBI Issue Offices for notes which have turned extremely brittle or badly burnt, charred or inseparably stuck together and, therefore, cannot withstand normal handling.

Dealing with Counterfeit notes / Fake Indian Currency Notes (FICNs)

Counterfeit money refers to fake or imitation currency that is produced with an aim to deceive. Counterfeiting of currency is a crime that continuously poses a threat to a country's economy and is a source of financial loss to its citizens.

Some of the ill-effects that counterfeit money has on society are reduction in the value of real money, increase in prices (inflation) due to more money getting circulated in the economy – an unauthorised artificial increase in the money supply, a decrease in the acceptability of paper money and losses for members of public whose counterfeit money is confiscated. In countries where paper money is a small fraction of the total money in circulation while the macroeconomic effects of counterfeiting of currency may not be significant, the economic effects, such as confidence in currency, may be large.

In India, section 489 A to 489 E of the Indian Penal Code deals with counterfeiting currency notes or bank notes. Under the law, counterfeiting, trafficking and even possessing of counterfeit notes knowingly is liable for punishment. The definition of 'counterfeiting' in the Indian Penal Code also covers currency notes issued by a foreign government authority as well. The Government of India has also framed Investigation of High Quality Counterfeit Indian Currency Offences Rules, 2013 under Unlawful Activities (Prevention) Act (UAPA), 1967. The Third Schedule of the Act defines High Quality Counterfeit Indian Currency Note i.e. Presence of Watermark(s), Security thread and any one of the following features: (a) Latent image; (b) See through registration; (c) Print quality sharpness; (d) Raised effect; (e) Fluorescent characteristics; (f) Substrate quality; (g) Paper taggant; (h) Colour shift effect in OVI; (i) Colour shift effect in security thread.

Activity of production, smuggling or circulation of High Quality Counterfeit Indian Notes has been brought under the ambit of UAPA, 1967.

To combat the incidence of counterfeit notes, the RBI, in consultation with the Government of India, continuously and periodically reviews and upgrades the security features of the bank notes to deter counterfeiting. It also shares information with various law enforcement agencies to address the issue of counterfeiting. The RBI has taken certain measures to create public awareness about the security features of bank notes and to educate the general public to help prevent circulation of forged or counterfeit notes. Basic information on features of Indian Bank Notes is presently hosted on the microsite <https://paisabolthai.rbi.org.in>.

It has also issued detailed guidelines to banks and government treasury offices on how to detect and impound counterfeit notes.

It has also instructed the banks that:

- Bank notes tendered over the counter / received directly at the back office / currency chest through bulk tenders should be examined for authenticity through Machines.
- Credit should not be given to customer's account for forged notes, if any, detected in

the tender received over the counter or at the back-office / currency chest.

- In no case, the counterfeit notes should be returned to the tenderer or destroyed by the bank branches/treasuries.
- For cases of detection up to four counterfeit note pieces, in a single transaction, a consolidated report has to be made at the end of the month to the police authorities along with the suspect counterfeit notes.
- For cases of detection of five counterfeit note pieces or more, in a single transaction, the notes should be forwarded to the police station immediately for investigation by filing of FIR.

Security Features of Indian Bank Notes

Counterfeiting is one of the major issues plaguing the issuers of Currency notes. Latest growth in computer technologies and photography, along with the accessibility to low-cost tools, has made the manufacturing of counterfeit money relatively easy. To prevent this menace and always stay one step ahead of the counterfeiters, RBI is updating its currency regularly by adding security features to the bank notes. These security features make the bank notes less prone to counterfeiting.

The following are the various security features of the new MG series bank notes:

- Watermark:** This consists of an image that is visible when the bank note is held up against the light, which is created during the manufacturing process such that it is an integral part of the paper. The Bank notes contain the Mahatma Gandhi portrait with the denomination numeral (electrotype) watermark.
- Security Thread:** Colour shifting windowed security thread is present in denomination of ₹100 and above the colour of which changes from green to blue when the note is tilted. The inscriptions 'भारत' 'RBI' is present in denominations of ₹100, 200, and 500. In ₹2000 the inscriptions are 'भारत' 'RBI' '2000'. For ₹10, 20 and 50 denominations, windowed demetalised security thread with inscriptions 'भारत' and 'RBI' is present.
- Latent Image:** The latent image is a security feature that is concealed within the note. It is visible only when it is held horizontally at eye level. In notes of denomination 100 and above, the latent image with the denomination of the numeral is visible at the bottom left hand corner, when the note is held at 45 degree angle from the eye level.
- Micro lettering:** Micro lettering are minute inscriptions which can be only read under a microscope / magnifying lens of higher capacity. This feature appears on the left shoulder of the Mahatma Gandhi portrait with inscriptions 'India' and 'भारत'. Micro letters can also be seen on the motifs in the reverse side of the notes.
- Intaglio Printing:** Raised printing which are due to deposits of ink and can be felt on touch are called intaglio printing. In notes of denominations of 100 and above, the portrait of

Mahatma Gandhi, the Ashoka Pillar Emblem, Guarantee clause, Governor's signature, Promise clause, RBI Emblem, bleed lines and the identification marks are in intaglio.

vi) See through Register: The see-through register is a design that is printed partially on both sides of the note, exactly opposite of each other, and looks like one single design when seen against the light.

vii) Fluorescence: This is a special security feature in which optical fibres and fluorescent ink is used which glows when exposed to ultraviolet light. The number panels of the notes are printed in fluorescent ink and the note also contains optic fibres, both of which glow when the note is held under an ultra violet lamp. The optical fibres are dual coloured (i.e. each fibre shows two colours) and are in combination of red/yellow and blue/green.

viii) Colour Shifting Ink: The rupee symbol and the denomination in the banknotes of denomination ₹200 and above is written in the obverse of the note in colour shifting ink (green to blue).

x) Ascending font of numbers: This is a new feature wherein the font size of the number (excluding prefix) in the number panel is increasing from left to right.

ix) Angular Bleed Lines: This feature is seen in the notes issued since 2016. It is a set of lines in raised prints at the left hand corner of the note slightly above the Ashoka Emblem. The number and blocks/sets of these lines vary as per the denomination - 4 lines (in 2 sets of 2) in notes of ₹100, 4 lines (in sets of 2 separated by two circles) in notes of ₹200, 5 lines (sets of 2-1-2) in ₹500, 7 lines (sets of 1-2-1-2-1) in ₹2000.

xi) Identification marks: These are features that appear on the higher denomination notes to help the visually impaired identify the denomination of notes. It is a triangle () in

notes of ₹100, a 'H' shape () in ₹200, a circle () in ₹500 and a rectangle () in ₹2000.

Salient Features of a Bank Note

Apart from the security features there are a few salient/essential features of a bank note. They are:

Name of the Issuer – Name of the issuing authority, viz., the Reserve Bank of India in Hindi and English at the top of the note.

Guarantee Clause – The clause which states that the note is guaranteed by the Govt of India.

Promissory Clause – The clause by which the signatory of the note promises to pay the bearer the sum of the amount mentioned in the note.

Signature of the Issuer – The signature of the Governor of RBI

Number Panel - The unique number for each note which is a six digit one, prefixed by three alpha numerical digits. A special, distinct font is used and the spaces between the numbers are

evenly distributed.

Denomination—The denomination of the currency in numerals.

Portrait of Mahatma Gandhi—Portrait of Mahatma Gandhi at the centre.

Language Panel—Denomination written in 15 languages on the reverse of the note.

Demonetisation

Demonetisation is the act of stripping a currency unit of its status as legal tender. It is the act or process of removing the legal status of currency unit. From the date of demonetization, all currencies which are demonetized cease to be a legal tender. Such currency is no longer money and cannot be used to do any transaction. Many countries have adopted this process of demonetization to overcome hyperinflation, to curb black money, to foster economic stability, to remove counterfeit currency, etc.

In India, the first demonetization took place in the year 1946, when higher denomination notes of ₹ 500, ₹1000 and ₹10000 notes were demonetised on January 12, 1946, to curb unaccounted money. However, subsequently ₹5000 was introduced and ₹1000 and ₹10000 notes were reintroduced. The second phase of demonetization was done on January 16, 1978 when an ordinance was promulgated to phase out notes with denomination of ₹1000, ₹5000 and ₹10000, to curb 'the illicit transfer of money for financing transactions which are harmful to the national economy...'.

The third phase of demonetization took place in 2016 when the legal tender character of bank notes in the denominations of ₹500 and ₹1000, referred to as Specified Bank Notes (SBNs), was withdrawn by Government of India vide Gazette Notification No. 3407 (E) of November 8, 2016. An ordinance on Specified Bank Notes (Cessation of Liabilities) was promulgated on December 30, 2016 (subsequently made into an Act), stipulating that SBNs shall cease to be liabilities of the RBI under Section 34 of the RBI Act and shall cease to have the guarantee of Central Government under sub-section (1) of Section 26 of the Act with effect from December 31, 2016. However, grace periods were provided for exchange of these notes by Non-Resident Indians and Resident Indians who were out of the country during the specified period vide various Gazette notifications subject to conditions specified therein. The Government of India also issued Specified Bank Notes (Deposit of Confiscated Notes) Rules, 2017 dated May 12, 2017 for deposit of SBNs confiscated / seized by law enforcement agencies before December 30, 2016.

Recent Developments

i. Laboratory for Banknote Quality Assurance

The Bank has set up a laboratory at Mumbai in October 2018 for bank note quality assurance, based on the recommendation of the Group of Experts. The lab has been set up to ensure standardisation and objectivity in approval of the banknotes in pre and post printing stage for all the printing presses, This is done to ensure that notes in circulation are within the

tolerance limits of the printing standards set by RBI. Presently the state of the art laboratory is used to check the print proof from the presses for Lab values before according approval.

ii. MANI (Mobile Aided Note Identifier)

The Indian Banknotes have several features which enables the visually impaired (color blind, partially sighted and blind people) to identify them viz. intaglio printing and tactile mark, variable banknote size, large numerals, variable color, monochromatic colors, patterns etc. While introducing new design notes, the old design notes are allowed to continue as legal tender as withdrawing the old series immediately would cause great public convenience. So, it is an accepted practice that the old series/design is allowed to continue till they return to banks as soiled notes in the normal course. This passive withdrawal of notes may take a few years as the lives of various denominations of banknotes are different. Both the MG (New) Series and the old Mahatma Gandhi Series notes are of different sizes with the lowest denomination being smallest and the higher denomination being of larger size. Once the old series banknotes are withdrawn from circulation in the natural course, identification of the new series banknotes will automatically become easy for the visually impaired.

Keeping in mind the concurrent circulation of both the MG Series and MG (New) Series, the Bank embarked upon exploring alternative technological solutions to help the visually challenged in identifying the denomination of banknotes. Accordingly, in January 2020, it launched the mobile application “MANI Mobile Aided Note Identifier” thereby making Indian banknotes more accessible for the visually impaired and facilitating their day to day transactions.

The mobile application developed by RBI has the following features:

- a) Capable of identifying the denominations of Mahatma Gandhi Series and Mahatma Gandhi (New) series banknote by checking front or reverse side/part of the note including half folded notes at various holding angles and broad range of light conditions (normal light/day light/low light/ etc.).
- b) Ability to identify the denomination through audio notification in Hindi/English and non-sonic mode such as vibration (suitable for those with vision and hearing impairment).
- c) After installation, the mobile application does not require internet and works in offline mode.
- d) Ability to navigate the mobile application via voice controls for accessing the application features wherever the underlying device & operating system combination supports voice enabled controls.
- e) The application is free and can be downloaded from the Android Play Store and iOS App Store without any charges/payment.

f) This mobile application does not authenticate a note as being either genuine or counterfeit.

iii. Integration of Currency Management Functions with Core Banking Solution (e-Kuber)

The earlier Integrated Computerised Currency Operations & Management System (ICCOMS) at the Reserve Bank and currency chests has been replaced with a new currency management module (CyM) in the Bank's Core Banking Solution (e-Kuber). Some of the salient features of the new module include improved inventory management, near real time accounting of currency chest transactions, transit accounting and better tracking of CIC. The integration project is to be implemented in three phases. While Phase I and Phase II that involve on-boarding of all the active currency chests (CCs) in CyM along with all 19 Regional Offices (ROs), is already completed, phase III that includes development of user reports and certain other functionalities such as dashboards for top management, portal services for printing presses/mints, integration of linked bank branches etc is likely to be completed in 2020.

iv. Installation of new CVPS machines

As the existing CVPS machine had become old and outdated, during 2017-18, 50 new CVPS machines were procured by RBI and installed in the various issue offices in a phased manner. These machines have already commenced operations. The advantages of these machines over the earlier ones are increased processing speed, facility of placing the notes in any of the four orientation, viz., front, back, side-ways etc. and can be used for processing multiple denominations simultaneously.

v. Minimum Standards for Currency Chests and Rationalisation of Currency Chest (CCs)

The Committee on Currency Movement [Chair: Shri D. K. Mohanty, Executive Director] had recommended that RBI should encourage banks to open large Currency Chests with modern facilities. Consequently RBI has undertaken rationalisation of number of CCs to have an optimum number of large modern CCs having sufficient capabilities for mechanised processing, large storage capacity and quicker transportation facilities so as to provide better customer service by making available good quality genuine notes to bank branches / members of public. Accordingly Reserve Bank encourages banks to open large Currency Chests and has prescribed the following minimum standards for setting up new CCs:

- a) Area of the strong room/ vault of at least 1500 sq. ft. For those situated in hilly / inaccessible places (as defined by central / state government/ any appropriate authority), the strong room/ vault area of at least 600 sq. ft.
- b) Processing capacity of 6,60,000 pieces of banknotes per day. For those situated in the hilly/ inaccessible places, capacity of 2,10,000 pieces of banknotes per day.
- c) Amenability to adoption of automation and adaptability to implement IT solutions.

- d) CBL of ₹1000 crore, subject to ground realities and reasonable restrictions, at the discretion of the Reserve Bank.
- e) Adherence to other extant technical specifications issued by DCM regarding construction of CCs.

Chapter 15: Banker to Banks and Governments

The powers and range of functions of central banks vary from country to country. But there are certain functions like ‘Banker to Banks’ and ‘Banker to Governments’ which are commonly performed by the Central Banks. In our country too, RBI acts as the ‘Banker to Banks’ and the ‘Banker to Governments’.

Banker to Banks

Like individual consumers, businesses and organisation of all kinds, banks need their own mechanism to transfer funds and settle inter-bank transactions, such as borrowing from and lending to other banks and customer transactions. As a banker to banks, the Reserve Bank fulfills this role. While discharging this role, RBI focusses on

- enabling smooth, swift and seamless clearing and settlement of inter-bank transactions
- providing an efficient means of funds transfer for banks
- enabling banks to maintain their accounts with the Reserve Bank for statutory cash reserve requirements and maintenance of transaction balances
- acting as a lender of last resort in case of need

As a lender of last resort, it can come to the rescue of a bank that is solvent but faces temporary liquidity problems by supplying it with much needed liquidity when no one else is willing to extend credit to that bank. The Reserve Bank extends this facility to protect the interest of the depositors of the bank and to prevent possible failure of the bank, which in turn may also affect other banks and institutions and can have an adverse impact on financial stability and thus on the economy.

Legal Provisions

- Sec.17 of RBI Act, 1934 – Business which the bank can transact including transactions with banks.
- Sec.42 of RBI Act, 1934 – Maintenance of Cash Reserves by banks with RBI.

Maintenance of current accounts of banks

Banks and financial institutions which are eligible to open account with the Bank can open only a single Current Account. The following entities maintain current accounts with RBI:

- Commercial Banks, Regional Rural Banks (Grameen Banks), Local Area Banks, State Co-operative Banks, District Central Co-operative Banks, Urban Co-operative Banks, State Land Development Banks and any other type of bank for which license is issued by RBI.

- Indian Financial Institutions, Primary Dealers, Insurance Companies, Mutual Funds Foreign Institutions viz., Foreign Central Banks, Supranational Institutions, International Organizations, etc.
- Other entities, if any, authorised/approved by the Bank to open current account with RBI.

Purpose

Current accounts are opened in the E-Kuber system⁸⁵ (CBS) at the Regional Offices of RBI, where the Head Office / Corporate Office of the entity is located. The current accounts are used for the following purposes:

- Maintenance of CRR by banks
- Inter-institutional funds transfer among the entities maintaining current accounts with RBI
- Inter-bank settlements
- Making payments to RBI and Govt. Departments.

Restrictions

Third party transactions are not allowed in the current accounts. Overdrafts, including intra-day overdrafts are also not permitted in the current accounts.

Special Purpose accounts

Financial Institutions/banks maintaining current account with RBI may require an additional account for some specific purpose. Example of such accounts are Line of Credit (LOC) account, SBI DD/TT Payable Account, CCIL Multi Modal Account etc. Such special purpose accounts can be opened at any Regional Office depending on the request and with the approval of the Central Office Department concerned.

RTGS Settlement accounts

In addition to current account, the banks also maintain a separate '*Settlement Account*' for RTGS transactions which is centrally maintained by Mumbai Regional Office (MRO).

Accounts of Institutions incorporated outside India

In terms of Section 17(13) of RBI Act 1934, RBI is authorised to act as agents/respondents of banks and institutions incorporated outside India and can open Rupee Accounts for them. Such accounts are opened in Mumbai Regional Office (except that of Nepal Rashtra Bank which is maintained at Kolkata RO). The policy in respect of opening of such accounts, maintenance of minimum balances, types of debit and credit etc. is laid down by the Central Office Department concerned at whose request such accounts are to be

⁸⁵ e-Kuber is one of the foremost central bank oriented Core Banking Systems in the World operationalised by the RBI. The provision of a single current account for each bank across the country, decentralised access to this account from anywhere-anytime using the portal based services in a safe manner and ease of operations.

opened. Following are some of the International Institutions that maintain current account with the RBI.

- International Monetary Fund (IMF)
- International Bank for Reconstruction and Development (IBRD)
- International Development Association (IDA)
- Asian Development Bank (ADB)
- International Finance Corporation (IFC)
- International Fund for Agricultural Development (IFAD)
- African Development Fund (ADF)

Operations in current accounts of foreign central banks, international institutions, supranational institutions will be guided by the instructions of the Central Office Department concerned.

Granting loans and advances to banks and others

The Bank is authorized to make loans, grant advances to and discount bills of scheduled banks, State Co-operative Banks and various other institutions, details of which are given in various sub-sections of Section 17 and 18 of the Reserve Bank of India Act, 1934. The types of loans and advances that can be granted and the entities to whom such loans and advances can be made are detailed in Sections 17 and 18 of the RBI Act, 1934. Accordingly, the banks can avail liquidity facility from RBI under Repo / Term Repo / Marginal Standing Facility (MSF) against the Government Securities as collateral. Apart from this facility, banks and other financial institutions such as NABARD, EXIM, SIDBI, etc., are eligible for loans and advances under various provisions of Section 17 of RBI Act, 1934. The Primary Dealers maintaining current accounts with RBI can also avail liquidity support facility and avail Repo/Term Repo.

Banker to Governments

Being the Banker to the government is one of the key functions of the RBI. Like individuals, businesses and banks, Governments need a banker to carry out their financial transactions in an efficient and effective manner, including the raising of resources from the public. Since its inception, the RBI has undertaken the traditional central banking function of managing the Government's banking transactions. The central bank also serves as an agent and adviser to the Government. As agent of the Government, it is entrusted with the task of managing the public debt and the issue of new loans and Treasury Bills on behalf of the Government. By acting as financial adviser to the Government, it advises the Government on important matters of economic policy such as deficit financing, devaluation of currency, trade policy, foreign exchange policy, etc. The conduct of Government business is also governed by the Central Government Treasury Rules, Treasury Rules of the State Government and instructions issued from time to time by Controller General of Accounts and other Departments of Central and State Governments.

Legal Provisions: Under Sections 20 and 21 of the RBI Act, the RBI shall have an obligation and right respectively to accept monies for account of the Central Government and to make payments up to the amount standing to the credit of its account, and to carry out its exchange, remittance and other banking operations, including the management of the public debt of the Union. In terms of Sec.21A of the Act, the RBI can transact the banking business of State Government through an agreement with the respective State Governments. All State Governments, except the State of Sikkim, have entered into agreements with the RBI and the RBI performs the role of banker to these governments. For Sikkim, there is a limited agreement for management of its public debt. Sec.45 of the RBI Act, 1934, empowers RBI to appoint agency banks for conduct of Government Business as RBI has limited presence across the country.

Banker to Central Government

Under the administrative arrangements, the Central Government is required to maintain a minimum cash balance with the RBI. The following accounts of Central Government are maintained in E-Kuber (CBS) system in all the Regional Offices of RBI and the Principal account of these accounts are maintained at Central Accounts Section (CAS), RBI, Nagpur.

- i. Central Government - Civil;
- ii. Railway Fund;
- iii. Post Fund;
- iv. Telecommunication Fund;
- v. Defence Fund;
- vi. Departmentalised Ministries;
- vii. Agency Transaction Account

All receipts, payments /disbursements, clearing/remittance transactions take place through these accounts.

Banker to State Governments

The Principal account of all State Governments except Sikkim is maintained at CAS, Nagpur under the account titled “Government Deposit Account – State”. The minimum balance required to be maintained by each State varies from State to State depending on the relative size of the State budget and economic activity. A standardized e-Receipt and e-Payment model for State Governments has been rolled out by RBI that is discussed at the end of this Chapter. At the end of April 2020, 16 States have been integrated with e-Kuber system for e-receipts and 19 States for e-payments. Depending upon the extent of integration, the States carry out their transactions through other Agency banks/RBI.

Types of Accounts maintained

Government departments will maintain one or more of the following types of accounts with RBI.

- ***Personal Ledger Account:*** These are in the nature of current account. Such accounts will be opened in the name of Government Officers specified, for the purpose of booking receipts and drawings on their behalf. The essential condition is that the drawings will be permitted to the extent of balances available in the account.
- ***Drawing Account:*** These accounts will be maintained for Government Officers who are permitted to operate on Government balances without limit of amount. Most of the government accounts maintained with the Bank pertain to this category.
- ***Assignment Accounts / Letter of Credit Account:*** These are only drawing accounts, which will be maintained by offices for Government Officers to whom a certain sum is allotted by the Pay and Accounts Officer/audit office concerned for a specified period. Payments on behalf of drawing and disbursing officers during the specified period will not exceed the amount of assignment or letter of credit.

Appointment of Agency Banks

Right from commencement of RBI's operations (April 1, 1935), the Imperial Bank of India functioned as the RBI's agent from day one (April 1, 1935) for the first two decades at centres where RBI did not have direct presence. The agency role then passed on to State Bank of India when it came into existence in July 1955. Under a scheme introduced in 1976, every ministry and department of the Central Government has been allotted a specific public sector bank for handling its transactions. Hence, the Reserve Bank does not handle Government's day-to-day transactions except where it has been nominated as banker to a particular ministry or department.

In terms of Section 45 of RBI Act, 1934, unless otherwise directed by the Central Government with reference to any place RBI may appoint NABARD, State Bank of India, its associates and other banks as its agent at all places, or at any place in India for conducting Government business having regard to banking convenience etc. The Government of India had, in terms of Section 45(1) of the Reserve Bank of India Act, 1934, notified on April 17, 2000, that the Reserve Bank may appoint any scheduled bank or the Stock Holding Corporation of India Limited as its agent at any place in India. Accordingly, all the public sector banks and a few private sector banks have been appointed as agents to maintain accounts of Central Government and State Government for conducting their business

While the Central Government account transactions are directly reported by the agency banks to CAS, Nagpur, and to Mumbai Regional Office [eg. GST, ICEGATE (Indian Customs EDI Gateway), etc.], the State Government transactions are reported to the Regional Offices of RBI of the respective State, who maintain the account details under the account head 'Agency Transaction Account-State'. The balance in these Central Government

and State Government accounts are transferred to their respective PGDA accounts maintained in CAS, Nagpur on 1st and 11th respectively of every month by the Regional Offices.

The agency banks are paid agency commission for the Government business work being handled by them. Inspection of these agency banks are also carried out at periodic intervals by RBI to assess their adherence to instructions on handling Government business. Reserve Bank does not receive any remuneration, other than holding their interest-free minimum balances, for performing ordinary banking functions for the Central and State Governments.

Role of Government agencies

The Government of India and the State Governments have various agencies responsible for the conduct of its banking and, therefore, continuously interact with the Reserve Bank of India. Two of the main institutions in this regard are the Offices of the Controller General of Accounts (CGA), and the Comptroller and Auditor General (C&AG). The accounting related work of non-civil ministries (Railways, Defence, Post, and Telecom) is undertaken by the respective accounting authorities, viz. Railway Board, Controller General of Defence Accounts, Postal Board and Telecommunications Board. CGA and C&AG take care of the accounting and auditing requirements of the Civil Ministries at the Central Government, and the entire banking activities of the State Governments as indicated below:

	Central Govt. (Civil)	Central Govt. (Non-Civil)	State Govt.
Accounting	Controller General of Accounts (CGA)	Respective accounting authorities (Railways, Defence, Post, and Telecom)	Comptroller & Auditor General (C & AG) through its AG Offices
Audit	Comptroller & Auditor General (C & AG)	Comptroller & Auditor General (C & AG)	Comptroller & Auditor General (C & AG) through its AG Offices

Provision for Safe Custody of Articles

Articles for safe deposit are also accepted from Government Ministries/Departments of Central/ State Governments/ Union Territories who are banking with the RBI. Small boxes/sealed packets are accepted for safe custody and stored in the vault space for this purpose. Articles for safe custody will be accepted initially for a period of six years. However, if any government department desires to keep the article in safe custody for longer duration, they may withdraw the articles on or before the expiry of stipulated period of six years and

apply to Regional Office for re-depositing the same, before expiry of six years. The Regional Office may permit the redeposit, at its discretion. No fees will be charged for safe custody of articles.

Functions of Central Accounts Section (CAS), Nagpur

CAS, Nagpur maintains the Principal accounts of Central Government and State Governments, and consolidates the balances in various accounts at the end of the day which is called as Daily Position (DP). The important functions being carried out by CAS, Nagpur are:

- Sending daily balance intimation after DP through e-mail to various Central Government Departments/Ministries and State Governments maintaining accounts with RBI. These intimations are also sent to select Central Office Departments.
- Keeping a watch over the minimum balances which are required to be maintained by the Central Government and all State Governments having accounts with the Bank under the terms of their respective agreements.
- Grant of Ways & Means Advances and OD to Central Government and Special Drawing Facility (SDF), WMA and OD to State Governments.
- Investment of surplus funds of the Central Government over and above the prescribed minimum balance as agreed upon, in Govt. of India Dated Securities.
- Investment of surplus funds of the State Governments in 14 Day Intermediate Treasury Bills and rediscounting thereof in case of shortfall in the prescribed minimum balances.
- Uploading the data containing direct tax collection by various offices of RBI in OLTAS-NSDL portal.
- Registration of mandates issued by various States Governments /UTs (for availing loan under RIDF, MIF etc.)
- Daily settlement of funds between Agency Banks and Central Government.
- Recovery of floatation charges and management commission on the State Development Loans from the accounts of respective State Governments.
- Payment of Turn-over Commission on quarterly basis to Agency banks conducting Central Government business.
- Clearance of inter-Government transactions through Inter Government Advices.
- Administration of Consolidated Sinking Fund and Guarantee Redemption Fund⁸⁶ for State Governments.

⁸⁶ Maintained at Public Debt Office, RBI, Nagpur from the contributions made by State Governments. While Consolidated Sinking Fund would be used by State Governments for servicing of their Debt in case of need, the Guarantee Redemption Fund would be used to meet the guarantee obligations of the State Governments and its undertakings.

- Settlement of funds for Relief Bonds and Savings Bonds between Agency Banks and Central Government.
- Making payment of brokerage and handling commission to agency banks for conducting Government of India Relief Bonds / Saving Bonds business.
- Other activities, which are not of a regular nature but are to be done as one-time activity or for a limited period of time. For instance, making apportionment of discharge value and interest payment in respect of bifurcated States, making payments to acquiring banks under Merchant Discount rate (MDR) reimbursement scheme on receipt of mandate from Ministry of Electronics & Information Technology (Meity) etc.
- Providing inputs to Central Government, State Governments, and Central Office Departments on policy matter on Government Business.

New Initiatives

e-receipts and e-payments for Governments

As the banker to State Governments, RBI strives to continuously upgrade and enhance the process for Government banking so as to make them smooth and efficient. As part of these efforts, a Working Group was set up to bring in uniformity and standardisation in procedures/data structure of e-receipts/e-transactions of State Governments, which submitted its report in February 2014. The major recommendations related to establishing treasury portals in each State and for functional integration with the banks, introduction of e-challans to make remittances to the Government, replacement of physical scrolls with e-scrolls, development of automatic and online reconciliation between banks and treasury, digital signing of information which flows online for strengthening legal standing of such transactions, among others. As a result, with effect from May 2015, the standardised e-receipts and e-payments model is being implemented for various State Governments and Union Territories. Integration with various Central Government Departments, including Goods and Services Tax (rolled out in July 2017) broadly follow the same model.

The standardised e-payment model envisages complete straight through processing (STP) of electronic payments of State Governments by establishing interface with the Core Banking Solution of RBI (e-Kuber). State Governments are required to establish a Centralised Treasury System with requisite infrastructure to establish secured integration with e-Kuber. The completely automated process flow in this model ensures end-to-end message processing, accounting, generation and dispatch of scrolls seamlessly, and also facilitates system-based reconciliation. This allows the State Governments to make just-in-time payments thus enabling better control over its funds position. Similarly, the e-kuber e-payments module is also used by the Public Funds Management System (PFMS), under the aegis of CGA, for making Central Government payments (excluding non-Civil Ministries at present) to beneficiaries having accounts with other banks (using NEFT/RTGS payment mode) as well as those having accounts with RBI itself (internal transfer mode).

The standardised e-Receipt model envisages revenue collections through –

- i) Agency banks with online reporting of collections / receipts to RBI enabling State Governments to receive consolidated receipt scrolls from RBI instead of individual receipt scrolls from different agency banks.
- ii) NEFT/RTGS mode of payment where collections are received directly in Government's account maintained with RBI at RO on T+0 basis. This facilitates in the credit of funds to respective State Governments quicker than the current system through agency bank collection and reporting.

Goods and Services Tax (GST)

A tax payer can make GST payment through online payment modes (internet banking/debit/credit cards) or through direct NEFT/RTGS to RBI or use the Over the Counter (OTC) payment option after generating a Common Portal Identification Number (CPIN) from GST portal. After receipt of payment, a Challan Identification Number (CIN) is generated by the respective banks which is shared with tax payer and GST portal. The funds are settled on T+1 basis by agency banks with RBI along with the transaction (Challan) details. RBI is the sole aggregator of all GST related transactions.

Besides GST, the e-receipts module of e-kuber is also integrated with other Central Government systems / platforms such as ICEGATE for direct NEFT/RTGS collection of receipts for other indirect taxes such as Excise, Customs duty etc. coming under the aegis of CBIC, and the Non-Tax Receipt Portal (NTRP) for online collection of non-tax dues / revenues to the government account through NEFT/RTGS payment options.

Conclusion

Though RBI carries out the traditional functions of a Central Bank by acting as banker to banks and Governments, it continuously strives to bring improvements in delivering these services smoothly and efficiently. Towards this end, RBI is leveraging the capabilities of e-Kuber by integrating the systems of Central Government and State Governments to bring efficiency in collection of receipts and disbursement of payments of the Government. At a policy level, business and operational efficiencies are also ushered in through a consultative approach with various stakeholders.

Chapter 16: Public Debt Management

As a debt manager to the Government Reserve Bank undertakes to float loans and manage them on behalf of the Government. It provides Ways and Means Advances to the Government, to meet temporary mismatches in their receipts and payments. It also arranges for investments of surplus cash balances of the Government.

Management of public debt on behalf of the Central and the State Governments involves issue of new rupee loans, payment of interest and repayment of these loans and other operational matters such as debt certificates and their registration. The function of management of public debt is done by the Internal Debt Management Department at the Central Office and Public Debt Office at Offices of the Reserve Bank.

Legal Background

Article 292 of the constitution provides for debt issuance by the Government of India on the security of Consolidated Fund of India. In terms of Section 20 and 21 of the RBI Act, it is incumbent upon the Central Government to entrust Reserve Bank of India with its debt and cash management functions and it is the responsibility of the Reserve Bank of India to conduct the debt & cash management functions of Government of India. The matters related to issue and servicing of Government debt are dealt as per the provisions of this G S Act 2006 & G S Regulation 2007 framed thereunder.

Article 293 of Constitution of India, empowers State Governments to issue bonds within the territory of India, on the security of consolidated fund of the State. However, explicit sanction of Government of India is required in case State Government owes any money to the Central Government. The State Government can enter into an agreement with RBI in terms of Section 21A of RBI Act for their banking and debt management functions. As on date, all State Governments and Union Territory of Puducherry & J&K have signed agreement with RBI to have their debt management activities to be handled by RBI.

Medium Term Debt Management Strategy (MTDS) & Monitoring Group on Cash and Debt Management (MCGDM)

Over the past years, Government debt management has undergone significant changes, reflecting the three pillars of MTDS- low cost, risk mitigation and market development. MTDS works with an objective to mobilise borrowings at low cost over medium to long-term, with prudent levels of risk and a stable debt structure while working towards developing a liquid and well-functioning domestic debt market. IDMD conducts public debt management within the overall framework of MTDS taking into account domestic and global financial market developments. To improve the stability of debt portfolio, the focus is towards consolidation, both passive and active methods. Passive consolidation is achieved through re-issuances and nearly 95 per cent of the bond issuance is through reissuance. Active consolidation is through switches and buy-backs.

A standing committee called the Monitoring Group on Cash and Debt Management (MCGDM) comprising officials from the Ministry of Finance and the Reserve Bank represents a formal working relationship between the MoF and the Bank. MCGDM periodically decides on the implementation of the borrowing program, based on proposals made by the Reserve Bank. It is further complemented by regular discussions between the Ministry and the Reserve Bank.

Role of RBI as Debt Manager

IDMD manages the Market Borrowing Programme (MBP) of the Centre as well as States and Union Territories (UTs) and maintains the accounting/ reporting related to these operations. This involves issue and servicing aspects i.e. retirement of rupee loans, interest payment on the loan and handling operational issues concerning debt certificates and their registration.

To execute the borrowing programme of the Central and State Governments, a Half yearly indicative borrowing calendar is prepared on the basis of MTDS taking into consideration demand assessment, GOI's budgetary and cash management needs, funding gap and market development considerations. In case of Treasury Bills(T-bills) a quarterly indicative borrowing calendar is prepared.

In 1995, the Reserve Bank of India (RBI) introduced the system of Primary Dealers (PDs) in the Government Securities (G-Sec) Market. The objectives of the PD system are to strengthen the infrastructure in G-Sec market, development of underwriting and market making capabilities for G-Sec, improve secondary market trading system and to make PDs an effective conduit for open market operations (OMO). PDs are expected to play an active role in the G-Sec market, both in its primary and secondary market segments through various obligations like underwriting the Central Government Primary auction, market making in G-Secs, predominance of investment in G-Secs, achieving minimum secondary market turnover ratio, maintaining efficient internal control system for fair conduct of business etc.

Instruments of Market Borrowing

Market borrowing on behalf of Governments is conducted by RBI by issuing marketable securities which come in variety of forms, depending upon the market demand. These borrowing instruments fall in following categories:

- Fixed rate bonds (*most popular*): These bonds pay same coupon rate on the face value of the bond held, throughout the life of the bond. Because of its simple structure, they are the most popular form of debt security issued by GoI.
- Floating Rate Bonds (FRBs): Such bonds pay coupon based on some benchmark rate and the coupon is reset at periodic interval. Most floating rate bonds issued by GoI are linked to yield of 91/182/364 day treasury bills.
- Zero Coupon bonds (Treasury Bills, Cash Management Bills): Zero coupon bonds pay no periodic coupon, rather they are issued at a discount and redeemed at full face

value. The difference in discounted issue price and face value accounts for the return on these bonds. Treasury bills and cash management bills issued by GoI are such money market instruments.

- Sovereign Gold bonds (SGB): These are newer type of GoI offering which is aimed primarily at retail investors to provide them gold linked return and a substitute to investment in physical gold. These bonds pay periodic coupon on the issue price of the bond.
- Inflation Indexed Bonds (Retail & Wholesale): Such bonds provide protection from erosion of real returns due to inflation, wherein inflation is measured through inflation index such as CPI & WPI. Issuance of such bonds is very infrequent, and the same were last issued in 2013/2014.
- Bonds with call/put Options: Bonds with call & put option provide additional flexibility to issuer and investor respectively to better manage the interest rate risk. Issuance of such bonds by GoI is rare.
- Special Securities e.g. Oil bonds, fertilizer bonds, UDAY recapitalisation bonds etc.: These securities are issued by GoI to specific entities for specific purposes. For example, power bonds (or UDAY Bonds) are result of restructuring of loans of Discoms through partial takeover of the liability by the States. Similarly, Oil Bonds & Fertilizer bonds were issued in lieu of subsidy payment by GoI to public sector oil marketing companies & fertilizer companies. Recently, GoI issued Recapitalization Bonds to PSBs on private placement basis.

Investors in Government Securities

Commercial banks in India are the largest investor class in Government securities, followed by insurance companies. RBI has been opening the Government securities market for foreign portfolio investors (FPIs) in a calibrated manner to mitigate the risk associated with such investors while simultaneously broadening the investor base for Government Securities in India. Recently, Voluntary Retention Route (VRR) scheme has been announced allowing greater operational flexibility to FPIs in Government Securities market. Further, Fully Accessible Route (FAR) in certain specified categories of Government securities have been started, to enable non-residents to invest in specified Government securities without any restrictions. Simultaneously, FPIs have been allowed to trade in various interest rate derivatives products in India for purpose of hedging or otherwise.

Role of RBI as Cash Manager to the Governments

The Reserve Bank also acts a cash manager to the central and the State governments. For cash management and liquidity management purposes, flows or changes in the Governments' cash balances are monitored and projected based on history and experience.

Ways and Means Advances (WMA)

To tide over temporary mismatches in the receipts and payments of Governments, Sec.17 (5) of RBI Act empowers RBI to grant Ways and Means Advances to Central Government and State Governments, which is a collateral free clean advance. The advance is granted as and when required by the Government (Central/State).

WMA for Central Government: The limit and period of the limit of these advances is decided by RBI, in consultation with the Central Government. If the Government borrows over and above this limit, then it amounts to Overdraft (OD). The Reserve Bank may trigger fresh floatation of market loans when the Government utilises 75 per cent of the WMA limit. It retains the flexibility to revise the limit at any time, in consultation with the Government, taking into consideration the prevailing circumstances.

WMA for State Governments: The limit of WMA varies from State to State and it was last revised on January 29, 2016 based on the recommendations of an Advisory Committee on Ways and Means Advances (WMA) Scheme for the State Governments, 2015 (Chairman: Shri Sudhir Shrivastava).Sumit Bose). In addition to WMA, State Governments are also eligible for a Special Drawing Facility (SDF), which is granted against collateral of Government Securities held by State Governments. As this is a collateralised advance, the interest rate for SDF is less than that of WMA. State Governments have to exhaust the SDF limit before availing WMA. When the advances to the State Governments exceed their SDF and WMA limits, overdraft (OD) facility is triggered.

Consolidated Sinking Fund (CSF) and Guarantee Redemption Fund (GRF)

State Governments maintain the Consolidated Sinking Fund (CSF) and the Guarantee Redemption Funds (GRF) with the Reserve Bank as buffers for repayment of their liabilities. These reserves are intended to provide a cushion to the State Governments in meeting the future repayment obligations. Consolidated Sinking Fund is maintained by states for amortisation of all loan including loans from banks, liabilities on account of NSSF etc. “Guarantees” are contingent liabilities that may have to be invoked if an event covered by the guarantee occurs. Since guarantees result in increase in contingent liability, State Governments maintains a Guarantee Redemption Fund for redemption of guarantees whenever such guarantees are invoked. These two funds are maintained by RBI. Investment in CSF and GRF with RBI, is voluntary at present.

Other Functions:

RBI regulates and supervises Primary Dealers (PDs), monitors their bidding commitments in primary auction, reviews their performance and authorizes new entrants. It also pays underwriting commission to the PDs. The functions related to debt management includes operating in G-sec market for purchasing/ selling securities from/in the secondary market for managing investments/ disinvestments of State Governments, and investments of Foreign Central Banks who invest in Government Securities.

Future Outlook

The market borrowing programme of the central and state governments continues to be guided by the overall objective of developing a deep and liquid market for G-sec as well as SDLs. A next step in consolidation of debt may be through a calendar of auction based switches and buyback operations. Issuance of Gol benchmarks, securities of 2, 5, 7 and 10 year tenor along with the issuance of half-yearly calendar for SGBs may be undertaken. For enhancing secondary market liquidity, it is proposed to formulate a market making scheme and operationalise it through the PDs; and to revise retail and mid-segment turnover targets for PDs based on market data in the G-sec market (primary market and secondary market). Investor base may be expanded by greater participation of multilateral financial institutions and multilateral development banks, apart from FCBs in the G-sec market. A close co-ordination with state governments is required to improve their cash and debt management practices. Specified Stock exchanges may be permitted in the Aggregator Scheme for bidding in the non-competitive segment of the SDLs. A review of the CSF/GRF scheme and a rule-based method for determining WMA limit of the central government and revision of the WMA limit for state governments are also proposed. Best practices in reporting data to improve the quality and veracity of data is proposed. Various options may explored to reflect risk asymmetry among state governments in their cost of borrowing. Capacity building programmes for sensitising state governments about the prudent measures of cash and debt management may be conducted⁸⁷.

⁸⁷ Annual Report 2018-2019

Chapter 17: Understanding RBI Balance Sheet

"The balance sheet of the RBI reflects and in a way, influences the development in the economy - the external sector, the fiscal and, of course, the monetary areas – Dr.Y.V.Reddy"

The balance sheet of a central bank is, in many ways, unique in character and distinct from those of other commercial organisations, including banks. It portrays the financial outcome of its diverse roles and responsibilities in an economy. By the virtue of being the monetary authority, a central bank's balance sheet reflects its exclusive feature of asset creation backing incurrence of monetary liabilities. A central bank is generally not only the sole currency issuance authority of a country, but also responsible for price and exchange rate stability in the economy and is often assigned special responsibilities as the banker to the Government and regulator of banking and financial system in the interest of financial stability. A central bank balance sheet typically centers around the three traditional central banking functions of (a) issuer of currency, (b) banker to government and (c) banker to banks. A stylised central bank balance sheet is presented in Table-I below.

Table - I: A Stylised Central Bank Balance Sheet

Liabilities	Assets
Currency	Gold
Deposits of Governments Banks	Loans and Advances Government Banks
Loans (including Securities)	Investments in Government Securities Foreign Assets
Other Liabilities	Other Assets
Capital Account Paid up Capital Reserves	
Total Liabilities	Total Assets

Source: IMF (2001)

RBI Balance Sheet

The Reserve Bank of India (RBI) being the central bank of the country is the monetary authority of India and the sole authority vested with the power to issue currency notes, regulate the supply of currency and credit in the economy to secure monetary and price stability consistent with growth objectives. It is also vested with the responsibility of regulation & supervision of the banking sector with an eye on securing financial stability and financial inclusion. The activities undertaken by RBI to achieve these objectives influence its

financials reflected in Weekly Statement of Affairs (WSA), Balance Sheet and Income Statement. These are in nature of general purpose financial statements of RBI designed to provide information to the stakeholder and also the readers about the nature of assets and liabilities, as also the sources of its income and expenditure. However, unlike a commercial institution, the operations of RBI are not conducted for making any profit.

Legal provisions

In terms of section 53(1) of the RBI Act 1934, the Bank is required to prepare and transmit to the Central Government a weekly account of the Issue Department and of the Banking Department in such form as the Central Government may, by notification in the Gazette of India, prescribe. As per section 53 (2) of the RBI Act 1934, the Bank is required to, within two months from the date on which the annual accounts of the Bank are closed, transmit to the Central Government a copy of the annual accounts together with a report by the Central Board on the working of the Bank throughout the year, to the Central Government.

The contents of the financial statements of the Reserve Bank are primarily based on the activities that the Bank can discharge under various provisions of Reserve Bank of India Act, 1934. While the format of WSA is notified by the central Government in terms of Section 53 (1) of RBI Act 1934; the format of Balance Sheet and Income Statement are laid down in the Reserve Bank of India General Regulations, 1949. The latest format of WSA was notified vide Gazette notification dated July 15,2015; while the latest formats of Balance Sheet and Income Statement were notified vide Gazette notifications dated July 6 and 15,2015. These also led to amendments in Regulation 22(i) and (ii) of RBI General Regulations, 1949 Regulation 22(i) of the Reserve Bank of India General Regulations, 1949 provides the form and content of balance sheet, while Regulation 22(ii) prescribes the form and contents of the Profit & Loss Account, which was renamed as ‘Income Statement’ in the year 2014-15 based on the recommendations of Technical Committee-I (Chairman: Y H Malegam) that was formed to examine the various aspects of RBI Annual Accounts including the form and presentation of the financial statements of RBI.

Format of Balance Sheet and Income Statement

Section 23 (1) of the RBI Act 1934 states that “*the issue of bank notes shall be conducted by the Bank in an Issue Department which shall be separated and kept wholly distinct from the Banking Department and the assets of the Issue Department shall not be subject to any liability other than the liabilities of the Issue Department...*”. This provision gave rise to two separate balance sheets and WSAs - one exclusively for currency function (Issue Department) and the other for the remaining functions of RBI (Banking Department). Intention behind having distinct balance sheet for Issue Department was mainly to create confidence in the minds of public for the currency notes (to be) issued by the Central Bank backed by an explicit promise to pay to the bearer the sum mentioned therein. Thus, the Bank was preparing two balance sheets, viz., for Issue Department (related to Notes issue) and

Banking Department (other functions) separately till 2013-14. Then, based on the recommendations of the Technical Committee-I, the form and content of the WSA, the Balance Sheet and the Income Statement were revised from the year 2014-15 onwards. The RBI General Regulations, 1949 was amended with the approval of Central Government and RBI has started preparing Single Balance Sheet. While WSA is prepared for each week ended Friday, the Balance Sheet and Income Statement are prepared annually as the end of June 30 every year. The present formats of combined RBI Balance Sheet & the Income Statement are given in Table-II & Table-III below:

Table - II: Format of RBI Balance Sheet

Liabilities	Assets
Capital	Notes, Rupee coin, small coin
Reserve Fund	Gold coin and Bullion
Other Reserves	Investments Foreign – BD Domestic - BD
Deposits	Bills Purchased & Discounted
Other Liabilities and Provisions	Loans & Advances
	Investment in subsidiaries
	Other Assets
Liabilities of Issue Department Notes issued	Assets of Issue Department Gold coin & Bullion (as backing for note issue) Rupee Coin Investments – Foreign – ID Investments – Domestic – ID Domestic Bills of exchange & Other commercial papers
Total Liabilities	Total Assets

BD – Banking Department; ID – Issue Department

In terms of Sec.33 of RBI Act, 1934, the Assets of Issue Department shall be subject to the Liabilities of Issue Department and Sec.34 of the Act states that the liabilities of the Issue Department shall be an amount equal to the total of the amount of the currency notes of the Government of India and bank notes for the time being in circulation. Hence, the liabilities of Issue Department and the corresponding matching assets are distinctly shown in the combined Balance Sheet of the Bank.

Table - III: Format of Income Statement

Income
Interest
Others
Expenditure
Printing of Notes
Expense on remittance of currency
Agency Charges
Interest
Employee Cost
Postage and Telecommunication Charges
Printing and Stationery
Rent, Taxes, Insurance, Lighting, etc.
Repairs and Maintenance
Directors' and Local Board Members' fees and expenses
Auditors' fees and expenses
Law Charges
Miscellaneous Expenses
Depreciation
Provisions
Available balance
Less: Contribution to Statutory funds
Surplus payable to the Central government

Wherever required the individual items in the Balance Sheet and Income Statement are further explained in the corresponding Schedules to the Balance Sheet and Income Statement.

Balance Sheet Components

The major heads of the assets and liabilities forming part of Reserve Bank's balance sheet along with relevant statutory provision (wherever applicable) are explained in Table – IV below:

Table – IV : RBI Balance Sheet components

Item	Statutory provision under RBI Act	Remarks
Capital	Sec.4	The Reserve Bank was constituted as a private shareholders' bank in 1935 with an initial paid up capital of ₹5 crore. The Bank was nationalized with effect from January 1, 1949 and its entire ownership remains vested in the Government of India. The paid-up capital continues to be ₹ 5
Reserve Fund	Sec.46	The original Reserve Fund of ₹ 5 crore was created with the contribution from the Central Government in the form of approved securities for the currency liability of the then sovereign Government taken over by the Reserve Bank. Thereafter, an amount of ₹6495 crore was credited to this Fund out of gains on periodic
<i>Other Reserves</i>		
National Industrial Credit (Long Term)	Sec.46C	Created in 1964 with an initial corpus of ₹10 crore for providing assistance to financial institutions. ₹1 crore is being contributed every year from the profit from 1992-93 onwards.
National Housing Credit (Long Term)	Sec.46D	Created in 1989 with an initial corpus of ₹50 crore for providing financial assistance to National Housing Bank. ₹1 crore is being contributed every year from the profit from 1992-93 onwards.
<i>Deposits</i>		
Central Government	Sec.20 & Sec. 21	Obligatory for RBI to be banker to Central Government. Minimum balance stipulated is ₹10 crore on a daily basis and ₹100 crore on Fridays, March 31(fiscal year end) and June 30 (RBI's year ..
State Governments	Sec.21 (A)	RBI acts as banker to State Governments through mutual agreements. Minimum balance is required to be maintained on a daily basis and it varies from State to State
Banks	Sec.42	For the purpose of maintenance of Cash Reserve Ratio and working funds to meet inter-bank payment and settlement obligations.

Item	Statutory provision under RBI Act	Remarks
Financial Institutions outside India	Sec.17(12AB)	Repo borrowing and lending with financial institutions outside India was started in 2016-17. The Repo borrowing and margin on Repo lending are reflected under this head.
Others		Includes deposits of domestic and international financial institutions, foreign central banks, mutual funds and deposits of banks placed with RBI under 'Reverse Repo' and 'Depositor Education and Awareness Fund'.
<i>Other Liabilities and Provisions</i>		
Contingency Fund (CF)		Created in 1997-98 to meet unexpected and unforeseen contingencies including depreciation in the value of securities, risks arising out of monetary / exchange rate policy operations, systemic risks and any risk arising on account of the special responsibilities enjoined upon the Central Bank.
Asset Development Fund (ADF)		Created in 1997-98 to meet internal capital expenditure and make investments in subsidiaries and associated institutions.
Currency and Gold Revaluation		Unrealised gains/losses on valuation of Foreign Currency Assets (FCA) and Gold are recorded in this account.
Investment Revaluation Account (IRA)		Unrealised gains/losses on mark-to-market valuation of domestic and foreign securities are recorded in IRA-RS and IRA-FS respectively
Foreign Exchange Forward		Unrealised gains/losses on mark-to-market valuation of foreign exchange forward contracts are recorded in this account
Surplus transferable to Govt. of India	Sec.47	Represents the surplus transferable to Government of India every year after making all provisions, depreciations and contribution to staff

Item	Statutory provision under RBI Act	Remarks
Provision for payables		This represents the year-end provisions made for expenditure incurred but not defrayed and income received in advance/payable, if any.
Bills payable		The balance under this head represents outstanding/ unclaimed amounts pertaining to Demand Drafts / Payment Orders issued by the Bank.
Miscellaneous		This is a residual head representing items such as interest earned on earmarked securities, amounts payable on leave encashment, medical provisions for employees, amount payable for SBMs on account of demonetization, etc.
<i>Liability of Issue Department</i>		
Notes Issued	Sec.34	Total amount of currency notes of Govt. of India taken over by RBI and notes in circulation issued by RBI since April 1, 1935. The amount also includes value of notes issued to and kept with the Banking Department for day-to-day requirements of various departments.
<i>Assets of Banking Department</i>		
Notes, Rupee coin and Small coin		The value of Notes and coins kept in Banking Department for day-to-day requirements. The balance on Notes here is also part of the Liabilities of Issue Department.
Gold coin and bullion		This represents Bank's investment in physical gold held abroad and gold deposits. This physical gold is held overseas in safe custody with the Bank of England and Bank for International Settlements (BIS), Switzerland and forms a part of foreign exchange reserves of the country.

Item	Statutory provision under RBI Act	Remarks
Investments – Foreign		Includes Bank's investments in foreign securities, deposits with foreign central banks, commercial banks, BIS, India Infrastructure Finance Company (UK) and shares held in BIS and SWIFT. This also includes Special Drawing Rights (SDR - an unit of IMF account) acquired from Govt. of India that forms a portion of foreign exchange reserves of the country.
Investments – Domestic		Bank's investments in Govt. of India Dated Securities, Treasury Bills and Special Oil Bonds mainly acquired during the course of monetary policy operations are accounted here.
Bills Purchased and Discounted	Sec.17(2)	Bank can purchase, sell and rediscount Bills of Exchange and Promissory Notes. However, this activity is not being carried out.
<i>Loans and Advances</i>		
To Central Govt.	Sec.17(5)	Extended as Ways and Means Advances (WMA) & Overdraft (OD) to tide over temporary mismatches in their receipts and payments. The advances under WMA system is extended at a mutually agreed rate of interest and has to be repaid in full by the Government within three months. Over and above WMA, overdraft (OD) facility is also given to GOI.
To State Governments	Sec.17(5)	Extended as Special Drawing Facility (SDF), Ways and Means Advances (WMA) & Overdraft (OD) to tide over mismatches in the cash flows of their receipts and payments. While WMA and OD facilities are similar to that of Central Govt., SDF is a facility which can be availed by them against collateral of Government Securities.

Item	Statutory provision under RBI Act	Remarks
To Commercial Banks and Co-operative Banks	Sec.17 (12) (AB)/Sec 17(3A)/(3B)/(4)	Primarily extended through LAF Repo and Marginal Standing Facility (MSF). RBI may extend loans and advances against promissory notes of such bank, repayable on demand or on the expiry of fixed periods as stipulated in RBI Act.
To NABARD	Sec.17 (4E)	Extended by way of short term loans against securities/stocks repayable on demand or for a fixed period not exceeding 18 months.
To Others	Sec.17 (4)	Includes all loans and advances extended to NHB, SIDBI, DICGC, liquidity support extended to Primary Dealers (PD) and outstanding Repo/ Term Repo conducted with the PDs.
To Financial Institutions outside India	Sec.17(12AB)	Repo borrowing and lending with financial institutions outside India was started in 2016-17. The Repo lending and margin on Repo borrowing are reflected under this head.
Investment in subsidiaries	Sec.17(8AA)	Includes investments in subsidiaries of RBI. While DICGC, BRBNMPL, ReBIT, IFTAS, etc. are wholly owned subsidiaries, RBI also makes part investments in certain entities like National Centre for Financial Education (NCFE) as and when such decisions are taken.
Other Assets		Includes Fixed Assets (net of depreciation), accrued income on loans and advances to employees, balances held in revaluation of forward contracts account, staff loans, security deposits, amount spent on projects pending completion and other miscellaneous items.
<i>Assets of Issue Department</i> (as backing for note issue)		
Gold Coin and Bullion	Sec.33	This represents Bank's investment in physical gold held in India as backing for Notes issued.
Rupee Coins	Sec.33	A small portion is held that was purchased from Govt. of India.

Item	Statutory provision under RBI Act	Remarks
Investments - Foreign	Sec.33	Includes investments in foreign securities- one part shown under Banking Department Assets and another part shown under Assets of Issue Department.
Investments – Domestic	Sec.33	Includes Bank's investment in Govt. of India Rupee Securities. A small portion held till 2015-16 matured during 2016-17. No investments are accounted under this head thereafter.
Domestic Bills of Exchange and other	Sec.33	Though the Bank can purchase domestic bills of exchange and commercial papers, this activity has not been done for long.

Note:

1. The Foreign Exchange Reserves (FER) of our country is the sum total of Foreign Currency Assets (FCA), Gold, SDR and Reserve Tranche Position (RTP) with IMF. Of these, FCA, Gold and SDR are accounted in RBI Balance Sheet, while RTP, which represents India's quota contribution to IMF in foreign currency is not part of RBI's balance sheet.
2. In addition to the two Funds listed under 'Other Reserves', RBI also contributes ₹1 crore each to two other Funds every year, viz., National Rural Credit (Long Term Operations) Fund and National Rural Credit (Stabilisation) Fund that were constituted under Sec.46A of RBI Act, 1934. These two funds were set up in 1956 to meet the funding requirements of apex institutions in the area of agricultural credit and are maintained by NABARD. Hence these funds are not reflected in the balance sheet of RBI.

Income Statement components

The Profit and Loss account or Income Statement of an entity is the net outcome/ result of the operations undertaken by the entity during the accounting/ financial year. Central Banks are unique and profit earning is not their objective. In that respect they are not comparable with commercial entities. However, a central bank's profit / dividend is an important source of fiscal revenue for the Government. Since it is not the primary objective of the central banks to earn profits, the nomenclature 'Profit & Loss Account' tends to be a misnomer and therefore the nomenclature of 'Profit and Loss account' was changed to 'Income Statement' from the year 2014-15 onwards.

The major items of income and expenditure of RBI is explained in Table - V below.

Table – V: Income Statement components

Head	Contents
Income Heads	
Interest	<p><u>Interest from foreign sources</u> include interest earned on holding of Foreign Securities, net Interest on foreign Repo / Reverse Repo transactions and interest on deposits kept overseas.</p> <p><u>Interest from Domestic Sources</u> include interest earned from Rupee Securities followed by net Interest on LAF (Repo and Reverse Repo) Operations, interest on MSF operations and interest on loans and advances.</p>
Income-Others	<p><u>Income from foreign sources</u> include income generated from amortization of premium/discount of foreign securities, Profit/Loss on sale and redemption of foreign securities and exchange gain/loss from foreign exchange transactions.</p> <p><u>Income from domestic sources</u> includes (i) Discount, (ii) Exchange, (iii) Commission, (iv) Amortization of Premium / Discount of Rupee Securities (v) Profit / Loss on Sale and Redemption of Rupee Securities (vi) Rent Realised (vii) Profit or loss on sale of Bank's property, and (viii) Provisions no longer required and miscellaneous income.</p> <p>Of the above, commission income mainly includes commission received from Central and State Governments for floatation of loans and management of public debt.</p>
Expenditure heads	
Printing of Notes	Expenditure incurred by RBI for printing of fresh note forms.
Expenses on Remittance of Treasure	Expenditure incurred for delivering the printed notes and coins obtained from presses/mints to the Currency Chests(CCs)/small coin depots ; the expenditure on remittance of soiled notes from CCs to RBI; expenditure on diversions etc.
Agency Charges	This consists of commission paid to agency banks for undertaking Central / State Governments receipts and payments ; underwriting commission paid to Primary Dealers at the time of floatation of public debt of Central and State Governments; handling charges paid to banks for Relief / Savings Bonds subscriptions and fees paid to the custodians, etc.

Head	Contents
Interest	Interest paid on the balances of Dr. B.R.Ambedkar Fund and the Employees' Benevolent Fund. While Dr. B.R.Ambedkar Fund is set up for giving scholarships to wards of employees of RBI, the Benevolent Fund is set up with the contribution from employees to assist the families of employees dying in harness.
Employee Cost	This includes salaries, allowances, leave and retirement fare concession, medical expenses etc. paid to the serving and retired staff and contribution towards accrued liabilities of the Gratuity and Superannuation Fund and other funds based on the actuarial valuation.
Postage and Telecom charges	Postage / courier charges, telecommunication charges, SWIFT / SMART card charges, maintenance of RBI websites, subscription towards online data services like Reuters, Bloomberg etc. are booked under this head.
Printing and Stationery	This includes expenditure incurred on purchase of stationery, printing of registers, computer consumables, printing of RBI publications etc.
Rent, Taxes, Insurance, Lighting, etc.	This includes rent, license fee and municipal taxes paid towards office and residential buildings, premium paid on insurance policies taken out in respect of premises and the movable assets of RBI, electricity charges, etc.
Repairs and Maintenance	This consists of expenditure incurred on repairs and maintenance of property owned by RBI.
Directors' and Local Board Members' Fees and Expenses	The fees paid to the Directors of Central Board and members of Local Board and the expenses incurred for holding the Board meetings are booked under this head.
Auditors' Fees and Expenses	Audit fees and expenses incurred in connection with Statutory Audit of the RBI's accounts, concurrent audit of all its Offices/branches and any
Law Charges	Fees paid to Lawyers and expenses incurred for instituting and defending legal proceedings on behalf of the Bank are booked under this head.
Depreciation	Depreciation on various fixed assets at prescribed rates are booked under this head.
Miscellaneous Expenses	All other miscellaneous expenses not covered under above expenditure heads are reflected here.
Provision	Provision made towards contribution to Contingency Fund and Asset Development Fund is reflected in this head.

Surplus transferable to the Government of India

As per Sec.47 of RBI Act, 1934, after adjusting expenditure, making necessary provisions from income, and making appropriations towards contribution for the two statutory funds maintained by RBI and two funds maintained by NABARD, the surplus transferable to Govt. of India is arrived at. This surplus is transferred to Govt. of India after the accounts of the Bank are approved by the Central Board of the Bank in its meeting held in August every year. In terms of Sec.48 of RBI Act, 1934 RBI is totally exempt from Income Tax or Super Tax or any tax on income.

Accounting principles and policies

Though the basic accounting principles like double entry book keeping, distinction of real and financial assets, etc. are universally followed by all entities including central banks, central banks being unique institutions, there are no universally accepted accounting principles that all central banks follow. The accounting principles and policies forming basis for drawing the accounts of the Bank are disclosed as part of the Annual Accounts of the Bank every year under 'Significant Accounting Policies'.

Audit of books of accounts of RBI

In terms of Sec.50 of RBI Act, 1934, not less than two auditors shall be appointed and their remuneration is fixed by the Central Government. At present five auditors are being appointed by the central Government- two Statutory Central Auditors and three Statutory Branch Auditors for auditing the books of the Bank. In terms of Sec.51 of RBI Act, 1934, Central Government can appoint Comptroller and Auditor General of India any time to examine and report on the accounts of the Bank to Government of India.

Conclusion

The major functions of RBI, viz., (i) monetary policy operations through OMO, LAF, MSS, etc. (ii) currency management (iii) its role as bankers to bank and Governments and (iv) management of foreign exchange reserves, largely impact the balance sheet of RBI. The Central Banks have to keep abreast with the changing economic scenarios and respond to the situation accordingly using various tools at their disposal as indicated by some of its major functions above. The tools so used ultimately impact the financials of the Central Bank and the changes in its financials over time in turn reflect the evolving role of a Central Bank.

Chapter 18: Foreign Exchange Management

Exchange Control to Foreign Exchange Management

- The British Government imposed exchange control in India under the Defence of India Rules on September 3, 1939 as part of their war efforts with a view to directing foreign exchange to nationally important objectives which was later put on a statutory footing with legislation in 1947. (FERA 1947)
- Foreign Exchange Regulation Act (FERA), 1947 was introduced after the World War II, to ration the scarce Foreign Exchange for all external payments. It was primarily concerned with regulation of inflow of foreign capital into India and deployment of imported capital.
- India faced an acute foreign exchange crisis in the 1960's and the most critical use of foreign exchange at that time was for import of food grains. In this backdrop, FERA, 1947 was replaced by Foreign Exchange Regulation Act, 1973 the purpose of which (as stated in the preamble to Act) was "*....for the conservation of the foreign exchange resources of the country and the proper utilization thereof....*" and mandated that any contravention of the provision of the Act was treated as a criminal offence punishable with imprisonment. This Act empowered the Reserve Bank, and in certain cases the Central Government, to control and regulate dealings in foreign exchange payments outside India, export and import of currency notes and bullion, transfer of securities between residents and non-residents, acquisition of foreign securities, and acquisition of immovable property in and outside India, among other transactions. The control framework was essentially transaction based in terms of which all transactions in foreign exchange including those between residents and non-residents were prohibited, unless specifically permitted.
- However, by the late 1970's Green Revolution had addressed our dependence on imported food grains and buoyant remittances from diaspora Indians had blunted the urgency of foreign exchange scarcity. The liberalisation of the exchange control regime was started in the mid-1980 and gathered momentum in the 1990's. After the Balance of Payments crisis of 1991, several liberalisation measures were introduced and extensive relaxations in the rules governing foreign exchange were initiated. The reform process also included the introduction of flexible exchange rate, starting with exchange rate adjustments in July 1991, continued with introduction of Liberalised Exchange Rate Management System in March 1992 and the implementation of completely market determined exchange rate system by March 1993. To ensure that the foreign exchange laws or regulations are responding to the evolving economic situation, the Foreign Exchange Management Act (FEMA) was enacted in 1999 to replace FERA, 1973 with effect from June 1, 2000. This enactment signalled the shift from conservation/restriction of foreign exchange transactions to their facilitation.

- Keeping in view the changing times, the Reserve Bank amended (since January 31, 2004) the name of its department dealing with the foreign exchange transactions from Exchange Control Department (ECD) to Foreign Exchange Department (FED).

Foreign Exchange Management Act (FEMA) 1999

Objective

As enshrined in the Preamble of the Act, the objective of FEMA is to facilitate external trade and payments and to promote orderly development and maintenance of foreign exchange market in India.

Applicability

FEMA, 1999 extends to the whole of India. It is also applicable to all branches, offices and agencies located outside India, which are owned and controlled by a person resident in India and also to any contravention committed outside India by any person to whom this Act applies.

Types of Transactions

FEMA classifies all foreign exchange transactions into two broad categories viz. Current Account and Capital Account Transactions. As defined under FEMA

- A “capital account transaction” is a transaction which
 - Alters the assets and liabilities outside India of a person resident in India or
 - Alters the assets and liabilities in India of a person resident outside India.
 - Liabilities include contingent liabilities also.
 - Example – Foreign Direct investment, Foreign Portfolio Investment External Commercial Borrowings, Non-resident deposits, investment in immovable property, etc.
- A “current account transaction” is transaction other than a capital account transaction i.e. mostly of a revenue nature.
 - Example – Exports, Imports, Personal remittances, Gift, Income etc.

Type of Persons

Applicability of FEMA is generally dependent upon the residential status of a person and the nature of the transaction undertaken. A ‘person’ can be an individual, a HUF, a company, a firm, an association of persons etc. A “person” under FEMA is either a “person resident in India” or a “person resident outside India”. The residential status of a person is not only based on the period of stay in India but also the intent to stay for a long/uncertain period.

- Person Resident in India(Resident): the definition of a resident as per FEMA broadly includes “a person residing in India for more than 182 days in the preceding financial year”; any person or body corporate registered / incorporated in India; an office, branch or agency in India owned or controlled by a person resident outside India; an office, branch or agency

outside India owned or controlled by a person resident in India. With regards to intent, any person who has come to or stays in India for taking up employment in India or carrying on business or vocation in India or any other purpose which indicates his intention to stay in India for an uncertain period is considered a Resident.

- Person Resident outside India (Non-Resident): A person who does not fall under the definition of a Resident is considered a non-Resident and includes persons who have gone out of India or who stay outside India for taking up employment or carrying on business or vocation or any other purpose which indicates his intention to stay outside India for an uncertain period.

Authorised Persons (APs)

Foreign Exchange Management Act (FEMA) stipulates that all foreign exchange transactions are required to be routed only through entities that are licenced by the Reserve Bank to undertake such transactions. In terms of Section 10 of the Foreign Exchange Management Act, 1999, Reserve Bank authorises entities designated as Authorised Persons to deal in foreign exchange which inter alia includes an Authorised Dealer or a Money Changer. The regulatory framework provided under FEMA casts a great responsibility on the “Authorised Persons” who are the immediate and necessary counterparty to every participant for any foreign exchange transaction.

The Reserve Bank may, on an application made to it in this behalf, authorise any person to be known as authorised person to deal in foreign exchange or in foreign securities, as an authorised dealer, money changer or off-shore banking unit or in any other manner as it deems fit. [Section 10(1) of the Foreign Exchange Management Act, 1999]. The Reserve Bank, currently, issues authorisation under Section 10(1) of FEMA 1999, to:

- select banks (as Authorised Dealers Category-I)
- select entities (as Authorised Dealers Category-II)
- select financial and other institutions (as Authorised Dealers Category-III)
- select registered companies as Full Fledged Money Changers (FFMC)

Table on categorisation

SI No.	Licence category	Eligible entities	Permissible activities
1	Authorised Dealer Category-I	Commercial Banks, State Cooperative Banks, Urban Cooperative Banks	All permissible current and capital account transactions
2	Authorised Dealer Category-II	Existing FFMCs, Urban Cooperative Banks, Regional Rural Banks, Small Finance Banks, Payments Banks,	Specified non-trade current account transactions as also all the activities permitted to Full Fledged Money

		Systemically Important Non-Deposit taking Non-Banking Financial Company – Investment and Credit Companies (NDSI-NBFC-ICCs)	Changers. Any other activity as decided by the Reserve Bank.
3	Authorised Dealer Category-III	Select financial and other institutions	Transactions incidental to the foreign exchange activities undertaken by these institutions
4	Full Fledged Money Changers (FFMC)	Select registered companies	Purchase of foreign exchange and sale of foreign exchange for private and business visits abroad

Reserve Bank also permits AD Cat – I Banks, AD Cat - II entities and FFMCs to enter into franchisee (also referred as agency) agreements at their option for carrying on Restricted Money Changing business i.e. conversion of foreign currency notes, coins or travellers' cheques into Indian Rupees.

Compounding of contraventions

The categorization of offences under FEMA as civil and not criminal constitutes one of the most important differences between FERA and FEMA. Contraventions of FEMA provisions are dealt with under civil law for which separate administrative procedure and mechanism in the form of Compounding Rules, Adjudicating Authority are put in place. Contravention is a breach of the provisions of the Foreign Exchange Management Act (FEMA), 1999 and rules/regulations/ notification/ orders/ directions/ circulars issued thereunder. Compounding refers to the process of voluntarily admitting the contravention, pleading guilty and seeking redressal. It is a voluntary process in which an individual or a corporate seeks compounding of an admitted contravention. Wilful, malafide and fraudulent transactions such as "hawala" transactions are, however, viewed seriously, and are not compounded by the Reserve Bank.

Regulatory framework under FEMA 1999

Under the Foreign Exchange Management Act, 1999, with current account fully convertible, except only for the minimal restrictions necessary to prevent a current account transaction being used as a camouflage for a capital account transaction, the entire focus of the regulatory framework for external sector transactions has been on the capital account transactions.

Current Account Transactions: Having accepted Article VIII of IMF and declared convertibility under current account, there is no restriction on any person for buying or selling foreign exchange from or to an authorised person, if the transactions pertain to a current account transaction. However, FEMA empowers the Government to impose reasonable restrictions for certain current account transactions in public interest and in consultation with Reserve Bank. The Government has prescribed the Current Account Transaction Rules, 2000 for the purpose. The Rules have three schedules appended.

- **Schedule I** – Specifies transactions which are prohibited such as remittance of lottery winnings, income from racing/riding etc., purchase of lottery tickets, banned magazines, sweepstakes, etc.
- **Schedule II** – Specifies transactions for which prior approval of Government is required such as cultural tours, remittance of freight of vessel chartered by a PSU etc.
- **Schedule III** – Specifies transactions for which prior approval of Reserve Bank is required above a certain monetary limit such as private visits to any country (except Nepal and Bhutan), gift or donation, emigration, maintenance of close relatives abroad, studies abroad etc. The limit for individuals are now linked to the Liberalised Remittance Scheme (LRS).

In addition to transactions mentioned in Schedule I, drawal of foreign exchange is also prohibited for travel to Nepal or Bhutan or a transaction with a person resident in Nepal or Bhutan.

Capital Account Transactions: Following liberalisation and structural adjustment since 1991, India has embarked upon a policy of encouraging capital flows in a cautious manner. A hierarchy is established in the sources and types of capital flows. The priority has been to liberalise inflows relative to outflows. Amongst inflows, the strategy has been to encourage long-term capital inflows and discourage short-term and volatile flows with more preference to equity than debt. A distinction is made between residents and non-residents and among residents, corporates, individuals and financial intermediaries. In the case of non-residents, the regime is liberal i.e. very few restrictions regarding inflows along with all outflows associated with the inflows. In the case of residents, the policy has provided a more liberal framework for corporate sector, a prudential framework for intermediaries and a window for overseas investments and diversification of the portfolio by individuals under the LRS.

Some of the types of capital flows are described below:

- **Non-Resident Deposits** – Deposit accounts for diaspora Indians was one of the earliest measures to strengthen capital inflows. It has served well when the other forms of capital flows were either non-existent or at best, weak. Though the importance of NRI deposits has relatively declined over time, a set of schemes continue to encourage the diaspora to use the Indian banking system for their banking as well as savings needs. The various accounts that can be opened by non-residents are:

- **NRE Account** – NRE or Non-Resident (External) Rupee Account can be opened by NRIs and PIO/OCIs. This account can be opened as savings, current, recurring and fixed deposit and is denominated in Indian Rupees.
- **NRO Account** – NRO or Non-Resident Ordinary Rupee Account can be opened by any non-resident. This account can be opened as savings, current, recurring and fixed deposit and is denominated in Indian Rupees.
- **SNRR Account** – Special Non-Resident Rupee (SNRR) Account can be opened by any non-resident having a business interest in India for putting through bona fide transactions in Rupees. The account can be opened as a current account without any interest payment and is denominated in Indian Rupees.
- **FCNR(B) Account** – FCNR(B) or Foreign Currency (Non-Resident) Account (Banks) Scheme can be opened by NRIs and PIO/OCIs. This account can be opened as a term deposit and can be opened in any freely convertible foreign currency.
- **Foreign Currency Accounts by Resident Individuals:** Residents can open foreign currency denominated accounts in India such as Exchange Earners Foreign Currency Account (EEFC), Resident Foreign Currency (Domestic) Account [RFC(D)], Resident Foreign Currency Account (RFC) etc. A Foreign Currency Account is an account held or maintained in currency other than the currency of India or Nepal or Bhutan.
- **Foreign Investment:** Any investment made by a person resident outside India on a repatriable basis in capital instruments of an Indian company or to the capital of an LLP (Limited Liability Partnership) is known as foreign investment. All foreign investments are repatriable (net of applicable taxes) except in cases where the investment is made or held on non-repatriation basis. A person resident outside India may hold foreign investment either as Foreign Direct Investment (FDI) or as Foreign Portfolio Investment (FPI) in any Indian company.

Foreign Direct Investment (FDI) implies investment through capital instruments by a person resident outside India in an unlisted Indian company or in 10 percent or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company. Fully diluted basis means the total number of shares that would be outstanding if all possible sources of conversion are exercised. Once an investment is made as Foreign Direct Investment, it will be continued to be treated as Foreign Direct Investment even if the investment levels fall below ten percent.

Foreign Portfolio Investment (FPI) refers to any investment made by a person resident outside India through capital instruments where such investment is less than ten percent of the post issue paid-up share capital on a fully diluted basis of a listed Indian company or less than ten percent of the paid-up value of each series of capital instruments of a listed Indian company. Sectoral cap is the maximum investment including both foreign investment on a repatriation basis by persons resident outside India in capital instruments of a company or the capital of an LLP and indirect foreign investment. This shall be the composite limit for the

Indian investee entity. Indirect Foreign Investment means downstream investment received by an Indian entity from another Indian entity (IE) which has received foreign investment, and which is not owned and not controlled by resident Indian citizens or is owned or controlled by persons resident outside India. Downstream Investment implies an investment made by an Indian entity or an Investment Vehicle in the capital instruments or the capital, of another Indian entity. Total Foreign Investment means the total of foreign investment and indirect foreign investment reckoned on a fully diluted basis.

- **Foreign Direct Investment:** Foreign Direct Investment (FDI), characterized by lasting interest and some degree of management control by the investor, is positioned high in the hierarchy of capital inflows as it is resource augmenting and also brings in better technology and more efficient management and business practices usually. The framework for FDI, which gets legal sanctity under the rules framed by the Govt (Non-Debt Instrument Rules, 2019) under FEMA, is set by the Government of India in consultation with the Reserve Bank of India. The only restriction on FDI - motivated by strategic or socio-economic considerations, pertains to sectoral caps - the degree of control that can be ceded to a non-resident in sectors like defence, print media, insurance, banking, pension, commodity and power exchanges etc and to receiving FDI from countries sharing land border with India. The FDI policy followed has been to encourage investment in manufacturing and infrastructure. Except a handful of activities like investments in gambling, betting, Nidhi companies, lottery business etc. which are prohibited for foreign investment, a person resident outside India or an incorporated entity outside India can invest either with the specific prior approval of the Government of India or under the Automatic route. Investment under automatic route is permissible without approval of the Government or the Reserve Bank subject to the prescribed sectoral cap. The FDI Policy frame work is not exactly static but is open to review.

- **Foreign Portfolio Investment and investment by Non-resident Indians:** Registered Foreign Portfolio Investors (RFPIs) registered with SEBI and Non-resident Indians are eligible to purchase shares and convertible debentures under the Portfolio Investment Scheme. Portfolio investment flows exhibit some volatility and surge either way and hence are subject to certain limits.

- Investment by individual FPIs should be less than 10 per cent of the paid-up capital of the Indian company on a fully diluted basis. The aggregate limit for investment by FPIs shall be the sectoral cap applicable to the Indian company with respect to its paid up equity capital on a fully diluted basis. This aggregate limit may be decreased to a lower threshold limit with the approval of the board of directors of the Indian company.
- Non- Resident Indian (NRIs) can purchase or sell FDI compliant instruments of Indian companies on the Stock Exchanges under the Portfolio Investment Scheme. An NRI can purchase shares up to 5 per cent of the paid-up capital of an Indian company on a fully diluted basis. All NRIs taken together cannot purchase more than

10 per cent of the paid-up value of the company. The aggregate limit of ten percent can be increased up to twenty four percent by passing a special resolution by the general body of the Indian company.

- Foreign Portfolio Investors (FPIs), Non-Resident Indians (NRIs), Foreign Central Banks, Multilateral Development Bank, Long term investors like Sovereign Wealth Funds (SWFs), Multilateral Agencies, Endowment Funds, Insurance Funds, Pension Funds which are registered with SEBI are also allowed to invest in Central Government Securities, State Development Loans, Corporate Bonds and Municipal Bonds subject to various limits.
- **External Commercial Borrowings:** External Commercial Borrowings (ECBs) are loans and bonds in foreign currency raised from non-resident eligible lenders.. These are commercial loans raised by eligible resident entities from recognised non-resident entities conforming to parameters such as minimum maturity, permitted and non-permitted end-uses, maximum all-in-cost ceiling, etc. The policy prescription for these loans has been that since the external liability of the economy should not be allowed to expand excessively, the ECBs need to be allocated, to their most productive use. This objective is sought to be achieved through a regulatory regime comprising restrictions regarding quantum of loan, end use, tenor, lender credentials, and cost of borrowing. The ECBs can be raised as foreign currency denominated ECBs or Rupee denominated ECBs. ECBs can also be raised as FCCBs (Foreign Currency Convertible Bonds) and FCEBs (Foreign Currency Exchangeable Bonds). All entities eligible to receive Foreign Direct Investment are eligible to raise ECBs. Change of currency of ECB from one freely convertible foreign currency to any other freely convertible foreign currency as well as to INR is freely permitted. Change of currency from INR to any freely convertible foreign currency is not permitted. The proceeds of ECBs can also be parked abroad or domestically.
- **Overseas Direct Investment (ODI) by Residents:** Direct investment outside India includes investments, either under the Automatic Route (without prior approval of Reserve Bank of India) or the Approval Route (with prior approval of Reserve Bank of India), by way of contribution to the capital or subscription to the Memorandum of a foreign entity or by way of purchase of existing shares of a foreign entity either by market purchase or private placement or through stock exchange, signifying a long-term interest in the foreign entity. It is generally in the form of a joint venture (JV) or a wholly owned subsidiary (WOS). A foreign entity is termed as JV of the Indian Party/Resident Indian when there are other foreign promoters holding the stake along with the Indian Party. In case of WOS entire capital is held by the one or more Indian Party/Resident Indian. The case for overseas direct investment (ODI) rests on permitting Indian entrepreneurs to exploit avenues for profitable investment abroad. The case for portfolio investment abroad and setting up of companies abroad by resident individuals, which can be done through LRS, rests on affording an opportunity to Indian residents to diversify their portfolio. The Overseas Direct Investment has been an

inalienable part of India's progressive integration with the world economy, serving the strategic interests of the Indian economy.

- **Investment in Immovable Property:** A person resident in India can hold, own, transfer or invest in any immovable property situated outside India if such property was acquired, held or owned by him/ her when he/ she was resident outside India or inherited from a person resident outside India. A resident individual can send remittances under the Liberalised Remittance Scheme (LRS) for purchasing immovable property outside India.

Payment for acquisition of immovable property in India by the NRIs/PIOs/OCIs has to be received in the form of funds remitted to India through banking channels or through funds held in NRE/ FCNR(B)/ NRO accounts of the NRIs/ PIOs. They can also avail housing loan in Rupees from an Authorized Dealer or housing finance Institution in India subject to conditions. Foreign nationals of non-Indian origin resident in India (except some specified countries) can acquire immovable property in India. Foreign nationals of non-Indian origin resident outside India can acquire/ transfer immovable property in India, on lease not exceeding five years and can acquire immovable property in India by way of inheritance from a resident. NRIs/ PIOs can remit the sale proceeds of immovable property (other than agricultural land/ farm house/ plantation property) in India subject to conditions.

Capital Account Convertibility

Currency convertibility refers to the freedom to convert the domestic currency into other internationally accepted currencies and vice versa. Convertibility in that sense is the obverse of controls or restrictions on currency transactions. While current account convertibility refers to freedom in respect of 'payments and transfers for current international transactions', capital account convertibility (CAC) would mean freedom of currency conversion in relation to capital transactions in terms of inflows and outflows.

Reserve Bank of India adopts an approach of gradual liberalization of capital account transactions, with an aim to manage internal shocks such as inflation and to encourage investments in real sector to augment growth. The policy stance of Reserve Bank of India has been to treat the capital account liberalisation as a process and manage it keeping in view the vulnerabilities of the economy and the potential for shocks. Though full capital account convertibility is yet to be achieved in India, the capital account is managed in a way as to meet the needs of the economy in a non-disruptive manner.

Way Forward

Reserve Bank of India endeavours to ensure a sound regulatory frame work for foreign exchange management in an economic environment wherein the rupee is fully convertible for current account flows and is partly convertible for the capital flows. This, coupled with effective systems and procedures, reporting mechanisms, surveillance enhances the chances of the capital flows fostering sustainable economic growth free of sudden disruptions. This will also ensure a healthy integration of Indian economy with the world economy.

Chapter 19: Foreign Exchange (Forex) Reserves

The Reserve Bank of India Act 1934 contains the enabling provisions for the RBI to act as the custodian of foreign exchange reserves, and manage reserves with defined objectives. Foreign exchange reserve forms the first line of defence to calm volatility in the forex markets and provide adequate liquidity for “sudden stop” or reversals in the capital flows. The foreign exchange reserves are kept in major convertible currencies and invested in very high quality assets based on the considerations of safety, liquidity and return, in that order. Reserve management is a process that ensures that adequate official public sector foreign assets are readily available to and controlled by the authorities for meeting a defined range of objectives for a country or union. In this context, a reserve management entity is normally made responsible for the management of reserves and associated risks.

Conceptually, a unique definition of forex reserves is not available as there is divergence of views in terms of coverage of items, ownership of assets, liquidity aspects and need for a distinction between owned and non-owned reserves. Nevertheless, for policy and operational purposes, most countries have adopted the definition suggested by the International Monetary Fund (Balance of Payments Manual, and Guidelines on Foreign Exchange Reserve Management, 2001); which defines reserves as:

“External assets that are readily available to and controlled by monetary authorities for direct financing of external payments imbalances, for indirectly regulating the magnitudes of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes.”

Accretion to Forex Reserves

Forex Reserves are the end consequence of current account and capital account dynamics. The level of foreign exchange reserves can change due to the mismatch in the inflow of foreign exchange vis-à-vis outflow of foreign exchange for both current and capital account transactions. While excess inflow leads to an increase in the level of foreign exchange reserve, excess outflow leads to a decrease in the levels. Operationally, the increase or decrease in the foreign exchange reserves can be primarily attributed to foreign exchange market intervention operations by the Reserve Bank of India. Post-independence, barring a few short periods, India has experienced deficit in the current account, which has been financed through inflows in the capital account. The excess inflows in the capital account, over and above required for financing the current account deficit accrue to the forex reserves. The level of forex reserves also changes on account of valuation changes in the forex assets and income accrued from deployment of the forex assets held by the RBI.

Foreign Exchange Reserves Management: RBI's Approach

The Reserve Bank, as the custodian of the country’s foreign exchange reserves, is vested with the responsibility of managing their investment. The legal provisions governing

management of foreign exchange reserves are laid down in the Reserve Bank of India Act, 1934.

Until the balance of payments crisis of 1991, India's approach to foreign exchange reserves was essentially aimed at maintaining an appropriate import cover. The approach underwent a paradigm shift following the recommendations of the High Level Committee on Balance of Payments chaired by Dr. C Rangarajan (1993). The committee stressed the need to maintain sufficient reserves to meet all external payment obligations, ensure a reasonable level of confidence in the international community about India's capacity to honour its obligations, and counter speculative tendencies in the foreign exchange market. Prior to 1993, the market exchange rate was determined by the central bank. After the introduction of system of market-determined exchange rates in 1993, the main objective of smoothening out the volatility in the exchange rates assumed importance. The overall approach to the management of foreign exchange reserves also reflects the changing composition of Balance of Payments (BoP) and liquidity risks associated with different types of capital flows.

The adequacy of reserves is a matter of debate right from 1990s. In 1997, the Report of the Committee on Capital Account Convertibility under the chairmanship of Shri S S Tarapore, suggested alternative measures for adequacy of reserves. The committee, in addition to trade-based indicators, also suggested money-based and debt-based indicators. Similar views have been also held by the Committee on Fuller Capital Account Convertibility (Chairman: Shri S S Tarapore, July 2006). The traditional approach of assessing reserve adequacy in terms of import cover has been widened to include a number of parameters such as size, composition, and risk profiles of various types of capital flows. The Reserve Bank also looks at the types of external shocks, including foreign exchange liquidity shocks, to which the economy is potentially vulnerable. The objective is to ensure that the quantum of reserves is in line with the growth potential of the economy, the size of risk-adjusted capital flows and national security requirements.

Management of Foreign Exchange Reserves

In India, the foreign exchange reserves are managed by Reserve Bank of India. The foreign exchange reserves include Foreign Currency Assets (FCA), Special Drawing Rights (SDRs), Reserve Tranche Position (RTP) with the IMF and Gold. The Foreign Currency Assets are managed following the principles of portfolio management. The foreign currency assets comprise multi-currency assets that are held in multi-asset portfolios as per the existing norms, which are similar to the best international practices followed.

In deploying reserves, the main risks associated with managing the reserves are credit risk, market risk and liquidity risk. On account of these risks, the Reserve Bank pays close attention to currency composition, interest rate risk and liquidity needs. All foreign currency assets are invested in assets of top credit quality and a good proportion is convertible into cash at a short notice. In assessing the returns from deployment, the total return (both interest and capital gains) is taken into consideration. One crucial area in the process of

investment of the foreign currency assets in the overseas markets relates to the risks involved in the process, which is detailed at the end of the Chapter.

The basic parameters of the Reserve Bank's policy for foreign exchange reserves management are safety, liquidity and returns. While safety and liquidity are the twin-pillars of reserves management, return optimization is an embedded strategy within this framework. The Reserve Bank has framed policy guidelines stipulating stringent eligibility criteria for issuers, counterparties, and investments to be made with them to enhance the safety and liquidity of reserves. The Reserve Bank, in consultation with the Government, continuously reviews the reserves management strategy.

The Reserve Bank's reserves management function has in recent years grown both in terms of importance and sophistication for two reasons. First, the share of foreign currency assets in the balance sheet of the Reserve Bank has substantially increased. Second, with the increased volatility in exchange and interest rates in the global market, including the interest rates of major economies testing the floor, the task of preserving the value of reserves and obtaining a reasonable return on them has become more challenging.

Within the overall framework of reserve management, the Reserve Bank focuses on:

- Maintaining market's confidence in monetary and exchange rate policies.
- Enhancing the Reserve Bank's intervention capacity to act in the event of undue volatility in the foreign exchange markets.
- Limiting external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis, including national disasters or emergencies.
- Providing confidence to foreign investors that all external obligations will be met, thus reducing the costs at which foreign exchange resources are available to market participants.
- Adding to the comfort of market participants by demonstrating the backing of domestic currency by external assets.

Investment Avenues

The Reserve Bank of India Act, 1934 provides the overarching legal framework for deployment of reserves in different foreign currency assets and gold within the broad parameters of currencies, instruments, issuers and counterparties. In terms of Section 17 of the RBI Act, the forex reserves are generally invested in:

- Deposits with Bank for International Settlements (BIS) and other central banks
- Deposits with foreign commercial banks
- Debt instruments representing sovereign or sovereign-guaranteed liability of not more than 10 years of residual maturity

- Other instruments and institutions as approved by the Central Board of the Reserve Bank in accordance with the provisions of the Act
- Certain types of derivatives

Risk Management in Reserve Management

The broad strategy for reserve management including currency composition and investment policy is decided in consultation with the Government of India. The risk management functions are aimed at ensuring development of sound governance structure in line with the best international practices, improved accountability, a culture of risk awareness across all operations, efficient allocation of resources and development of in-house skills and expertise. The risks attendant on deployment of reserves, viz., credit risk, market risk, liquidity risk and operational risk and the systems employed to manage these risks are detailed in the following paragraphs:

Credit Risk

The Reserve Bank is sensitive to the credit risk it faces on the investment of foreign exchange reserves in the international markets. The Reserve Bank's investments in bonds/treasury bills represent debt obligations of highly rated sovereigns, central banks and supranational entities. Further, deposits are placed with central banks, the BIS and overseas branches of foreign commercial banks. RBI has framed requisite guidelines for selection of issuers/ counterparties with a view to enhancing the safety and liquidity aspects of the reserves. The Reserve Bank continues to apply stringent criteria for selection of counterparties. Credit exposure vis-à-vis sanctioned limit in respect of approved counterparties is monitored continuously. Developments regarding counterparties are constantly under watch. The basic objective of such an on-going exercise is to assess whether any counterparty's credit quality is under potential threat.

Market Risk

Market risk for a multi-currency portfolio represents the potential change in valuations that result from movements in financial market prices, for example, changes in interest rates, foreign exchange rates, equity prices and commodity prices. The major sources of market risk for central banks are currency risk, interest rate risk and movement in gold prices. Gains/losses on valuation of FCA and gold due to movements in the exchange rates and/or price of gold are booked under a balance sheet head named the Currency and Gold Revaluation Account (CGRA). The balances in CGRA provide a buffer against exchange rate/gold price fluctuations which in recent times have shown sharp volatility. Foreign dated securities are valued at market prices prevailing on the last business day of each month and the appreciation/depreciation arising therefrom is transferred to the Investment Revaluation Account (IRA). The balance in IRA is meant to provide cushion against changes in the security prices over the holding period.

- **Currency Risk:** Currency risk arises due to movements in the exchange rates. Decisions are taken on the long-term exposure to different currencies, depending on the likely movements in exchange rates and other considerations in the medium and long-term. The decision-making procedure is supported by reviews of the strategy on a regular basis.
- **Interest Rate Risk:** The crucial aspect of the management of interest rate risk is to protect the value of the investments as much as possible from adverse impact of interest rate movements. The interest rate sensitivity of the portfolio is identified in terms of the benchmark duration and the permitted deviation from the benchmark.

Liquidity Risk

Liquidity risk involves the risk of not being able to sell an instrument or close a position when required without facing significant costs. The reserves need to have a high level of liquidity at all times in order to be able to meet any unforeseen and emergency needs. Any adverse development has to be met with reserves and hence, the need for a highly liquid portfolio is a necessary constraint in the investment strategy. The choice of instruments determines the liquidity of the portfolio. For example, in some markets, treasury securities could be liquidated in large volumes without much distortion of the price in the market and thus, can be considered as liquid. Except fixed deposits with the BIS, overseas branches of commercial banks and central banks and securities issued by supranationals, almost all other types of investments are highly liquid instruments, which could be converted into cash at short notice. The Reserve Bank closely monitors the portion of the reserves, which could be converted into cash at a very short notice, to meet any unforeseen/ emergency needs.

Operational Risk and Control System

In tune with the global trend, close attention is paid to strengthen the operational risk control arrangements. Key operational procedures are documented. Internally, there is total separation of the front office and the back office functions and the internal control systems ensure several checks at the stages of deal capture, deal processing and settlement. The deal processing and settlement system, including generation of payment instructions, is also subject to internal control guidelines based on the principle of one-point data entry. There is a system of concurrent audit for monitoring compliance in respect of all the internal control guidelines. Further, reconciliation of accounts is done regularly. In addition to internal annual inspection, the accounts are audited by external statutory auditors. There is a comprehensive reporting mechanism covering significant areas of activity/operations relating to reserve management. These are provided to the senior management periodically, viz., on daily, weekly, monthly, quarterly, half-yearly and yearly intervals, depending on the type and sensitivity of information. The Reserve Bank uses SWIFT as the messaging platform to settle its trades and send financial messages to its counterparties, banks with whom Nostro accounts are maintained, custodians of securities and other business partners. All international best practices with respect to usage of SWIFT are ensured.

Transparency & Disclosure

The Reserve Bank of India publishes half-yearly reports on management of foreign exchange reserves for bringing about more transparency and enhancing the level of disclosure. These reports are prepared half yearly with reference to the position as at end-March and end-September each year. The Reserve Bank also publishes quarterly reports on Sources of Variation in Foreign Exchange Reserves in India.

The Reserve Bank also makes available data/information in the public domain relating to foreign exchange reserves, its operations in foreign exchange market, position of the country's external assets and liabilities and earnings from deployment of foreign currency assets and gold through periodic press releases of its Weekly Statistical Supplements, Monthly Bulletins, Annual Reports, etc. The Reserve Bank's approach with regard to transparency and disclosure closely follows international best practices in this regard. The Reserve Bank along with most other Central Banks has adopted the Special Data Dissemination Standards (SDDS) template of the IMF for publication of the detailed data on foreign exchange reserves. Such data are made available on monthly basis on the Reserve Bank's website.

The Reserve Management function of Reserve Bank of India is handled by the Department of External Investments and Operations (DEIO).

Chapter 20: Consumer Education and Protection

Reserve Bank of India (RBI) is committed to the critical facet of consumer protection. RBI's mission and core purpose of safeguarding consumers and ensuring financial stability keep the Consumer Protection at the centre of its endeavour. RBI is, *inter alia*, entrusted with a responsibility under the Statute (Banking Regulation Act, 1949), which provide in detail the "*Power of the Reserve Bank of India to give directions in the public interest; or in the interest of banking policy; or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors*". RBI derives similar powers under the RBI Act, 1934 for Non-Banking Financial Companies and Payment and Settlement Systems Act, 2007 for System Participants.

This responsibility clearly places the protection of consumers' and depositors' best interests at the core of the functions of the RBI. The RBI discharges this function through regulatory intervention, supervisory oversight, moral suasion, consumer education and provision of avenue to customers of regulated entities to redress their grievances through RBI's intermediation process. Over the years, the RBI has fine-tuned the customer service and protection of bank customers through these measures and also by leveraging the experience and knowledge of domain experts by setting up various Committees, which dates back to the Talwar Committee (1975), the Goiporia Committee (1990) and the Narasimham Committee (1991). The Narasimham Committee Report not only stimulated the competition in banking sector through deregulation and entry of new private sector banks, but also ensured better customer service to the customers. Further, the Tarapore Committee (2003) and the Damodaran Committee (2010) reshaped the framework of Customer Service in Banks. RBI has been taking measures on an ongoing basis, for protection of customers' rights, enhancing the quality of customer service and strengthening the grievance redress mechanism in banks and in RBI.

A detailed institutional mechanism in the banks starting from their Board level has been mandated. The important initiatives of RBI in this matter are a) mandating the Board of the banks to discuss the customer service aspects and the implementation of regulatory instructions on a half-yearly basis, b) advising banks to constitute a Customer Service Committee of the Board and include experts and representatives of customers as invitees to enable the bank to formulate policies and assess the compliance thereof to strengthen the corporate governance structure in the banking system and also to bring about ongoing improvements in the quality of customer service provided by the banks, c) mandating banks to set up Standing Committee on Customer Service cutting across various departments in the bank which can serve as the micro level executive committee driving the implementation process and providing relevant feedback, while the Customer Service Committee of the Board would oversee and review /modify the initiatives, d) advising banks for setting up of Customer Service Committees in branches to encourage a formal channel of communication between the customers and the bank at the branch level, e) requiring banks to designate Nodal department and Nodal officer in the bank for handling customer service and grievances of

customers, f) mandating Board approved policies on Customer Service, Customer Rights, Deposits, Cheque Collection, Customer Compensation and Customer Grievance Redressal.

RBI centralized the activities relating to customer service in banks and RBI, which were so far undertaken by different departments of the Reserve Bank and constituted a new department called '**Customer Service Department (CSD)**' on July 1, 2006 in its endeavour to give a major fillip to the important issue of consumer protection. CSD was rechristened as "**Consumer Education and Protection Department (CEPD)**" during organizational restructuring of RBI in November 2014 and positioned in the '*Supervision & Inclusion Cluster*' of the Bank. The major functions of erstwhile CSD included (i) Dissemination of instructions / information relating to customer service and grievance redress by banks and RBI; (ii) Overseeing the grievance redress mechanism in respect of services rendered by various RBI offices / departments; (iii) Administering the Banking Ombudsman (BO) Scheme, 2006, (iv) Acting as a nodal department for the Banking Codes and Standards Board of India (BCSBI); (iv) Ensuring redress of complaints received directly by RBI on customer service in banks; (vi) Liaison between banks, Indian Banks Association, Offices of Banking Ombudsman and RBI regulatory departments on matters relating to customer services and grievance redress.

Besides the above enlisted functions, CEPD has been entrusted with the role of i) single nodal point for receipt & disposal of all external complaints on deficiency of services provided by RBI and RBI-regulated entities; ii) creating awareness and educating public on banking and financial services; iii) issuing cautionary advices / notifications to the public a) on fictitious offers made in the name of RBI, b) for keeping their banking credentials (i.e., password, card number, CVV number etc.,) safe and not sharing them to the third parties etc., and iv) nodal department for enforcing ethical behaviour by the Financial Service Providers under the regulatory purview of RBI. With the introduction of two new Ombudsman Schemes, namely Ombudsman Scheme for NBFCs - 2018 and Ombudsman Scheme for Non-bank System Participants – 2019, the number of such schemes administered by CEPD now stands at three.

Banking Ombudsman Scheme (BOS): Recognising the imperative need for appropriate consumer protection for the bank customers, the Banking Ombudsman Scheme (BOS), an Alternate Dispute Redressal mechanism was introduced by the RBI in the year 1995 in India for expeditious and inexpensive redress of customers' grievances against deficiencies in banking services. Over the years, the Scheme has gained wider acceptance among bank customers. The Scheme is presently administered by RBI through various Offices of Banking Ombudsman (OBOs) with specific jurisdiction covering entire country. Such OBOs are also opened in small centres like Dehradun, Jammu, Ranchi, Raipur, etc. with a view to enhance the reach of the BOS in rural and semi-urban areas and to rationalize the jurisdiction of a few OBOs⁸⁸.

⁸⁸ Details of various Offices of Banking Ombudsman is available at <https://www.rbi.org.in/Scripts/AboutUsDisplay.aspx?pg=BankingOmbudsmen.html>

The Scheme, so far, has undergone five revisions since its inception, the latest being in July 2017. The improvements brought about in the BO Scheme through the revisions are highlighted below:

- First Revision- BOS 2002: The first revision of BOS 1995 came into effect on June 14, 2002 and led to the following updates - (a) Review option for bank against an Award passed by the BO (b) Introduction of arbitration for individual disputes (upto ₹10 lakh) and (c) inclusion of the Regional Rural Banks (RRBs) within the ambit of BOS 2002.

- Second Revision-BOS 2006: BOS 2002 was revised with effect from January 01, 2006 and the main improvements comprised: (a) Online mode of submission of complaints was permitted (b) new grounds of complaints were incorporated such as credit card complaints, deficiencies in providing the promised services, levying of service charges without prior notice and Non-adherence to Fair Practice Code (c) It was decided to appoint RBI officers as BOs and the Human Resources for the BO secretariat would be deputed fully by RBI, instead of from banks and RBI earlier, (d) 'Review' option for banks was replaced by provision for 'Appeal' and the 'Appeal' mechanism was extended to customers of banks against Awards passed by BOs (e) Arbitration clause was withdrawn.

- Third Revision-2007: The revision came into effect from May 24, 2007 whereby, the 'Appeal' mechanism was extended to customers of banks in case of rejection of the complaints on certain grounds.

- Fourth Revision BOS 2006 (February 3, 2009): The revision came into effect from February 3, 2009. More grounds of complaints were added under BOS such as Non-adherence to the Code of Bank's Commitments to Customers issued by BCSBI, Non-observance of RBI guidelines on engagement of recovery agents by banks and complaints on deficiency of services arising from internet banking. The revision also factored the provision for compensation not exceeding one lakh rupees to the complainant, in the case of complaints arising out of credit card operations, taking into account the loss of the complainant's time, expenses incurred by him as also harassment and mental anguish suffered, apart from awarding compensation for the actual loss suffered by the complainant as a direct consequence of the act of omission or commission of the bank up to ten lakh rupees as introduced in BOS 1995.

Presently the BOS 2006 (as amended up to July 1, 2017) is in operation. The salient features of the latest revision of the Scheme in July 2017 are as under:

- Pecuniary Jurisdiction of BO for issuing an Award has been increased from ₹ 10 lakh to ₹ 20 lakh.
- Compensation of one lakh rupees for loss of time, expenses, harassment and mental anguish previously available in credit card complaints has been extended to all types of complaints.

- Additional grounds for filing complaints to the BOs introduced viz: i) Mis-selling of third party products and ii) Deficiency in Mobile Banking/ Electronic Banking Services have been included under the BO Scheme.

- The scope of appealable clauses has been widened to include the complaints closed by BOs on the ground (Clause 13 (c) of the old Scheme) that the case requires elaborate documentary and oral evidence.

- The procedure for Settlement of Complaint by Agreement has been simplified by specifying that BOs will provide an opportunity to the complainant to furnish his / her submission in writing within a timeframe on the written submission made by the bank. If the documentary evidence furnished by both the parties before the BO are not enough to arrive at a decision, BO may hold a meeting with the bank and complainant to promote an amicable resolution. The proceedings of the meeting shall be documented and signed by the parties where they are agreeable to the resolution of the complaint.

The complete Scheme is available on RBI's website⁸⁹.

Ombudsman Scheme for Non-Banking Financial Companies, 2018: With a view to broad-base the consumer protection measures to the customers of Non-Banking Financial Companies (NBFCs), based on the need and requirement, RBI has set up a cost effective, expeditious and easily accessible alternate dispute resolution mechanism, in line with that of the banks, in the form of Ombudsman Scheme for customers of NBFCs. The Scheme that was notified under Section 45-L of RBI Act, 1934 was initially made applicable to all deposit taking NBFCs (NBFC-D) with effect from February 23, 2018 and then extended to all non-deposit taking NBFCs (NBFC-ND) having asset size of ₹100 crore and above and having customer interface with effect from April 26, 2019. A few categories of NBFCs viz., the Non-Banking Financial Company-Infrastructure Finance Company (NBFC-IFC), Core Investment Company (CIC), Infrastructure Debt Fund-Non-banking Financial Company (IDF-NBFC) and an NBFC under liquidation, are excluded from the ambit of the Scheme.

The offices of the NBFC Ombudsman are functioning at four metro centres viz. Chennai, Kolkata, Mumbai and New Delhi and handle complaints of customers in the respective zones. The Scheme also provides for an Appellate mechanism under which the complainant / NBFC has the option to appeal against the decision of the Ombudsman before the Appellate Authority, in case of award or rejection under certain clauses. The complete Scheme is available on RBI's website⁹⁰.

Ombudsman Scheme for Digital Transactions, 2019: As announced in the Monetary Policy Statement of December 5, 2018, RBI launched the Ombudsman Scheme for Digital Transactions (OSDT) vide Notification dated January 31, 2019 for redressal of customer complaints against System Participants as defined in the said Scheme.

⁸⁹ https://rbidocs.rbi.org.in/rdocs/Content/PDFs/BOS2006_2302017.pdf

⁹⁰ <https://rbidocs.rbi.org.in/rdocs/Content/PDFs/NBFC23022018.pdf>

The Scheme, launched under Section 18 of the Payment and Settlement Systems Act, 2007, provides a cost-free and expeditious complaint redressal mechanism relating to deficiency in services for customers of non-bank entities regulated by RBI. Complaints relating to digital transactions conducted through banks continue to be handled under the BOS 2006. The offices of Ombudsman for Digital Transactions function from all the existing OBOs and handle complaints of customers from their respective territorial jurisdiction. The Scheme provides for an Appellate mechanism under which the complainant / System Participant has the option to appeal against the decision of the Ombudsman before the Appellate Authority, in case of issue of an Award or rejection of a complaint under certain clauses of the Scheme. The complete Scheme is available on RBI's website⁹¹.

Charter of Customer Rights: RBI, in its endeavour to augment the measures on consumer protection, in the year 2014-15, formulated a "*Charter of Customer Rights*", which is in the nature of overarching principles of customer protection and primarily applicable for bank customers. The Charter consists of five rights that is:

- a) *Right to Fair Treatment;*
- b) *Right to Transparency, Fair and Honest Dealings;*
- c) *Right to Suitability;*
- d) *Right to Privacy; and*
- e) *Right to Grievance Redress and Compensation*

The banks have also formulated, with the approval of their Boards, a Customer Rights Policy encapsulating the Charter as per the RBI's direction. Monitoring of the implementation of the Charter is also being undertaken for effective regulatory oversight.

Internal Ombudsman in Banks: As a measure of strengthening the internal grievance redressal structure and mechanism of banks, in 2015, RBI had instructed all the public sector banks, select private sector banks and foreign banks to appoint Internal Ombudsman (IO). The IO has been mandated to examine all the grievances wholly/ partially rejected by the banks. The communication issued by banks to the complainants must necessarily have a clause stating that the complaint has been examined by the IO.

As a part of this customer-centric approach, to enhance the independence of the IO while simultaneously strengthening the monitoring system over the functioning of the IO mechanism, RBI has reviewed the arrangement and issued revised directions under Section 35 A of the Banking Regulation Act, 1949 in the form of '**Internal Ombudsman Scheme, 2018**'. The revised IO Scheme was extended to all Scheduled Commercial Banks (excluding Regional Rural Banks) having more than 10 banking outlets in India. The Scheme covers, inter-alia, appointment / tenure, roles and responsibilities, procedural guidelines and oversight mechanism for the IO. The banks concerned have appointed the IOs.

⁹¹ <https://rbidocs.rbi.org.in/rdocs/Content/PDFs/OSDT31012019.pdf>

The IO Scheme stipulates that the IO shall, *inter alia*, examine customer complaints which are in the nature of deficiency in service on the part of the bank, (including those on the grounds of complaints listed in Clause 8 of the BOS 2006) that are partly or wholly rejected by the bank's internal grievance redressal machinery. As the banks internally escalate all complaints, which are not fully redressed, to their respective IOs before conveying the final decision to the complainant, the customers of banks need not approach the IO directly. The implementation of IO Scheme, 2018 has to be monitored by the bank's internal audit mechanism, apart from the supervisory oversight by RBI.

The Internal Ombudsman (IO) Scheme for Non-Bank System Participants, 2019: The Scheme, drawn on the lines of IO Scheme for banks was issued on October 22, 2019 under Section 18 of the Payment and Settlement Systems Act, 2007, is applicable to non-bank issuers of pre-paid payment instruments (PPIs) with more than one crore outstanding PPIs as on March 31, 2019. Customer complaints that are partly or wholly rejected by the non-bank issuer of PPI must be referred to the IO, an internal, independent authority at the apex of the internal grievance redressal mechanism, for a final decision.

Consumer Education and Protection Cells at ROs: During the year 2015-16, Consumer Education and Protection Cells (CEP Cells) were set up in all the Regional Offices of RBI to facilitate grievance redressal of customers with regard to grounds not covered under the Ombudsman Scheme and of entities regulated by the RBI but not covered under the Ombudsman Scheme.

Consumer Education: RBI's endeavour is to educate the consumers of entities regulated by it about the availability of customer protection (grievance redress) mechanism and cautioning the masses on the unsolicited dubious offers made in the name of the Bank. The awareness to consumers is provided in the form of Town Hall events, Awareness Campaigns, participating in important *Melas*, Exhibitions, Trade Fairs etc. Offices of Ombudsman organize town hall events with a view to creating awareness among the public about Ombudsman Schemes, security aspects of banking especially using ATM / Debit / Credit card, net banking, fund transfers, avenues for redressal of grievances, education loans, etc. These events are being conducted in local / vernacular language and in Hindi.

Offices of Ombudsman have also been organizing awareness campaigns in the area of their jurisdiction. A large number of villagers, school & college students, bank customers, bank officials of public and private sector banks, representatives from Pensioners' Association, Depositors' Association participate in these awareness programmes. The salient features of the Ombudsman Schemes and the applicability of the Schemes are explained to the participants. These events are mainly being arranged in rural and semi urban areas. Offices of Ombudsman also participate in various *Melas*, Trade Fairs and Exhibitions by setting up stalls and displaying documentaries, informative brochures, etc. about the Ombudsman Schemes.

As a part of consumer education, advertisement campaign in print media, radio and television are also carried out with a view to create awareness amongst common public about

the fictitious offers of cheap funds / lottery, customer protection regulations of RBI, safe digital banking and avenues for grievance redressal. The critical aspects of creating awareness amongst public on fictitious offers made in the name of public authorities including RBI has been reviewed by RBI and the banks have been advised to include the standard messages in all their promotional advertisements without detracting from the contents of the main advertisement. To augment the consumer education initiatives envisaged by the Bank, Ombudsmen and senior officers of the RBI participate in various awareness programmes across the country and respond to the queries raised by public / customers of banks on various aspects of the protection measures available for the consumers.

'RBI Kehta Hai': A Public Awareness Initiative of RBI: To further amplify the consumer education initiatives, a public awareness campaign has been launched by RBI through SMSes to educate the members of the public about various banking regulations and facilities available to them. To begin with, RBI started sending messages cautioning the people against falling prey to unsolicited and fictitious offers received through emails / SMSes / phone calls. The cautionary messages have been sent from RBI's SMS handle '**RBISAY**'.

The Reserve Bank has also been alerting members of the public against fictitious offers through press releases (<https://www.rbi.org.in/Scripts/RBICautions.aspx>) issued from time to time. With the initiative of RBISAY, it is using the same media (SMS and emails) as those used by the fraudsters. Members of public can give a missed call to 14440 to get more information through Interactive Voice Response System (IVRS) on fake calls/emails as well as investing wisely and cautiously in chit funds. They can also send their feedback on the campaign by email.

Setting up of Complaint Management System: The RBI has launched a web-enabled Complaint Management System (CMS) on June 24, 2019 with a view to harnessing the benefits of Information Technology for managing the increasing volume of complaints being received. The web-based CMS has replaced the earlier Complaint Tracking System (CTS), which has served for over a decade. CMS helps the Bank not only to manage the complaints more efficiently but will also provide a robust Management Information System. It also facilitates data analytics and will help to study the patterns of complaints and, where feasible, pre-empt complaints by addressing the root causes. Further, it integrates the grievance redress mechanism in the Bank by bringing the Offices of Ombudsman, the CEP Cells and the banks on the CMS platform for efficient management of complaints with seamless flow of information. It will support the efforts to proactively pursue the complaint-prone areas in banking services to bring about a qualitative change in the resolution process. CMS has also strengthened monitoring the performance of the regulated entities in the area of management and redressal of complaints.

(Consumer Education and Protection Department is the appropriate department in RBI with regards to Consumer Education & Protection)

Chapter 21: Financial Inclusion and Development

Over the last decade, the term financial inclusion has become a public policy priority and has escalated up the reform agenda. The increased emphasis on the inclusion agenda reflects a continuously growing realization of its implications for reducing poverty and boosting overall prosperity. *"Financial inclusion may be defined as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low-income groups at an affordable cost"*. Financial Inclusion and Financial Literacy are considered as twin pillars, where Financial Inclusion acts on the supply side i.e. for creating access and Financial Literacy acts from the demand side i.e. creating a demand for the financial products and services⁹². Consumer protection is the third pillar of sustainable and inclusive financial growth.

Need for Financial Inclusion

Financial Inclusion broadens the resource base of the financial system by developing a culture of savings among large segment of the population and plays its own role in the process of economic development. Further, by bringing low income groups within the perimeter of formal banking sector, financial inclusion protects their financial wealth and other resources in exigent circumstances. It also mitigates the exploitation of vulnerable sections by the usurious money lenders by facilitating easy access to formal credit. Financial Inclusion is a much-cherished policy objective in India and the economic policy has always been driven by an underlying intent of a sustainable and inclusive growth. It has been a focus since the profound ILO Declaration of Philadelphia (1944) which states that *"Poverty anywhere is a threat to prosperity everywhere."* The policy makers in India too i.e. Government of India and the RBI, had an early realization about the implications of *poverty for financial stability* and have endeavored to ensure that poverty is tackled in all its manifestations and that the benefits of economic growth reaches the poor and excluded sections of the society⁹³.

Brief Background

While financial inclusion as a term is of recent origin, India has a long history of attempting inclusive economic development through the banking sector. The steps taken in the banking sector at the behest of the Government or the Reserve Bank has been in the form of mandates, creating alternate structures and innovations. The thrust towards inclusive growth of banking can probably be traced to the first phase of bank nationalization in 1969 & subsequently in 1980. In 1969, the Lead Bank Scheme was launched and priority sector lending guidelines were issued in 1972. By 1975, there was a focus on building new infrastructure at the grassroots level for rural banking and the Regional Rural Banks (RRBs) were set up. In 1977, RBI mandated banks to open at least 25% of their branches in unbanked

⁹²Rangarajan Committee Report: January 2008

⁹³ Shri S. S. Mundra, Former Deputy Governor, RBI, *Financial Inclusion in India – The Journey so far and the Way Ahead*, September 2016

rural areas. The establishment of National Bank for Agriculture and Rural Development (NABARD) was established as an apex agency for agricultural and rural lending in 1982 has paid rich dividends. In 1988, banks were encouraged to adopt the service area approach. The 1990s witnessed the setup of Local Area Banks (LAB) and the launch of SHG linkage scheme. The turn of the century saw many initiatives including a focus on Financial Inclusion (FI) as a mainstream banking objective and the Business Correspondent (BC) model. Co-terminus with the above efforts, RBI also encouraged banks to adopt a structured and planned approach to financial inclusion with commitment at the highest levels through preparation of Board-approved Financial Inclusion Plans (FIPs). The first two phases of FIPs implemented over 2010-13 and 2013-16 were interspersed with the implementation of PMJDY by the Government of India during 2014-15, whereby the supply side efforts received an adequate impetus. To sustain the momentum of achieving the financial inclusion objectives by setting FIP targets for banks, the third phase of Financial Inclusion Plans for the three years 2016-19 focuses on more granular monitoring of the progress made by banks under FIPs at district level.

Within the RBI too, the function has evolved to mirror the requirements of the external environment and stated public policy objectives. The Agricultural Credit Department (ACD) evolved into the Rural Planning and Credit Department (RPCD) in 1982 after NABARD was formed. Reflecting the focus of the Bank, the department has been rechristened as Financial Inclusion and Development Department (FIDD) in 2014.

Legal Framework

In terms of Sec. 54 of RBI Act 1934, the Bank may maintain expert staff to study various aspects of rural credit and development and, in particular, it may, tender expert guidance and assistance to NABARD and conduct special studies in such areas, as it may consider necessary to do so, for promoting integrated rural development.

The major role and functions of RBI under this role are summarized as under:-

- Policy formulation relating to rural credit and priority sector lending with special emphasis on increasing credit flow to agriculture, micro and small enterprises and the weaker sections.
- Assessment of quantitative and qualitative performance of commercial banks in priority sector lending.
- Dealing with policies relating to penalties on commercial banks on account of non-achievement of priority sector lending targets.
- Financial Inclusion initiatives and monitoring of Financial Inclusion Programmes
- Implementation and monitoring of Lead Bank Scheme
- Forming policies and guiding the flow of credit to the MSME sector
- Dealing with NABARD, based on various statutory provisions
- Promoting financial literacy

Institutional Mechanism for promotion of Financial Inclusion

The strength lies in a robust institutional mechanism to support the roll out of banking services across the country. This is essential considering the enormity of the task in terms of the number of excluded people and the geographical size of the country. The institutional architecture includes:

- The Financial Stability and Development Council (FSDC) chaired by the Union Finance Minister and involving heads of all financial sector regulators that has financial inclusion and financial literacy as one of its important mandates.
- A technical group on financial inclusion and financial literacy under the FSDC involving not just the financial sector regulators, but also the education boards and curriculum developers.
- A high level Financial Inclusion Advisory Committee (FIAC) set up by RBI to focus on providing strategic direction to FI initiatives across various stakeholders.
- A strong institutional mechanism at the level of banks through State Level Bankers' Committees (SLBC) in all the States, District Consultative Committees (DCC) and District Level Review Committee (DLRC) in all the Districts, Block Level Bankers' Committee (BLBC) in all the Blocks in the country and more than 120 thousand bank branches
- Many Financial Literacy Centres (FLC) and Rural Self Employment Training Institutes (RSETIs) imparting financial literacy to complement the financial inclusion measures.

Business Correspondents

With the objective of ensuring greater financial inclusion and increasing outreach of the banking sector, RBI, in January 2006 permitted banks to use intermediaries as Business Facilitators (BF) or Business Correspondents (BC) for providing financial and banking services. Scheduled Commercial Banks (SCBs) including Regional Rural Banks (RRBs), Local Area Banks (LABs), the recently licensed Payments and Small Finance Banks have been permitted to use the services of Business Facilitator / Business Correspondents. The BCs are allowed to conduct banking business as agents of the banks at places other than the bank premises. The categories of entities that could act as BCs were also specified. The scope of activities may include identification of borrowers, collection and preliminary processing of loan applications including verification of primary information/data, creating awareness about savings and other products, education and advice on managing money and debt counselling, processing and submission of applications to banks, promoting, nurturing and monitoring of Self Help Groups (SHG) / Joint Liability Groups (JLG) /Credit Groups/others, post-sanction monitoring, follow-up for recovery, etc. The BCs are generally paid a commission/fee by the bank for their services. In order to support the BC structure, a web portal containing details of the BCs (BC Registry) has been developed by IBA, which has a separate tracker for usage by public. This would not only ensure greater oversight on the functioning of BCs but would also provide

more user friendly information to the end customers. A scheme for graded certification programme for BCs has also been mandated to enable the BCs to acquire necessary skills and knowhow to handle complex tasks that are beyond deposits and remittances. Further, to ensure efficient and effective delivery of financial services to the last mile, a Two Tier Skill Upgradation for Performance of Resources- Business Correspondents (SUPER-B) programme for capacity building and sensitisation of BCs has been introduced. During the first tier of the programme, Members of Faculty from the banks' Training Establishments and officers from the Regional Offices of FIDD, RBI were sensitized. The second tier of the programme involves a one-day sensitization workshop for Rural Branch Managers to be driven by the trainers who attended the first tier of the programme. Finally, the banks officials being covered under the second tier programme are expected to sensitize and handhold the BCs attached to their branches.

Increasing Brick and Mortar Presence

While there is considerable improvement in access of banking services through a mix of physical and virtual mode, it is believed that there should be a fair balance between the number of BCs and brick and mortar branches for better alignment of the inclusion efforts. Accordingly, it is mandated to open physical bank branches or Banking Outlets⁹⁴ in all unbanked villages above a population of 5000 in a phased manner. This would also enable banks to not only provide quality financial services but also timely support to their BC network. Fixed point BC locations are also recognised as Banking Outlets of banks.

National Strategy for Financial Inclusion (NSFI)

RBI, under the aegis of the FIAC and with due approval from the FSDC has launched the National Strategy for Financial Inclusion (NSFI) 2019-2024⁹⁵, which sets forth the vision and key objectives of the financial inclusion policies in India to help expand and sustain the financial inclusion process at the national level through a broad convergence of action involving all the stakeholders in the financial sector. The strategy aims to provide access to formal financial services in an affordable manner, broadening & deepening financial inclusion and promoting financial literacy & consumer protection. Further, to achieve the vision of ensuring access to an array of basic formal financial services, NSFI Document impresses upon leveraging technology and adopting a multi-stakeholder approach for sustainable financial inclusion.

Priority Sector Lending

The description of the priority sectors was formalized in 1972 on the basis of the report submitted by an Informal Study Group on Statistics relating to advances to the Priority Sectors constituted by the Reserve Bank in May 1971. Although initially there was no specific target fixed in respect of priority sector lending, the banks were advised in November 1974 to raise

⁹⁴A ‘Banking Outlet’ for a bank is a fixed point service delivery unit, manned by either bank’s staff or its Business Correspondent (BC) where services of acceptance of deposits, encashment of cheques/ cash withdrawal or lending of money are provided for a minimum of 4 hours per day for at least five days a week.

⁹⁵ NSFI 2019-24 (Document link: <https://rbidocs.rbi.org.in/rdocs/content/pdfs/NSFIREPORT100119.pdf>)

the share of advances to these sectors in their aggregate advances to the level of 33 1/3 percent by March 1979. Subsequently, all commercial banks were advised to achieve the target of priority sector lending at 40 percent of aggregate bank advances by 1985.

The objective of priority sector lending (PSL) has been to ensure that vulnerable sections of society get access to credit and there is adequate flow of resources to those segments of the economy which have higher employment potential and help in making an impact on poverty alleviation. Thus, the sectors that impact large sections of the population, the weaker sections and the sectors which are employment-intensive such as agriculture and micro and small enterprises were included in priority sector. There are economic reasons why some sectors/borrowers do not receive adequate finance. At any given point of time, the lendable resources of institutions are limited and there is always a trade-off between how much time and effort can be put in and what kind of top line and bottom line the new businesses would generate. Given this sort of business dynamics, it is possible that the sectors which rightly deserve bank credit get excluded. This is precisely the motive behind the institution of priority sector lending norms. These guidelines are reviewed periodically to realign it with the national priorities and financial inclusion goals of the country. The present priority sector guidelines have been in force since April 2015 incorporating many recommendations of the Internal Working Group set up in July 2014 to revisit the existing priority sector lending guidelines. The emphasis now, over and above lending to vulnerable sections, is to increase employability, create basic infrastructure and improve competitiveness of the economy, thus creating more jobs. Hence, the categories of Medium enterprises, Social infrastructure and renewable energy have been added. The present categories under priority sector are as follows:

- i. Agriculture
- ii. Micro, Small and Medium Enterprises
- iii. Export Credit
- iv. Education
- v. Housing
- vi. Social Infrastructure
- vii. Renewable Energy
- viii. Others

Reserve Bank stipulates the overall priority sector target and the sub-targets for certain categories of priority sector to Scheduled Commercial Banks (SCBs), Regional Rural Banks (RRBs), Small Finance Banks (SFBs) and Urban Co-operative Banks (UCBs).

The guidelines are issued in the form of Master Directions that can be accessed at https://www.rbi.org.in/Scripts/BS_ViewMasterDirections.aspx?did=343

Non-Achievement of Priority Sector targets

Scheduled Commercial Banks (SCBs) and Small Finance Banks (SFBs) having any shortfall in lending to priority sector are allocated amounts for contribution to the Rural

Infrastructure Development Fund (RIDF) established with NABARD and other Funds with NABARD/NHB/SIDBI/MUDRA Ltd., as decided by the Ministry of Finance and Reserve Bank of India from time to time. The achievement will be arrived at the end of the financial year based on the average of priority sector target /sub-target achievement as at the end of each quarter.

Priority Sector Lending Certificates

In order to enable banks to achieve the priority sector lending targets and sub-targets in the event of shortfall and at the same time incentivize the banks having surplus in their lending to different categories of priority sector, a new participative financial instrument called the Priority Sector Lending Certificates (PSLCs) was launched. The goal of PSLCs is to allow market mechanism to drive priority sector lending by leveraging the comparative strength of different banks. PSLCs are denominated in 4 different categories, PSLC-General, PSLC-Agriculture, PSLC-Small & Marginal Farmers and PSLC-Micro Enterprises. The four types of certificates count for achievement under overall and sub-targets of PSL categories. The eligible sellers / buyers are Scheduled Commercial Banks, Regional Rural Banks, Local Area Banks, Small Finance Banks and Urban Co-operative Banks. Normally, PSLCs will be issued against the underlying assets. However, with the objective of developing a strong and vibrant market for PSLCs, a bank is permitted to issue PSLCs up to 50 percent of its previous year's Priority Sector Lending (PSL) achievement without having the underlying in its books. A platform to enable trading in these certificates by banks has been provided through the PSLC Module on the e-Kuber core banking system of RBI. The banks, which fall short of achievement can purchase these PSLCs at a market determined premium. There will be no transfer of risks or loan assets to the buyer of the certificate. All PSLCs will be valid till March 31st of the Financial Year in which they were issued and will expire on April 1st. In effect PSLCs do NOT represent specific loans. They represent achievement under PSL only. Theoretically it is possible for a bank to have zero loans and still have achieved 40% target of PSL. Also, as PSLC are not balance sheet items, there is no transference of loans.

Interest Subvention Schemes

With the approval of Government of India, RBI announces Interest Subvention Schemes related to Agriculture and MSME sectors. Such subvention schemes are thus aimed at bringing certain sections of society into formal banking channels thereby promoting financial inclusion.

Interest subvention Scheme for Crop loan

The Govt. of India under the Ministry of Agriculture & Farmers' Welfare implements 2% interest subvention for production loans pertaining to short term crops upto ₹ 3 lakhs (since 2006-07) and for working capital loans to animal husbandry farmers and fisheries (since 2019). Within the scheme a 3% prompt repayment incentive is also available if the loan is repaid on time, thereby bringing down the lending at the ground level to 4%.

Relief Measures in areas affected by Natural Calamity

Currently, the National Disaster Management Framework of the Government of India covers 12 types of natural calamities under its ambit, viz., cyclone, drought, earthquake, fire, flood, tsunami, hailstorm, landslide, avalanche, cloud burst, pest attack and cold wave/frost. Accordingly, the Reserve Bank has mandated banks to provide relief measures, where the crop loss assessed was 33 per cent or more, in the areas affected by natural calamities. The relief measures by banks, inter alia, include restructuring/ rescheduling existing loans and sanctioning fresh loans as per the emerging requirement of the borrowers.

Kisan Credit Card (KCC)

The Kisan Credit Card (KCC) has emerged as an innovative credit delivery mechanism to provide adequate and timely bank credit to farmers under a single window for their cultivation and other needs, including consumption, investment and insurance. The KCC Scheme has now been extended to farmers involved in animal husbandry and fishery to enable them to meet their working capital requirements.

New Banking Entities permitted in the Financial Inclusion Space

RBI has granted in-principle approval to some entities to set up differentiated banks namely “Small Finance Banks” (SFBs) and “Payments Banks” (PBs) to further the cause of financial inclusion in the country. Other than serving as vehicles for savings, SFBs and PBs are expected to enhance the supply of credit to small business units, small and marginal farmers, micro and small industries and other entities in the unorganized sector and enable provisions for cost-efficient remittance services in a secured technology driven environment respectively. Small Finance Banks were allowed to participate in various fora under the Lead Bank Scheme i.e., SLBC, DCC/ DLRC and BLBC in their respective locations as regular members from Financial Year 2018-19 with also being part of the credit planning exercise whereas Payments Banks, due to their differentiated and limited mandate (viz. lending is not permitted by virtue of the licensing conditions), were included under the Lead Bank Scheme since May 2019 to give a further impetus to financial inclusion also financial literacy related initiatives without participation in the Annual Credit Plan (ACP) exercise under the Lead Bank Scheme. Also, considering the strong linkage between financial inclusion and the payment systems, RBI has taken several steps. Some of these include encouraging use of Mobile Banking, pre-paid instruments in the form of digital wallets and mobile wallets, operationalization of the Aadhaar Bridge Payment System (ABPS) and Aadhaar-Enabled Payment system (AEPS) etc.

Financial Literacy

OECD defines Financial Literacy as a combination of financial awareness, knowledge, skills, attitude and behaviour necessary to make sound financial decisions and ultimately achieve individual financial wellbeing. People achieve financial literacy through a process of financial education. OECD also defines Financial Education as “*the process by which financial consumers/investors improve their understanding of financial products, concepts and risks and, through information, instruction and/or objective advice, develop the skills and*

*confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being*⁹⁶.

Financial Literacy is important to enable consumers of financial services to make informed choices and thereby enhance their financial well-being. Recognizing this, the Technical Group on Financial Inclusion and Financial Literacy (TGFIFL) of the FSDC sub-committee was set up to co-ordinate the efforts on financial inclusion and literacy at the policy level. The group is chaired by the Deputy Governor, Reserve Bank of India and has representatives from all regulators and the Finance Ministry. The Reserve Bank of India has come up with various policies to strengthen Financial Literacy in the country.

A snapshot of the important initiatives that have been undertaken by RBI are as under:

- i. Instructions have been issued to banks to open and operationalize Financial Literacy Centres (FLCs) and also undertake financial education through the rural bank branches across the country. Financial Support for the same is also made available from the Financial Inclusion Fund managed by NABARD.
- ii. Financial Education outreach through the Regional Offices of RBI through the Financial Literacy Architecture for Regional Environment- Unified Programme (FLARE-UP) guidelines
- iii. Creation of financial education literature which has been uploaded on the Financial Education website of RBI. The content is available in 13 languages which can be downloaded by banks and other stakeholders to create awareness about financial products and services, good financial practices, going digital and consumer protection. In addition, content has also been prepared for certain target group specific content for School Children, SHGs, Farmers, Small Entrepreneurs and Senior Citizens.
- iv. Undertaking capacity building of officials of RBI ROs and officials looking after Financial Literacy Policy in Scheduled Commercial Banks. The trained officials are in turn expected to impart training to the Financial Literacy Counsellors.
- v. Pursuing with Ministry of Human Resources Development, Government of India and various State Government's Education Departments to integrate financial education in school curriculum.
- vi. Mass Media awareness of matters related to Financial Literacy in co-ordination with Department of Communication.
- vii. Observing Financial Literacy Week (FLW) every year since 2016 to propagate financial education messages on a particular theme across the country. FLW 2018 and FLW 2019 were focused on "Consumer Protection" and "Farmers" respectively. The theme selected for 2020 was "Micro, Small and Medium Enterprises (MSMEs)," which was observed from February 10 to February 14, 2020. During the Financial Literacy Week, banks were advised to disseminate the information and create awareness among its

⁹⁶Speech delivered by former Finance Minister, Shri Pranab Mukherjee during RBI- OECD Workshop on Delivering Financial Literacy in March 2010

customers and general public on the theme of MSMEs. Further, RBI also undertook a centralized mass media campaign during the month of February 2020 to broadcast essential financial awareness messages to MSME Entrepreneurs.

- viii. Involving NGOs to partner with banks in the pilot Centre for Financial Literacy project to bring together innovative and participative approaches to improve financial awareness in the country. Currently, banks have partnered with six NGOs in setting up CFLs across 100 blocks of the country (including 20 tribal blocks from three states of Jharkhand, Madhya Pradesh and Rajasthan). The experiences gathered from the CFLs are being evaluated through an impact assessment exercise which would be used during scaling up of the CFLs in the country.

In addition to the above, the Reserve Bank of India is a full member of the OECD-INFE which is a global forum to bring together policy makers from across the globe to guide on strengthening financial education. The experiences gathered by our participation in these forums (viz. the working groups on Implementation and Standards; the working group on Financial Education at Workplace; Working Group on Financial Education for Elderly population; Working Group on Digital Financial Literacy) is useful in helping us shape our policies in line with global best practices. Further, sharing of our experiences in this forum is also helping other policy makers to strengthen financial education measures in their territories.

National Centre for Financial Education (NCFE)

According to OECD, framework of National Strategy for Financial Education (NSFE) promotes a smoother and more sustainable co-operation between regulators and stakeholders, avoids duplication of resources and allows development of articulated and tailored roadmaps with measurable and realistic objectives, based on dedicated national assessments. Globally, countries like Czech Republic, Netherlands, New Zealand, Spain, and UK have already implemented National Strategy of Financial Education (NSFE), while many other countries are in the process of formulation and implementation.

In India, the mission of National Strategy of Financial Education (NSFE) is to undertake campaigns to help people manage money more effectively to achieve financial well-being by accessing appropriate financial products and services through regulated entities with fair and transparent machinery for consumer protection and grievance redressal. To achieve this mission, the National Centre for Financial Education (NCFE) has been incorporated as a Section 8 (Not for Profit) Company promoted by all regulators, viz., Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority of India (IRDAI) and Pension Fund Regulatory and Development Authority (PFRDA). It has two main objectives as detailed below:

- To promote Financial Education across India for all sections of the population as per the National Strategy for Financial Education (NSFE) of Financial Stability and Development Council (FSDC).

- To create financial awareness and empowerment through financial education campaigns across the country for all sections of the population through seminars, workshops, conclaves, trainings, programmes, campaigns, discussion forums with/without fees by itself or with help of institutions, organisations and provide training in financial education and create financial education material in electronic or non-electronic formats, workbooks, worksheets, literature, pamphlets, booklets, fliers, technical aids and to prepare appropriate financial literature for target based audience on financial markets and financial digital modes for improving financial literacy so as to improve their knowledge, understanding, skills and competence in finance.

Subsequent to the completion of the first National Strategy for Financial Education (2013-2018), RBI in co-ordination with NCFE, other financial sector regulators, Government and other stakeholders has revised the National Strategy for Financial Education (2020-2025) which is expected to be approved by FSDC-SC shortly. <https://www.ncfe.org.in/survey>

Chapter 22: Development of Institutions

The Reserve Bank is one of the few central banks that has taken an active and direct role in supporting developmental activities in their country. The Reserve Bank's developmental role includes ensuring credit to productive sectors of the economy, creating institutions to build financial infrastructure, and expanding access to affordable financial services. Over the years, its developmental role has extended to institution building for facilitating the availability of diversified financial services within the country. With the changing development needs of the economy, the Reserve Bank has been redefining its developmental role in institution building, encouraging efficient customer service throughout the banking industry, extension of banking service to all, through the thrust on financial inclusion, to name a few.

Institutions to Meet Needs of the Evolving Economy

A mature economy is characterized not only by a capable central bank but also by the institutional framework supporting various functions. One of the unique functions that Reserve Bank performs is the facilitating the germination of new institutions and enabling the development of market-oriented entities to perform various roles. This was crucial especially in the context of an underdeveloped and evolving financial system. In the absence of a well-developed capital market, the Reserve Bank played a proactive role in setting up a number of specialised financial institutions at the national and regional level to widen the facilities for term finance to industry and for institutionalisation of savings - a novel departure for a central bank.

The institutions that RBI has enabled to set up include:

Institutions for deposit insurance and credit guarantee: In 1962, Deposit Insurance Corporation was set up and in 1971, Credit Guarantee Corporation was set up. These two entities were merged in 1978 to form the Deposit Insurance and Credit Guarantee Corporation (DICGC), which is a wholly owned subsidiary of the Reserve Bank of India.

Development of Financial Institutions: Many of the developmental financial institutions in the country trace their roots to the Reserve Bank of India. In 1964, the Unit Trust of India (UTI) was set up to help channelize small investors into the stock market. In the same year, the Industrial Development Bank of India (IDBI) was set up, which subsequently converted itself into universal bank. To support two priority sectors of the economy, development finance institutions in the form of National Bank for Agriculture and Rural Development (NABARD) and Export-Import Bank of India (EXIM) Bank were set up in 1982. NABARD performs the role of the apex body for agriculture and rural development, taking over the functions of another entity, Agricultural Refinance Corporation, which was also set up by RBI in 1963. EXIM Bank was set up to ensure adequate availability of concessional bank credit to exporters. Further, National Housing Bank was set up in 1988 and Small Industries Development Bank of India (SIDBI) in 1990 to provide financial support to the housing sector and MSME sector respectively.

Institutions for Research and Learning: The role of Reserve Bank in promoting research and learning is often less recognized. In 1969, the Bank set up the National Institute of Bank Management (NIBM) at Pune. In 1987, the Indira Gandhi Institute of Development Research (IGIDR) was set up, which has become one of the respected institutions for economic and development research. Seeing a gap in banking technology, the Institute for Development and Research in Banking Technology (IDRBT) was set up in 1996. Centre for Advanced Financial Research and Learning (CAFRAL) was set up in 2011, as an independent think-tank by the Reserve Bank of India (RBI) in the backdrop of India's evolving role in the global economy.

Market Institutions: Discount and Finance House of India Ltd. (DFHI) was set up in March 1988 by Reserve Bank of India jointly with Public Sector Banks and All India Financial Institutions to develop the money market and to provide liquidity to money market instruments. Securities Trading Corporation of India (STCI) was promoted by Reserve Bank of India in May 1994 with the objective of fostering an active secondary market in Government of India Securities and Public Sector Bonds. The Reserve Bank's stake in STCI was subsequently divested and it operates now as a systemically important NBFC.

Financial Market Infrastructure: For the critical infrastructure required to facilitate payment and settlement systems, two entities were set up at the instance of RBI. The Clearing Corporation of India Ltd. (CCIL) was set up in April, 2001 to provide guaranteed clearing and settlement functions for transactions in Money, G-Secs, Foreign Exchange and Derivative markets. National Payments Corporation of India (NPCI) was set up as an umbrella organization for all retail payments in India in 2008. It was set up with the guidance and support of the Reserve Bank of India (RBI) and Indian Banks Association (IBA).

Institutions for Information Technology (IT) related services: Reserve Bank Information Technology Pvt Ltd. (ReBIT) was set up by in January 2017 to take care of the IT requirements, including the cyber security needs of the Reserve Bank and its regulated entities. ReBIT will focus on IT and cyber security (including related research) of the financial sector and assist in IT systems audit and assessment of the RBI regulated entities, advise, implement and manage internal or system-wide IT projects (both the existing & the new) of the Reserve Bank as mutually decided between the Reserve Bank and ReBIT.

Indian Financial Technology and Allied Services (IFTAS), which was earlier a subsidiary of IDRBT was taken over by Reserve Bank of India in 2018-19. It is mandated to design, deploy & support IT-related services to the Reserve Bank of India, and all Banks and Financial Institutions in the country. IFTAS was established to facilitate the smooth functioning of banks, supporting them to innovate, and to craft unique digital banking experiences.

Institution for Currency Management: Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL) was established by Reserve Bank of India (RBI) as its wholly owned subsidiary in 1995 with a view to augmenting the production of bank notes in India to enable the RBI to bridge the gap between the supply and demand for bank notes in the country. The company

manages 2 currency presses, one at Mysuru in Karnataka and the other at Salboni in West Bengal. In order to make India self-reliant in banknote paper production, Bank Note Paper Mill India Private Limited (BNPMIPL) has been incorporated and registered in 2010 in Mysuru, Karnataka. This company is a Joint Venture between Security Printing & Minting Corporation of India Limited (SPMCIL) and Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL) and is engaged in production of Bank note papers with a capacity of 12000 TPA.

Institution for Financial Education: National Centre for Financial Education (NCFE) is a Section 8 (Not for Profit) Company that is jointly promoted by Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority of India (IRDAI) and Pension Fund Regulatory and Development Authority (PFRDA) with a vision of a financially aware and empowered India. The objectives of the company are:

- i. To promote Financial Education across India for all sections of the population as per the National strategy for Financial Education of Financial Stability and Development Council.
- ii. To create financial awareness and empowerment through financial education campaigns across the country for all sections of the population through seminars, workshops, conclaves, trainings, programmes, campaigns, discussion forums with/without fees by itself or with help of institutions, organisations and provide training in financial education and create financial education material in electronic or non-electronic formats, workbooks, worksheets, literature, pamphlets, booklets, fliers, technical aids and to prepare appropriate financial literature for target based audience on financial markets and financial digital modes for improving financial literacy so as to improve their knowledge, understanding, skills and competence in finance.

Chapter 23: Research, Surveys and Data Dissemination

Research and Knowledge Dissemination

Safeguarding price stability, financial stability and overall macroeconomic stability (with sometimes temporary trade-off) are the primary objectives of modern central banks. Towards this, policy-makers in the fields of monetary policy and financial stability are deeply dependent on a stream of timely, relevant and reliable data with adequate analytical and innovative research. The RBI has developed its own research proficiencies across the domains of economics, finance and statistics and yields a number of research papers and empirical studies regularly. The Research undertaken mostly revolves around the contemporary issues having implications on the Indian economy. The key areas of research include estimating/forecasting macroeconomic variables, monetary policy issues and challenges, its transmission mechanism, contemporary financial stability issues, innovative methods for information management and use of new analytical techniques including big data analytics. Along with these, proactive dissemination of research outputs and statistics with micro levels in some case adds to the transparency and credibility of the Bank on its various regulatory and monetary policy actions.

The RBI disseminates research analysis carried out by its own employees through RBI Bulletin, RBI Occasional Papers and RBI Working Paper series. Brief analytical reports on contemporary issues prepared by the staff are disseminated through Mint Street Memos (MSM). Under the Development Research Group (DRG) studies, research in collaboration with external experts and the staff of the RBI are published for wider circulation with a view to generating constructive dialogue among professional economists and policy makers on subjects of current interest.

Besides these, the RBI releases resolutions of Monetary Policy Committee (MPC), minutes of the proceedings and the comprehensive Monetary Policy Reports in terms of Section 45-ZK, Section 45-ZL and Section 45-ZM of the RBI of India Act, 1934 respectively. The RBI is under legal obligation to publish two other reports every year - the Annual Report and the Report on Trend and Progress of Banking in India. The Annual Report, which provides detailed accounts on the working and operations of the Bank, is submitted to the Central Government in terms of Section 53(2) of the RBI of India Act, 1934. The Report on Trend and Progress of Banking in India, submitted under Section 36(2) of the Banking Regulation Act, 1949, provides detailed accounts on the operations and performance of Scheduled Commercial Banks, Co-operative Banks and Non-Banking Financial Institutions. The Financial Stability Report reflects the overall assessment on the stability of India's financial system and its resilience to risks emanating from global and domestic factors. The Report also discusses issues relating to development and regulation of the financial sector.

Besides these publications, the RBI releases several periodicals and occasional publications. Other occasional publications include Manuals, Vision Documents, Guidelines, Working Group/Committee Reports, etc. Official press releases, notifications, articles,

speeches and interviews of the top management which articulate the RBI's views on assessment and outlook of the economy, are also released to the public at large.

Data Dissemination Policy and Methods

The Bank receives large information from various sources as input for its regulatory and supervisory functions as well as for its policy making processes. In addition, considerable data are received through transaction and other processes. Data being a valuable asset used for public policy, need to be disseminated in public domain, to the level of aggregation which is non-sensitive for commercial confidence and other statutory prescriptions.

The RBI has a long tradition of compiling and disseminating large volumes of macroeconomic and financial sector statistics for researchers, market participants and for general public as per the best international practices. Within the RBI, the Department of Statistics and Information Management (DSIM) is entrusted with the responsibility to compile and disseminate high quality macroeconomic and financial statistics with a special focus on banking, monetary, corporate and external sectors as well as through dedicated surveys for monetary policy formulation. The monetary and balance of payments (BoP) statistics generated by the Bank conform to the special data dissemination standards (SDDS) and general data dissemination system (GDDS) of the International Monetary Fund (IMF). DSIM also provides statistical and analytical support for various functions of the Bank through information management as well as applied research. In this pursuit, the Department maintains a centralised database (Database on Indian Economy - DBIE) for the Bank and a range of information management related support services apart from undertaking other structured surveys to fill the data gaps. In addition to the data compiled by the Reserve Bank, the portal also disseminates data on certain macroeconomic variables compiled by other official agencies (*e.g.*, national accounts statistics and price indices compiled by the National Statistical Office (NSO), Ministry of Statistics and Program Implementation, Government of India).

The Bank collects micro-level data from regulated and unregulated entities through statutory and other returns and disseminates such data in the public domain, mostly at the aggregate level. As a public authority, the Bank proactively disseminates in public domain the aggregated and suitable disaggregated-level information that are useful for monitoring of macroeconomic, monetary and financial sector development and also provides other information as per the provisions under the Right to Information (RTI) Act, 2005, the Reserve Bank of India Act, 1934 [Section 43], the Banking Regulations Act, 1949 [Section 28] and the Foreign Exchange Management Act, 1999. In line with changing times, unit level data of Inflation Expectations Survey of Households (IESH) and the Consumer Confidence Survey (CCS) are also released after suitably masking the identity of the respondents to encourage the use of these data by researchers and analysts.

The RBI has been committed to disseminate data at regular periodicity in the form of various publications.

- RBI Bulletin is a monthly publication which contains important articles, speeches and statistics related to RBI Balance Sheet, Money and Banking, Public Finance, Financial Markets, External Sector, etc. The statistics portion of the Bulletin has over 40 tables.
- The Weekly Statistical Supplement (WSS) to the RBI Bulletin is released every week containing high frequency statistics such as RBI balance sheet items, monetary statistics, reserve positions, commercial bank balance sheet items, and key rates, etc.
- The Bank's annual Handbook of Statistics on the Indian Economy serves as a single reference publication for most of the macroeconomic time series data furnished in 240 tables. A near real-time on-line version of this publication is also made available on the DBIE portal.
- RBI also publishes annual publication of Handbook of Statistics on Indian States and State Finances: A Study of Budgets.
 - 'Handbook of Statistics on Indian States' provides state-wise information on a wide range of socio-economic indicators of the regional economy of India, *viz.*, social and demographic characteristics, state domestic product, agriculture, industry, infrastructure, banking and fiscal developments.
 - 'State Finances: A Study of Budgets' provides information and analysis of the fiscal position of the state governments based on primary state level data.

Monetary Statistics

The RBI has a long tradition of compilation and dissemination of monetary statistics, since July 1935. Monetary aggregates are published on a regular basis in most of the major publications of RBI, such as Annual Report, Handbook of Statistics on the Indian Economy, Bulletin, Weekly Statistical Supplement, etc. The monetary statistics at present are compiled on a balance sheet framework with data drawn from the banking sector and postal authorities. The rationale and analytical foundations behind the compilation of monetary aggregates have been provided to the public through various reports, especially through the reports of the various working groups *viz.*, the First Working Group on Money Supply (FWG) (1961), the Second Working Group (SWG) (1977) and the "Working Group on Money Supply: Analytics and Methodology of Compilation" (WGMS) (Chairman: Dr. Y.V. Reddy) (1998).

Banking Statistics

The banking system in India comprises of commercial, co-operative banks and the emerging categories of Payment Banks and Small Financial Banks. As a part of central banking activities, keeping the overall economic perspective of the country's banking system, RBI collects a vast amount of data on banking system through various statutory and non-statutory

returns. The non-statutory statistical returns cover aspects of banking information like spatial distribution of deposits and credit, international banking, priority sectors lending, etc.

- As per Section 42(2) of RBI Act, 1934, each Scheduled Bank (commercial and co-operative bank) is required to furnish fortnightly return showing major items of its assets and liabilities in India at the close of business on Reporting Fridays. Based on these data, system-level banking aggregates are released on a fortnightly basis.
- Detailed banking statistics based on annual accounts of SCBs are released in the publication ‘Statistical Tables Relating to Banks in India’, which contains various performance aggregates and ratios: it is the only publication, which provides bank-level data as other publications provide system-level or bank-group level information.

Apart from the standard balance sheet related data, the RBI collects granular data on important parameters of financial intermediation by the banking sector under the Basic Statistical Return (BSR) system since December 1972, following the recommendation of the Committee on Banking Statistics. The BSR system was adapted from the erstwhile data reporting system called Uniform Balance Book (UBB), which captured sectoral and regional flow of bank credit.

- The annual publication ‘Basic Statistical Returns of Scheduled Commercial Banks in India’ provides aggregate information across important dimensions such as geography, occupation/activity and organisational sector of the borrower, type of account and interest rates.
- These details are also released on quarterly basis for all SCBs (other than RRBs).
- The annual BSR-2 return collects detailed data on various dimensions of deposits (including their composition and ownership pattern which was separately collected through BSR-4 survey up to 2018).
- Quick statistics on total credit and deposits, disaggregated by type classified by states/union territories (UTs), districts, centres, population groups and bank groups, are released on quarterly basis within two months from reference date under the BSR-7 system.

To study global financial sector inter-linkages, RBI also collects detailed information on international claims and liabilities of banking system under the International Banking Statistics (IBS) system, which is co-ordinated by the Bank for International Settlements (BIS). The IBS system collects/compiles/provides information on international liabilities (*e.g.*, non-resident deposits, foreign currency borrowings, international bonds issuances by banks) and claims (*e.g.*, loan to non-residents, foreign currency loan to residents, foreign currency in hand, overseas investments) of banks.

Most of the statistics compiled by the Bank are released through the DBIE and users can access these pre-formatted data tables of the respective publications in spreadsheet /pdf form.

The Reserve Bank maintains the directory of all bank branches / offices / Non-Administratively Independent Offices (NAIOs) in India [earlier known as the “Master Office File” (MOF) system] since 1972. Consistent with the emerging needs of branch licensing and financial inclusion policies as well as the requisite coverage of additional dimensions / features, the comprehensive Central Information System for Banking Infrastructure (CISBI) has been operationalised in June 2019 to replace the legacy MOF system. In addition to commercial banks, CISBI also covers co-operative banks, ATMs and fixed-location BCs. All banks submit online information on their banking outlet details (such as, location, contact details) and are allotted BSR codes without manual intervention, after due validation. The system provides the mapping of BSR, IFSC and MICR and banks can also use CISBI portal for accessing their own information. The system also serves as an axis to generate various banking statistics with multiple dimensions. Using these data, a “Branch Locator” portal giving details of banking outlets is also provided on DBIE for meeting the requirements of common citizens.

External Sector Statistics

External sector statistics compiled and disseminated by the RBI includes Balance of Payments (BoP), international trade in services, external debt, foreign investment inflows, NRI deposits, international investments position, foreign exchange reserves, etc. The data on each of these components are compiled following the international best practices (especially, the IMF's Balance of Payments and International Investment Position Manual – Sixth Edition (BPM6)). A web-based Foreign Exchange Transactions Electronic Reporting System (FETERS) collects purpose-wise details of all foreign exchange sale/purchase transactions in the country from Authorised Dealers (ADs), which are used to generate Balance of Payments (BoP) statistics. Total flows and stocks of (a) external commercial borrowings (ECBs) and (b) Non-Residents Deposits [based on Non-resident deposits - Consolidated Single Return (NRD-CSR)] are maintained under dedicated systems and used for compilation of BoP and External Debt Statistics.

The Annual Census on Foreign Liabilities and Assets of Indian Companies (FLA) is conducted to facilitate India's participation in the IMF's Co-ordinated Direct Investment Survey (CDIS) and Co-ordinated Portfolio Investment Survey (CPIS) as well as for items in BoP and IIP. It focuses on cross-border financial collaboration through direct investment, and also contains items of Foreign Affiliate Trade Statistics (FATS) as per the global prescriptions. Information on standardised financial parameters of companies are collected through web-based Foreign Liabilities and Assets Information Reporting (FLAIR) portal in IMF-prescribed extensive templates.

BoP statistics presents aggregate-level data, which often require to be supplemented through surveys for information on additional dimensions. As software-related exports, cross-border banking services and foreign technical collaboration are important areas, RBI conducts surveys on International Trade in Banking Services, Computer Software and ITES/ BPO Services Exports and Foreign Liabilities and Assets of Mutual Fund Companies and Foreign Collaboration Survey. The survey results are disseminated on the RBI's website and articles

based on the same are also published in the Bulletin. RBI reports foreign investment flows in accordance with the IMF definition on a monthly basis, using an international transactions reporting system (ITRS) as the principal source of information.

Non-resident Indians (NRIs) are allowed to open and maintain bank account in India under special deposit schemes – both rupee denominated and foreign currency denominated (such deposits are termed NRI deposits). Presently outstanding positions and flows of NRI deposits under FCNR (B), NRE, and NRO type accounts are compiled and disseminated by the RBI.

RBI has been publishing the data on Foreign Exchange Reserves to fulfil statutory and international obligations as a member of International Monetary Fund (IMF). The Foreign Exchange Reserves consist of the following components – (i) Foreign Currency Assets (ii) Gold (iii) Special Drawing Rights and (iv) Reserve Tranche Position in IMF. Further, the RBI also publishes forex market related information such as exchange rates, market turnover and sale and purchase of foreign currency by the RBI etc.

Corporate Statistics

RBI compiles and disseminates corporate statistics on non-government non-financial companies and non-government NBFCs. The sources of data for corporate statistics include audited annual financial statements filed by companies through MCA-21 system of Ministry of Corporate Affairs which consists of two mutually exclusive systems, viz., Extensible Business Reporting language (XBRL) and Form AOC-4 (Non-XBRL) platform. Under XBRL based system, all listed companies and unlisted companies above the threshold level of paid up capital (PUC)/turnover submit their complete annual accounts, whereas remaining companies submit limited data through 'Form AOC-4 system'.

Based on corporate database, RBI prepares and publishes regular studies on performance of corporate sector in the RBI Bulletin. Besides bestowing analytical inputs in the studies, statements on consolidated balance sheet, profit and loss account are disseminated regularly on the RBI website. Data from these studies is used by NSO, Ministry of Statistics and Programme Implementation, GoI for national accounts aggregates. Corporate performance studies also provide input for monetary policy. On request, anonymised company-level data on select balance sheet and profit/loss account parameters are also shared with researchers. Regular analysis on investment intentions of the private corporate sector and annual forecast of their envisaged capex are disseminated based on the ex-ante phasing of their project proposals by banks and financial institutions involved in project financing.

With a mission to enhance the extant credit information system in India and to strengthen the credit culture in the economy, the RBI is envisaging to develop a Public Credit Registry (PCR), an extensive digital registry of authenticated granular credit information database, in a phased manner. In essence, PCR will work as a financial information infrastructure providing access to various stakeholders and enrich the existing credit information ecosystem.

Monetary Policy Surveys

Regular reporting by banks and other institutions through statutory or statistical (non-statutory) returns and macroeconomic indicators are supplemented by individual / industry perceptions on economic parameters, which are collected through structured surveys. Given the well-known lags in the transmission of monetary policy, increasing globalisation and greater liberalisation of the domestic financial system, the importance of quick and forward-looking information has increased. The Monetary Policy Committee reviews the results of the household and enterprise surveys to gauge consumer confidence, households' inflation expectations, corporate sector performance, credit conditions, the outlook for the industrial, services and infrastructure sectors, feedback from industry associations and the projections of professional forecasters. Such information, used for monetary policy formulation, are released in public domain immediately after the MPC resolution to ensure transparency of decision process.

Survey of Professional Forecasters on Macroeconomic Indicators

Forecasting of various key economic indicators is a pre-requisite for a forward looking macroeconomic policy. Estimation of the future path of these indicators, such as output growth, inflation rate and exchange rate are important not only for the Central Bank, but also for the government, private businesses and individual households. The Bank has been conducting the Survey of Professional Forecasters (SPF) since September 2007 to supplement the internal analysis and macroeconomic forecasting exercises. The SPF panellists provide annual and quarterly forecasts of around 20 key macroeconomic indicators such as growth, inflation, banking sector indicators, external sector variables.

Industrial Outlook Survey (IOS)

This quarterly survey captures the business sentiments for the current quarter and expectations for the ensuing quarter, based on qualitative responses on a set of parameters pertaining to demand conditions, financial conditions, employment conditions, price situation and external account. The survey is being conducted since 1998 and targets a panel of manufacturing companies representing a good mix of size and industry-groups, where the participation is voluntary.

Order Books, Inventories and Capacity Utilization Survey

This quarterly survey is being conducted since 2008 to fill the data gap on capacity utilisation, order books and inventories in the Indian manufacturing sector. The survey collects actual quantities of new orders, backlog of orders, pending orders, breakup of work-in-progress and finished goods in total inventories and item-wise production in terms of both quantity and value vis-à-vis the installed capacity. These data provide estimates of capacity utilisation (CU).

Inflation Expectation Survey

Inflation expectations affect people's behaviour such as savings and purchasing power in ways that have long-term economic impact: they can influence and be influenced by the linkage between money, interest rates and prices. Measures of inflation expectations are important for central banks particularly those adopting inflation targeting framework.

The Bank has been conducting Inflation Expectations Survey of Households (IESH) since September 2005. The survey elicits qualitative and quantitative responses from public on expected price changes (general prices and prices of food, non-food, household durables, housing and cost of services) over three-month and one-year horizon, in addition to their assessments of current inflation based on their own consumption basket. The respondents include financial sector employees, other employees, self-employed, homemakers, retired persons, daily workers, and others. The survey periodicity is aligned to the bi-monthly monetary policy. The survey follows a two-stage probability sampling design and covers around 6,000 households in 18 cities.

Consumer Confidence Survey

The changes in consumer confidence have the potential to affect real economic activities through changes in business sentiments. The Bank is conducting its consumer confidence survey since 2010 to capture perceptions of consumers on the general economic situation, prices, employment, financial situation and their own income and spending for the current year as well as expectations for the ensuing year using two-stage probability sampling design. The survey covers around 5,400 households in 13 cities and its periodicity is aligned with the bi-monthly monetary policy.

Ad-hoc Surveys

With a focus on conducting innovative surveys to fill the data gaps in emerging areas relevant in Indian situation and to gauge activity and sentiment in new economy areas, the Bank conducts several one-time surveys to get more insight on the behaviour of economic agents. These included:

- Survey on Indian Start-up Sector (SISS) to create a profile of the start-up sector in India including their dimension relating to turnover, profitability and workforce.
- Survey for assessing sectoral variation in cash transactions and demand by corporates and households.
- Survey on Retail Payment Habits of Individuals (SRPHi) to gauge customer habits on various aspects of payments systems to get an idea on digital modes of payments.
- Survey of automobile dealers for assessing demand and employment situation and prospects in the wake of slowdown.

Indices Compilation and Dissemination

House Price Index

Changes in housing prices are related to real estate activities, credit market, household balance sheet and are, therefore, important for macroeconomic policy and maintenance of financial stability. The Reserve Bank compiles quarterly House Price Index (HPI) (base 2010-11=100) at all India level and for ten major cities (*viz.*, Mumbai, Delhi, Chennai, Kolkata, Bengaluru, Lucknow, Ahmedabad, Jaipur, Kanpur and Kochi). These indices are based on property price transactions collected from registration authorities of respective state governments. The index is compiled using Laspeyres' Price index formula and disseminated through the RBI website with a lag of one quarter.

Banking Services Price Index (BkSPI)

As a follow up to the recommendation of the Government of India Expert Committee on Development of Business Service Price Index (BSPI) in India (Chairman Prof. C.P. Chandrasekhar; set up in April, 2007), the Reserve Bank has been compiling the experimental Banking Services Price Index (BkSPI). The services provided by the banking sector are classified into two broad categories, *viz.*, Direct services (*e.g.*, fees, commissions, brokerage) and financial intermediation services indirectly measured – FISIM (estimated as a margin between rates applied to depositors and borrowers). Currently, the Index is compiled with base year 2011-12 at monthly frequency using Laspeyres' formula and disseminated through the website of the Office of the Economic Adviser, Ministry of Commerce and Industries.

Research and Analysis

In pursuit of delivering quality research, DSIM undertakes several research and analysis using advanced forecasting and nowcasting techniques for assessment of macroeconomic indicators and media sentiments analysis on monetary policy issues, especially using Big Data analytics, Artificial Intelligence and Machine Learning techniques. The policy oriented research on macroeconomic development continues in the overall ambit of the Inter-Departmental Group (IDG) on Inflation and Growth. The Data Science Lab (DSL) has been set up to harnessing the power of big data analytics for surveillance and domain specific early-warning detection capabilities for supporting operational functions of the Bank. A Granular Data Access Lab (GDAL) is being setup under the centralised information management system (CIMS) for seamless access to micro-level data to support research.

Coordination and Information Sharing

- With the objective to disseminate information, facilitate research on economic and financial issues, assist in formulation of public policies and promote co-operation and co-ordination among South Asian Association for Regional Cooperation (SAARC) countries, a dedicated SAARCFINANCE Database (SFDB) portal with automatic data uploads facility was managed by the Reserve Bank and hosted through the DBIE. The

time series data in the SFDB are presented sector-wise and frequency wise, both in respective national currencies and in the US dollar.

- DSIM co-ordinates the data exchange with government and other external agencies on a timely and periodic basis. The Bank reports 172 data series on various domains to the Bank for International Settlements (BIS) with different frequency on a regular basis. Similarly, the 'National Fact Sheet' for the National Statistics Office (NSO) was updated regularly.
- DSIM contributes towards methodological and other developments in official statistics and information management and technical guidance through participation in the committees/working groups and membership in national / international organisations.

In wake of the recent financial crisis, there is renewed focus on availability of information and statistical gaps globally. The DSIM, RBI is actively engaged with other international bodies such as the IMF, G20, BIS and FSB in strengthening our financial statistics and adopting international best practice. The department coordinates for monitoring progress towards implementation of various recommendations set out by G20 Data Gaps Initiatives (DGI) with the objective to implement the regular collection and dissemination of reliable and timely statistics for policy use.