Handbook for Directors of Urban Cooperative Banks

College of Agricultural Banking, Pune

A

Handbook

for

Directors

of

Primary (Urban) Co-operative Banks

College of Agricultural Banking
Reserve Bank of India
University Road,
Pune 411016
Tel. +91 20 2558 2301, Fax +91 20 2553 7756
Email ID: principalcab@rbi.org.in
https://cab.rbi.org.in

For training and academic purpose only.

The Handbook is updated up to March 31, 2024. The relevant circulars or statutory provisions may be referred to for any specific reference.

Disclaimer: “This handbook is for training and academic purposes only. Please be guided by the relevant laws, circulars, instructions etc. in this regard. The usual disclaimer shall apply."

FOREWORD

Financial inclusion plays an important role in the economic well-being of people, reduced inequality in society, achievement of sustainable development goals and overall economic growth. Urban financial inclusion is particularly important for an inclusive society, given the rapid urbanization in India. Primary (Urban) Cooperative Banks (UCBs), therefore, have an important role to play in financial inclusion in urban areas. Accordingly, the Reserve Bank decided to set up Cooperative Bankers' Training College (CBTC) on September 29, 1969. Within no time, the College broad-based its focus to capacity building in agricultural finance and development banking. It was accordingly renamed as "College of Agricultural Banking (CAB)' in 1974. Over the five decades, CAB has been catering to the capacity-building needs of the UCBs across the country through conferences, seminars, workshops, training programmes, and customized training programmes for individual UCBs.

Governance and capacity building plays an important role in sustaining and further enhancing the role of UCBs in realizing the financial inclusion objectives of the country. Towards this end, and in line with the mission of CAB, a handbook for the Directors of UCBs has been published by CAB periodically to build capacity among the Directors and Management of UCBs relating to governance, credit management, investments, IT and cyber security and systems & controls. I am happy to note that the handbook has been very popular with the cooperative bankers and they have been eagerly looking forward to the updated version of the handbook. Accordingly, the handbook has been updated as on March 31, 2024, by the Members of Faculty (MoF) of the Management, Regulation and Supervision (MRS) Channel of CAB. The handbook presents a comprehensive coverage of almost all the important areas of urban cooperative banking and will be useful in particular to the Directors of UCBs.

I appreciate the Members of the Faculty for painstakingly updating the handbook. I hope that its perusal will benefit the readers and their banks immensely.

Pune
May 05, 2024

V G Sekar
Principal & CGM

Acknowledgements

This handbook draws upon the contribution made in the area of banking and finance by the academicians, practitioners, and researchers and owes an intellectual debt to them. The contents have also been drawn from various statutes, regulatory circulars, and guidelines issued by the Reserve Bank of India from time to time.

I would like to thank Shri V G Sekar, Principal, College of Agricultural Banking (CAB) for providing an opportunity to the Management, Regulation and Supervision (MRS) Channel to prepare and periodically update this handbook for the benefit of trainees.

I am grateful to the previous pool of members of faculty of the erstwhile Cooperative Banking Channel including Shri A S Pillai, Shri Cedric Lawrence, Dr Ajit Kumar, Shri Ashutosh Upadhyay, Shri Rajesh Sharma, Shri Yaswant Acharya, Dr. Ashish Srivastava and Shri Rajender Kumar and for their inputs in the earlier versions of the handbook. I am indebted to my fellow members of faculty from the MRS Channel namely, Shri Abhishek Kumar and Shri Murlee Krishna M. for their contribution to the updation of the handbook. I would also like to place on record my appreciation for the support provided by Shri Tushar Rokade, Assistant, MRS Channel.

Pune
May 05, 2024

Santosh Kumar Pandey
Channel Coordinator & DGM

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MODULE I

Primary (Urban) Co-operative Banks
Structure, Operations, and Governance

The first module of this handbook comprises closely-knit five chapters which present an insight into the origin, structure and operations of Primary (Urban) Cooperative Banks (UCBs). Governance is a key focus of this module duly augmented by statutory provisions of the Banking Regulation Act, 1949 (AACS), and the Supervisory Action Framework (SAF) applicable to the UCBs issued by the Reserve Bank of India.

Chapter I

Primary (Urban) Cooperative Banking Sector

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1. Introduction to Cooperative Banking Sector

The cooperative institutions were born in the 19^{th} century when the people of smaller means and peasants, who were socially and financially excluded from the mainstream, voluntarily organized themselves into groups/societies. The voluntary nature, mutual help, service orientation and not for 'profit alone' approach of this institutional model immensely appealed to the vulnerable sections of the society and they spontaneously embraced it. Taking inspiration from the success of co-operative movements in Britain and Germany, the movement in India began as a means of providing affordable credit to people of smaller means. This was achieved through individuals pooling their resources and organising themselves as cooperative societies for the mutual benefit of their members.

Access to finance and financial services are the lifeblood of any economy. The more organized and vibrant the financial sector of a country is, the more developed the country is likely to be. Financial institutions and banks perform the very important function of financial intermediation in an economy and banks are the most prominent among them. Banks mobilize surplus resources with the savers and provide the same to the people who need resources for creating economic assets. The banking space in India is occupied mainly by the commercial banks, which primarily cater to the requirements of large enterprises and financing of infrastructure projects. The big banks, in a competitive market, operate with an eye on their margins, increasing their profits, achieving economy of scales, reduce transaction cost, etc. In the process, sometimes people of small means, small businesses, entrepreneurs etc. are not encouraged by these banks as it is neither economical nor profitable for them to cater to the needs of these people. Thereby, sometimes in the urban/semi-urban areas, people of small means, small businesses do not get access to the financial services and products from these big banks.

The Urban cooperative banks, operating in the urban/semi-urban areas are considered ideal to meet the financial needs of the people of smaller means given their size and structure. Generally, the people of small means feel comfortable and at ease while dealing with these cooperative banks. Groups of people having common needs and background come together in different areas/ parts of the country and form their cooperative credit institutions to address their financial needs.

1.1 Genesis of Urban Cooperative Banking in India[1]

The term Urban Co-operative Banks (UCBs), which is not formally defined anywhere, refers to primary cooperative banks which are located in urban/ semi-urban areas. These banks were traditionally sprung on community lines and were situated in localities and workplaces of the community which set them up. They generally lent to small borrowers and business enterprises within their community and locality. Till 1996, UCBs were allowed to lend only for non-agricultural uses. However, this restriction does not hold today. As on date, the scope of operations of UCBs has widened much and these banks have grown in size and have not restricted their service to a particular community.

1.2 The Beginning of the Co-operative Movement in India

The first known mutual aid/ co-operative society in India was the 'Anyonya Sahakari Mandali' which was organised in the erstwhile princely State of Baroda in the year 1889 under the guidance of Shri. Vithal Laxman, also known as Bhausaheb Kavthekar. Initially, the urban co-operative credit societies were organised on community lines for meeting the consumption-oriented credit needs of their members. Salary earners' societies played a significant role in popularizing the movement by inculcated the habit of thrift and self-help, especially amongst the middle class and organized labour force.

The real impetus to the co-operative movement in India came after the enactment of Cooperative Credit Societies Act, 1904. The first urban cooperative credit society was registered in Canjeevaram (Kanjivaram) in the erstwhile Madras province in October 1904. Amongst the prominent credit societies were the “Pioneer Urban” in erstwhile Bombay (Mumbai) (November 11, 1905), the “No.1 Military Accounts Mutual Help Co-operative Credit Society” in erstwhile Poona (Pune) (January 9, 1906). Cosmos in Poona (January 18, 1906), Gokak Urban (February 15, 1906) and Belgaum Pioneer (February 23, 1906) in the Belgaum district, the Kanakavli-Math Co-operative Credit Society and the Varavade Weavers' Urban Credit Society (March 13, 1906) in the South Ratnagiri (now Sindhudurg) district. The most prominent amongst the early credit societies was the Bombay Urban Co-operative Credit Society, sponsored by Shri Vithaldas Thackersey and Shri Lallubhai Samaldas was established on January 23, 1906.

The Maclagan Committee (1915) reviewed the performance of co-operative societies and suggested measures to strengthen them. The committee observed that such institutions were well suited to cater to the needs of the lower and middle-income strata of the society and would inculcate the habit of banking amongst the middle classes. Committee’s recommendations played a vital role in strengthening the urban cooperative credit movement. In the present day context, it may be of interest to recall that during the banking crisis of 1913-14, when around

[1] Reserve Bank of India, https://rbi.org.in/scripts/fun_urban.aspx

57 joint-stock banks failed, there were a flight of deposits from joint-stock banks to cooperative (urban) banks. The Committee stated this event in the following lines:

"The crisis had a contrary effect and in most provinces, there was a movement to withdraw deposits from non-cooperatives and place them in cooperative institutions, the distinction between two classes of institutions being well appreciated and a preference being given to the latter owing partly to the local character and publicity of cooperative institutions but mainly, we think, to the connection of Government with Cooperative movement".

1.3 Under the State Purview

With the enactment of the Government of India Act in 1919, the subject of "Cooperation" was transferred from Central Government to the Provincial Governments. The first State Cooperative Societies Act was passed by the then Government of Bombay in the year 1925 which helped the co-operative movement in a great way by promoting the concept of thrift, mutual-aid and self-help, and acted as a pacesetter of the cooperative activities in India. Soon other states/ provincial governments also enacted the co-operative laws.

A consensus developed that urban co-operative banks play an important role in the economic development. This was also emphasized by several committees. The Indian Central Banking Enquiry Committee (1931) felt that *"the urban cooperative banks have a duty to help the small business and middle-class people"*. The Mehta-Bhansali Committee (1939) recommended that *"those societies which had fulfilled the criteria of banking should be allowed to work as banks and recommended an association for these banks"*. The Co-operative Planning Committee (1946) went on the record to say that *"urban banks have been the best agencies for small people in whom Joint-stock banks are not generally interested"*. The Rural Banking Enquiry Committee (1950), impressed by the low cost of establishment and operations, recommended the establishment of such banks even in places smaller than taluka towns.

The first study of the Urban Co-operative Banks was taken up by the RBI in the year 1958-59. The Report published in 1961 acknowledged the "widespread and financially sound framework of urban co-operative banks and emphasized the need to establish primary urban cooperative banks in new centres" and suggested that *"the state governments (should) lend active support to their development"*. In 1963, Varde Committee recommended that "such banks should be organised at all the urban centres with a population of 1 lakh". The committee introduced the concept of minimum capital requirement and the criteria of the population for the incorporation of UCBs.

1.4 Regulatory Set-up

The concerns regarding the lack of professionalism in the management of UCBs underscored the need for a robust regulatory set-up. Further, there was also a debate going on about the lack of protection to the depositors of the urban cooperative banks, on the lines similar to the depositors of the commercial banks, through the RBI owned Deposit Insurance and Credit Guarantee Corporation (DICGC). However, there was a problem in extending the insurance cover to these institutions because these banks were not closely regulated by the RBI under which the DICGC was set up. The Government of India sought to solve the problem by amending the Banking Regulation Act, 1949 and make some select provisions of the B.R. Act, 1949 applicable to the urban cooperative banks by virtue of which the RBI would be in a position to have regulatory control over these institutions. Thus from March 1, 1966, by addition of section 56 to the B.R. Act, 1949 some sections of the B.R. Act were made applicable to Urban Cooperative Banks. Thus in its present form, the B.R. Act 1949 (As applicable to Cooperative Credit Societies) is the statutory framework under which the RBI regulates the UCBs. Large cooperative banks with paid-up share capital and reserves of ₹1 lakh were brought under the purview of the Banking Regulation Act, 1949 with effect from 1st March 1966 and within the ambit of the Reserve Bank's regulation and supervision. Therefore, from 1966, depositors of UCBs were also covered by deposit insurance. However, this also marked the beginning of an era of the duality of control from Government (State or Central) and RBI over Co-operative banks. Banking related functions viz., licensing, area of operations, interest rates etc., were to be regulated by the RBI and the matters relating to registration, management, audit and liquidation, etc., of these banks were to be regulated by the state governments as per the provisions of respective State legislation.

Around the late 1960s, UCBs were looked at as important players for promotion of the small scale industries. The Working Group on Industrial Financing through Co-operative Banks (1968), known as Damry Group recommended that these banks should finance the small/ cottage industries. The Banking Commission (1969) also reiterated this need. The Madhavdas Committee (1979) drew a roadmap for the future role of UCBs and recommended that the RBI and government support the establishment of UCBs in backward areas.

The Hate Working Group (1981) expressed a need for better utilization of these banks' surplus funds and recommended that the maintenance of the Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR) of UCBs should be brought at par with commercial banks, in a phased manner. The Marathe Committee (1992) redefined the viability norms and ushered in the era of liberalization. The Madhava Rao Committee (1999) focused on consolidation of these banks, control of sickness/ weakness, need for better professional standards and sought to align the urban cooperative banking structure with the commercial banks.

An important feature of the UCB Sector is its heterogeneous character and uneven geographical spread. Most of the UCBs are concentrated in six states viz., Gujarat, Maharashtra, Andhra Pradesh, Telangana, Karnataka and Tamil Nadu. While a majority of the banks are unit banks i.e., without any branch network, some large UCBs have a presence in many states after the multi-state cooperative banking was allowed in 1985. Some of these UCBs are also acting as authorized dealers in foreign exchange.

1.5 Unique Features of UCBs

1.5.1 The subject of co-operation falls under the state list in the constitution of India[2] and, therefore, each of the state government has enacted its own Co-operative Societies Act. Management related functions of the co-operative banks are governed by the respective state co-operative societies acts, whereas their banking-related activities are under the purview of the Banking Regulation Act, 1949 (B. R. Act) (As Applicable to Cooperative Societies (AACS), a central act, which is administered by the RBI. UCBs having a branch presence in the states other than the state of registration are governed by the Multistate Co-operative Societies Act, 2002.

1.5.2 Banking related functions of these institutions were brought under the BR Act, with effect from March 1, 1966, and the RBI, the Central Bank of the country, was vested with the powers to regulate and supervise operations such as acceptance of deposits, maintenance of cash reserves and liquid assets, regulation of loans and advances, the opening of new places of business, calling for returns on banking operations, on-site inspection of books of accounts, the publication of audited balance sheet and profit and loss account etc.

1.5.3 UCBs have several features which are unique in the financial spectrum of the country,

i. UCBs are generally localized in their operations and offer a local feel and personal touch in their operations. They primarily cater to the needs of lower and middle-income groups.

ii. Loans are granted by UCBs only to members while they accept deposits from the public.

iii. Members are required to maintain a percentage of their loan amounts as share capital with the bank as per the extant share-linking norms.

iv. UCBs are run democratically. The voting policy is that of “one member - one vote”. The management committee of the UCBs is elected from its members.

v. There are quantitative controls on the maximum number of shares that can be held.

1.5.4 Difference between UCBs and Commercial Banks

The following table explains the difference between the UCBs and the commercial banks.

Features	UCBs	Commercial Banks
Organization	Co-operative Societies.	Joint-stock Companies.
Regulation and	The duality of control -	Reserve Bank of India.

[2] http://lawmin.nic.in/olwing/coi/coi-english/Const.Pock%202Pg.Rom8Fsss(35).pdf

Control	State government or Central Government (in case of multi-state cooperative banks) and the RBI.	
Reach	Localized operations.	All India operations.
Target Market	Urban and Semi-urban Population.	Entire geographical area
Nature of Business	Member-driven - Loans to the members only.	Customer-driven – No need to be a shareholder to obtain a loan.
Scope of Business	Restricted to the permitted area of operations only.	Diverse and spread all over India.

1.5.5 Difference between the UCBs and Cooperative Credit Societies

It is important to understand a few terminologies and their specific legal meaning in the context of the B. R. Act, 1949 (AACS). Following are some of the important terms.

- **Co-operative bank** means a state co-operative bank, a central co-operative bank and a primary co-operative bank. *[Section 5(cci), B. R. Act, 1949 (AACS)]*
- **Co-operative credit society**" means a co-operative society, the primary object of which is to provide financial accommodation to its members and includes a co-operative land mortgage bank. *[Section 5(ccii), B. R. Act, 1949 (AACS)]*

  As such, a co-operative credit society is not a bank and hence, it cannot accept chequable deposits and cannot directly participate in the payment & settlement system. Deposits placed with a co-operative credit society are not covered under the deposit insurance.

- **Co-operative society** means a society registered or deemed to have been registered under any Central Act for the time being in force relating to the multi-State co-operative societies, or any other Central or State law relating to co-operative societies for the time being in force. *[Section 5(cciia), B. R. Act, 1949 (AACS)]*

- **Primary agricultural credit society** means a co-operative society, --

(i) the primary object or principal business of which is to provide financial accommodation to its members for agricultural purposes or purposes connected with agricultural activities (including the marketing of crops); and

(ii) The bye-laws of which do not permit the admission of any other co-operative society as a member:

Provided that this sub-clause shall not apply to the admission of a co-operative bank as a member by reason of such co-operative bank subscribing to the share capital of such co-operative society out of funds provided by the State Government for the purpose.

[Section 5(cciv), B. R. Act, 1949 (AACS)]

- **Primary co-operative bank** means a co-operative society, other than a primary agricultural credit society, --

(i) The primary object or principal business of which is the transaction of banking business;

(ii) The paid-up share capital and reserves of which are not less than one lakh of rupees; and

(iii) The bye-laws of which do not permit the admission of any other co-operative society as a member:

Provided that this sub-clause shall not apply to the admission of a co-operative bank as a member by reason of such co-operative bank subscribing to the share capital of such co-operative society out of funds provided by the State Government for the purpose.

[Section 5(ccv), B. R. Act, 1949 (AACS)]

- **Primary credit society** means a co-operative society, other than a primary agricultural credit society, --

(i) The primary object or principal business of which is the transaction of banking business;

(ii) The paid-up share capital and reserves of which are less than one lakh of rupees; and

(iii) The bye-laws of which do not permit the admission of any other co-operative society as a member:

Provided that this sub-clause shall not apply to the admission of a co-operative bank as a member by reason of such co-operative bank subscribing to the share capital of such co-operative society out of funds provided by the State Government for the purpose.

[Section 5(ccvi), B. R. Act, 1949 (AACS)]

If any dispute arises as to the primary object or principal business of any co-operative society referred to in clauses (cciv), (ccv) and (ccvi), a determination thereof by the Reserve Bank shall be final.

1.6 Classification of UCBs

For regulatory purposes[3], the UCBs have been categorized into following four tiers for regulatory purposes:

a. Tier 1 - All unit UCBs and salary earners' UCBs (irrespective of deposit size), and all other UCBs having deposits up to ₹100 crore;
b. Tier 2 - UCBs with deposits more than ₹100 crore and up to ₹1000 crore;
c. Tier 3 - UCBs with deposits more than ₹1000 crore and up to ₹10,000 crore;
d. Tier 4 - UCBs with deposits more than ₹10,000 crore.

The deposits referred to above shall be reckoned as per audited balance sheet as on 31st March of the immediate preceding financial year. If a UCB transits to a higher Tier on account of increase in deposits in any year, it may be provided a glide path of upto a maximum of three years, to comply with higher regulatory requirements, if any, of the transited higher Tier.

[3] DOR.REG.No.84/07.01.000/2022-23 dated December 01, 2022.

1.7 Area of operations of UCBs

Area of operation of a UCB means the geographical area as defined in its bye-laws as approved by the registering authority. UCBs are allowed to expand their area of operation by passing a resolution by its general body, amending its bye-laws, and then getting the amended bye-law registered with the concerned Registrar of Cooperative Societies (RCS)/Central Registrar of Cooperative Societies (CRCS). Prior permission/ no-objection certificate from RBI is required before such revision, wherever applicable.

Regulatory requirements for an extension of the area of operation

(A) Within the district of registration and adjoining districts with the State

UCBs satisfying the extant criteria, as laid down by the RBI from time to time, for Financially Sound and Well Managed (FSWM) banks may extend their area of operation to the whole of the district of registration and its adjoining districts within their State of registration, without prior permission from the Reserve Bank of India. Presently, the UCBs satisfying the following norms are called FSWM[4] banks:

a. The CRAR shall be at least 1 percentage point above the minimum CRAR applicable to an UCB as on the reference date;
b. Net NPA of not more than 3%;
c. Net profit for at least three out of the preceding four years subject to it not having incurred a net loss in the immediate preceding year;
d. No default in the maintenance of CRR / SLR during the preceding financial year;
e. Sound internal control system with at least two professional directors on the Board;
f. Core Banking Solution (CBS) fully implemented; and
g. No monetary penalty should have been imposed on the bank on account of violation of RBI directives/ guidelines during the last two financial years.

2. The process of deciding the eligibility for being classified as a FSWM UCB may be carried out by UCBs themselves as per the revised criteria based on the assessed financials and findings of RBI inspection report or audited financial statements, whichever is latest. The Boards of the banks shall examine the compliance to the FWSM criteria and pass necessary resolution approving the same and inform the concerned Regional Office of Department of Supervision, Reserve Bank of India immediately, and in any case, not later than within 15 calendar days from the date of passing the resolution. UCBs may review the compliance with FSWM criteria every year at Board level as indicated above immediately after the audit of the financial statements and RBI inspection report as and when received. This process will be subject to supervisory review.

[4] DOR.REG.No.85/07.01.000/2022-23 dated December 01, 2022.

Such banks may directly approach the RCS of the State concerned for extension of the area of operation to the entire district of registration and its adjoining districts within the State of registration.

(B) Beyond the adjoining districts and to the entire State of registration

The uni-state Tier II UCBs satisfying FSWM conditions may extend their area of operation to the entire State of registration. Tier II UCBs registered or deemed to be registered under the Multi-State Co-operative Societies Act, 2002 satisfying FSWM conditions are permitted to extend their area of operation to the entire State of original registration.

UCBs have to fulfil the FSWM criteria as per the last RBI inspection. Assessed Net-Worth of such FSWM UCBs should not be less than the entry point capital norms as prescribed by the RBI for the highest category centre in that district(s), applicable to a new general category bank. RBI give due consideration to the system of internal controls prevailing in the bank and supervisory comfort while considering such requests for extension of the area of operation. UCBs desirous of extending their area of operation to the entire state need to approach the Regional Offices of the RBI for prior approval.

(C) Beyond the State of registration and Extension of Area of Operation of Multi-State UCBs

FSWM UCBs that have assessed net worth of ₹50 crore and above, are allowed to extend their area of operation beyond their State of registration as also to any other State/s of their choice.

(D) Entry Point Capital Norms[5]

In the tables below A, B, C and D denote centres with the following population:

Category of centre	**Population**
A	Over 10 lakh
B	5 lakh and above but less than 10 lakh
C	1 lakh and above but less than 5 lakh
D	Less than 1 lakh

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[5] UCBs have revised net worth criteria (Ref. DOR.CAP.REC.No.86/09.18.201/2022-23 dated December 01, 2022)

- Tier 1 UCBs operating in a single district shall have a minimum net worth of ₹2 crore.
- All other UCBs (of all tiers) shall have a minimum net worth of ₹5 crore.
- UCBs which currently do not meet the minimum net worth requirement, as above, shall achieve the minimum net worth of ₹2 crores or ₹5 crore (as applicable) in a phased manner. Such UCBs shall achieve at least 50 per cent of the applicable minimum net worth on or before March 31, 2026, and the entire stipulated minimum net worth on or before March 31, 2028.

I. Entry Point Capital Norms for General Category

Particulars	A	B	C	D
Assessed Net Worth (₹ lakh)	400	200	100	25
Membership	3000	2000	1500	500

II. Entry Point Capital Norms for Unit Banks/ Banks organised by Mahila/ SCs/ STs and those organized in less developed States

Particulars	A	B	C	D
Assessed Net Worth (₹ lakh)	200	100	50	12.50
Membership	3000	2000	1500	500

III. Entry Point Norms for Banks organised in the least developed States/North-Eastern States/Tribal Regions

Particulars	A	B	C	D
Assessed Net Worth (₹ lakh) (33.33% of the regular Entry Point Norm (EPN)	133.33	66.67	33.33	8.33
Membership (66.67% of normal membership)	2000	1334	1000	334

1.8 Extant Norms for Branch Authorization

General Permission to open Branches[6]

1.8.1 In order to rationalise the process of branch opening and to enable the UCBs to tap growth opportunities in the sector, it has been decided to grant general permission for branch expansion in the approved area of operation to financially strong UCBs. The general permission of branch expansion in the approved area of operation will be available to UCBs in all Tiers (except Salary Earners' Banks) which comply with applicable Financially Sound and Well Managed (FSWM) criteria. The eligible UCBs are permitted to open new branches up to 10 per cent of the number of full-fledged branches (at the end of previous financial year) in a financial year, subject to a maximum of five branches without having the need to take permission from Reserve Bank of India. However, in case the UCB has less than 10 branches, then they would be permitted to open atleast one branch.

1.8.2 The UCBs, which are eligible to be classified as FSWM, shall put in place a policy, approved by their Board of Directors for opening branches, which should be formulated keeping in view the financial health of the bank, viability study of the new branches and

[6] Rationalization of Branch Authorisation Policy for Urban Co-operative Banks (UCBs) dated June 8, 2023

customer service in these branches. The UCBs shall ensure that the proposal for opening of such branches in a particular financial year, based on their policy, is duly approved by their Board of Directors. UCBs shall also report the details of the branches opened under General permission, within 15 Calendar days, to the concerned Regional Office of Department of Supervision of RBI, and also to Central Information System for Banking Infrastructure (CISBI) portal as per timelines laid down in the instruction.

Branch Authorisation- Prior Approval Route

1.8.3 In addition to the general permission to open branches as mentioned above, UCBs are permitted to open new branches under the prior approval route as per the existing framework, as hitherto. As per the extant guidelines[7], eligible UCBs may prepare an Annual Business Plan (ABP) for the opening of branches (including extension counters and up-gradation of extension counters into full-fledged branches, in their existing area of operation, for the next financial year, with the approval of their Board of Directors and submit the ABP, in duplicate, to the respective Regional Offices of Reserve Bank of India. The plan may be submitted preferably by end of December of the previous financial year.

1.8.4 In order to reduce the time taken for opening new branches, the following revised timelines must be ensured.

Sr. No.	Activity	Timeline
1.	Submission of ABP by UCBs	ABP may be submitted preferably by November of previous financial year and in any case, not later than 15th December of previous financial year.
2.	Allocation of Centres by RBI	RBI will allocate centres within 90 calendar days of receipt of complete ABP.
3.	Application for Authorization	The bank must approach RBI within 90 calendar days from date of allocation of centre in the prescribed Form V, indicating the exact postal address of the place where the branch is to be opened, to obtain valid authorization.
4.	Authorization provided by RBI	RBI will provide authorization for new branches within 30 calendar days of receipt of complete application.
5.	Validity of Authorization	The authorization will be valid for 180 calendar days from date of issue or 360 calendar days from date of allocation of centre, whichever is earlier.

1.8.5 While there is no requirement of submission of exact location of branch at the time of submission of ABP, UCBs should try to firm up their plans for opening branches at the

[7] RBI Master Circular on Area of Operation, Branch Authorisation…, dated July 01, 2015

requested centers well in advance to quicken the process of opening the branches. The banks may, at their discretion, include the address of their proposed branch in ABP.

1.8.6 A valid authorization from the Reserve Bank of India is required for opening a new place of business including extension counters, off-site ATMs or changing the location of any existing place of business (except to the extent permitted) under Section 23 of the BR Act, 1949 (AACS).

1.8.7. Ordinarily, no extension of time will be granted after the expiry of the validity period of the licence. Only in exceptional cases, where the bank is unable to open the branch for reasons beyond its control, an extension of time not more than 180 calendar days may be granted by the Regional Offices.

1.8.8 The opening of branches without a valid authorization from the Reserve Bank is an act of violation of Section 23 of the BR Act, 1949 (AACS), and liable to attract penalties. In case, the information/particulars furnished by any bank are found to be incorrect, the Reserve Bank of India will take a serious view in the matter and the bank will be liable for penal action, including debarring it from the allotment of centers for three years.

1.8.9 UCBs may refer to extant guidelines of RBI, *as updated from time to time*, in respect of procedure to be followed for opening branches including specialized branches, extension counters, up-gradation of extension counters into full-fledged branches, shifting of branches, closure of branches, the opening of controlling offices, opening of central processing/ retail asset processing centres and setting up of on-site/ off-site ATMs.

1.9 Authorization for opening Controlling Offices (i.e., Regional/ Zonal/ Administrative Offices)[8]

UCBs meeting the FSWM criteria may open one controlling office (Regional /Zonal/ Administrative Office) for a cluster of not less than 40 branches without prior approval of the RBI.

However, it must be ensured that the controlling office is opened within the bank's approved area of operation. Further, the controlling office should not have any direct interface or business transactions with the customers. UCBs should report full details regarding the opening of such offices, within two weeks to the concerned Regional Office of Department of Supervision, RBI for the issue of license under Section 23 of the B. R. Act, 1949 (AACS).

1.10 Shifting, Acquisition, Surrender of leased premises, etc. by UCBs not categorized as Financially Sound and Well Managed (FSWM) as per the extant criteria

UCBs not satisfying the extant FSWM criteria and not complying with section 11 (1) of BR Act, 1949 (AACS) are required to obtain prior approval of the RBI and/or RCS *for*:

[8] RBI/2015-16/438 - DCBR.CO.LS (PCB) Cir.No.19/07.01.000/2015-16 dated June 30, 2016

(a) Selling the bank's premises;

(b) Surrendering existing premises which were taken on lease or rental basis;

(c) Acquiring new premises on ownership or lease or rental basis; and

(d) Shifting of offices/ departments resulting on account of sale, surrender, and acquisition of new premises.

Such UCBs should submit their application in the prescribed format to the concerned Regional Office of Department of Supervision, RBI.

1.11 Branch Authorization Policy for Salary Earners' Banks

Salary earners' banks (SEBs) have neither been permitted under General Permission nor have been covered under ABP mentioned above for the opening of new branches, in view of their special status. Licensed SEBs fulfilling the under-noted norms are eligible for applying to RBI for opening branches.

(a) SEB’s bye-laws should not provide for giving loans to outsiders i.e. non-employees.

(b) SEB should have at least be 1000 members at the place where it intends to open the branch.

(c) SEB should comply with the regulatory framework prescribed by RBI.

(d) The bank should have earned net profits during the last two years.

(e) Net NPAs of the bank should be less than 10 per cent as on the last balance sheet date and the bank should have made required provisions as per RBI norms.

(f) Minimum CRAR should be as per the norms prescribed by RBI.

(g) For opening a new branch within the bank’s district of registration, its ANW should at least be equal to the prescribed entry point capital norms for opening a new general category bank at that centre where the bank was organized or where the branch is to be opened, whichever is higher. Illustratively, if a SEB organized in the "C" category centre desires to open a branch in "B" category centre within its district of registration, its ANW should be at least equivalent to the entry point capital norm prescribed for "B" category centre.

(h) For opening a branch outside its district of registration but within the State of registration, the bank should have ANW not less than the entry point capital norm prescribed for opening a new general category bank at the highest category centre in that State.

(i) SEBs satisfy the above norms, may submit the board approved branch expansion programme to the Regional Office concerned of the DOS of RBI giving information in the prescribed format enclosed to the RBI circular UBD.BL(SEB) No.5A/07.01.00/ 2001-02 dated August 8, 2001. Once a centre is allotted no request for a change in the allotted centre is not entertained. Within six months from the date of allotment letter, the banks have to make preliminary arrangements for opening the branches and are required to submit applications in Form V for the issue of branch authorization/s. The banks can open the branches only after obtaining branch authorization and within the validity period of the branch authorization.

1.12 Acquisition of Accommodation on Lease / Rental Basis by UCBs

In terms of the extant instructions, RBI issues authorization for opening a bank branch/es or office at a particular centre based on the exact postal address of the place (as mentioned by the banks in their applications) where the branch/ office is to be opened. Therefore, it is incumbent upon banks to ensure that their branches operate from premises, which have a subsisting and valid lease agreement, free of any dispute between the bank and the landlords of the premises in question. Banks are required to furnish quarterly progress reports as per the prescribed format to enable RBI to take a view on the appropriateness, or otherwise, of continuing the authorization for the branch/ office which is functioning in a 'disputed' premises, to the concerned Regional Office of DOS, RBI, within a period of one month from the close of the respective quarter.

Reference–

1. Rationalization of Branch Authorisation Policy for Urban Co-operative Banks (UCBs) - DOR.REG.No.19/07.01.000/2023-24 dated June 08, 2023
2. Master Circular - RBI/2015-16/62 - DCBR.LS.(PCB)MC.No.16/07.01.000/2015-16 dated July 1, 2015

Chapter II

Governance Structure and Board of Directors

Chapter II

Governance Structure and Board of Directors

2.1 Introduction

UCBs came under the purview of the BR Act, 1949 from March 01, 1966. Since then, they grew in number, size, and scale as well as business complexity. The challenges relating to financial inclusion, credit delivery, entrepreneurial development, etc. can effectively be managed through a co-operative model with professional ethics and good governance. The Board of Directors perform both the executive and supervisory roles and has the responsibility to oversee the functioning of UCB as a co-operative society as well as its functions as a bank. It is desirable that the persons who manage the affairs of UCBs are professionally competent, follow the principles of corporate governance in the decision making, devoid of vested interests and subjected to supervision and control[9].

2.2 Characteristics of the Co-operatives and need for the governance

The International Co-operative Alliance (ICA)[10] defines a co-operative as "an autonomous association of persons united voluntarily to meet their economic, socio-cultural needs and aspirations through a jointly-owned democratically-controlled enterprise."

The ICA has come out with the seven principles and values that characterize co-operatives.

a) Voluntary and open membership
b) Democratic member control
c) Member participation
d) Autonomy and independence
e) Education, training and information
f) Co-operation among co-operatives
g) Concern for community

While the professional management and high standards of the corporate governance are accepted as the *sine qua non* i.e., an essential condition for success in the long run for any organisation, the challenge for the co-operatives including UCBs remains to strike a judicious balance between the principles of good governance and a member focussed organisational structure based on the democratic system of one member one vote. The governance structure at UCBs, thus, has to be compliant with these principles.

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[9] RBI Guidelines on Board of Management in UCBs, dated December 31, 2019
[10] https://ica.coop/en/the-alliance/about-us

2.3 Governance and Professional Management

Governance refers to the set of procedures, structures, policies, and people that drives an organisation to the right path and towards right ways of doing things. Corporate Governance is all about 'recognizing' the interest of all stakeholders and 'protecting' their long term interests. Ethics and Transparency are the two most important principles of corporate governance. In the case of banks, effective compliance to the prudential regulations and supervisory instructions, accountability in the decision-making structure and chain of command, and integrity in the managerial processes are the fundamental underpinnings of a good governance structure. To put in place a good governance structure, the four important pillars of corporate governance must be considered while making decisions viz., Fairness, Transparency, Responsibility and Accountability. To ensure this, the UCBs must have professional management.

Corporate governance for all institutions, including financial intermediaries, has always been an important issue in all forums. In 1997, the Organization for Economic Cooperation and Development (OECD) issued a set of corporate governance standards and guidelines to improve the legal, institutional and regulatory frameworks for corporate governance[11]. Corporate governance, therefore, is based on three basic tenets[12]:

- Ensuring 'transparency' in the decision-making process.
- Ensuring the 'accountability' for the decisions taken.
- Ensuring 'fairness' in decision-making to safeguards all stakeholders' long-term interests.

2.4 Bank for International Settlements (BIS) Guidelines

Considering the importance of the governance for the banks, the Bank for International Settlements (BIS) has issued guidelines[13] for banks to serve as a framework for national supervisors.

1	Board of Directors need to be possessing the required qualification for their positions, should develop a proper understanding of their role and should be exercise proper judgment about the bank's affairs.
2	Directors should be approving and overseeing the bank's strategic objectives and values that are communicated throughout the bank.
3	The Board should ensure that lines of responsibility and accountability are clearly set and enforced throughout the bank.
4	Board should ensure an appropriate oversight by senior management in line with the bank's policy.

[11] http://www.oecd.org/corporate/principles-corporate-governance.htm
[12] Vittal, N.; Issues in Corporate Governance in India, 5th JRD Tata Memorial Lecture Series
[13] Enhancing Corporate Governance for Banking Organisations, February 2006, BCBS, Bank for International Settlements, Basel

5	Board should ensure effective utilization of the work conducted by the internal control and internal audit function as well as external auditors.
6	The Board should ensure that the bank's compensation policies and practices are in consonance with its culture, long-term objectives and strategy.
7	The Board should ensure that the bank is governed in a transparent manner.
8	The Board should understand the bank's operational structure, including the jurisdictions it operates, or through structures, that impede transparency (i.e. "know-your-structure").

Implementation of good corporate governance seeks to lay down explicit codes of conduct, which organizations should follow. The effectiveness of corporate governance depends on the people's commitment to the organisation. The first is the management's commitment to the principle of integrity and transparency. The second is the legal and administrative framework put in place by the government. Strong public governance is essential for ensuring good corporate governance standards. Hence, effective supervisory oversight is a very important factor in shaping the governance standards.

2.5 RBI Guidelines for strengthening corporate governance

In line with the BIS guidelines, RBI has also issued comprehensive guidelines especially oriented towards the BOD of the Urban Co-operative Banks[14].The guidelines clearly lay down the Role of the board of directors, the necessity of undertaking periodic reviews, and need for at least two professional directors, besides a prohibition on the creation of honorary posts/ designations at Board level. Donations to the trusts and institutions, where directors or their relatives hold position or are interested, are also prohibited. Boards of the UCBs are expected to establish a high level of governance and control standards through various committees such as the Audit Committee of Board (ACB) and committee to monitor high-value frauds. The RBI has also underscored the fact that professionalization is a key to effective governance systems in co-operatives and accordingly it has made conscious efforts in this direction.

2.6 RBI's recommendations for enhancing professionalization of management – Board of Management (BOM) in addition to Board of Director (BOD)[15]

The High Powered Committee (HPC) set up by the RBI in January 2015 recognized that *"a weak corporate governance has been one of the major factors plaguing the co-operative sector and has led to bank failures/unsatisfactory growth of the sector"*. Pursuant to the recommendations of another high powered committee on Urban Co-operative Banks constituted by the RBI in 2001, the presence of at least two professional directors on the board

[14] RBI Master Circular on Board of Directors - RBI/2024-25/01- DoR.HGG.GOV.No.1/18.10.010/2024-25 dated April 1, 2024

[15] Report of the High Powered Committee on UCBs, Reserve Bank of India, August 2015

of UCBs was already made mandatory. It was also made one of the enabling conditions for UCBs to be termed as Financially Sound and Well Managed (FSWM).

Under the present legal framework, the Board of Directors of a UCB perform both the executive and supervisory roles. Malegam Committee (2011) observed that since UCBs are accepting public deposits, it was imperative that a separate mechanism be put in place to protect the interests of depositors and suggested a new organizational structure for UCBs consisting of a Board of Management, in addition to the Board of Directors, to facilitate professional management and focused attention to the banking related activities of UCBs. The idea was segregation of the ownership of an urban co-operative bank as a co-operative society from its functioning as a bank. While the Registrar of Co-operative Societies continues to exercise its control and regulation as a co-operative society, the RBI exercises control and regulation on its function as a bank. Accordingly, the HPC (2015) recommended that the concept of BoM put forward by the Malegam Committee has to be implemented at UCBs. Accordingly, it has been advised by the RBI vide its guidelines dated December 31, 2019,[16] that UCBs with deposit size of ₹100 crores and above shall constitute BoM which will also be a mandatory requirement for allowing such banks to expand their area of operation and open new branches. UCBs with a deposit size less than ₹100 crore may also constitute BoM if they so desire.

In terms of extant guidelines, the BoM shall exercise oversight over the banking-related functions of the UCBs, assist the BOD on the formulation of the policy and any other related matters specifically delegated to it by the Board for the proper functioning of the bank. The functions of the BoM shall include the following:

i. Rendering expert advice on all proposals being put up to the Board or any committee of the Board for sanction of loans
ii. Recommending action for recovery of NPAs, One Time Settlement or Compromise Settlement and assisting the Board in monitoring the same
iii. Overseeing the management of funds and borrowings in the bank
iv. Recommending proposals for investment of bank's funds as per the board approved policy
v. Oversight on internal controls and systems and risk management in the bank
vi. Exercising oversight on the implementation of computerisation, technology adoption and other incidental issues in the bank
vii. Overseeing internal audit and inspection functions including compliance
viii. Oversight on complaint redressal system

[16] Guidelines on constitution of BOM in UCBs, December 31, 2019 (www.rbi.org.in)

ix. Assisting the Board in the formulation of policies related to banking functions, illustratively loan policy, investment policy, recovery policy, ALM and Risk management, etc. to ensure that policies are in tune with RBI guidelines

x. Any other responsibility as may be delegated to it by the BOD.

In the event where the BOD differs with the recommendations of BoM, it shall do so by recording, in writing, the reasons thereof. As the BOD is responsible for the general direction and control of a UCB, they will continue to look after all the administrative functions as spelt out in the respective Co-operative Societies Act. BOD will continue to be the apex policy setting body and constitute various committees of the Board including the Board of Management to assist the Board in carrying out its responsibilities. It will delegate powers to the various committees as considered appropriate. BOD may ensure that there are no conflicts in powers delegated to the Committees of the Board and BoM.

Further, as per guidelines[17], UCBs (except those having deposit size of less than ₹100 crores and Salary Earners Banks) shall obtain prior approval of Reserve Bank for the appointment of CEO. In this connection, it is advised that Scheduled UCBs shall approach the Department of Regulation of Reserve Bank for approval at least three months prior to the end of the tenure of the incumbent CEO. Non-Scheduled UCBs shall approach the concerned Regional Office of the Department of Supervision for the requisite approval.

2.7 Balancing co-operative principles vs. governance principles

Balancing the co-operative principles with that of the governance principles remains a major challenge in establishing a robust professionalized governance framework in the co-operatives. While the proximity to the members and member’s welfare remains the key driving force guiding the affairs of a co-operative institution, a sound professional and governance structure requires separation of ownership and managerial control besides ensuring the independence of its directors. The co-operative governance is different from corporate governance as their boards not only need to take care of the institution’s strategic interests and regulatory compliance but they must also carefully look after the interests of the members. However, gradually, the co-operatives have started reconciling these twin objectives and have also understood the need for good governance standards along with the need for professionalization.

2.8 Management of UCBs

The term ‘Management’ of UCBs in its wider sense includes (i) the General Body (ii) the BOD, (iii) the CEO and the other managerial staff. To make the management of UCBs much more watchful, professional and effective, and to ensure their financial soundness, protect the

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[17] Appointment of Managing Director (MD) / Whole-Time Director (WTD) in Primary (Urban) Co-operative Banks - DOR.GOV.REC.25/12.10.000/2021-22 dated June 25, 2021

interests of their depositors and also to integrate them with the financial sector, the RBI has been issuing necessary instructions in this regard to UCBs from time to time.

A vigilant General Body of members, *conscious of its rights as well as responsibilities*, can contribute substantially to the sound management of a UCB by ensuring an effective corporate governance structure at the board level. The foremost task of the general body is to elect the right type of persons at the helm of affairs who can inspire confidence in the members and public. It is necessary that the members of the UCBs are sufficiently imbued with the importance of their participation in the bank's working as well as their rights and obligations.

The meetings of General Body are of two types, viz. Annual General Body Meeting (AGM) and Special General Body Meeting (SGM). The AGM is a statutory obligation and is to be convened every year within the period and the manner stipulated in the respective State Co-operative Societies Act/ Multi-State Co-operative Societies Act, 2002. The SGM is normally convened by a resolution passed by BOD as provided in the bye-laws. However, such a meeting can also be convened on a specifically written request made to the Chairman of the board by a minimum number of members as prescribed in the bye-laws or under instructions from the Registrar of Cooperative Societies (RCS) concerned or the Central Registrar of Co-operative Societies (CRCS).

The AGM normally considers approval of the annual report prepared by BOD on bank’s working for the preceding year, audited balance sheet and profit and loss account of the bank. It also approves the distribution/ appropriation of profit and declaration of dividend at a rate not exceeding the rate prescribed in the Co-operative Societies Acts and Rules. The declaration of dividend also may be subject to the instructions from RCS and RBI. The AGM also deals with the election of BOD, approval of the appointment of auditors, fixing maximum of borrowing powers and amendment to bye-laws, etc. The Special General Body can transact only the business as specified in the notice and no other business.

2.9 Board of Directors (BOD)

The overall supervision and control over functioning of the UCB is vested in the BOD elected at the General Body Meeting as provided in the bye-laws or applicable Co-operative Societies Acts/ Rules. Providing direction for the functioning of bank is the primary responsibility of BODs. The directors, in the discharge of their responsibility of ensuring sound and efficient management, should be competent and have sound business judgment/ skills. They must also exercise adequate supervision and control over the bank’s affairs. Since one of the cardinal features of a co-operative bank is its democratic management, BOD must be as representative of character as possible. There should not be any restrictive provisions in the bye-laws or election rules prescribing a minimum share qualification for a member to contest for election to the Board. The stipulation of high share qualification would preclude members of small means from contesting for elections to BOD. Further, at least one seat for women shareholders may be reserved on the BOD.

The directors of UCBs must have adequate knowledge, having high integrity, function in a cohesive manner and provide proper leadership for the efficient functioning of the bank. Therefore, a certain degree of professionalism in the BODs of UCBs is needed.

In view of the inadequate level of professionalism in BOD in many banks, RBI has prescribed that at least two directors who have suitable banking experience or persons with relevant professional qualifications in the fields of law, accountancy or finance. Besides, certain eligibility/qualification/disqualification criteria for becoming director in a UCB are also prescribed in the BR Act and the co-operative laws concerned.

Further, to ensure adequate representation of members of different branches, it is desired that the branches may be grouped according to the following categories for the purpose of election of directors on the board[18].

i. Branches within the limits of the head office including only the branches within about 25 km. from the head office town.

ii. Branches falling outside the above limits but within the district.

iii. Branches outside the district including those outside the state.

The representation may be based on membership and rather than the business of branches. Some seats on the board may be kept exclusively for the head office town and every branch in a particular group mentioned above should be represented on a rotation basis. It is desirable to give representation to depositor class also in the BOD.

2.10 Eligibility for Director's Position

UCB’s directors are elected from amongst the members except for co-opted and nominated directors, hence anyone who is not eligible to be a member will not be eligible to be a director of the UCB. Persons who are engaged in the business of money lending/ financing/ investment activities and anyone who was convicted for any criminal offences including moral turpitude is also ineligible in terms of relevant clauses of the model by-law No. 9 and/or the provisions contained in the applicable co-operative societies act.

To allow the efficient and ethical election of the BOD, UCB’s members are generally allowed to participate in the election of its BOD after completion of a minimum period of 12 months after acquiring the membership. Further, adequate representation to women members should be given on the board.

[18] Recommendations made by Madhav Das Committee and recommended by RBI for adoption by UCBs - RBI Master Circular on Board of Directors - RBI/2024-25/01-DoR.HGG.GOV.No.1/18.10.010/2024-25 dated April 1, 2024

In terms of Clause (a) of sub-section (2) of section 10A of the B R Act, 1949 (AACS) atleast 51% of members of the board of directors should have special knowledge or practical experience in the fields of Accountancy, Agriculture & Rural Economy, Banking, Cooperation, Economics, Finance, Law, SSI, or any other aspect useful in the opinion of RBI.

2.11 Role of Board of Directors

Board of Directors (BOD or Board) is primarily concerned with formulation of policies keeping in view the applicable statutory provisions and the guidelines issued by the RBI. The Board should also exercise overall supervision and control over the functioning of the bank, leaving the day-to-day administration to the Managing Director (MD) / Chief Executive Officer (CEO).

Directors of UCBs are advised to be guided inter alia by the following guidelines:

1. The directors should attend Board meetings regularly and effectively. They should study the Board papers thoroughly and should call for information at Board Meetings through the MD/CEO, rather than directly calling for information from the concerned departments. Management, on its part, is expected to furnish full facts and complete papers to the directors well in advance as also all additional information/clarification that the directors may seek before taking a decision.
2. The directors should ensure confidentiality of the Bank's agenda papers/notes and should not reveal any information relating to any constituent of the bank to anyone.
3. The directors should involve themselves thoroughly in the matter of formulation of general policy and ensure that performance of the bank is monitored adequately at the Board level. They should not issue/give any instructions/direction to any individual officer/employee of the bank in any manner, and should also discourage the individual officer/employee or unions from approaching them in any manner.
4. The directors should be familiar with the broad objectives of the bank and the policies laid down by the Reserve Bank. They should analyse the trends of economy, assist in the discharge of management's responsibility to public and formulation of measures to improve customer service and be generally of constructive assistance to the bank management.
5. The directors must work as a team and in the spirit of co-operation and should give as much of their wisdom, guidance and knowledge as possible to the management. The Board should function in a cohesive manner and provide proper leadership to manage the affairs of the bank on smooth and efficient lines.
6. The Directors should bestow their attention on the bank’s working related to:
    a. Compliance with the regulatory policies of the RBI
    b. Observance of Cash Reserve and Statutory Liquidity Ratios
    c. Efficient management of funds and improving profitability
    d. Priority sector/weaker section lending targets

e. Ensure that bank's funds are utilized in a proper and judicious manner for the benefit of general members
f. Prompt recoveries and reduction of overdues
g. Compliance with guidelines on income recognition, asset classification and provisioning towards non-performing assets
h. Customer service
i. Review of action taken on RBI inspection report/statutory audit report
j. Development of a robust management information system
k. Reviews on items as prescribed by RBI
l. Vigilance, frauds and misappropriation of funds
m. Strengthening of internal control system and housekeeping, viz., proper maintenance of books of accounts and periodical reconciliation
n. Computerization of operations

7. The directors should not involve in any matter relating to appointment, transfer, posting or promotion, or redressal of individual grievances of any employee nor should they interfere with and/or be subversive of maintenance of discipline, good conduct and integrity of the staff.
8. The directors should not approach or exert influence for sanction of any kind of facility noe should they sponsor any loan proposal, buildings or sites for bank's premises, enlistment or empanelment of contractors, architects, doctors, lawyers, etc.
9. The directors should not participate in the Board discussion if a proposal in which they are directly or indirectly interested comes up for discussion and should disclose their interest well in advance.
10. The directors may indicate their directorship of the bank on their visiting card or letter head, but the logos or distinctive design of the bank should not be displayed on the visiting card / letter head.

Functions and Responsibilities of Board and Chairman

2.11.1 Functions and Responsibilities of the BOD

- Setting the strategies and formulation of various policies of the bank;
- Ensuring compliance with applicable laws and other statutory obligations of the bank;
- Assessment and Management of various risks faced by the bank;
- Adhering to requirements of confidentiality and privacy;
- Overall monitoring of the audit function in the bank;
- Putting in place suitable guidelines for compensation;
- Putting in place a suitable code of ethics and values;
- Relationship management among various stakeholders;
- Keep in mind the responsibility towards society at large and environment;
- Ensuring adherence to the disclosure of material information;

- Ensuring regular and proper conduct and frequency of meetings of the BOD/ various committees;

2.11.2 Responsibility of the Chairman

- Assuming principal responsibility for the functioning of the BOD.
- Providing overall leadership to the Board.
- Ensuring that the Board is able to function independently of management.
- Deciding on the agenda which is reflective of overall responsibilities of the Board and strategies/ priorities set by it.
- Effective chairing of Board meetings, ensuring that the Board members get the agenda papers timely, encouraging individual directors to participate and contribute in the board discussions in an effective manner, encouraging health debates, try to bring in the consensus, and ensuring that the decisions are duly recorded.
- Respect dissent.
- Ensuring compliance with code of conduct of meetings, governance standards, the flow of information, disclosure standards etc.

2.13 Committees of the Board

Some of the important committees that are generally formed in the banks are as mentioned below (the list is only indicative, not exhaustive):

2.13.1 Loan Committee

It is desirable to have a loan committee which would be in a position to meet frequently to deal expeditiously with loan applications or other important functions related with the credit management entrusted to it. The first important duty of the Loan Committee is to formulate and periodically update a Loan Policy for the bank. The policy will set out the broader framework under which bank will sanction loans and advances to eligible borrowers in sync with the instructions issued by the RBI from time to time. The Loan Policy, in fact, is not only a document of procedural aspects of loan sanctioning but it also articulates bank's view on target market segment and target sector within the boundaries set by Reserve Bank.

2.13.2 Investment Committee

Investment Committee is as important as the Loan Committee, as it has to take decisions regarding gainful deployment of bank's surplus resources in SLR/ govt. securities and non-SLR investments. The committee should frame, with the approval of BOD, an investment policy which should keep in view RBI guidelines as well as the bank's internal requirements. The policy should be reviewed every year. The committee as well as top management of the bank should actively oversee investment transactions. The policy should clearly define the authority to sanction the deals, authority to put through deals, the procedure that should be followed for taking the sanction of the designated authority, the process for putting through the deals, fix prudential exposure limits, and put in place an effective reporting system.

The policy should prescribe the ceiling as well as qualitative parameters of different types of securities to be acquired and held by the bank. The policy should be prepared strictly in strict adherence to the guidelines issued by RBI/ RCS. The policy should clearly spell out the internal control mechanism, accounting standards, audit, review and reporting system for investment transactions.

2.13.3 Audit Committee of Board (ACB)

As per RBI guidelines, banks should set up an Audit Committee of Board (ACB) which is responsible for ensuring and enhancing the effectiveness of internal audit/ inspection and for overseeing and providing directions to the internal audit department and other executives of the banks. The committee may consist of a chairman and three or four directors, with one or more of such directors being chartered accountant or having experience in management, finance, accountancy and audit systems. ACB is required to review the implementation of RBI guidelines issued from time to time and also submit a quarterly report/ note to the BOD. Some of the duties and responsibilities of the audit committee are enumerated below:

i. Providing direction to and overseeing the entire audit function in the bank. The entire audit function will imply the organization, operationalisation and quality control of internal audit and inspection within the bank, follow up on the statutory audit of the bank and inspection report of the Reserve Bank.;

ii. Reviewing the internal inspection/ audit function, including the system, its quality and effectiveness in terms of follow up. ACB should review the follow-up action on the internal inspection reports and especially focus on:

- **(a)** Reconciliation of interbranch adjustment accounts
- **(b)** unreconciled long outstanding entries in inter-branch accounts and inter-bank accounts
- **(c)** arrears in balancing of books
- **(d)** Matters relating to frauds risk management in the bank
- **(e)** Housekeeping matters

iii. Compliance with the statutory audit /concurrent audit /RBI inspection reports ;

iv. ACB should view seriously any omissions/ laxity by/ ineffectiveness of internal inspecting staffs and failure to detect or not reporting the serious irregularities by them in their reports.

v. ACB should undertake periodic review of the bank's accounting policies/ systems keeping in view the need to ensure greater transparency in the bank's accounts and take the required steps to ensure the adequacy of accounting controls in the bank.

2.13.4 Risk Management Committee:

The primary responsibility of Risk management in the bank lies with the Board. UCBs having asset size greater than ₹5000 crore have been mandated vide the extant instructions to constitute a Risk Management Committee of the Board. The Board shall decide the membership, scope of work and frequency of meeting of the Committee.

2.13.5 Staff Committee:

Human resource is a very important component of the survival and growth of any organisation. Issues like recruitment, compensation, training, promotion, work environment are of critical importance and need the attention of the top management. Constitution of a Staff Committee, therefore, is of utmost importance for all UCBs. This Committee is also expected to monitor and oversee issues like wage negotiation, industrial relation and staff discipline.

The Committee should broadly oversee and ensure the following:

i. Proper assessment of staffing requirement keeping in mind bank' business size and growth potential.
ii. Fairness and Transparency in the recruitment process.
iii. That the job role and compensation structure is well defined at the time of recruitment.
iv. Designing of compensation structure in such a manner that it may attract the desired talent to meet the specific job requirement.
v. The work environment and career progression structure are good enough to keep staff members motivated.
vi. The performance management system is geared towards meeting organisational as well as individual aspirations.
vii. The organisational behaviour is in sync with organisational development
viii. Robust career succession planning is in place.

2.14 The Way Forward

The co-operative movement continuously grapples with the question of how to relate member engagement and democratic control of co-operative societies to the way that boards of directors and senior managers strategically manage their businesses. It is a well-known fact that frauds, embezzlements and unethical business operations perpetrated during the market upswings are uncovered during the downturn after inflicting losses and causing reputational risk. The only way to tackle such risks is to nip them in the bud, i.e., to curb the very occurrence of such events. A sound system of corporate governance and professional management helps in achieving this end. By adopting a sound governance structure that imbibes the leading good practices of corporate organisations duly augmented by tools and tactics that serve the unique characteristics of the co-operative environment, the co-operatives have an opportunity to develop and grow as a business model with a judicious balance of competitive markets, regulatory compliance and democratic member-driven organisational structure.

Reference –

1. International Cooperative Alliance, https://www.ica.coop/en/what-co-operative-0
2. RBI Master Circular on Board of Directors - RBI/2024-25/01-DoR.HGG.GOV.No.1/18.10.010/2024-25 dated April 1, 2024

Chapter III

Conduct of Board Meetings

Chapter III

Conduct of Board Meetings

Board of Directors oversees the functioning of a UCB. The Board is primarily responsible for formulation of policies, and also exercise overall supervision and control over the functioning of the bank. The Board functions as per the overall mandate of the General Body which meets at least on an annual basis. The Board generally meets every month to discuss and evaluate the performance of the bank.

3.1 Meetings of the General Body

General Body Meetings are of two types, namely, Annual General Body Meeting, and Special General Body Meeting.

3.1.1 Annual General Meeting

The bank has to hold an Annual General Meeting (AGM) every year within a period prescribed under the respective State/ Multi-State Cooperative Societies Act, 2002 and the relevant rules framed under the acts. In case it is not possible to hold AGM within the time period prescribed, the bank should approach the Registrar seeking extension time.

Generally, the items/ agenda for discussion in the AGM are prescribed under the respective State Co-operative Societies Acts or Multi-State Cooperative Societies Act and rules. However, the bank should mandatorily place before the AGM, any loan or advance outstanding against the name of any director or his/ her relative or any firm in which he or she is interested. Although as per extant guidelines of RBI, UCBs are prohibited from sanctioning any loan or advance to any director or his/her relative or any firm in which he or she is interested, it is quite possible some loan sanctioned prior to he or her becoming a director has not matured and is due for payment. The other items placed before the AGM are the Balance Sheet and Profit and Loss of the bank together with a statement of the Board of Directors about the current state of affairs of the bank, its financial health, its future plans and changes in business strategy during the year, etc. In addition, major findings of the audit report together with the compliance and observations of the BOD/ Chairman should also be placed before the AGM. Any proposed changes in the bank’s bye-laws should be placed before the AGM for approval/ consideration.

As the holding of the AGM on time is the responsibility of the Board, it should be ensured by the Board that the Chief Executive Officer or any other officer authorized under byelaws of the bank for the purpose, convene such meeting and makes preparation for the same on time.

Adequate notice as prescribed under the relevant Act / Rules / Byelaws need to be ensured and mode of communication of such notice as legally prescribed must be followed.

Normally, the Chairman does not have to interrupt the meeting or adjourn it unless the business, as shown in the agenda, is complete except when the quorum is not complete. The various decisions to be taken in the AGM require either a simple majority or 2/3 majority depending upon the subject. Therefore, the Chairman / Convener of the meeting should keep himself abreast with the statutory requirement in this regard so that the decisions taken in the meeting remain valid for implementation.

3.1.2. Special General Meeting

While holding of AGM is statutorily compulsory for adopting the annual financial statements (i.e., Balance Sheet and Profit & Loss Account), there is no compulsion to hold a Special General Meeting (SGM). However, the circumstances under which such meetings are required to be held are given in the respective State / Multi-State Cooperative Act and Rules. If such a need arises the meeting may be convened. The conditions, mode of convening, powers, procedure, a period of notice, subjects/business to be conducted in SGM etc. are normally elaborated in the respective State / Multi-State Cooperative Societies Act / Rules.

3.2 Meeting of Board of Directors

The BOD should meet at periodic intervals, and as often as is necessary to plan for the future growth of the institution by drawing an appropriate business plan, monitoring such plan at prescribed intervals and ensuring adequate follow-up. The business plans should cover all the important aspects of the bank for ensuring sustained growth. In addition, all the important policy circulars issued by the RBI / RCS or CRCS should be also placed before the Board and discussed. Bank's compliance with reference to the statutory inspections of RBI, RCS, and the inspection/ scrutiny conducted by others if any, should be discussed in the Board meetings.

The Board, subject to the provisions of the applicable co-operative societies acts and rules, should meet at least once every month at the office of the bank or any other place if so, provided under the bye-laws. Meetings are to be presided over by the Chairman and in his absence, by the Vice-chairman and in his absence by any other Director authorized by the members.

Although no list of items is prescribed in the Act and Rules to be considered in the meetings of the Board of Directors, they should consider all the relevant subjects and information in these meetings to be able to effectively discharge their role and responsibilities as Directors. Normally, the following items may be considered for inclusion in the agenda of the Board meetings.

1. Confirmation of the minutes of the previous Board Meeting.

2. Follow up the action of decisions taken during the previous Board Meetings.

3. Review of the financial position of all the branches by rotation.

4. Review of sanctions made by the Chairman since the last Board meeting.

5. Review of SLR/CRR position of the Bank and particulars of investments made since the last Board meeting.

6. Review of pending disciplinary cases/fraud cases and follow-up thereof.

7. The position of suit-filed accounts and execution of petitions in various courts by the Bank.

8. Internal control and housekeeping of the Bank:

    i. Balancing of books
    ii. Interest checking in all accounts
    iii. Reconciliation of balances in sundry, suspense and other critical accounts.
    iv. Items in Sundry Assets/Sundry Liabilities outstanding for more than 3 months.

9. Statement of the latest financial position and deployment of funds.

10. Important communications/letters received from RBI / RCS / State Government and action is taken thereon.

11. Review of top NPA accounts and the gross and net NPA position of the bank.

12. The position of various court cases (other than for recovery of NPAs).

13. The statement of potential NPAs.

14. Statement of the exercise of the delegated powers by various delegated authorities.

15. The statement of the loans sanctioned and disbursed since the previous meeting.

16. Proceeding/minutes of various committees particularly loan committee, audit committee, investment committee, recovery committee, etc.

17. Admission/retirement of new members and allotment/transfer of shares.

The above items for deliberation in Board meetings are only illustrative and not exhaustive. Besides, the above, the following items should also be included on the agenda from time to time i.e.

1. Branch rationalization programme for the year viz., branch expansion, conversion of extension counters closure and merger of branches.

2. Adoption of audited financial statements.

3. Classification of investments (i.e., held for trade, held till maturity, available for sale) and review of the investment portfolio.

4. Note on loss-making branches.

3.3 Calendar of Reviews – matters to be placed before the Board

The Reserve Bank, however, has issued a circular suggesting certain information/statements which need to be reviewed by the Board of Directors periodically in its meetings. An illustrative list of the reviews which should receive the attention of the directors as also the periodicity at which these may be placed before the Board of Directors is indicated in the Annexure-II to the RBI Master Circular on Board of Directors – UCBs, dated April 1, 2024. There are few monthly reviews and certain quarterly/ half-yearly and yearly reviews which have to be carried out/ put up to the Board.

3.4 Agenda Notes

Agenda notes should be circulated among the directors of the board sufficiently in advance so that there could be meaningful deliberations in the meeting for arriving at decisions. All important decisions should be taken at regular meetings of the Board. Decisions by the circulation of papers should be avoided as far as possible. If in emergent and exceptional cases decisions are taken by the circulation of papers, the same should be placed before the Board in the next meeting for ratification.

3.5 Recording of Minutes / Proceedings

The proceeding/minutes of the meetings of General Body, Board of Directors and the various sub-committees should be separately recorded in the minute book which is to be signed by the Chairman or the person who presided over the particular meeting. Though generally, the copies of such minutes are forwarded to each Director by post, it is better if the latest available communication means (e-mail, etc.) are used in transmitting the minutes. As indicated earlier, the minutes of each meeting are placed before the next meeting for confirmation. Sometimes, there is a lack of follow-up of the decisions taken at the meetings and the directors rely entirely on the response given by the bank. Such a situation should be avoided and actual and full compliance with all decisions should be ensured.

The decision, on the issues discussed, in the Board is by a majority vote by the directors present and voting. However, in case equality of votes on any issue, the Chairman has a second or casting vote. If there is dissent by a Director / Directors on any agenda item placed for transacting the business in a meeting, it should be properly recorded, along with the reasons for the dissent. In case the dissent is not recorded/is refused to be recorded, the concerned Director / Directors may communicate the details of the meeting, agenda item, the decision recorded and their dissent opinion in writing to the Registrar of Cooperative Societies.

Reference –

1. RBI Master Circular on Board of Directors - RBI/2024-25/01-DoR.HGG.GOV.No.1/18.10.010/2024-25 dated April 1, 2024

Chapter IV

Provisions of Banking Regulation (B R) Act ,1949
(As Applicable to Cooperative Societies)

Chapter IV

Provisions of the B. R. Act 1949 (AACS)

4.1 The Banking Regulation Act, 1949 was made applicable to the Urban Cooperative banks by an amendment to the Act in 1966. The provisions which are not applicable or differently applicable are spelt out in Section 56 the Banking Regulation Act, 1949. Reserve Bank of India regulates and supervises the UCBs as per various provisions of the Act as applicable to UCBs, namely -

- Requirement of minimum paid-up capital and reserves (Sec 11)
- Maintenance of cash reserves (Sec 18 of B.R. Act, 1949 and Sec 42 of RBI Act, 1934 for Scheduled UCBs)
- Restriction on holding shares in other co-operative societies (Sec 19)
- Licensing of banks (Sec 22)
- Maintenance of SLR (Sec 24)
- Depositor Education and Awareness Fund (Sec 26A)
- Accounts and its Submission/Publication (Sec 29, 31), Additional audit (Sec 30(1))
- Power to inspect the books of accounts (Sec 35)
- Power to give directions (Sec 35A)
- Power to issue caution, advice, insolvency resolution process, supersession, etc. (Sec 36)
- The power to impose a penalty (Sec 46, 47 and 47A)
- Chairman, Director, etc., to be public servants for the purposes of Chapter IX of the Indian Penal Code (Sec 46A)

Besides dealing with the important provisions of the Act that are relevant for an existing and functioning UCB, this chapter also focuses on certain significant amendments in the provisions of the Act. An attempt has been made to discuss the various provisions of the Act in a simple and abridged manner.

4.2 In recent times, a major amendment to the Banking Regulation Act, 1949 (AACS) was brought in vide the Banking Laws (Amendment) Act, 2012 which came into effect from January 05, 2013[19]. A subsequent amendment, though not applicable to the UCBs, was brought vide the Banking Regulation (Amendment) Act, 2017 with effect from August 25, 2017[20]. The amendment to the Act brought out in the year 2020[21] and made applicable to Primary (Urban)

[19] http://financialservices.gov.in/sites/default/files/Banking%20Laws%20Amendment%20Act%202012.pdf
[20] http://egazette.nic.in/WriteReadData/2017/178282.pdf
[21] https://financialservices.gov.in/act-rule/Banking/Banking-Notification

Cooperative Banks with effect from June 29, 2020, has introduced significant changes for the UCBs.

As per 2020 amendment, RBI has powers under section 53A to notify the application of provisions of certain sections of the Act to a specific co-operative bank or a class of co-operative banks. A summary of important changes introduced by the B R Act (Amendment), 2020 has been included in the last section of this chapter.

4.3 A brief description of important sections -

4.3.1 Section 11: Minimum Paid-up Share Capital – In terms of provisions of the Section, no UCB can carry on the business of banking unless the aggregate value of its paid-up capital and reserves is a minimum of one lakh rupees.

4.3.2 Section 18: Cash Reserve – Non-scheduled UCBs are required to maintain on daily basis Cash Reserve Ratio (CRR) in such per cent to its demand and time liabilities (DTL) as the Reserve Bank may specify from time to time. The CRR can be maintained in specified per cent of its DTL as on the last Friday of the second preceding fortnight by way of:

a) Cash with itself
b) Balance in a current account with Reserve Bank or the State Cooperative Bank of the state of registration
c) Net current account balance with the State Bank of India or a nationalized bank or IDBI Bank Ltd.
d) Balance with Central Co-operative bank of the district concerned

(The scheduled UCBs, however, are required to maintain the CRR in terms of Section 42 of the RBI Act, 1934 in the manner prescribed therein and as per instructions issued by RBI from time to time in this regard).

However, "unencumbered balances maintained by a primary co-operative bank with the central co-operative bank of the district concerned or with the State co-operative bank of the State concerned, in excess of the balance required to be maintained by it under section 18 of the Banking Regulation Act, 1949 read with section 56 thereof is not eligible to be counted towards the SLR under section 24 of the Act, ibid after March 31, 2015[22]."

If any UCB fails to maintain CRR of such per cent as specified by the Reserve Bank, it will be liable to pay penal interest to the Reserve Bank at the rate of three per cent above the Bank Rate on the shortfall for that day. If the shortfall continues further, the penal interest so charged will be increased to five per cent above the Bank Rate in respect of each subsequent day.

[22] Ref. UBD.BPD.(PCB).Not. No. 2 /16.26.000/2013-14 dated June 05, 2014

4.3.3: Section 19: Restrictions on holding shares in other co-operative societies

UCBs are prohibited from holding shares in any other co-operative society except to such extent and in such manner as the Reserve Bank may permit. No such restriction is applicable on UCB's holding of shares of the central cooperative bank to which it is affiliated or in the State Cooperative Bank of the state in which it is registered.

4.3.4: Section 20: Restrictions on loans and advances-

As per Section 20 of the principal Act made applicable to UCBs wef June 29, 2020, UCBs shall not make, provide or renew any loans and advances or extend any other financial accommodation to or on behalf of their directors or their relatives, or to the firms/companies / concerns in which the directors or their relatives are interested (collectively called as **“director-related loans”**). Further, the directors or their relatives or the firms/companies/ concerns in which the directors or their relatives are interested shall also not stand as surety/guarantor to the loans and advances or any other financial accommodation sanctioned by UCBs. ‘Advances’ for the purpose shall include all types of funded/working capital limits such as cash credits, overdrafts, credit cards, etc.

The following categories of director-related loans shall, however, be excluded from “loans and advances” for the purpose of these directions[23]:

i. Regular employee-related loans to staff directors, if any, on the Boards of UCBs;
ii. Normal loans, as applicable to members, to the directors on the Boards of Salary Earners' UCBs;
iii. Normal employee-related loans to Managing Directors / Chief Executive Officers of UCBs;
iv. Loans to directors or their relatives against Government Securities, Fixed Deposits and Life Insurance Policies standing in their own name.

Explanation: For the purpose of these directions -

i. The term 'any other financial accommodation' shall include funded and non-funded credit limits and underwritings and similar commitments, as under:

a. The funded limits shall include loans and advances by way of bill / cheque purchase / discounting, pre-shipment and post-shipment credit facilities and deferred payment guarantee limits extended for any purpose including purchase of capital equipment and acceptance limits in connection therewith sanctioned to borrowers, and guarantees by

[23] Master Circular- Exposure Norms and Statutory / Other Restrictions – UCBs - DoR.CRE.REC.71/07.10.002/2023-24 dated January 16, 2024

issue of which a bank undertakes financial obligation to enable its constituents to acquire capital assets. It shall also include investments which are in the nature of / in lieu of credit.

b. The non-funded limits shall include letters of credit, guarantees other than those referred to in paragraph (a) above, underwritings and similar commitments. It shall also include off-balance sheet exposure in the form of derivatives.

ii. The word “relative” shall have the meaning as under:

A person shall be deemed to be a relative of another, if and only if:-

a) They are members of a Hindu Undivided Family; or

b) They are husband and wife; or

c) The one is related to the other (or vice-versa) in the manner indicated below:

i. Father (including step-father)
ii. Mother (including step-mother)
iii. Son (including step-son)
iv. Son’s wife
v. Daughter (including step-daughter)
vi. Daughter’s husband
vii. Brother (including step-brother)
viii. Brother’s wife
ix. Sister (including step-sister)
x. Sister’s husband

iii. The word “interested” shall mean the director of the UCB or his relative, as the case may be, being a director, managing agent, manager, employee, proprietor, partner, coparcener or guarantor, as the case may be, of the firm / company / concern (including HUF):

Provided that a director of a UCB or his relative shall also be deemed to be interested in a company, being the subsidiary or holding company, if he/she is a director, managing agent, manager, employee or guarantor of the respective holding or subsidiary company:

Provided further that a director of a UCB shall also be deemed to be interested in a company/firm if he/she holds substantial interest in or is in control of the company/firm or in a company, being the subsidiary or holding company, if he/she holds substantial interest in or is in control of the respective holding or subsidiary company:

Provided further that a relative of a director of a UCB shall also be deemed to be interested in a company/firm if he/she is a major shareholder or is in control of the company/firm or in a company, being the subsidiary or holding company, if he/she is a major shareholder or is in control of the respective holding or subsidiary company:

iv. The term “substantial interest” shall have the same meaning as assigned to it in section 5(ne) of the Banking Regulation Act, 1949.

v. The term “control” shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in another manner.

vi. The term “major shareholder” shall mean a person holding 10% or more of the paid up share capital.

UCBs shall submit information pertaining to their director-related loans as at the end of each quarter (i.e. 31 March, 30 June, 30 September and 31 December), in the prescribed format to the concerned Regional Office of Department of Supervision of Reserve Bank of India within fifteen days from the end of the respective quarter. In the case of UCBs functioning under Administrator(s) / Person(s)-in-Charge / Special Officers, the UCBs concerned should submit the information in respect of loans and advances availed by the Administrator(s) / Person(s)-in-Charge / Special Officers, including their relatives.

4.3.5: Section 20-A – Restrictions on power to remit debt – UCBs are prohibited from remission or waiver in whole or in part any debt/ loan due to it by:

a) any of its past and present directors.
b) any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor.
c) any individual if any of its directors is his partner or guarantor .

4.3.6: Section. 22- License - No banking by Primary Credit Societies

No cooperative society shall carry on banking business in India unless - it is a cooperative bank and holds a license issued in that behalf by the Reserve Bank.

Every primary credit society which had become a primary co-operative bank on or before the commencement of the Banking Laws (Amendment) Act, 2012, shall before the expiry of three months from the date on which it had become a primary co-operative bank apply in writing to the Reserve Bank for a license under this section. The ability to pay its present and future depositors and not conducting its affairs in a way which is detrimental to the interests of its present and future depositors remains a key licensing condition of a bank.

4.3.7: Section 23- Restrictions on the opening of new, and transfer of existing, places of business: UCBs cannot open a new place of business or change except within the same city, town or village the location of an existing place of business without obtaining prior permission of the Reserve Bank.

4.3.8: Section 24- Statutory Liquidity Ratio (SLR) – Every UCB (whether scheduled or non-scheduled) is required to maintain assets, the value of which should not be less than such percentage not exceeding forty per cent of the total of its demand and time liabilities as on last Friday of the second preceding fortnight as the Reserve Bank may specify by notification in the Official Gazette. The form and manner, in which the assets, qualifying for SLR have to be maintained, shall be specified by the Reserve Bank by Gazette notification.

If any UCB fails to maintain SLR of such per cent as specified by the Reserve Bank, it will be liable to pay a penalty to RBI at the rate of three per cent above the Bank Rate on the shortfall for that day. If the shortfall continues further, the penal interest so charged will be increased to five per cent above the Bank Rate in respect of each subsequent day.

At present, the UCBs are required to maintain the SLR primarily in Government securities as the balances kept with State Co-operative Banks / District Central Co-operative Banks as also term deposits with public sector banks are not eligible for being reckoned for SLR purpose w.e.f., April 01, 2015[24].

4.3.9: Section 26- Return on unclaimed deposits- UCBs are required to submit within thirty days after the close of each calendar year a return of all accounts which have not been operated upon for ten years. Provided that in the case of money deposited for a fixed period the said term of ten years shall be reckoned from the date of the expiry of such fixed period.

4.3.10: 26A – Establishment of Depositor Education and Awareness Fund- Reserve Bank has established a fund called the "Depositor Education and Awareness Fund". Every UCB has to transfer the balance in all accounts which have not been operated for more than ten years to this fund maintained by the Reserve Bank. This unclaimed balance is required to be credited to the fund within three months from the expiry of the said period of ten years.

If and when any depositor makes a claim for refund of his deposit amount at a date after the transfer of his balance to the Reserve Bank, the UCB may apply for a refund of such amount. The UCB will be liable to repay such deposit or amount to the depositor at such rate of interest as may be specified by the Reserve Bank in this behalf.

4.3.11: Section 29 – Accounts and Balance Sheet- At the end of each year UCBs are required to prepare a balance sheet and profit and loss account as on the last working day in the forms set out in the 'Third Schedule {Section 56 (zl)}' of B R Act, 1949 (AACS) or in a manner which is near thereto. The accounts and balance-sheet referred to in section 29 together with the auditor's report shall be published in the prescribed[25] manner and three

[24] UBD.BPD.(PCB).Cir.No. 68 /16.26.000/2013-14 dated June 05, 2014
[25] As prescribed in relevant rules.

copies thereof shall be furnished as returns to the Reserve Bank within three months from the end of the period to which they refer (Section 31).

4.3.12: Section 30 – Audit

The balance-sheet and profit and loss account prepared in accordance with section 29 shall be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

If the Reserve Bank so requires, in the public interest or in the interest of the cooperative bank or its depositors to do so, it may at any time by general or special order direct an additional audit of the co-operative bank accounts. The expenses of such an audit shall be borne by the cooperative bank concerned.

4.3.13: Section 35 – Inspection – Reserve Bank may at any time, and on being directed to do so by the Central Government cause an inspection of the books and accounts of UCB by one or more of its officers and shall furnish a copy of the report to the bank. It is the duty of every director or other officer of the banking company to produce to RBI inspecting officer all such books of accounts and other documents as the said officer may require of him within such time as the said officer may specify. Besides examining several other aspects of banking on CAMELS pattern (Capital adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and Control), the RBI Inspection examine the adherence to the following statutory provisions by the UCBs:

- **a)** The bank is in a position to pay its present and future depositors in full as and when the claim arises [Section 22(3)(a)]
- **b)** The affairs of the UCB are not being conducted in a manner detrimental to the interests of its present and future depositors [Section 22(3)(b)]
- **c)** The general character of the management of the bank is not prejudicial to the public interest or the interest of its depositors. [Section 22(3)(c)]
- **d)** The bank has adequate capital structure and earning prospects [Section 22(3)(d)]
- **e)** The bank has a minimum paid-up capital of rupees one lakh. [Section 11(1)]

4.3.14: Insolvency Resolution Process[26] –

Section 35AA- The Central Government may, by order, authorize the Reserve Bank to issue directions to a co-operative bank to initiate insolvency resolution process in respect of a default, under the provisions of the Insolvency and Bankruptcy Code, 2016.

35AB (1) Without prejudice to the provisions of Section 35A, the Reserve Bank may, from time to time, issue directions to a co-operative bank for resolution of stressed assets.

[26] Banking Regulation Amendment Act, 2016 read with Section 56(a)(i) of the B R Act, 1949 (AACS)

35AB (2) The Reserve Bank may specify one or more authorities or committees with such members as the Reserve Bank may appoint or approve for appointment to advise any banking company or banking companies on the resolution of stressed assets.

4.3.15: Section 36AAA – Supersession of Board of directors of a co-operative bank – Where the Reserve Bank is satisfied that in the public interest or for preventing the affairs of a multi-State co-operative bank being conducted in a manner detrimental to the interest of depositors, it may supersede the Board of directors of such multi-state cooperative bank. Reserve Bank can also supersede the Board of directors of a single-state bank in consultation with the state government.

4.3.16: Section 46 - Penalties- If anybody from a co-operative bank, willfully makes a false statement in any return, balance sheet or another document for the purposes of provisions of the B R Act 1949 (AACS) or willfully omits to make a material statement, he will be liable for imprisonment for a term which may extend to three years or fine which may extend to one crore rupees or with both. If any director or officer of a co-operative bank fails to produce any book, account or other document or furnish any statement or information as demanded by an RBI officer making an inspection or scrutiny under the provisions of Section 35 of the B R Act, 1949 (AACS), he shall be punishable with fine which may extend to twenty lakh rupees in respect of each offence. If he persists in such refusal, he shall be punishable with a further fine which may extend to fifty thousand rupees for every day during which the offence continues.

4.3.17: Section 46A - Chairman, Director, etc., to be public servants for the purposes of Chapter IX of the Indian Penal Code - Every Chairman who is appointed on a whole-time basis, Managing Director, Director, auditor, liquidator, manager and any other employee of a bank shall be deemed to be a public servant for Chapter IX of the Indian Penal Code, 1860.

4.3.18: Section 47A- Power of Reserve Bank to impose a penalty- If any provision of the B. R. Act, 1949 (AACS) is contravened or if any default is made by a co-operative bank in complying with any requirement of this Act or any order issued under the provisions of this Act, a penalty not exceeding one crore rupees or twice the amount involved in such contravention will be imposed by the Reserve Bank on such co-operative bank. If such contravention or default is a continuing one, a further penalty which may extend to one lakh rupees for every day will be imposed.

4.3.19 B R Act (Amendment), 2020 – Important Provisions

Sr. No.	Provisions of the Amendment Ordinance/ Act
1.	**Act not to apply to PACS and Land Development Banks if they do not use** the words “bank”, “banker” or “banking” and do not act as drawee of cheques

	(S.3 of the Principal Act amended)
2.	**Management of banks including Qualification of members of Board** (S.10/10A/10B) This includes provisions relating to persons disqualified to manage a bank, their maximum one-time tenure, and requirement of the Board having not less than 51% members having special knowledge/experience in specified areas and requirement to have a whole-time chairman or managing director to run the bank.
3.	**Restrictions on whole-time directors having substantial interest/employment in other companies /firms** (S.10/10B) These relate to restrictions on whole-time directors having any substantial interest/connection with other companies/firms carrying on trade, commerce etc. while managing the bank - at par with banking companies.
4.	**Approval of appointment of Chairman/ MD/ CEO/ whole-time director and appointment of MD/ Additional directors** (S.10B/10BB/35B/36AB) These sections have provisions requiring RBI's approval for appointment of Chairman/MD/whole-time director/CEO, RBI's power to appoint MD when the post is vacant and RBI appointing additional directors on the Board.
5.	**Raising of capital by issue of equity/ preference/ special shares and debentures/ bonds/ like securities, subject to such conditions as the RBI may specify in this behalf** (S.12) This section enables co-operative banks to issue various types of shares and securities to help them garner capital and resources. Besides, this also provides that RBI shall issue guidelines on redemption and reduction of capital by co-operative banks.
6.	**Prohibition on common directorship across banks** (S.16) Director of one bank becoming director of another is prohibited by the Act on the lines of banking companies.
7.	**Restrictions on loans/ advances to directors at par with banking companies** (S.20) This provides for statutory restrictions on loans/advances to directors of co-operative banks, which were not as stringent as those applicable to banking companies. Further, giving loans to companies, where the director of the bank is a director/ guarantor/ employee etc. of the holding or subsidiary company of such company was also not prohibited. The applicable restrictions are brought at par with banking companies.
8.	**Approval of appointment/ removal of statutory auditors** (S.30) Before the amendment, RBI had no role in the appointment or removal of auditors of co-operative banks. Section 30 now is applicable for cooperative banks grants powers to RBI on the lines of banking companies.

9.	**Submission of balance sheet within three months** (S.31) Similar to commercial banks, co-operative banks are now required to submit their audited balance sheet within three months from the close of the financial year. This period can be extended by RBI by not more than another three months. This section is not applicable until December 31, 2020, whereas all other sections of the amendment are applicable from June 29, 2020.
10.	**Removal of Chairman/MD/CEO/ directors** (36AA) It grants the RBI power to remove Chairman/MD/CEO/ directors from office.
11.	**Supersession of Board (for all co-operative banks)** [S.36AAA] So far, RBI had powers to supersede the Board of multi-State co-operative banks only. Now the same has been extended to all co-operative banks, albeit in consultation with state governments in case of uni-state banks.
12.	**Winding up of co-operative banks by High Court at the instance of RBI** (S.37/38) As per this section, the liquidation of co-operative banks shall be carried out on the lines of banking companies.
13.	**Sanctioning voluntary amalgamations, preparing schemes for reconstruction or compulsory amalgamation of co-operative banks with the approval of Central Government** (S. 44A/45). Before the amendment, the provisions relating to voluntary/ compulsory amalgamations and reconstruction of banking companies under the BR Act were not applicable to co-operative banks. Now, these provisions have been extended to the co-operative banks.
14.	**RBI powers to notify the application of provisions of certain sections of the Act to a specific co-operative bank or a class of co-operative banks** (S.53A) This section has provided flexibility to RBI to apply certain provisions of the BR Act and also exempting certain co-operative banks from the purview of amended provisions.
Provisions of item (iii) of clause (b) of sub-section (1), and sub-section (2) of section 10, clause (a) of sub-section (2) of section 10A, sub-section (1A) of section 10B, and clause (b) of sub-section (1) of section 35B of the B R Act, 1949 (AACS) shall not apply to a primary co-operative bank having liabilities in the form of deposits amounting to less than Rs 100 crores as per preceding year's audited balance sheet and to a primary co-operative bank, which is a Salary Earners' Co-operative Bank. [Ref. No. DoR.HGG.GOV. 668/12.10.000/2020-21 dated March 23, 2021 - THE GAZETTE OF INDIA, JUNE 12, 2021]	

Reference –

1. B R Act, 1949 (AACS)
2. Master Circular- Exposure Norms and Statutory / Other Restrictions – UCBs - DoR.CRE.REC.71/07.10.002/2023-24 dated January 16, 2024
3. Master Direction - Reserve Bank of India [Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions - 2021 (Updated as on September 25, 2023)

Chapter V

Supervisory Action Framework

Chapter V

Supervisory Action Framework

5.1 Introduction

5.1.1 Urban Co-operative Banks (UCBs) are subject to supervision, both onsite inspection and offsite surveillance, by the RBI as per the provisions of the Banking Regulation (BR) Act, 1949 (AACS). RBI conducts supervision of UCBs to assess their financial position as well as their adherence to the various statutory and regulatory requirements. The offsite supervision is conducted based on periodical returns/ statements submitted by the UCBs. Based on the assessment of the UCB, RBI initiates supervisory action(s), if needed. Supervisory actions initiated by the RBI are always in accordance with the supervisory rating framework for the UCBs. Since March 2009, RBI moved from graded supervisory rating model to CAMELS (**C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, **S**ystems and controls) rating for the UCBs. The CAMELS rating is continuously fine-tuned by RBI to bring it in greater alignment with the functioning of the UCBs.

5.1.2 RBI introduced the Supervisory Action Framework (SAF) based on certain trigger points for UCBs for the first time in 2012. The SAF was revised subsequently in 2014 and has again been revised in 2020[27] to make it more effective. The revised SAF envisages initiation of corrective action by the UCB and/ or supervisory action by the RBI on breach of the specified thresholds (triggers) in respect of the specified financial parameters/ indicators (as detailed in para 5.2 below).

5.1.3 RBI will typically initiate the supervisory action under the revised SAF based on the financial position of UCBs as assessed during the statutory inspection. However, RBI may also initiate supervisory action based on the review of the reported/ audited financial position, if needed. Further, apart from the trigger points and the supervisory action detailed below, RBI may also take appropriate supervisory action(s) on other indicators/ parameters, if observed to be necessary due to stress or severe governance issues.

5.2 Thresholds/triggers and Supervisory Action

RBI may initiate one or a combination of more supervisory action(s) depending upon the severity of the stress in the UCB.

[27] Circular DOR (PCB).BPD.Cir No. 9/12.05.001/2019-20 dated January 06, 2020

5.2.1 Asset Quality

Trigger Point	Net NPAs exceed 6% of its net advances
Supervisory Actions	• UCB may be advised to submit a Board-approved Action Plan for reducing its Net NPAs below 6%. • Board of Directors may be advised to review the progress under the Action Plan on a quarterly/ monthly basis. • UCB may be advised to submit the post-review progress report to RBI. • UCB may be restricted from declaring/ paying dividend/ donation without prior approval of RBI. • UCB may have to curtail sanction/ renewal of credit facilities to sectors/ segments having a high proportion of NPAs/ defaults. • UCB may have to reduce its exposure limits for new loans and advances. • UCB may be restricted for sanctioning new loans and advances carrying risk-weights more than 100%.

5.2.2 Profitability

Trigger Point	Continuous losses for two consecutive financial years or has accumulated losses on its balance sheet.
Supervisory Action	• UCB may be advised to submit a Board-approved Action Plan for restoring the profitability and /or wiping out the accumulated losses • Board of Directors of the UCB may be advised to review of progress under the Action Plan on a quarterly (or more frequent) basis. • UCB may be prohibited from declaration /payment of dividend /donation. • UCB may be required to take prior approval from RBI before incurring capital expenditure beyond a specified limit. • UCB may be advised to put in place measures for reduction in interest and operating /administrative expenses.

5.2.3 Capital to Risk-weighted Assets Ratio (CRAR)

Trigger Point	CRAR falls below the minimum regulatory requirement of 9%
Supervisory Action	• UCB may be advised to submit a Board-approved Action Plan for increasing the CRAR to 9% or above within 12 months. • Board of Directors of the UCB may be advised to review the progress under the Action Plan on a quarterly /monthly basis and may be advised to submit the post-review progress report to RBI. • UCB may be advised to have a Board-approved proposal for either merging itself with another bank or converting itself into a credit society. • UCB may be prohibited from declaration/payment of dividend/donation. • UCB may be restricted on incurring capital expenditure beyond a specified limit, without prior approval of the Reserve Bank

	• UCB may be advised to put in place measures for reduction in interest and operating /administrative expenses. • UCB may have to reduce their exposure limits for new loans and advances. • UCB may be restricted for sanctioning new loans and advances carrying risk-weights beyond the specified limit. • UCBs may be advised not to expand the size of its balance sheet • Restriction on fresh borrowings, except for meeting temporary liquidity mismatches. • UCBs may be prohibited from sanctioning /disbursal of fresh loans and advances other than loans against collateral security of term deposits / NSCs / KVPs / insurance policies. • UCBs may be prohibited from the expansion of the size of its deposits.

5.2.4 Other Critical Issues

Trigger Point	The functioning of the UCB is no longer considered to be in the interest of its depositors /public.
Supervisory Action	• All-inclusive directions under section 35A of the Banking Regulation Act, 1949 (as applicable to co-operative societies) may be imposed on the UCB. • UCB may be issued a show-cause notice for cancellation of its banking license.

Reference –

RBI Circular dated January 06, 2020, on 'Supervisory Action Framework' (DOR (PCB).BPD.Cir No. 9/12.05.001/2019-20).

MODULE II

Primary (Urban) Co-operative Banks
Capital, Investments, and Funds Management

This module presents a bouquet of three chapters which provide a detailed description of RBI guidelines on Capital Adequacy, Investment Management, and Funds & Liquidity Management. Together these chapters besides explaining the regulatory architecture relating to the subjects, provide a clear understanding of mobilization and deployment of funds by Urban Cooperative Banks.

Chapter VI

Capital Adequacy Framework

Chapter VI

Capital Adequacy Framework

6.1 Need for Capital

The bank acts as a financial intermediary between various participants in an economy. The banks, while doing so, brings in many risks on their books. The banks normally put in place safeguards, in the form of systems and controls, to manage those risks. In case the risk materializes, the banks may suffer losses. The capital acts as a buffer to absorb such losses. The sufficiency of the available capital in the banks, therefore, instil the confidence of the depositors. As such, the world over, the adequacy of capital is one of the pre-conditions for licensing of a new bank as well as its continuance in the banking business.

6.2 Statutory and Regulatory Capital Requirements

6.2.1 The banks in India, both commercial and co-operative banks, are governed by the Banking Regulation (BR) Act, 1949. The BR Act 1949 prescribes minimum statutory capital required for the banks to operate in India. The BR Act 1949 also provides powers to the RBI to prescribe regulatory capital and the other related regulations for the banks in India.

6.2.2 As per Section 11 of the BR Act 1949 (AACS), no co-operative bank shall commence or carry on the business of banking in India unless the aggregate value (real or exchangeable) of its paid-up capital and reserves is not less than rupees one lakh.

6.2.3 In addition to above, under Section 22 (3) (d) of the above Act, the RBI prescribes minimum capital requirement (termed as entry point norms) for starting a new UCB.6.2.4 Apart from the above, there was a need to prescribe capital adequacy to ensure its sufficiency vis-à-vis the risk elements in various types of assets in the balance sheet as well as in the off-balance sheet business, in compliance with Basel norms. Therefore, RBI prescribed the capital adequacy ratio (i.e. Capital to Risk-weighted Assets Ratio (CRAR)) of 9% for the UCBs since 2005.

6.3 Capital Adequacy Norms

The first common approach to the capital adequacy norms was prescribed in 1988 under Basel-I. The important features of capital adequacy norms are: -

(a) Tier Approach to Capital

In this approach, depending upon the certain eligibility criteria, the total capital is classified under one of the following two levels (or 'tiers'):-

. (i) Core Capital (termed as Tier I Capital).

(ii) Supplementary Capital (termed as Tier II Capital)

Further, minimum 50% of the total capital should be the core capital. In other words, the maximum amount of supplementary capital (Tier-II capital) that can be included in total capital is restricted to 100% of the core capital (i.e., Tier-I capital). For example, if the core capital is ₹100 lakh, then only ₹100 lakh of supplementary capital may be included in total capital, even if the supplementary capital of the bank is, say, ₹150 lakh.

(b) Risk-Weighted Assets

It comprises both exposures, i.e. the assets on the balance sheet and off-balance sheet items. These exposures are risk-adjusted as per their perceived credit risk by multiplying them with the corresponding risk weights. Depending upon the riskiness of the exposure, the different risk weights ranging from 0% to 127.5% are applied. For example, inter-bank assets are assigned a 20% risk weight. The off-balance sheet item is first converted into exposure by multiplying it with credit conversion factor (CCF), and after that, corresponding risk weight is applied.

(c) Capital to Risk-Weighted Assets (CRAR)

CRAR, is also commonly termed as capital adequacy ratio, is computed as under: -

$$\text{CRAR} = \frac{\text{Tier I Capital + Tier II Capital}}{\text{Total Risk-Weighted Assets (RWAs)}} \times 100$$

UCBs shall maintain minimum CRAR as under:

- Tier 1 UCBs shall maintain, as hitherto, a minimum CRAR of 9 per cent of Risk Weighted Assets (RWAs) on an ongoing basis.
- Tier 2 to 4 UCBs shall maintain a minimum CRAR of 12 per cent of RWAs on an ongoing basis.
- UCBs in Tier 2 to 4, which do not currently meet the revised CRAR of 12 per cent of RWAs, shall achieve the same in a phased manner. Such UCBs shall achieve the CRAR of at least 10 per cent by March 31, 2024, 11 per cent by March 31, 2025, and 12 per cent by March 31, 2026.

6.4 Components of Tier I Capital

6.4.1 Tier I capital would include the following items:-

(i) Paid-up share capital[1] collected from regular members having voting rights.

(ii) Contributions received from associate / nominal members where the bye- laws permit allotment of shares to them and provided there are restrictions on withdrawal of such shares, as applicable to regular members.

(iii) Contribution / non-refundable admission fees collected from the nominal and associate members which is held separately as 'reserves' under an appropriate head since these are not refundable.

(iv) Perpetual Non-Cumulative Preference Shares (PNCPS), which comply with the regulatory requirements.

(v) Free Reserves as per the audited accounts. Reserves, if any, created to meet outside liabilities should not be included in the Tier I Capital. Free reserves shall exclude all reserves / provisions which are created to meet anticipated loan losses, losses on account of fraud etc., depreciation in investments and other assets and other outside liabilities. For example, while the amounts held under the head "Building Fund" will be eligible to be treated as part of free reserves, "Bad and Doubtful Reserves" shall be excluded.

(vi) Capital Reserves representing surplus arising out of sale proceeds of assets.

(vii) Perpetual Debt Instruments (PDIs) which comply with the regulatory requirements.

(viii) Any surplus (net) in Profit and Loss Account i.e., balance after appropriation towards dividend payable, education fund, other funds whose utilisation is defined, asset loss, if any, etc.

(ix) Outstanding amount in Special Reserve created under Section 36(1) (viii) of the Income Tax Act, 1961

(x) Revaluation reserves, arising out of change in the carrying amount of a bank's property consequent upon its revaluation, may be reckoned as Tier 1 capital at a discount of 55 per cent, subject to meeting the following conditions:

- the bank is able to sell the property readily at its own will and there is no legal impediment in selling the property;
- the revaluation reserves are presented/disclosed separately under "Reserve Fund and Other Reserves" in the Balance Sheet;
- revaluations are realistic, in accordance with applicable accounting standards;
- valuations are obtained, from two independent valuers, at least once in every three years;
- where the value of the property has been substantially impaired by any event, these are to be immediately revalued and appropriately factored into capital adequacy computations;
- the external auditor(s) of the bank have not expressed a qualified opinion on the revaluation of the property;
- RBI Guidelines on Valuation of Properties – Empanelment of Valuers as included in the Master Circular on Management of Advances – UCBs, are strictly adhered to.

Revaluation reserves which do not qualify as Tier 1 capital shall also not qualify as Tier 2 capital. The bank may choose to reckon revaluation reserves in Tier 1 capital or Tier 2 capital at its discretion, subject to fulfilment of all the conditions specified above.

6.4.2 The following points may be noted while computing the total Tier I Capital: -

(i) Amount of intangible assets, losses in a current year and those brought forward from previous periods, deficit in NPA provisions, income wrongly recognized on non-performing assets, the provision required for liability devolved on the bank, etc. will be deducted from Tier I Capital.

(ii) For a Fund to be included in the Tier I Capital, the Fund should satisfy two criteria viz., the Fund should be created as an appropriation of net profit and should be a free reserve and not a specific reserve.

(a) For example, if any Fund has been created by a charge on the profit (and not by the appropriation of profit), then it is in effect a provision. Therefore, it will not be eligible for being reckoned as Tier I capital.

(b) Similarly, suppose any Fund has been created by the appropriation of profit but is attributed to any identified potential loss or diminution in value of an asset or a known liability. In that case, it will not be eligible for reckoned as Tier I capital.

6.5 Components of Tier II Capital

6.5.1 Tier II capital would include the following items:-

(i) General Provisions and Loss Reserves

(a) These would include such provisions (created by the charge to Profit and Loss Account) of general nature appearing in the books of the bank which are not attributed to any identified potential loss or a diminution in value of an asset or a known liability.

(b) Adequate care must be taken to ensure that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering any amount of general provision as part of Tier II capital as indicated above.

For example, General provision for Standard Assets, excess provision on transfer of stressed loan etc. could be considered for inclusion under this category.

(c) Such provisions which are considered for inclusion in Tier II capital will be admitted up to 1.25% of total weighted risk assets.

The prudential treatment of different type of provisions and its treatment for capital adequacy purposes is given below:

(a) **Additional general provisions (floating provisions)** for bad debts, i.e., provisions not earmarked for any specific loan impairments (NPAs) may be used either for netting off of gross NPAs or for inclusion in Tier II capital(within overall ceiling of 1.25% of total RWA) but cannot be used on both counts

(b) **Additional Provisions for NPAs at higher than prescribed rates:** In cases where banks make specific provision for NPAs in excess of what is prescribed under the prudential norms, the total specific provision may be deducted from the amount of Gross NPAs while reporting the amount of Net NPAs. The additional specific provision made by the bank will not be reckoned as Tier II capital.

(c) **Excess Provisions on transfer of stressed loans to Asset Reconstruction Companies (ARC):** Excess provisions on transfer of stressed loans to ARC, until reversal, shall continue to be shown under 'provisions' and would be considered as Tier II capital within the overall ceiling of 1.25% of risk weighed assets.

(ii) Investment Fluctuation Reserve (IFR)

(a) Investment Fluctuation Reserve, irrespective whether it is below the regulatory requirement of 5% or above 5%, may be considered as Tier II capital.

(b) Excess Investment Depreciation Reserve (IDR) may not be considered for Tier I or Tier II capital. Excess IDR needs to be reversed as per Master Circular on Investments by UCBs, as updated. From time to time.

“If IDR created on account of depreciation in investments is found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss Account and an equivalent amount (net of taxes, if any, and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to the IFR Account to be utilised to meet future depreciation requirement for investments.”

(iii) Hybrid Capital Instruments

(a) UCBs are permitted to issue Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative Preference Shares (RNCPS)/ Redeemable Cumulative Preference Shares (RCPS) with the prior permission of the respective Registrar/ Central Registrar of Cooperative Societies (RCS/ CRCS) granted in consultation with the Reserve Bank. These three instruments collectively are referred to as Tier II preference shares.

(b) These Tier II preference shares should be issued at par and should not have ‘Put’ option.

(c) The Tier II preference shares could be either perpetual (PCPS) or dated (RNCPS and RCPS) instruments with a fixed maturity of minimum 15 years.

(d) The Tier II preference shares should be fully paid-up, unsecured, and free of any restrictive clauses. However, the investors in Tier II preference shares shall not be eligible for any voting rights.

(e) The Redeemable Preference Shares (both cumulative and non-cumulative) shall be subjected to a progressive discount for capital adequacy purposes over the last five years of their tenor (detail below in table)

Remaining Period of Maturity	Rate of Discount
Less than one year	100%

One year and more but less than two years	80%
Two years and more but less than three years	60%
Three years and more but less than four years	40%
Four years and more but less than five years	20%

(iv) Subordinated Debt

(a) To be eligible for inclusion in Tier II capital, the instrument should be fully paid up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses and should not be redeemable at the initiative of the holder or without the consent of the banks' supervisory authorities.

(b) They often carry a fixed maturity, and as they approach maturity, they should be subjected to progressive discount (as detail in the table below) for inclusion in Tier II capital.

Remaining Period of Maturity	Rate of Discount
Less than one year	100%
More than one year and Less than two years	80%
More than two years and less than three years	60%
More than three years and less than four years	40%
More than four years and less than five years	20%

(c) Instruments with an initial maturity of less than five years should not be included as part of Tier II capital.

(d) Subordinated debt instruments will be limited to 50 per cent of Tier I capital.

6.6 Share linking to Borrowings

Borrowings from UCBs shall be linked to shareholdings of the borrowing members as below:

i. 5 per cent of the borrowings, if the borrowings are on unsecured basis.

ii. 2.5 per cent of the borrowings, in case of secured borrowings.

iii. In case of secured borrowings by Micro and Small Enterprises (MSEs), 2.5 per cent of the borrowings, of which 1 per cent is to be collected initially and the balance of 1.5 per cent is to be collected in the course of next 2 years.

The above share linking norms may be applicable for member's shareholdings up to the limit of 5 per cent of the total paid up share capital of the bank. Where a member is already holding 5 per cent of the total paid up share capital of a UCB, it would not be necessary for him / her to subscribe to any additional share capital on account of the application of extant share linking norms. In other words, a borrowing member may be required to hold shares for an amount that may be computed as per the extant share linking norms or for an amount that is 5 per cent of the total paid up share capital of the bank, whichever is lower.

Share-linking to borrowing norms shall be discretionary for UCBs which meet the minimum regulatory CRAR criteria of 9 per cent and a Tier 1 CRAR of 5.5 per cent as per the latest audited financial statements and the last CRAR as assessed by RBI during statutory inspection. Such UCBs shall have a Board-approved policy on share-linking to borrowing norms which shall be implemented in a transparent, consistent and non-discriminatory manner. The policy may be reviewed by the Board at the beginning of the accounting year. UCBs, which do not maintain the minimum CRAR of 9 percent and Tier 1 CRAR of 5.5 per cent, shall continue to be guided by the norms on share-linking to borrowing as specified above.

Perpetual Non-Cumulative Preference Shares (PNCPS) held by members/ subscribers, may be treated as shares for the purpose of compliance with the extant share linking to borrowing norms.

6.7 Refund of share capital

In terms of Section 12 (2) (ii) read with Section 56 of the BR Act, a co-operative bank shall not withdraw or reduce its share capital, except to the extent and subject to such conditions as the Reserve Bank may specify in this behalf. Accordingly, it has been decided to permit UCBs to refund the share capital to their members, or nominees / heirs of deceased members, on demand[2], subject to the following conditions:

a) The bank's CRAR is 9 per cent or above, both as per the latest audited financial statements and the last CRAR as assessed by RBI during statutory inspection.

b) Such refund does not result in the CRAR of the bank falling below regulatory minimum of 9 per cent.

For the purpose of computing CRAR as above, accretion to capital funds after the balance sheet date[3], other than by way of profits, may be taken into account. Any reduction in capital funds, including by way of losses, during the aforesaid period shall also be considered.

6.8 Measures for protection of investors in regulatory capital instruments

For the purpose of enhancing investor education on the risk characteristics of regulatory capital instruments, UCBs, which issue regulatory capital instruments shall adhere to the following conditions:

a) For floating rate instruments, banks should not use its Fixed Deposit rate as benchmark.

b) A specific sign-off, as quoted below, from the investors, for having understood the features and risks of the instruments, may be incorporated in the common application form of the proposed issue:

"By making this application, I / we acknowledge that I / we have understood the terms and conditions of the issue of [Name of the share/security] being issued by [Name of the bank] as disclosed in the Prospectus and Offer Document".

c) UCBs shall ensure that all the publicity material / offer document, application form and other communication with the investor should clearly state in bold letters (Arial font, size 14, equivalent size in English / Vernacular version) how a PNCPS / PCPS / RNCPS / RCPS / PDI / LTSB, as the case may be, is different from a fixed deposit, and that these instruments are not covered by deposit insurance.

d) The procedure for transfer to legal heirs in the event of death of the subscriber of the instrument should also be specified.

7. Capital for Market Risk: Market risk is defined as the risk of losses in on-balance sheet and off- balance sheet positions arising from movements in market prices. The market risk positions, which are subject to capital charge are as under:

- The risks pertaining to interest rate related instruments and equities in the trading book; and
- Foreign exchange risk (including open position in precious metals) throughout the bank (both banking and trading books).

As an initial step towards prescribing capital requirement for market risks, UCBs were advised to assign an additional risk weight of 2.5 per cent on investments. These additional risk weights are clubbed with the risk weights prescribed for credit risk in respect of investment portfolio of UCBs, and banks are not required to provide for the same separately. Further, UCBs are advised to assign a risk weight of 100% on the open position limits on foreign exchange and gold, and to build up investment fluctuation reserve as per extant instructions. UCBs having AD Category I license are required to provide capital for market risk in terms of circular UBD.BPD(PCB)Cir.No.42/09.11.600/2009-10 dated February 8, 2010 as updated from time to time.

8. Returns

Banks should furnish to the respective Regional Offices annual return indicating (i) capital funds, (ii) conversion of off-balance sheet / non-funded exposures, (iii) calculation of risk-weighted assets, and (iv) calculation of capital funds and risk assets ratio in the prescribed format.

9. Net Worth

UCBs shall have minimum net worth as under:

- Tier 1 UCBs operating in a single district shall have minimum net worth of ₹2 crore.
- All other UCBs (of all tiers) shall have minimum net worth of ₹5 crore.
- UCBs which currently do not meet the minimum net worth requirement, as above, shall achieve the minimum net worth of ₹2 crore or ₹5 crore (as applicable) in a phased manner. Such UCBs shall achieve at least 50 per cent of the applicable minimum net worth on or before March 31, 2026 and the entire stipulated minimum net worth on or before March 31, 2028.

Computation of Net Worth by UCBs

Sr. No.	Description	Amount (Rs. crore)
1	Paid-up share capital collected from regular members having voting powers	
2	Perpetual Non-Cumulative Preference Shares (PNCPS)	
3	Contributions received from associate/ nominal members where the by-laws permit allotment of shares to them and provided there are restrictions on withdrawals of such shares, as applicable to regular members	
4	Contribution/ non-refundable admission fees collected from the nominal and associate members which is held separately as 'reserves' under an appropriate head since these are not refundable	
5	Free Reserves including "Building Fund", Capital Reserves etc. but excluding Revaluation Reserves. Free reserves shall exclude all reserves / provisions which are created to meet anticipated loan losses, losses on account of fraud etc., depreciation in investments and other assets, and other outside liabilities.	
6	Investment Fluctuation Reserve (IFR) in excess of stipulated 5% of investment in AFS & HFT categories[1]	
7	Credit balance in Profit & Loss Account, if any	
	Deductions	
8	Debit balance in Profit & Loss Account, if any	
9	All Intangible Assets, including, inter alia, Deferred Tax Assets (DTA)	

Note:

1. Funds raised through Perpetual Debt Instruments included in Tier 1 capital and debt capital instruments included in Tier 2 capital should not be reckoned as part of net worth.

2. Perpetual Cumulative Preference Shares (PCPS), Redeemable Non-Cumulative Preference Shares (RNCPS) and Redeemable Cumulative Preference Shares (RCPS) included in Tier 2 capital should not be reckoned as part of net worth.

3. No general or specific provisions should be included in computation of net worth.

Reference –

- Master Circular DOR.CAP.REC.11/09.18.201/2023-24 dated April 20, 2023.

Chapter VII

Investment Management

Chapter VII

Investment Management

7.1 Investment Portfolio

The investment portfolio of UCBs plays a key role in liquidity and funds management. Banks also need to invest in order to fulfil the statutory liquidity ratio (SLR) obligations. Over and above this statutory requirement, if the banks make informed decisions and constantly monitor their investments, it can yield good income to the bank and can also help in efficient funds and liquidity management. Presently, the UCBs are prohibited from investing in the equities market in any form, either directly or indirectly. However, they are free to invest in government securities, other debt securities, debt-oriented mutual funds, commercial paper, treasury bills, corporate bonds, debentures etc.

7.2 Investment Policy

a. All UCBs should have a Board approved Investment Policy. The BOD should take an active interest in laying down a comprehensive investment policy encompassing transaction guidelines, and control mechanism. The board should ensure that the policy is adhered to in all the investment transactions undertaken by the UCBs.

b. The policy should be reviewed every year by the Board in tune with the regulatory requirement and market operations.

c. The authority to put through the deals, the maximum permissible exposure ceiling, the reporting mechanism etc. should be detailed in the policy

d. The policy has to lay down internal control mechanism, the audit and inspection mechanism to cover the investment transactions.

e. The policy should cover nature and extent of investments intended to be made in non-SLR securities and proper risk management systems for making investment in non-SLR securities which should include entry-level minimum credit ratings/ quality standards and industry-wise, maturity-wise, duration-wise, issuer-wise, etc., limits to mitigate the adverse impact of concentration and liquidity risk.

7.3 Guidelines on Investment

"UCBs cannot undertake investments as agents or on behalf of its clients as Portfolio Management Services (PMS). UCBs are also not allowed to undertake purchase/sale with broking firms or intermediaries on a principal to principal basis. UCBs generally cannot undertake the sale of securities without actually holding them in the portfolio. However, well managed Urban Co-operative Banks, who are members of NDS-OM and have a regular concurrent audit of their treasury operations, have been permitted to undertake short selling of Government Securities, subject to fulfilling the certain conditions and permission from the

Regional Offices concerned to undertake such transactions. UCBs are also required to adhere to the Short Sale (Reserve Bank) Directions, 2018 issued by the Financial Market Regulation Department of RBI, as updated from time to time.

7.4 Negotiated Dealing System – Order Matching

All licensed UCBs fulfilling the eligibility criteria contained in circular IDMD.DOD.No.13/10.25.66/2011-12 dated November 18, 2011 as amended from time to time, are allowed direct access to Negotiated Dealing System – Order Matching platform. The eligibility criteria are as under:

a. Current account with RBI or a funds account with one of the Designated Settlement Banks (DSBs) chosen by Clearing Corporation of India Limited (CCIL) for funds settlement.
b. Subsidiary General Ledger (SGL) Account with RBI.
c. Membership of Negotiated Dealing System (NDS).
d. Indian Financial Network (INFINET) connectivity.
e. Membership of CCIL.
f. Minimum Capital to Risk Weighted Assets Ratio (CRAR) of 9 per cent.
g. Net Non-Performing Assets (NPA) of less than 5 per cent.
h. Minimum net worth of ₹25 crore.

All eligible UCBs desirous of obtaining NDS-OM membership are required to apply to concerned Regional Office of the Department of Supervision, RBI, for regulatory clearance before applying to Financial Markets Regulation Department (FMRD), RBI for NDS-OM membership.

Eligible UCBs applying for NDS-OM membership need to have the required infrastructure in place for direct access to NDS-OM and also bear the cost involved in setting up the infrastructure. After opening a SGL account with the RBI (which is one of the several requirements to be fulfilled by a UCB for obtaining NDS-OM membership), the UCB concerned cannot open / maintain a gilt account with a CSGL account holder. However, such UCBs can continue to bid for Government securities under the scheme of non-competitive bidding in Government securities.

UCBs having an SGL account with RBI can directly deal (buy/sell) in the government securities using the platform, NDS-OM. The banks holding constituent accounts (CSGL) can also deal on the NDS-OM by obtaining login credentials through the bank (primary member -PM) with whom they are maintaining their CSGL account. NDS-OM is a screen-based electronic anonymous order matching system for secondary market trading in Government securities owned by RBI and operated by Clearing Corporation of India Limited (CCIL). The system is owned by RBI and there are no charges for use of this application by clients. However, since all trades are to be guaranteed and settled by CCIL, PMs will have to pay settlement charges and also continue to deposit adequate margin on behalf of their clients to CCIL All NDS OM-Web users need to use Digital Certificates issued by the designated Certifying Authority, embedded into e-tokens (of the prescribed configuration). A safe, reliable, stable internet connection with suitable bandwidth and hardware infrastructure is necessary for efficient operations.

7.5 Engagement of Brokers

The inter-bank securities transactions should be undertaken directly between banks and no bank should engage the services of any broker in such transactions. Banks may, however, undertake securities transactions among themselves or with non-bank clients through members of the National Stock Exchange (NSE), the Bombay Stock Exchange, Mumbai (BSE)/Over the Counter Exchange of India (OTCEI) wherein the transactions are transparent. The SBI DFHI has been permitted to operate as a broker in the inter- bank participation market. This would enable the banks to seek intermediation of SBI DFHI for borrowing/lending, if required. However, the banks shall be free to settle transactions in the inter-bank participations market directly, if so desired.

If a deal is put through with the help of a broker, the role of the broker should be restricted to that of bringing the two parties to the deal together. Under no circumstances banks should give power of attorney or any other authorisation to the brokers/ intermediaries to deal on their behalf in the money and securities markets.

Disclosure of counter party should be insisted upon on conclusion of the deal put through brokers. Banks should have a Board approved a panel of brokers. The banks have to ensure that there is even distribution of business amongst a panel of brokers. A limit of 5% of total transactions (both purchases and sales) entered into by the banks during a year should be treated as the aggregate upper contract limit for each of the approved brokers.

7.6 SLR and Non-SLR investments

Investment portfolio of banks is broadly classified into SLR securities and Non-SLR securities. However, the investments are classified in the Balance Sheet, for the purpose of disclosure, under five groups namely, i) Government Securities, ii) Other approved securities, iii) Shares, iv) Corporate Bonds and v) Others.

7.6.1 SLR Investments

In terms of provisions of section 24 of the BR Act 1949, (AACS), every primary (urban) cooperative bank is required to maintain liquid assets, which at the close of business on any day should not be less than the prescribed percent of its demand and time liabilities in India (in addition to the minimum cash reserve requirement). The Reserve Bank of India decides the form and manner in which the SLR has to be maintained by the banks. The 'approved securities' are as defined by section 5(a) (i) & (ii) of the Banking Regulation Act, 1949 (AACS). All Scheduled UCBs and non-scheduled UCBs are required to maintain SLR in the form of Government and other approved securities only. All UCBs are required to maintain investments in Government Securities only in SGL accounts with Reserve Bank or in CSGL Accounts with PDs, scheduled commercial banks, and state co-operative banks and Stock Holding Corporation of India Ltd.(SHCIL) or in the dematerialised accounts with depositories such as National Securities Depositories Ltd (NSDL), Central Depository Services Ltd. (CDSL), and National Securities Clearing Corporation Ltd. (NSCCL).

7.6.2 Non-SLR investments

UCBs are allowed to undertake eligible transactions for acquisition/ sale of non-SLR investment in the secondary market with mutual funds, pension/ provident funds and insurance companies, in addition to undertaking transactions with scheduled commercial banks and primary dealers. All fresh investments under Non-SLR category should be classified under Held for Trading (HFT)/ Available for Sale (AFS) categories only and marked to market as applicable to these categories of investments. However, investments in the long term bonds issued by companies engaged in executing infrastructure projects and having a minimum residual maturity of seven years may be classified under Held to Maturity (HTM) category.

In order to contain risks arising out of the non-SLR investment portfolio of banks, the following restrictions have been put:

Prudential limits: Non-SLR investment should not exceed 10% of the aggregate deposits of March 31st of the preceding year. Unlisted non-SLR investments should not exceed 10% of the total non-SLR investments as on March 31st of the previous year. All Non-SLR investments will be subject to the prescribed prudential single/group counterparty exposure limits.

Instruments: UCBs should not invest in any form of equity instruments. They can invest only in debt instruments, namely, CPs, CDs Units of Debt and money market mutual funds and money market instruments.

Restrictions: UCBs are not permitted to invest in perpetual debt instruments.

7.6.3 Zero-Coupon Bonds: Investment in zero-coupon bonds is prohibited unless the issuer maintains and builds a sinking fund to redeem the bonds and keeps the funds invested in Government securities.

7.7 Classification of Investments

UCBs are required to classify their entire investment portfolio (including SLR and Non-SLR securities) under three categories viz. –

i. Held to Maturity (HTM)
ii. Available for Sale (AFS)
iii. Held for Trading (HFT)

Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

7.7.1 Held to Maturity

Securities acquired by the banks with the intention to hold them up to maturity will be classified under HTM category. The investments included under HTM category should not exceed 25 per cent of the bank's total investments. However, UCBs are permitted to exceed the limit of 25 per cent, of their total investments, under HTM category provided, the excess comprises of:

a. SLR securities. However, the total SLR securities held in the HTM category is not more than 25 per cent of their NDTL as on the last Friday of the second preceding fortnight.
b. Investments made by UCBs under Targeted Long-term Repo Operations (TLTRO) as specified by the Reserve Bank of India.

UCBs are not expected to resort to the sale of securities held in the HTM category. However, if due to liquidity stress, UCBs are required to sell securities from HTM portfolio, they may do so with the permission of their Board of Directors, and rationale for such sale may be clearly recorded. Profit on sale of investments from HTM category shall first be taken to the Profit and Loss account and, thereafter, the amount of such profit shall be appropriated to 'Capital Reserve' from the net profit for the year after statutory appropriations. Loss on a sale shall be recognized in the Profit and Loss Account in the year of sale.

7.7.2 Held for Trading

Securities acquired by the banks with the intention to trade, by taking advantage of the short-term price/interest rate movements, will be classified under the HFT category. Securities kept in this category is to be sold within 90 days from the date of purchase or putting them in this category. If banks are not able to sell the security within 90 days due to exceptional circumstances such as tight liquidity conditions, or extreme volatility, or market becoming unidirectional, the security can be shifted to the AFS category subject to depreciation, if any, applicable on the date of transfer, with the approval of the Board of Directors/Investment Committee.

7.7.3 Available for Sale

Securities which do not fall within the above two categories will be classified under AFS category. Banks have the freedom to decide on the extent of holdings under the AFS category. This may be decided by them considering various aspects such as intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position, etc. Profit or loss on the sale of investments in HFT & AFS categories should be taken to Profit and Loss Account.

7.7.4 Shifting of investments

Banks may shift investments to/from HTM category with the approval of the Board of Directors once in a year. Such shifting is normally allowed at the beginning of the accounting year. No further shifting to/from this category will be allowed during the remaining part of that accounting year. Shifting securities from AFS to HFT also has to be approved by the Board. Shifting from HFT to AFS generally is not permitted but under exceptional circumstances, they may shift securities to AFS category. Shifting is to be done at acquisition cost/ market value or book value whichever is least on the date of shifting and the depreciation if any, should be fully provided for. In case of shifting of security to HTM category, the transfer should be done at the lower of the book value or market value (by reducing the book value, in case of loss) and the resultant loss should be debited to the Profit & Loss Account, or, IDR account if in surplus.

7.8 Valuation of investments

Investments classified under HTM category need not be marked to market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortized by debit to Profit & Loss account over the period remaining to maturity. The individual scrip in the AFS category will be marked to market at quarterly or at more frequent intervals. The book value of the individual securities would not undergo any change after the valuation. The individual scrip in the HFT category will be marked to market at monthly or at more frequent intervals. The book value of individual securities in this category would not undergo any change after marking to market.

Securities under AFS and HFT categories shall be valued scrip-wise and depreciation/appreciation shall be aggregated for each classification, namely, i) Government Securities, ii) Other approved securities, iii) Shares, iv) Corporate Bonds and v) Others, separately for AFS and HFT. Net depreciation, if any, shall be provided for. Net appreciation, if any, should be ignored. Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification. Similarly, net depreciation for any classification in one category should not be reduced from appreciation in similar classification in another category.

The 'market value' for the purpose of periodical valuation of investments included in the AFS and the HFT categories would be the market price of the scrip as available from the trades/quotes on the stock exchanges, and/or as listed by Financial Benchmarks India Private Limited (FBIL). Treasury Bills should be valued at carrying cost. In respect of unquoted non-SLR securities, valuation should be done on the YTM basis using the appropriate markup, based on rating and residual maturity, over the YTM rates for Central Government securities as put out by FBIL periodically.

7.9 Investment Depreciation Reserve

Investment Depreciation Reserve required to be created on account of depreciation in the value of investments held under 'AFS' or 'HFT' categories in any year should be debited to the Profit & Loss Account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to Statutory Reserve) or the balance available in the IFR Account, whichever is less, shall be transferred from the IFR Account to Profit & Loss Account. In the event that IDR created on account of depreciation in investments is found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss Account and an equivalent amount (net of taxes, if any, and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to the IFR Account to be utilised to meet future depreciation requirement for investments. The amounts debited to the Profit & Loss Account for depreciation provision and the amount credited to the Profit & Loss Account for reversal of excess provision should be debited and credited respectively under the head "Expenditure - Provisions & Contingencies". The amounts appropriated from the Profit & Loss Account/ to IFR and the amount transferred from the IFR to the Profit & Loss Account should be shown as 'below the line' items after determining the profit for the year.

7.10 Investment Fluctuation Reserve (IFR):

Banks should build up IFR out of realized gains on the sale of investments, and subject to available net profit, of a minimum of 5 per cent of the investment portfolio. This minimum requirement should be computed with reference to investments in two categories, viz. HFT and AFS. However, banks are free to build up a higher percentage of IFR depending on the size and composition of their portfolio, with the approval of their Board of Directors. Transfer to IFR shall be as an appropriation of net profit, after appropriation to Statutory Reserve, which would be eligible for inclusion in Tier II capital. Creation of IFR as per the above guidelines is mandatory for all UCBs.

UCBs may, at their discretion, draw down the balance available in IFR in excess of 5 per cent of its investment in AFS & HFT, for credit to the balance of profit/loss as disclosed in the profit and loss account at the end of any accounting year. In the event the balance in the IFR is less than 5 per cent of its investment in AFS & HFT, a drawdown will be permitted subject to the following conditions:

a) The drawn down amount is used only for meeting the minimum Tier I capital requirements by way of appropriation to free reserves or reducing the balance of loss, and

b) The amount drawn down is not more than the extent to which the MTM provisions made during the aforesaid year exceed the net profit on the sale of investments during that year.

7.11 Investment Accounting

In respect of the booking of income on units of mutual funds (debt mutual funds and money market mutual fund) and equity of AIFIs, as a prudent practice, UCBs should book such income on a cash basis and not on an accrual basis. However, in respect of income from Government Securities/bonds of public sector undertakings and AIFIs, where interest rates on the instruments are predetermined, income may be booked on an accrual basis, provided interest is serviced regularly and is not in arrears. Further, to bring uniformity in the accounting treatment of broken period interest on Government Securities paid at the time of acquisition and to comply with the Accounting Standards prescribed by the Institute of Chartered Accountants of India, the banks should not capitalize the broken period interest paid to seller as part of the cost, but treat it as an item of expenditure under Profit & Loss Account.

Moreover, while accounting for investments in Government Securities, the UCBs should follow "Settlement Date" accounting for recording both outright and ready forward purchase and sale transactions in Government Securities.

7.12 Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) for Scheduled Co-operative Banks Liquidity Adjustment Facility (LAF) has been extended to select Scheduled UCBs with effect from November 28, 2014. Further, with effect from August 20, 2018, Marginal Standing Facility (MSF) has also been extended to select Scheduled UCBs. These facilities are available to only those scheduled UCBs which are CBS enabled, have CRAR of at least 9 per cent and are fully compliant with the eligibility criteria prescribed for LAF. The terms and conditions for availing LAF including minimum bid size prescription, etc. would be as per the instructions issued by Financial Markets Operations Department (FMOD) of the Reserve Bank of India from time to time. The names of the scheduled UCBs which meet the eligibility norms to participate in LAF (Positive List), and those of UCBs found ineligible (Negative List) is communicated to the banks concerned by RBI

7.13 Internal Control

The Internal Audit Department should audit the transactions in securities on an ongoing basis and monitor compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of the bank. The Board should supervise and have oversight of the treasury functions of the bank. The Board of Directors has to review the investment portfolio at half-yearly intervals. The BOD should insist that a comprehensive note on the investment transactions is placed before it at half-yearly intervals. The Top Management of the UCBs shall actively oversee investment transactions and undertake a monthly review of investment transactions. A copy of the monthly review, including the details of large transactions shall be put up to the Board once a month, for information. All the treasury operations of the bank have to be mandatorily subjected to concurrent audit on a continuous basis. Deal Slips should be serially numbered and controlled separately to ensure that each deal slip has been properly accounted for. The Internal Audit Department should audit the transactions in securities on an ongoing basis and monitor compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of the bank. UCBs should undertake a half-yearly review (as of March 31 and September 30) of their investment portfolio, which should, apart from other operational aspects of the investment portfolio, clearly indicate and certify adherence to the laid down internal investment policy and procedures and Reserve Bank's guidelines, and put up the same before the Board within two months. Such review reports should be forwarded to respective Regional Office of DOS by 15th June & 15th December, respectively.

Reference-

1. Master Direction – Reserve Bank of India (Classification, Valuation and Operation of Investment Portfolio of Primary (Urban) Co-operative Banks) Directions, 2023 dated April 01, 2022.

2. RBI, FMRD Circular, FMRD.DIRD.05/14.03.007/2018-19 dated July 25, 2018.

Chapter VIII

Funds and Liquidity Management

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Funds and Liquidity Management

8.1 Maturity transformation and liquidity management are two important cornerstones of banking. The structure of bank's balance sheets which constitutes chiefly illiquid assets funded by liquid liabilities – leaves them prone to the liquidity risk, which is defined as a risk that a bank may not be able to meet its payment obligations as they fall due or may not be able to timely fund increases in assets without bearing unacceptable losses. In the case of UCBs, the manifestation and management of liquidity risk could be more challenging due to their smaller size and limited access to the funding market.

Liquidity problems may even lead to the collapse of a bank which is otherwise sound and solvent. A liquidity crisis impacting an individual bank may have systematic consequences for other banks and the banking system as a whole. By ensuring, a bank's ability to meet its due liabilities, the liquidity management can reduce the stress on an individual bank and also on the system as a whole.

The following figure depicts the anatomy of liquidity risks[28].

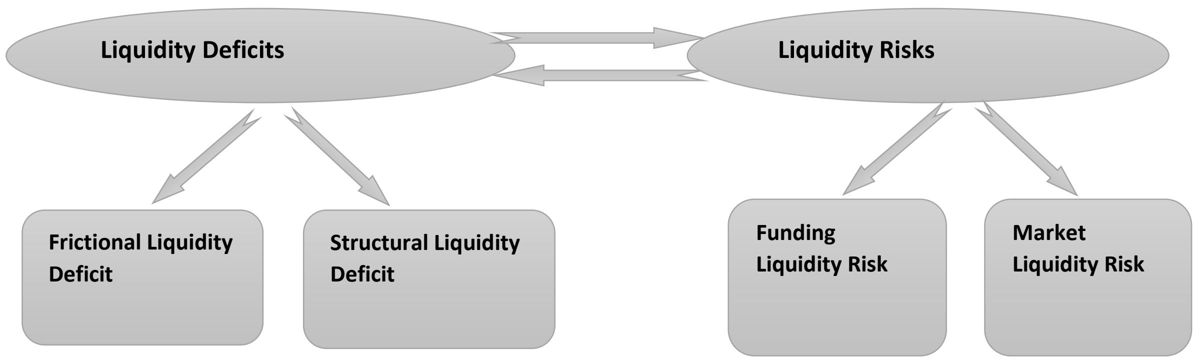

Figure: Manifestation of Liquidity Risk

Frictional Liquidity Deficit occurs due to transient factors, like quarterly tax payments or lumpy government receipts, or large one time receipts.
Structural Liquidity Deficit is caused by the widening difference between credit pick-up and deposit growth in the banking system coupled with high growth in currency in circulation.
Funding Liquidity Risk is the risk that a bank's counterparties for short-term funding might not provide or roll-over the funding.
Market Liquidity Risk is the risk of a generalized disruption in asset markets thereby making otherwise normally-liquid assets, illiquid.

[28] Srivastava, Dr Ashish, Systemic Liquidity Management: A Challenge for Central Banking, Compliance, Risk and Opportunity, Finsight Media, May 2011, p 12-16

To manage liquidity needs, to provide funds, either the asset management or the liability management or a combination of both may be adopted. Through liability management, the funds may be raised from the market or from the sanctioned line of credits from other, higher financing agencies or through availing of the refinance against eligible lending/investments or availing of the lending from the lender of the last resort. The asset management is done through primary reserves i.e. CRR in the form of cash and balances with RBI and other banks and/or through secondary reserves consisting short-term and trading book securities and/or through tertiary reserves which include securities in an investment account, maturing assets and sale of assets.

8.2 Managing and Measuring Liquidity

It is important for UCBs to closely monitor its overall liquidity position and also keep a watch on the individual position of each of its liquid assets. To help obtain this, the bank should ensure -

- Adequate internal control system.
- Board approved written policies for the day-to-day management of liquid assets.
- Monitoring of external as well as internal factors affecting funding requirements, as well as the probability of such events occurring.
- Contingency funding plans with identified minimum and maximum liquidity needs.

The measurement of the liquidity risk can be either based on a static approach based on ratios or dynamic liquidity analysis. The key ratios for static approach involve the following

- Loans / Assets
- Loans / Core deposits
- (Volatile Liabilities – Temporary Investments) / (Net Loans + Long Term Investments)
- Temporary Investments / Total Assets
- Purchased Funds / Total Assets
- Loan Losses / Net Loans

In cash flow approach the balance sheet items (assets and liabilities) are dissected and placed in a time ladder according to their residual maturity over a time horizon ranging from one day to 5 years and above. This dissection of liabilities into various residual time horizon would indicate the outflow of funds from the bank on the maturity of these liabilities. Similarly, assets maturing over a time horizon ranging from one day to 5 years and above indicate inflows to the bank. The difference between inflow of funds, from maturing assets and outflow of, from maturing liabilities in each of the 8 time periods or buckets would indicate the net gap, which would be positive if the inflows are more than outflows and negative if outflows exceed the inflows. The net position shows the gap. The cumulative gap over various time horizons shows potential liquidity gaps. A negative gap shows a liquidity problem or entails a funding requirement. A positive gap shows surplus liquidity or reinvestment requirement. Prudential limits may be fixed on the gaps on the basis of financial flexibility. The Reserve Bank of India closely monitors the liquidity of banks in the first two time buckets.

8.3 Prudential Measures for Managing Liquidity

Some of the prudential limits to avoid the liquidity crisis are as under:

- Prudential ceiling on call money borrowings by daily monitoring inflows and outflows.
- The proportion of liquid assets in the overall composition of assets.
- Core deposits vis-à-vis core assets Duration of liabilities and Duration of assets
- Close watch over high-value deposits
- Maximum cumulative outflows
- Close watch over the proportion of long-term assets such as housing loans.

8.4 Asset Liability Management (ALM): ALM refers to active management of a bank's assets (primarily loans and investments) and liabilities (mainly, deposits, and other obligations) to ensure that they stay balanced over time. The objectives are to maximize profitability and optimize capital and always have just enough cash available (liquidity) to meet current needs. ALM is akin to 'just in time' inventory management, which attempts to avoid having inventory sitting on a shelf.

"**8.4.1 Three Pillars of ALM:** ALM is a good tool for taking care of liquidity and interest rate risk. The process of **ALM rests on three pillars:**

- **ALM Information System-** ALM Information Systems have to be a part of the bank's Management Information Systems. Its effectiveness depends upon availability, accuracy and adequacy of the information
- **ALM Organisation –** BOD has to lay down the risk management policy, set prudential limits, ensure auditing, reporting & review of various risks and ALCO consisting of senior management including the CEO should ensure adherence to guidelines of BOD as also the business strategy regarding assets/liabilities of the bank. For examples, ALCO has to consider the pricing of deposits & advances, their maturity (short term vs. long term, fixed vs floating etc.).
- **ALM Techniques / Methods** Laying down techniques and procedures for identifying, measuring, monitoring risk & setting risk parameters/controls

8.5 Two approaches to liquidity management

UCBs could follow two approaches for liquidity management, namely stock approach, and flow approach.

8.5.1 Stock approach: This measures the liquidity of a bank at a point in time. The BOD may prescribe some ratios/ceilings to measure and monitor liquidity. Some of these ratios are listed below:

- Loans to Total Assets

- Loans to Core Deposits
- Purchased (Borrowed)Funds to Total assets
- NPAs to Loans

Besides, banks could also stipulate prudential limits on –

- Interbank borrowings
- Borrowed Funds vs. Liquid Assets
  - Core Deposits vs. Core Assets
  - Maximum Cumulative Outflows
  - High-Value Deposits
  - Banks should study the seasonal Pattern of Loans/Deposits.

However, the main drawback of the stock approach is that it does not inform the top management of a bank about the liquidity position of the bank in the future, as it is static in approach by providing point-of time estimates. As compared to the stock approach, the flow approach provides a dynamic view of liquidity estimates.

8.5.2 Flow approach: The flow approach is dynamic as it measures liquidity over a period of time. As the future is not certain, this approach predicts the liquidity of the bank and therefore it can be at best an approximation of the actual. Under the flow approach, cash inflows on account of maturing assets(e.g. repayment of advances) and cash outflows on account of maturing liabilities (e.g. repayment of deposits) are placed under various time periods or buckets like 1-14 days (more granular for scheduled banks – next day, 2-7 days, 8-14 days), 15-28 days, 29 days-3 months etc. The statement to track the residual maturity of assets and liabilities by way of cash inflows and cash outflows is known as **the structural liquidity statement (SLS)** prescribed by RBI for all the UCBs. This statement helps the bank/ regulator to know the gap between the cash inflows and outflows in each time bucket. If the cash inflow is more than the cash outflow, the gap is positive representing a cash surplus. If on the other hand, the cash inflow is less than the cash outflow, the gap is negative which means the bank has a cash deficit.

Illustration

Suppose a bank has ₹80/- as cash inflow and ₹125/- as a cash outflow in the first time bucket, there is a negative gap of ₹45/- which is 36 per cent of the cash outflows. The bank should guard itself against such high negative gap. Banks should also measure the cumulative gaps in the various time buckets and calculate their percentage of cumulative cash outflows. For example, if a bank has a negative gap of ₹45/- in the first time bucket and a positive gap of ₹20/- in the second one (₹40/- cash inflow and ₹20/- cash outflow), it has a cumulative negative gap of ₹25/- in the second time bucket which is 17 per cent [(25/ 145 *100) of the cash outflows]. The UCBs can prescribe internal ceilings for gaps in time buckets (other than the first two buckets for which there is a regulatory tolerance limit of 20 per cent) and for cumulative gaps. In case of scheduled UCBs, the net cumulative negative mismatches during the next day, 2-7 days, 8-14 days and 15-28 days buckets should not exceed 5 per cent, 10 per cent, 15 per cent, and 20 per cent of the cumulative cash outflows in the respective time buckets in order to recognize the cumulative impact on liquidity. UCBs will also do well by stress testing this statement i.e. assume severe conditions like non-renewal of deposits, non-re-payment of advances etc. and its impact on the liquidity of the bank. Guidance on preparing the SLS is provided in a tabular format at the end of the chapter.

A related statement is the **statement of dynamic liquidity** which measures the cash inflows and outflows over a 90 days' time horizon. This statement takes into account the fresh borrowings or investments to be made by the bank to take care of the gaps in the structural liquidity statement (SLS). Hence, it should be read along with the SLS. As this statement is predictive about the future, UCBs are required to backtest it i.e., compares the actual cash inflows/ outflows and the resultant gaps with the ones predicted in SLS, arrive at the difference and probe into their reasons. This is very important as this statement is based on the assumptions of the bank regarding the pattern of cash flows like the percentage of savings bank deposits withdrawn, percentage of fixed deposits renewed/ withdrawn, percentage of advances getting repaid in time etc., which may have to be fine-tuned depending on its own experience and market conditions. Banks have to calculate the gaps, cumulative gaps, decide how to meet the deficits/ invest the surplus so as to optimize its cash management and also maintain comfortable liquidity".

8.6 A summary of the RBI Guidelines on ALM

Asset-Liability Committee (ALCO)

UCBs should form an Asset-Liability Committee (ALCO), comprising of senior management and headed by the MD/ CEO, which will be responsible to ensure adherence to various limits set by the BOD and to decide its business strategy for management of bank's assets and liabilities in accordance with bank's risk management objectives.

An ALM desk should be set up which may comprise of operating staff and be made responsible for analyzing, monitoring and reporting various risks to the ALCO. ALM desk officials should also prepare forecasts keeping in view the market conditions related to the balance sheet and recommend the required actions in order to adhere to the internal limits set by the bank/ ALCO. ALCO is a decision-making body which is responsible for balance sheet planning from the risk-return perspective as well as the strategic management of interest rate and liquidity risks faced by the bank. ALCO should ensure that the bank's business and risk management strategy is operated within the broad limits and parameters set by the BOD. ALCO should handle issues relating to pricing of the incremental assets and liabilities. ALCO should also review the progress in the implementation of its previous decisions and the outcomes thereof. ALCO should also be articulating the current interest rate views and accordingly take its decisions for deciding the bank's future business strategy.

ALCO should be able to take a view regarding the movement and direction of future interest rate and accordingly take a decision on funding mix e.g., choosing between fixed or floating rate funds, wholesale or retail funds, money market or bond market funding, etc. This committee should meet regularly at least once a fortnight, to review the liquidity position, vis-à-vis market conditions and determine the strategies to maintain adequate liquidity, decide on raising resources having regard to the cost in tune with the market conditions, and deployment of resources in profitable avenues.

While framing their ALM policy, UCBs should adhere to the following guidelines issued by the RBI in respect of asset-liability management.

a. ALCO to meet at regular intervals and assess the liquidity position of the bank
b. ALCO to ensure adherence to RBI guidelines regarding the preparation of SLS & Dynamic Liquidity Statements.
   i. ALCO to report to BOD regarding compliance with the RBI ceilings/ BOD approved ceilings to the board.
   ii. ALCO should prepare a contingency funding plan which should state the avenues for deployment of surplus funds as well as the possible sources of borrowing to take care of the positive and the negative gaps respectively.
   iii. The ALCO should have active interaction with the investment committee/department to decide about the possible opportunities of investment/ borrowing taking into account the prevailing interest rate scenario and the likely return/ cost which the bank may earn/ incur and accordingly place its proposals to BOD for approval.

8.7 Interest Rate Risk

In addition to maturity/liquidity mismatches, there is a risk of interest rates going up or down in the economy and thereby causing possible losses to a bank on account of that. This risk has an impact on the NII margin as well as the market value of equity (net worth) of banks.

10.7.1 Methods to measure and control interest rate risk

Scheduled and non-scheduled tier-II UCBs are required to prepare the statement of interest rate sensitivity called 'IRS' (gap statement) which measures the gap between Rate Sensitive Assets (**RSAs)** and rate-sensitive liabilities (**RSLs**) in various time buckets like up to 3 months, over 3 months to 6 months, over 6 months to 1 year etc.

RSA and RSL - Assets or liabilities are considered rate sensitive in a given period if they reprice during the concerned time period either because they are maturing or their interest rates reset during that period.

- For preparing IRS prescribed by RBI, RSAs & RSLs have to be bucketed in accordance with their repricing maturities and not their remaining maturities. Repricing maturity of an asset or liability is the earlier of remaining maturity or repricing maturity. For instance, a fixed-rate advance which is maturing in 6 months will be shown as RSA in the 3-6 months bucket. A borrowing at a floating rate of interest with a reset period of 6 months but maturing in 3 months will be shown as RSL in the up to 3 months bucket.

- The assets and liabilities which are insensitive to interest rates like capital, reserves, fixed assets etc. will be shown in the non-sensitive bucket.
- The RSAs & RSLs are placed in different time buckets based on their remaining maturity (or repricing period whichever is earlier) and the gap is measured by finding the difference between the two. When RSA is more than RSL we have a positive gap and vice-versa. The impact of the gap on the Net Interest Income (NII) will depend on the interest rate scenario. In case of rising interest rates, a positive gap will boost the NII of the bank as the increase in interest income on assets will be more than the increase in interest cost on liabilities resulting in higher NII.
- We can assume the following interest rate scenarios coupled with positive/negative gaps and then see their impact on NII.

Relationship between GAP & NII

Type of GAP	**Interest Rate Change**	**Change in NII**
RSA = RSL	Increase	No Change
RSA = RSL	Decrease	No Change
RSA > RSL	Increase	Increase
RSA > RSL	Decrease	Decrease
RSA< RSL	Increase	Decrease
RSA< RSL	Decrease	Increase

Statement of Structural Liquidity as on : ______									
									(Amounts in Crores of Rupees)
	Residual Maturity								
Outflows **Inflow**	**1 to 14 days**	**15 to 28 days**	**29 days and upto 3 months**	**Over 3 months and upto 6 months**	**Over 6 Months and upto 1 year**	**Over 1 year and upto 3 years**	**Over 3 years and upto 5 years**	**Over 5 years**	**Total**

Statement of Interest Rate Sensitivity as on : __________

(Amounts in Crores of Rupees)										
	Interest Rate Sensitivity									
Liabilities Assets		Upto 3 months	Over 3 months and upto 6 months	Over 6 Months and upto 1 year	Over 1 year and upto 3 years	Over 3 years and upto 5 years	Over 5 years	Non-sensitive	Total

Statement of Short-term Dynamic Liquidity as on ________

(Amounts in Crores of Rupees)				
	Outflow/ Inflow	1-14 days	15.28 days	29-90 days

8.8 Periodicity for SLS/ IRS/ STDL in XBRL

Returns/ Type of bank	SLS	IRS	STDL
Scheduled UCB	Fortnightly	Monthly	Fortnightly
Non-Scheduled Tier II	Quarterly	Quarterly	-
Non-Scheduled Tier I	Quarterly	-	-

8.9 The Reserve Bank has broadly defined the behaviour of some assets and liabilities and has also indicated the placement of these assets into various time buckets to help those banks which do not have sufficient MIS capabilities.

Guidance for preparing SLS: Maturity Profile - Liquidity

Heads of Accounts		**Classification into time buckets**
A.	**Outflows**	
1.	Capital, Reserves and Surplus	Over 5 years bucket.
2.	Demand Deposits (Current and Savings Bank Deposits)	Savings Bank and Current Deposits may be classified into volatile and core portions. Generally, 10 % of Savings Bank and 15 % of Current Deposits are withdrawable on demand. This portion may be treated as volatile. While volatile portion can be placed in the Day 1, 2-7 days and 8-14 days' time buckets, depending upon the experience and estimates of banks and the core portion may be placed in over 1- 3 years bucket.
		The above classification of Savings Bank and Current Deposits is only a benchmark. Banks which are better equipped to estimate the behavioural pattern, roll-in and roll-out, embedded options, etc. based on past data / empirical studies could classify them in the appropriate buckets, i.e. **behavioural** maturity instead of **contractual** maturity, subject to the approval of the Board / ALCO.
3.	Term Deposits**,** Long Term Deposits (Tier-II).	Respective maturity buckets. Banks which are better equipped to estimate the behavioural pattern, roll-in and roll-out, embedded options, etc. based on

		past data / empirical studies could classify the retail deposits in the appropriate buckets based on behavioural maturity rather than residual maturity. However, the wholesale deposits should be shown under respective maturity buckets. (Wholesale deposits for this statement may be ₹ 15 lakhs or any such higher threshold approved by the bank's Board).
4.	Certificates of Deposit, Borrowings and Bonds (including Subordinated Debt **if any)**	Respective maturity buckets. Where call/put options are built into the issue structure of any instrument/s, the call / put date/s should be reckoned as the maturity date/s and the amount should be shown in the respective time buckets.
5.	**Other Liabilities and Provisions**	
	(i) Bills Payable	(i) The core component which could reasonably be estimated based on past data and behavioural pattern may be shown under 'Over 1-3 years' time bucket. The balance amount may be placed in Day 1, 2- 7 days and 8-14 days buckets, as per behavioural pattern.
	(ii) Provisions other than for loan loss and depreciation in investments	(ii) Respective buckets depending on the purpose.
	(iii) Other Liabilities	(iii) Respective maturity buckets. Items not representing cash payables (i.e. income received in advance, etc.) may be placed in over 5 years bucket.
6.	Export Refinance - Availed	Respective maturity buckets of underlying assets.
B.	**Inflows**	
1.	Cash	Day 1 bucket
2.	Balances with RBI / Public sector banks and SCBs and DCCBs for CRR/SLR purpose	While the excess balance over the required CRR / SLR may be shown under Day 1 bucket, the Statutory Balances may be distributed amongst various time buckets corresponding to the maturity profile of DTL with a time-lag of 14 days.
3.	**Balances with other Banks**	
	(i) Current Account	(i) Non-withdrawable portion on account of stipulations of minimum balances may be shown under 'Over 1-3 years' bucket and the remaining balances may be shown under Day 1 bucket.
	(ii) Money at Call and Short Notice, Term Deposits, Long Term deposits (Tier II), and other placements	(ii) Respective maturity buckets.
4.	**Investments (net of provisions)**#	
	(i) Approved securities	(i) Respective maturity buckets, excluding the amount required to be reinvested to maintain SLR corresponding to the DTL profile in various time buckets.
	(ii) Corporate debentures and bonds, PSU bonds, CDs and CPs, Redeemable preference shares, eligible units of Mutual Funds (close-ended), etc.	(ii) Respective maturity buckets. Investments classified as NPIs should be shown under over 3-5 years bucket (sub-standard) or over 5 years bucket (doubtful).
	(iii) Equity of all India FIs and Co-operative	(iii) Listed shares in 2-7days bucket, with a haircut of 50%. Other shares in 'Over 5 years' bucket.

	(iv)	Units of Mutual Funds (open ended)	(iv) Day 1 bucket
	(v)	Investments in Subsidiaries	(v) 'Over 5 years' bucket.
	(vi)	Securities in the Trading Book	(vi) Day 1, 2-7 days, 8-14 days, 15-28 days and 29-90 days according to defeasance periods.
	#	Provisions may be netted from the gross investments provided provisions are held security-wise. Otherwise, provisions should be shown in over 5 years bucket.	
5.	**Advances (Performing)**		
	(i)	Bills Purchased and Discounted (including bills under DUPN)	(i) Respective maturity buckets.
	(ii)	Cash Credit / Overdraft (including TOD) and Demand Loan component of Working Capital.	(ii) Banks should undertake a study of the behavioural and seasonal pattern of availments based on outstanding and the core and volatile portion should be identified. While the volatile portion could be shown in the near-term maturity buckets, the core portion may be shown under 'Over 1-3 years' bucket.
	(iii)	Term Loans	(iii) Interim cash flows may be shown under respective maturity buckets.
6.	**NPAs (Net of provisions, interest suspense and claims received from ECGC / DICGC)**		
	(i)	Sub-standard	(i) Over 3-5 years bucket.
	(ii)	Doubtful and Loss	(ii) Over 5 years bucket.
7.	**Fixed Assets / Assets on lease**		'Over 5 years' bucket / Interim cash flows may be shown under respective maturity buckets.
8.	**Other Assets**		
	(i)	Intangible assets	Intangible assets and assets not representing cash receivables may be shown in 'Over 5 years' bucket.
C.	**Off-balance sheet items**		
1.	**Lines of Credit committed / available**		
	(i)	Lines of Credit committed to/from Institutions	(i) Day 1 bucket.
	(ii)	Unavailed portion of Cash Credit / Overdraft / Demand loan component of Working Capital limits (outflow)	(ii) Banks should undertake a study of the behavioural and seasonal pattern of potential availments in the accounts and the amounts so arrived at may be shown under relevant maturity buckets up to 12 months.
	(iii)	Export Refinance - Unavailed (inflow)	(iii) Day 1 bucket.
2.	**Contingent Liabilities**		
	Letters of Credit / Guarantees (outflow)		Devolvement of Letters of Credit / Guarantees initially entails cash outflows. Thus, historical trend analysis ought to be conducted on the devolvement and the amounts so arrived at in respect of outstanding Letters of Credit / Guarantees (net of margins) should be distributed amongst various time buckets. The assets created out of devolvement may be shown under respective maturity buckets based on probable recovery dates.
3.	**Other Inflows/outflows**		

	(i)	Repos / Bills Rediscounted (DUPN) / TREPS / Swaps INR / USD, maturing forex forward contracts etc. (outflow / inflow)	(i) Respective maturity buckets.
	(ii)	Interest payable/receivable (outflow/inflow) - An accrued interest which is appearing in the books on the reporting day	(ii) Respective maturity buckets.
	Note :		
	(i)	Liability on account of event cash flows i.e. shortfall in CRR balance on reporting Fridays, wage settlement, capital expenditure, etc. which are known to the banks and any other contingency may be shown under respective maturity buckets. The event cash outflows, including incremental SLR requirement, should be reported against "Outflows - Others".	
	(ii)	All overdue liabilities may be placed in the Day 1, 2-7 days and 8-14 days buckets, based on behavioural estimates.	
	(iii)	Interest and instalments from advances and investments, which are overdue for less than one month may be placed in Day 1, 2-7 days and 8-14 days buckets, based on behavioural estimates. Further, interest and instalments due (before classification as NPAs) may be placed in '29 days to 3 months bucket' if the earlier receivables remain uncollected.	
D.	**Financing of Gap**		
	In case the net cumulative negative mismatches during the Day 1, 2-7 days, 8-14 days and 15- 28 days buckets exceed the prudential limit of 5 %, 10%, 15 % and 20% of the cumulative cash outflows in the respective time buckets, the bank may show by way of a footnote as to how it proposes to finance the gap to bring the mismatch within the prescribed limits. The gap can be financed from market borrowings (call/term), Bills Rediscounting, Repos, LAF and deployment of foreign currency resources after conversion into rupees (un-swapped foreign currency funds), etc.		

Guidance for preparing IRS: Interest Rate Sensitivity

Heads of Accounts		**Rate sensitivity and time band**
Liabilities		
1.	Capital, Reserves and Surplus	Non-sensitive.
2.	Current Deposits	Non-sensitive.
3.	Savings Bank Deposits	Sensitive to the extent of Interest paying (core) portion. This should be included in over 3-6 months' time band. The non-interest-paying portion may be shown in the non-sensitive band.
4.	Term Deposits, Long Term Deposits (Tier II) and Certificates of Deposit	Sensitive: reprices or resetting of interest rates on maturity. The amounts should be distributed to different time bands based on the remaining term to maturity.
5.	Borrowings - Fixed	Sensitive: reprices on maturity. The amounts should be distributed to different time bands based on remaining maturity.
6.	Borrowings - Floating	Sensitive: reprices when the interest rate is reset. The amounts should be distributed to the appropriate time band that refers to the resetting date.
7.	Borrowings - Zero Coupon	Sensitive: reprices on maturity. The amounts should be distributed to the respective maturity time band.
8.	Borrowings from RBI	Up to 3 months' time band.
9.	Refinances from other Agencies	(a) Fixed rate: As per respective Maturity.
		(b) Floating rate: Reprices when the Interest rate is Reset.

10.	**Other Liabilities and Provisions**		
	i)	Bills Payable	i) Non-sensitive.
	ii)	Branch Adjustments	ii) Non-sensitive.
	iii)	Provisions	iii) Non-sensitive.
	iv)	Others	iv) Non-sensitive.
11.	Repos / Bills Re-discounted (DUPN). Swaps (Sell / Buy) etc.		Sensitive reprices only on maturity and should be distributed to the respective maturity bands.
Assets			
1.	Cash		Non-sensitive.
2.	Balances with RBI		Interest earning portion may be shown in over 3-6 months' time band. The balance amount non-sensitive.
3.	**Balances with other Banks**		
	i)	Current Account	i) Non-sensitive.
	ii)	Money at Call and Short Notice, Term Deposits, Long Term Deposits (Tier II) and other placements	ii) Sensitive on maturity. The amounts should be distributed to the respective maturity bands.
4.	**Investments (Performing)**		
	i)	Fixed-Rate / Zero Coupon	i) Sensitive on maturity.
	ii)	Floating Rate	ii) Sensitive at the next repricing date
5.	Shares of All India FIs and other co-operatives / eligible categories of mutual funds.		Sensitive, may be shown under 3 months category.
6.	**Advances (Performing)**		
	(i)	Bills Purchased and Discounted (including bills Under DUPN)	(i) Sensitive to maturity.
	(ii)	Cash Credits / Overdrafts (including TODs) / Loans repayable on demand and Term Loans	(ii) Sensitive; may be shown under over 3-6 months' time band.
7.	**NPAs (Advances and Investments)**		
	(i)	Sub-Standard	(i) Over 3-5 years' time band.
	(ii)	Doubtful and Loss	(ii) Over 5 years' time band.
8.	Fixed Assets		Non-sensitive.
9.	**Other Assets**		
	(i)	Inter-office Adjustment	(i) Non-sensitive.
	(ii)	Leased Assets	(ii) Sensitive on cash flows. The amounts should be distributed to the respective maturity bands corresponding to the cash flow dates.
	(iii)	Others	(iii) Non-sensitive.
10.	Reverse Repos, Swaps (Sell / Buy) and Bills Rediscounted (DUPN)		Sensitive on maturity.
11.	**Other products (Interest Rate)**		
	(i)	Swaps	(i) Sensitive and should be distributed under different bands with reference to maturity.
	(ii)	Other	(ii) Should be suitably classified as and when introduced.

8.10 Understanding the Concept of Duration

Interest rates on assets and liabilities also affect their values leading to their appreciation or depreciation and therefore, affect the equity or net worth of the bank - (Value of assets – the value of outside liabilities = net worth). The concept of **duration** is important to understand for protecting a bank's net worth from fluctuations in interest rates. Duration (also known as

Macaulay Duration) of a bond or an interest-bearing asset is a measure of the time taken to recover the initial investment in present value terms. In the simplest form, it refers to the payback period of a bond to break even i.e. the time taken for a bond to repay its own purchase price or weighted average time to maturity. Duration is expressed in the number of years. It is similar to the effective maturity of an asset/liability. Consider a 3-year loan of ₹ 20 lakh in which the entire principal is repayable on maturity and another identical loan in which principal is repayable in three equal annual instalments. It could be seen intuitively that the second loan's effective maturity is less than 3 years as 2/3rd of the principal comes back in the first two years. Duration is the weighted average maturity of an asset/liability that takes into account the timing of the cash flows. Duration will also be less than the contractual maturity of assets/ liabilities that entail periodic payment of interest, as there are inflows/outflows of interest before maturity. A bank can also know how the duration will affect the market value of its investments by calculating its Modified Duration (MD).

8.10.1 Modified Duration (MD)

It is a modified version of Macaulay Duration. It refers to change in the value of an interest-bearing financial instrument (security/loan, etc.) to one per cent change in interest rates (yield).

MD = Macaulay Duration / (1+ Yield)

MD predicts by how much per cent the value of security/asset will depreciate/ appreciate due to one percentage point (1% or 0.01 or 100 basis points) change in the yield (interest rates).

Approximate Percent Price change = (-) Modified Duration x Change in Yield x Price x 100

Using MS-Excel Utilities

Besides understanding the concepts of duration, modified duration, and duration gap analysis, it is also quite useful to know the following MS-Excel formulae for computations.

DURATION function –

DURATION (settlement, maturity, coupon, yield, frequency, [basis])

MDURATION function –

MDURATION (settlement, maturity, coupon, yield, frequency, [basis])

Here,

Settlement = Date for which values are computed

Maturity = Date of Maturity of instrument

Coupon = Fixed period rate interest received on the instrument

Yield = Applicable YTM (Yield to Maturity)

Frequency = Number of time interest is serviced in a year

Basis = Day Count Convention (0 or 4)

Another useful concept is **PV01 (Basis Point Value)**, predicts the price change of an instrument changes if the interest rate changes by 1 basis point (0.01%). In a rising interest rate scenario, a bank should try to reduce the duration of its investments as longer-term securities depreciate faster than shorter-term securities and vice-versa. It is therefore desirable that the BOD should set the desired duration of its investment portfolio based on the suggestion of its investment committee and monitor the same through an appropriate information system. However, it should be understood that MD works only for small changes in yields, and is influenced by the Convexity, which measures the impact of change in the duration on account of changes in interest rates. Larger banks can also measure VaR (value at risk) which predicts (with some approximation which is the confidence level) the maximum loss that a bank can be put to on its investment portfolio over a particular time period say, the next 15 days and accordingly helps in taking a decision to reduce/ increase their investment exposure considering the impact on their capital. The BOD should ensure that the RBI guidelines are followed regarding treasury operations viz., functional separation of the front office (dealing) and the back office & accounting dept., prescription of various dealer wise limits (like daylight & stop loss), a quarterly concurrent audit of dealing room operations and other internal control guidelines as also the master circular/ circular instructions of RBI on investments for UCBs.

8.11 Alarming signals for liquidity management

The Board of Directors while reviewing various reports/ parameters may come to know about impending liquidity problems. Some of the signals which indicate the potential liquidity crisis is illustrated below:

Directors should watch for these signals and take necessary pro-active actions.

i. The decline in the asset quality or earnings performance or the projections made by the bank.
ii. Rapid asset growth funded by short-term deposits, large deposits or through negotiable deposits.
iii. Mobilization of deposits by paying higher than the market rate of interest coupled with low CD ratio.
iv. Funding resources from a single source or a group of connected sources or different sources but with the same rates sensitivity which in particular may create a problem in the rising rate interest scenario.
v. The increased cost of the funds.
vi. Increased dependence on short-term deposits or call money borrowings.
vii. Maturity mismatches in the individual buckets or the cumulative gap are negative and beyond the prudent limit prescribed by the Board.
viii. The absence of contingency funding plan and no alternative sources of raising funds quickly.
ix. A significant drop in the renewal of the deposits noticed through the behavioural analysis of the depositors.
x. Adverse market information about the bank and the possibility of depositor’s run.

References –

1. Circular UBD. PCB. Cir. No12/12.05.001/2008-09 dated September 17, 2008

2. Circular UBD. PCB. Cir. No 13 /12.05.001/2008-09 dated September 17, 2008

3. Circular UBD.BPD.(PCB).Cir No. 39 /12.05.001/2009-10 dated December 30, 2009

MODULE III

Primary (Urban) Co-operative Banks Financial Statements, Earnings, and Advances

This module comprises of four chapters. The primary focus is upon developing an understanding of financial statements of UCBs through a detailed analysis and to explain the importance of earnings for successful operations of banks. Closely connected with earnings, discussions on management of advances, exposure norms, credit appraisal process, and priority sector lending provide a comprehensive coverage on the subject.

Chapter IX

Financial Statements and Earnings of UCBs

Chapter IX

Financial Statements and Earnings of UCBs

9.1 Financial Statements

Financial statements of any bank include its Balance Sheet and Profit & Loss account. These two statements provide a bird's eye view of the financial health of a bank. In addition, cash flow statement, and statement of changes in equity also provide useful information about the bank's financial position.

Section 29 of BR Act 1949 (AACS) requires every UCB to prepare Profit and Loss Account and Balance Sheet as at the end of March each year in the forms set out in the Third Schedule (or as near thereto as circumstances admit) to the Act. In terms of Section 31 of BR Act, 1949 (AACS), urban cooperative banks are required to publish their Balance Sheet and Profit & Loss Account along with the auditor's report, and three copies thereof are required to be furnished as returns to the RBI within three[29] months from the reference date of the financial statements.

9.2 Analysis of the financial statements

Analysis of financial statements helps in understanding the key strengths and weaknesses in the financial parameters of the bank concerned. An assessment of sources and usages of funds as depicted in the balance sheet, as also an understanding of the liquidity, solvency, and quality of assets vis-a-vis the composition, timing, and cost of liabilities remains a key responsibility of the management, auditors, supervisors, and stakeholders. Besides the stock of assets and liabilities as depicted in a balance sheet, it is also important to examine the flow of income, and expenditure and their resultant impact on the bank's profitability. The emphasis should be to evaluate the quality, consistency, and reliability of earnings, and integrity of expenditure, besides the quality and nature of cash flows. Moreover, the analysis of financial statements should involve examination of trends and patterns and expected future direction. The central idea in the analysis of financial statement is to assess the bank's present and potential financial soundness.

To ensure financial soundness, an urban cooperative bank should focus on the following:

1. Manage its operational costs within reasonable level.
2. Contain its non-performing assets.
3. Focus on speedy recovery of bad loans.
4. Sound investment strategies.

[29] Period changed in three months from the previous six months as per B R Act (Amendment), 2020.

5. Building up reserves thereby strengthening its capital base.
6. Strike a healthy balance between retained earnings and a consistent dividend policy.
7. Ensure adherence to income recognition, asset classification and provisioning norms.
8. Maintain a healthy credit-deposit ratio.
9. Ensure effective asset-liability management.
10. Ensure scientific and risk sensitive pricing for products

Analysis of Profit and Loss Account

The **profit and loss account** shows the expenses incurred and the income earned during the year and the resultant profit or loss. The main sources of income of a UCB are:

A. Income

a). Interest Income

i. Interest on loans and advances.
ii. Interest on investments
iii. Interest lending in call money market.

b). **Non-Interest Income**

i. Commission, exchange and service charges.
ii. Profit from treasury operations and foreign exchange dealings.
iii. Other income such as application fee, processing fee, etc.

B. Expenses can be broadly divided into:

a) Interest expenditure
b) Non-interest expenditure or Operating Costs
 (i) Staff costs
 (ii) Overheads
 (iii) Depreciation and amortization
c) Provisions

9.2 Profit and Profitability

It is quite important to understand the difference between the terms *profit and profitability*. While profit is stated in absolute terms, profitability is worked out as a percentage of profit to the working funds. Profitability is a better measure for comparison between banks as well as a bank's performance across time-periods. While the profit of a bank may increase, profitability may decline as compared to the previous year. This may be due to a fall in the percentage of total income to working funds or an increase in the percentage of total expenses to working funds or a decrease in the spread. The Board of Directors should review the profitability of the bank at regular intervals and analyze the reasons for its decline or improvement. The top management of the bank should also analyze the profitability of its branches and should take corrective steps in case of loss-making branches. The following terms and ratios are computed for analysis of profitability in banks.

(a) Total Interest Income
(b) Total Non-Interest Income
   i. Treasury Income
   ii. Fee based Income
(c) Total Interest Expenditure
(d) Total Non-Interest Expenditure
(e) Provisions & Write Offs
(f) Total Income = **(a + b)**
(g) Operating Profit = **(a + b) – (c + d)**
(h) Net Operating Profit = (**g – e)**
(i) Net Profit = Net Operating Profit - Taxes
(j) Net Interest Income (NII) = (**a – c)**

Decline in profits may be due to the following factors:

- Decline in interest income
- Decline in non-interest income
- Increase in interest expenditure
- Increase in non-interest expenditure or operating costs
- Decline in interest spread
- Decline in both income and expenditure, with a sharper fall in income
- Increase in both income and expenditure, with a sharper increase in expenditure
- Increase in frauds and NPAs

The top management of a UCB should ascertain the exact reasons for decline in profitability and take corrective measures. For example, a decline in interest income may be due to rising NPAs. Similarly, a decline in non-interest income may be due to fall in treasury income or fee-based income. The bank may probe whether there has been any leakage in its fee-based income for which it may ask its internal audit machinery to examine this aspect. On the expenditure side, a UCB may have to examine whether its interest rates on deposits are in alignment with the market. It is also important to fine-tune the structure of interest rates with reference to the ALM position and scope for profitable deployment of funds. This requires comparison with the interest rates paid by commercial banks and the need to ensure that UCBs are not totally out of tune with them. An increase in operating costs may be due to increase in staff costs, or other overheads like stationery costs, directors' fees, auditors' fees, legal expenses etc. Strict budget control must be exercised especially relating to its capital expenditure.

Due to deregulation of interest rates and increasing competition, banks especially UCBs have to explore possibilities of increasing fee-based income. Some examples could be insurance related commission or fees relating to LC bill discounting for its customers, guarantees etc. However, the UCBs must study the risks involved in these products, preferably set internal limits for these and monitor their exposure vis-a-vis internal limits.

9.3 Analysis of income and expenditure: Ratios

In order to exercise effective control, bank's top management should analyse the various components of income and expenditure i.e., how a rupee is earned and how a rupee is spent. A comparison of the following ratios over a period of time can show the trend in bank's financial performance.

- ***Proportion of Interest Income to total income of the bank:***

A very high ratio shows banks' complete dependence on fund based business only. Non-fund based business is free from interest rate risk and helps recover non-interest cost from non-interest income.

- ***Proportion of treasury income to total income of the bank:***

A sharp increase in treasury income is unlikely to be sustained for long and hence, an overdependence on treasury income should be avoided. However, treasury income is a good avenue to supplement income from core banking business.

- ***Proportion of fee-based Income to total income of the bank:***

A rising trend is considered healthy. However, it should not be at the cost of core income.

- ***Proportion of Interest Expenses to total income of the bank:***

(Financing efficiency)

A decreasing trend in this ratio shows how efficiently the bank has raised resources. A high ratio could be due to several reasons: (i) a large part of deposits are long-term/ high-cost and, (ii) bank's borrowings are at high-interest rates, (iii) Low credit-deposit ratio.

- ***Proportion of Non- Interest Expenses to total income of the bank:***

(Operating efficiency)

A high ratio would indicate lower productivity. If the ratio shows declining trend it is generally a good sign. Generally, a ratio of more than 50% would indicate that the bank is inefficient.

- ***Cost-income ratio - proportion of Non-Interest Expenses to Net Total Income (Total Income – Interest Expense):***

A lower ratio is considered as better.

- ***Proportion of Risk costs of the bank - provisions and write off to total income:***

A declining trend is desirable.

Net Profit Margin- Net profit to Total Income: The top management has to be equally alert if there is a sudden increase in the profits of a bank as compared to its profit in the previous years. They have to ascertain whether the profits are sustainable in the long run. For example, a bank may make a huge treasury profit in a year, but it may not be sustainable if interest rates move unfavourably in the market.

9.4 Other ratios to gauge the profitability of a bank

i) Return on Average Total Assets = Net profit x 100/ Average Total Assets
ii) Net Interest Margin (spread in %) = Net interest income x 100/ Average Total Assets
iii) Ratio of Retained Earnings to Net Profit = Retained Profit* x 100/ Net Profit
iv) Operating Profit as % of Avg. Total Assets = Operating Profit x 100/ Average Total Assets

**Retained Profit = Accretion to Reserves and Funds = Net Profit as reduced by Dividend paid/ proposed to be paid, and other outside liabilities.*

9.5 Spread Analysis:

A simple measure of spread would be to calculate NII (Interest Income – Interest Expenditure) and then NIM (NII/Average Total Assets) to get an idea whether it is showing an upward or a downward trend as compared to the previous years. A more detailed and accurate analysis would be to calculate spread as the gap in the yield on earning assets and the cost of interest-bearing liabilities. However, for the purpose studying the trend, the NIM is easier to calculate and should be preferred.

NIM depends on (a) the yield on assets, (b) cost of liabilities and (c) level of NPAs (since interest on NPAs is not recognized). The trend in NIM should be read with the trends in these three factors to arrive at correct conclusions.

9.6 Efficiency Analysis:

The top management should analyse the various items of cost as a proportion of its average assets to ensure cost control and efficiency in its operations. Two kinds of ratios can be calculated here.

First, **Total Assets / Total Non-interest Cost**. A higher ratio shows better efficiency.

Second, the ratio of '**Change in Total Assets to Change in Total Non-Interest Cost'** helps in examining the justifiability of additional expenditures.

Asset-based efficiency ratios must be read with income-based efficiency ratios, else erroneous inferences may result. If in any period a bank has focused on recovery rather than new business, the asset-based efficiency ratio will decline but income based efficiency ratio will improve due to lower/ reversal of provisions. Likewise, an improvement in income based efficiency ratio brought about by an increase in treasury income may not show up in asset-based efficiency indicators.

9.7 Analysis of NPAs and loan-loss provisions:

The bank may examine the level of NPAs as compared to its previous years.

1. NPAs in the beginning of the year
2. Additions during the year
3. Recoveries made during the year (up-gradation, cash recovery or Write-offs)
4. Balance at the end of the year (item 1 + 2 - 3)

Also gross and net advances percentages may be worked out to know in which direction they are heading.

Gross NPA in % = Gross NPA X 100/ Gross Advances
Net NPA in % = Net NPA X 100/ Net Advances

Net NPA and Net Advances can be calculated after deducting provisions & part payments received from customer/ DICGC for Gross NPA and Gross advances respectively.

9.8 Implications of NPAs

Banks have to make provisions for NPAs which means a reduction of their net profits. Moreover, banks cannot recognize interest income on NPAs which again means a reduction of income/profits. A high gross NPA and a low net NPA indicates that the bank has not adopted robust measures to improve its credit management or made serious recovery efforts to reduce its overall NPA levels and it has merely made adequate provisions to cover its NPAs. The bank should try to reduce its gross NPA level, which is a better indicator of bank's credit risk management standards.

9.9 Earnings Analysis: The continued viability of a bank depends on its ability to earn an appropriate return on its assets. It enables the bank to fund expansion, remain competitive, and increase capital. Key factors to be considered in respect of earnings are:

- Level, growth trends, and stability of earnings, particularly return on average assets;
- Quality and composition of earnings;
- Adequacy of various provisions and their effect on earnings;
- Future earnings prospects;
- Net interest margin;
- Net non-operating income and losses and their effect on earnings;
- Quality and composition of assets;
- Capital adequacy level
- Sufficiency of earning for necessary capital formation.

It should be ensured that the material factors affecting the bank's income-producing ability (standard loans, investments, fixed assets etc.) are not significantly changed and such a change may indicate an impending problem. There could be reasons for worry if current and projected earnings are not sufficient to provide for the absorption of losses and the formation of capital to comply with regulatory requirements.

Analysis of Balance Sheet

9.10 Balance Sheet Analysis:

The balance sheet of a bank tells us the position of its assets and liabilities as on a particular date. Its analysis can throw light on several aspects of a bank's health like profitability, productivity, net worth, net worth vis-à-vis deposit liabilities, capital funds, liquidity, NPAs, etc.

9.11 Liquidity Analysis:

The balance sheet provides information to the top management regarding some liquidity parameters of the bank. The main sources of a bank's funds are its own funds, deposits and borrowings. The extent to which a bank generates profits & follows a prudent dividend policy has an impact on its capacity to retain its earnings for meeting its commitments or funding growth. The bank may analyse the extent of volatile and stable deposits depending on its own experience and historical data. It may then maintain 100% liquidity for volatile deposits and a lesser percentage of liquidity to cover other deposits. Normally, a portion of its current and savings bank deposits and short-term market borrowings are reckoned as volatile. Evaluation of bulk deposits as a proportion to total deposits also provides information about liquidity risk.

On the asset side, the bank may calculate its proportion of liquid and non-liquid assets. Cash, government securities and excess balances with RBI/other banks are considered as liquid assets. The bank may work out the ratio of liquid assets to its volatile liabilities to gauge the extent of coverage. Similarly, CD ratio also provides rough indication of the liquidity. A very high ratio say above 70-75%, may indicate that the bank may not be very comfortable in case of a liquidity shock, if it is primarily financed by deposits. To measure liquidity more accurately and in a dynamic scenario, banks should construct a maturity ladder and prepare asset liability management (ALM) statements as per RBI guidelines.

Following important ratios could be used for the purpose of balance sheet analysis in conjunction with the profit & loss account.

1. Capital to Risk-Weighted Assets Ratio (CRAR) (%)
2. Ratio of Tier I to Tier II Capital
3. Ratio of Debt to Equity
4. Gross NPAs to Gross Advances (%)
5. Provision Coverage Ratio (%): Loan-loss provisions/Gross NPA
6. Ratio of bulk deposits to total deposits (%)

7. Ratio of liquid assets to short term liabilities (%)

9.12 Accounting issues impacting Balance Sheet & Profit and loss account of UCBs:

a. IRAC and provisioning norms:

RBI's prescriptions on IRAC & provisioning norms must be followed by all the banks. The income recognition should be based on the actual record of recovery. Interest income from NPAs should not be recognised on accrual basis but should be booked as income on cash basis.

Income recognized in the case of accounts which later on become NPAs should be derecognized by putting through reversal vouchers. This rule is also applicable to Central government-guaranteed advances which enjoy exemption in respect of asset classification. Interest Income on investments in equity of All India Financial Institutions (AIFIs)/ units of UTI, except GOI securities has to be recognized only on cash basis. Only in the case of GOI bonds/ AIFI & PSU bonds, the banks may recognize income on accrual basis provided interest has been serviced regularly. Interest accrued in respect of non-performing advances should not be debited to borrowal accounts but shown separately under Interest Receivable on Loans and Advances with a contra entry in the overdue interest reserve.

b. Creation of Overdue Interest reserve account

In respect of NPAs, interest accrued should be debited to Interest Receivable account to be shown on the asset side and credited to overdue interest reserve (OIR) to be shown on the liability side. In the case of assets, turning into non-performing as on March 31st, unrealized interest should be reversed by debit to P & L account and credit to the OIR. The OIR is not created out of profits earned by a bank and therefore, should not be counted for calculating its net worth.

c. IDR and IFR

"Securities under Available for Sale (AFS) and Held for Trading (HFT) categories should be valued scrip-wise and depreciation/appreciation shall be aggregated for each classification (G-Sec, Other Approved, Shares, PSU-Bonds, Others) separately for AFS and HFT. Net depreciation should be provided for and net appreciation, if any, should be ignored. Net depreciation required to be provided for in any one classification should not be reduced or adjusted on account of net appreciation in any other classification. Similarly, net depreciation for any classification in one category should not be reduced from appreciation in similar classification in another category.

Investment Depreciation Reserve (IDR) required to be created on account of depreciation in the value of investments held under 'AFS' or 'HFT' categories in any year should be debited to the Profit & Loss Account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to Statutory Reserve) or the balance available in the IFR Account, whichever is less, shall be transferred from the IFR Account to Profit & Loss Account. In the event that IDR created on account of depreciation in investments is found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss Account and an equivalent amount (net of taxes, if any, and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to the Investment Fluctuation Reserve (IFR) Account to be utilised to meet future depreciation requirement for investments.

The amounts debited to the Profit & Loss Account for depreciation provision and the amount credited to the Profit & Loss Account for reversal of excess provision should be debited and credited respectively under the head "Expenditure - Provisions & Contingencies".

The amounts appropriated from the Profit & Loss Account/ to IFR and the amount transferred from the IFR to the Profit & Loss Account should be shown as 'below the line' items after determining the profit for the year[30]."

d. Draw-down from IFR:

"A bank may, at its discretion, draw down the balance available in IFR in excess of 5 percent of its investment in AFS & HFT, for credit to the balance of profit / loss as disclosed in the profit and loss account at the end of any accounting year. In the event the balance in the IFR is less than 5 percent of its investment in AFS & HFT, a draw down will be permitted subject to the following conditions:

a) The drawn down amount is used only for meeting the minimum Tier I capital requirements by way of appropriation to free reserves or reducing the balance of loss, and

b) The amount drawn down is not more than the extent to which the MTM provisions made during the aforesaid year exceed the net profit on sale of investments during that year[31]."

9.13 Disclosure Requirements

UCBs are also required to refer to Annex III of the Master Direction on Disclosures in Financial Statements for making required disclosures in their financial statements. Part B of Annex II containing specifies guidance with respect to relevant issues in the application of certain Accounting Standards should also be referred to.
(Ref. DOR.ACC.REC.No.45/21.04.018/2021-22 dated August 30, 2021).

Specially beginning March 2023, UCBs are required to disclose[32] the divergence in asset classification and provisioning, if either or both of the following conditions are satisfied:

[30] As per the extant RBI Guidelines – Master Circular on Investments by Primary (Urban) Co-operative Banks
[31] RBI Circular dated July 06, 2018, see references
[32] Disclosure to be made in the financial statements of UCBs for year ending March 31, 2023 and onwards.

a) The additional provisioning for NPAs assessed by Reserve Bank of India as part of its supervisory process, exceeds five per cent of the reported profit before provisions and contingencies for the reference period, and

b) The additional Gross NPAs identified by the Reserve Bank of India as part of its supervisory process exceed five[33] per cent of the reported incremental Gross NPAs for the reference period. Provided that in the case of UCBs, the threshold for the reported incremental Gross NPAs shall be 15 per cent for the present. This threshold shall be reduced progressively in a phased manner, after review.

(Amount in ₹ crore)

Sr.	Particulars	Amount
1.	Gross NPAs as on March 31, 20XX* as reported by the bank	
2.	Gross NPAs as on March 31, 20XX as assessed by Reserve Bank of India	
3.	Divergence in Gross NPAs (2-1)	
4.	Net NPAs as on March 31, 20XX as reported by the bank	
5.	Net NPAs as on March 31, 20XX as assessed by Reserve Bank of India	
6.	Divergence in Net NPAs (5-4)	
7.	Provisions for NPAs as on March 31, 20XX as reported by the bank	
8.	Provisions for NPAs as on March 31, 20XX as assessed by Reserve Bank of India	
9.	Divergence in provisioning (8-7)	
10	Reported Profit before Provisions and Contingencies for the year ended March 31, 20XX	
11.	Reported Net Profit after Tax (PAT) for the year ended March 31, 20XX	
12.	Adjusted (notional) Net Profit after Tax (PAT) for the year ended March 31, 20XX after considering the divergence in provisioning	

* March 31, 20XX is the close of the reference period in respect of which divergences were assessed

References-

1. Mukherjee, D.D., Credit Analysis, Risk Analysis & Decision Making, 2014, Snow While Pub.
2. Balance Sheet of Banks - Disclosure of Information, RBI Circular, UBD CO BPD (PCB) Cir. No.52/12.05.001/2013-14 dated March 25, 2014.

10 per cent for disclosures required to be made in the financial statements upto the year ended March 31, 2023. To determine this threshold, UCBs should add back (a) tax expense, and (b) provisions for standard and non-performing assets (recognised as expenses in their Profit and Loss Account) to their reported net profits for the year (Annex III Disclosure in financial statements – 'Notes to Accounts')

3. RBI Circular, DCBR.BPD.(PCB/RCB)Cir.No.1/16.20.000/2018-19 dated July 6, 2018
4. Master Direction on Financial Statements - Presentation and Disclosures (Updated as on February 20, 2023) - DOR.ACC.REC.No.45/21.04.018/2021-22

Chapter X

Management of Advances

Chapter X

Management of Advances

This chapter covers the extant (a) Exposure Norms and (b) Income Recognition, Asset Classification and Provisioning Norms for Primary (Urban) Cooperative Banks.

10.1 Exposure Norms, Statutory and Other Restrictions

UCBs needs to be conscious of this credit concentration risk while framing their loan policies and prescribing limits on their exposure to an individual borrower, a group of connected borrowers as well as exposure to various industries/ sectors or sensitive sectors of the economy.

To manage the credit concentration risk at UCBs, the RBI has prescribed the following prudential exposure norms for loans and advances of UCBs:

Single and Group Borrower Exposure Limits

- With effect from March 13, 2020, the prudential exposure limit for UCBs' exposure to a single borrower and group of connected borrowers have been revised to 15% and 25% of their **Tier-I capital**. Before this, the limits were 15% and 40% of UCBs' total capital funds.
- The revised limits apply to all types of **fresh exposures** taken by UCBs and the banks were required to bring down their existing exposures within the above-mentioned revised limits by March 31, 2023.
- Existing exposures (if consists of only term loans and non-fund-based facilities) may be allowed to continue as per their respective repayment schedule/ till maturity.
- The decision in regard to the definition of a group is left to their perception, as banks are generally aware of the basic constitution of their clientele. The guiding principle in this regard being **commonality of management** and **effective control**. The different firms with one or more common partners engaged in the same line of business, viz. manufacturing, processing, trading activity, etc. should be deemed to be connected group and units coming under common ownership should be deemed to be a single party/ borrower.
- As per the revised RBI guidelines dated March 13, 2020, 50 per cent of UCBs' aggregate loans and advances should be comprising loans of not more than ₹25 lakh or 0.2% of their Tier I capital, whichever is higher, subject to a maximum of ₹1 crore, per borrower. UCBs

not presently in compliance with the prescribed threshold limit will have to conform with the above requirements by **March 31, 2024**.

- Ideally, the bank's BOD should fix a lower internal ceiling for single and group borrowers considering the bank's size and risk-absorbing capacity. The banks can decide about the concept of group and identify the group borrowers themselves. The guiding criteria for identifying a group would be a commonality of management and controlling interests across firms or companies.
- The "exposure" includes both credit exposure and investment exposure (i.e., non SLR). The credit exposure is calculated by considering the sanctioned limit or balance outstanding whichever is higher. In the case of credit exposure, both the fund based (like CC, TL, ODs, etc.) and non-fund based limits (LCs, Guarantees etc.) as also ad-hoc amounts sanctioned, if any, are to be reckoned for calculation of limits. However, loans against the bank's own term deposits will not be reckoned for computation of exposure norms.
- In the case of term loans, the banks may reckon the outstanding limit lower than the sanctioned limits, as exposure, provided the outstanding balance has been reduced as a result of repayments by the borrower and there is no condition in the loan agreement that the borrower can avail of additional limits after repayment of principal.
- The exercise of computing the exposure ceilings may normally be carried out every year after the finalization and audit of bank's balance sheet and the exposure ceilings may be advised to the loan sanctioning authorities and investment department in the bank.
- In view of the linking of shareholding to lending, accretion to or reduction in the share capital may be considered for determining exposure ceiling even at half-yearly intervals, with the approval of the board of directors. Accordingly, banks may, if they so desire, fix a fresh exposure limit considering the amount of share capital available as on 30th September.

Exposure to housing, real estate and commercial real estate:

- A UCB's exposure to housing, real estate and commercial real estate loans is required to be limited to 10% of total assets as on March 31st of the previous financial year.
- An additional limit of 5% of total assets for the purpose of grant of housing loans to individuals as per the eligibility limits for priority sector classification, as contained in Master Direction FIDD.CO.Plan.BC.5/04.09.01/2020-21 dated September 04, 2020, amended from time to time.
- Tier-I UCBs can extend a maximum loan of ₹60.00 lakhs for housing. Tier-II UCBs can extend the maximum loan of ₹140.00 lakhs for the same, subject to the total exposure ceilings stipulated above.

- Working capital loans granted against hypothecation of construction materials, to contractors, who undertake comparatively small construction on their own, without receiving advance payments are exempted from this limit.

Exposure to Unsecured loans:

The limits on unsecured (with or without surety) have been revised w.e.f., November 15, 2010[34]. The banks will have to fix limits based on their CRAR and DTL. The revised limits are furnished in the following table:

Criteria/ UCBs with….	**DTL up to ₹10 crore**	**DTL above ₹10 crore and up to ₹50 crore**	**DTL above ₹50 crore and up to ₹100 crore**	**DTL above ₹100 crore**
CRAR => than 9%	₹1.00 lakh	₹2.00 lakh	₹3.00 lakh	₹5.00 lakh
CRAR < than 9%	₹0.25 lakh	₹0.50 lakh	₹1.00 lakh	₹2.00 lakh

The total unsecured loans and advances (with or without surety) granted by a UCB to its members should not exceed 10% of its total assets as per the audited balance sheet as on March 31st of the preceding year.

a) Unsecured advances to salaried employees

- Advances granted by salary earners' banks to salaried employees against personal security is treated as secured, provided that the Co-operative Societies Act of the State concerned contains an obligatory provision for deduction of periodical loan instalments by the employer out of the employee's salary/ wages to meet the bank's claims and provided further that the bank has taken advantages of this provision in respect of each of such advances and a general limit for such advances is fixed by the bank in terms of certain multiples of the pay packet taking into account the monthly income of the employees.
- However, for the other UCBs, the above provision applies only for computation of the aggregate limit on the unsecured advances to the members as a whole. While granting advances to the individual salaried borrowers, the banks should ensure that these advances do not exceed the maximum limit on unsecured advances as mentioned in the table above.

b) Special Dispensation for unsecured advances[35]

- Unsecured loans up to ₹10,000/- are exempt from the aggregate ceiling of 10% of total assets, provided:
- Individual loan amount does not exceed ₹10,000/-.
- Loan is given for productive purpose and banks ensure the end-use of funds.
- The bank's CRAR is 9% or above and Gross NPAs are less than 10%.

[34] Circular UBD. BPD. (PCB) Cir. No. 21/13.05.000/2010-11 dated November 15, 2010

[35] Circular UBD CO BPD (PCB) Cir. No.29/13.05.000/2013-14 dated October 10. 2013

- Unsecured loans so extended should not exceed 15% of the bank's total assets. Financial parameters detailed above shall be as on March 31 of the previous year, as assessed by RBI.

c) Further Special Dispensation for unsecured advances[36]

UCBs with priority sector loan portfolio of 90% or above, are allowed to grant unsecured advances to the extent of 35% (10% + 25%) of their total assets as per the audited balance sheet at the end of the preceding financial year, provided:

- Additional unsecured loan portfolio above the normally permitted 10%, should comprise of only priority sector loans and the exposure to any individual borrower should do not exceed ₹40,000/-.
- The bank's CRAR is not less than 9% and Gross NPAs are not more than 7% as per the latest RBI Inspection Report and audited financial statements:

Loans against the security of bank's own shares:

In terms of Section 20(1) (a) of the Banking Regulation Act 1949 (AACS), UCBs are not permitted to grant loans and advances against the security of their own shares.

Remission of debt of Directors

Section 20A (1) of the Banking Regulation Act 1949 (AACS) prescribes that a UCB, without the prior approval of RBI, remit in whole or in part any debt due to it by:

(a) Any of its past or present directors

(b) Any firm or company in which any of its directors is interested as director partner, managing agent or guarantor or

(c) Any individual, if any of bank's directors is his partner or guarantor

(d) In terms of section 20-A (2) of the said Act, any remission made in contravention of the provision of subsection (1) should be void and of no effect.

Exposure Limits on loans to nominal members

UCBs may sanction loans to nominal members for short/temporary period and for purchase of consumer durables, subject to following limits:

- Banks with deposits up to ₹50 crores can give a maximum loan of ₹50000/- per borrower.
- Banks with deposits above ₹50 crores can give a maximum loan of ₹100000/- per borrower.

Banks should desist from making loans against FDRs/term deposits of other banks.

Granting of loans and advances to Directors and their relatives

UCBs shall not make, provide or renew any loans and advances or extend any other financial accommodation to or on behalf of their directors or their relatives, or to the firms / companies

[36] Circular DCBR.CO.BPD. (PCB). No.15/13.05.000/2015-16 dated April 21, 2016

/ concerns in which the directors or their relatives are interested. Further, the directors or their relatives or the firms / companies / concerns in which the directors or their relatives are interested shall also not stand as surety / guarantor to the loans and advances or any other financial accommodation sanctioned by UCBs. 'Advances' for the purpose shall include all types of funded / working capital limits such as cash credits, overdrafts, credit cards, etc.

Exceptions:

- Regular employee-related loans to staff directors on the board of UCBs
- Normal loans as applicable to member directors on the boards of salary earners cooperative banks
- Normal employee-related loans to managing directors/CEOs of UCBs
- Loans to directors and their relatives against fixed deposits, government securities and life insurance policies standing in their own name.
- Directors/relatives cannot be guarantors or sureties to loans by UCBs

Loans against shares/debentures:

Aggregate of all such loans should not exceed 20% of bank's owned funds. Banks are prohibited from extending any loan or similar facility to stockbrokers.

Loans against pledge of shares:

UCBs can grant loans against the security of shares/ debentures/ bonds/ units of mutual funds to **individuals** subject to a ceiling of ₹5 lakh in case the shares offered as security is in physical form (non-dematerialized) and ₹10 lakh in case the shares offered are in dematerialized form. However, in such loans, a minimum margin of 50% should be obtained.

Bank Guarantees:

As a rule, UCBs may provide only financial guarantees and not performance guarantees. However, scheduled UCBs may issue performance guarantees on behalf of their constituents subject to exercising due caution in the matter. It would be desirable for UCBs to confine their guarantees to relatively short-term maturities. In any case, guarantees should not be issued for periods exceeding ten years.

Limit on Bank Guarantees: Total guarantees should not exceed 10% of paid-up capital, reserves and deposits and within the overall ceiling the proportion of unsecured guarantees outstanding at any time may be limited to an amount equivalent to 25% of the bank's own funds (paid-up capital + reserves) or 25% of the total amount of the guarantees, whichever is less.

Bank finance to Non-Banking Financial Companies (NBFCs)

UCBs are not expected to enrol non-banking financial institutions like investment and financial companies as their members since it would be in contravention of the state cooperative societies act concerned and also not in conformity with the provisions of model bye-law No.9 recommended for adoption by all UCBs.

UCBs are also not permitted to finance NBFCs other than those engaged in hire purchase/ leasing (also known as Asset Finance Companies). Further, financing of asset finance companies by UCBs on a large scale is also not favoured by RBI since UCBs are required to cater to the credit needs of the people of small means. UCBs with working capital funds aggregating to ₹25 crores and above only are permitted to finance asset finance companies. The level of finance to asset finance companies depends on the net owned funds of the companies subject to an overall ceiling on their borrowings up to 10 times of their net owned funds.

Financing of agricultural activities

UCBs are permitted to finance agricultural activities under priority sector provided:

- They provide direct finance, only to regular members (i.e., not nominal members), and not through any agency like PACS or land development banks, etc.
- They extend credit only after obtaining "no dues certificate" from the existing credit agencies in the area.
- They follow the scales of finance and obtain security as per extant guidelines issued by RBI/ NABARD.

Loans to Self Help Groups (SHGs)/ Joint Liability Groups (JLGs)

UCBs may lend to SHGs and JLGs as per their Board approved policy. Only direct lending is allowed and lending through intermediaries is not permitted. The extant exposure limits on the grant of unsecured loans and advances do not apply to loans granted to SHGs. However, loans granted to JLGs to the extent not backed by tangible security are treated as unsecured, and accordingly, are subject to the extant exposure limits on unsecured loans and advances. Normally, the maximum amount of loan to SHGs should not exceed four times of the savings of the group. However, this limit may be exceeded in case of well-managed SHGs subject to a ceiling of ten times of savings of the group. As JLGs are not obliged to keep deposits with the bank, the loans granted to JLGs would be based on the credit needs of the JLG and bank's assessment of the credit requirement.

10.2 Income Recognition, Asset Classification & Provisioning (IRAC & P) Norms

Banks need to pay close attention to the quality of assets in their books and should frame transparent policies and guidelines for credit management, with the approval of their boards, keeping in view the prudential guidelines issued by RBI for income recognition, asset classification and provisioning on advances.

To ensure that the bank's actual financial health is reflected in its balance sheet, RBI introduced prudential norms for income recognition, asset classification and provisioning

(IRAC & P norms) for the asset portfolio of the banks based on the recommendations made by the Committee on Financial System (Chairman Shri M. Narasimham) so as to move towards greater consistency and transparency in the published accounts.

The classification of assets of banks has to be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms. Similarly, the income recognition should be objective and based on record of recovery rather than on any subjective considerations. Likewise, the provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realisable value thereof. Further, banks need to ensure that while granting loans and advances, realistic repayment schedules are fixed by them on the basis of cash flows with borrowers which would go a long way to facilitate prompt repayment by the borrowers and thus improve the record of recovery in advances.

10.3 Important Concepts and Definitions

A. Specification of due date/repayment date

- The extant instructions on IRACP norms specify that an amount is to be treated as overdue if it is not paid on the due date fixed by the bank. Sometimes, it is observed that due dates for repayments are sometimes not specifically mentioned in the loan agreements, and instead a description of due dates is mentioned, leaving scope for different interpretations.

- It is essential for the banks to specify the exact due dates for repayment of a loan, frequency of repayment, breakup between principal and interest, examples of SMA/NPA classification dates, etc. clearly in the loan agreement and the borrower should be apprised of the same at the time of loan sanction and also at the time of subsequent changes, if any, to the sanction terms/loan agreement till full repayment of the loan.

- In cases of loan facilities with moratorium on payment of principal and/or interest, the exact date of commencement of repayment should also be specified in the loan agreements.

B. Classification as Special Mention Account (SMA) and NPA)

- The banks should recognize incipient stress in borrower accounts, immediately on default, by classifying them as special mention accounts (SMA).

- In order to remove any ambiguity, the intervals are intended to be continuous and accordingly, the basis for classification of SMA categories shall be as follows:

Loans other than revolving facilities		Loans in the nature of revolving facilities like cash credit/overdraft	
SMA Sub-categories	Basis for classification – Principal or interest payment or any other amount wholly or partly overdue	SMA Sub-categories	Basis for classification – Outstanding balance remains continuously in excess of the sanctioned limit or drawing power, whichever is lower, for a period of:
SMA-0	Upto 30 days		-
SMA-1	More than 30 days and upto 60 days	SMA-1	More than 30 days and upto 60 days
SMA-2	More than 60 days and upto 90 days	SMA-2	More than 60 days and upto 90 days

C. Classification as SMA as well as NPA as part of "Day-end Process"

- The borrower accounts should be flagged as overdue by the banks as part of their day-end processes for the due date, irrespective of the time of running such processes.
- Similarly, classification of borrower accounts as SMA as well as NPA shall be done as part of day-end process for the relevant date and the SMA or NPA classification date shall be the calendar date for which the day end process is run. In other words, the date of SMA/NPA shall reflect the asset classification status of an account at the day-end of that calendar date.
    - <u>*Example:*</u> *If due date of a loan account is March 31, 2022, and full dues are not received before the lending institution runs the day-end process for this date, the date of overdue shall be March 31, 2022. If it continues to remain overdue, then this account shall get tagged as SMA-1 upon running day-end process on April 30, 2022 i.e. upon completion of 30 days of being continuously overdue. Accordingly, the date of SMA-1 classification for that account shall be April 30, 2022.*
    - *Similarly, if the account continues to remain overdue, it shall get tagged as SMA-2 upon running day-end process on May 30, 2022 and if continues to remain overdue further, it shall get classified as NPA upon running day-end process on June 29, 2022.*
- RBI instructions on SMA classification of borrower accounts are applicable to all loans, including retail loans, irrespective of size of exposure of the lending institution.

D. Clarification regarding definition of 'out of order'

A cash credit/overdraft (CC/OD) account is classified as NPA if it is 'out of order'.

In order to avoid any ambiguity regarding determination of 'out of order' status of CC/OD accounts on a continuous basis, RBI vide circular dated November 12, 2021 clarified that an account shall be treated as 'out of order' if:

- the outstanding balance in the CC/OD account remains continuously in excess of the sanctioned limit/drawing power for 90 days, or

- the outstanding balance in the CC/OD account is less than the sanctioned limit/drawing power but there are no credits continuously for 90 days, or the outstanding balance in the CC/OD account is less than the sanctioned limit/drawing power but credits are not enough to cover the interest debited during the previous 90 days' period. The aforesaid 'previous 90-day period' is inclusive of the day for which the day-end process is being run.

E. NPA classification in case of interest payments

In terms of paragraph 2.1.1 of the Master Circular on IRACP norms dated April 02, 2024, in case of interest payments, an account is classified as NPA if the interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan.

F. Income recognition policy for loans with moratorium on payment of interest

- In cases of loans where moratorium has been granted for repayment of interest, lending institutions may recognize interest income on accrual basis for accounts which continue to be classified as 'standard'. This shall be evaluated against the definition of 'restructuring' provided in paragraph 1 of the Annex-1 to the above-mentioned 'Prudential Framework for Resolution of Stressed Assets' dated June 7, 2019. However, income recognition norms for loans towards projects under implementation involving deferment of DCCO and gold loans for non-agricultural purposes shall continue to be governed as per the existing instructions.

- The extant instructions (compiled at paragraph 3.2 of the Master Circular on IRACP norms dated October 1, 2021) require that once an account is classified as NPA, the entire interest accrued and credited to income account in the past periods, must be reversed to the extent it remains unrealised. It is clarified that if loans with moratorium on payment of interest (permitted at the time of sanction of the loan) become NPA after the moratorium period is over, the capitalized interest corresponding to the interest accrued during such moratorium period need not be reversed.

G. Upgradation of accounts classified as NPAs

- It has been observed that some lending institutions upgrade accounts classified as NPAs to 'standard' asset category upon payment of only interest overdues, partial overdues, etc.
- In order to avoid any ambiguity in this regard, RBI has clarified that loan accounts classified as NPAs may be upgraded as 'standard' asset only if entire arrears of interest and principal are paid by the borrower. With regard to upgradation of accounts classified as NPA due to restructuring, non-achievement of date of commencement of

commercial operations (DCCO), etc., the instructions as specified for such cases shall continue to be applicable.

G. Consumer Education

- With a view to increasing awareness among the borrowers, lending institutions shall place consumer education literature on their websites, explaining with examples, the concepts of date of overdue, SMA and NPA classification and upgradation, with specific reference to day-end process.
- Lending institutions may also consider displaying such consumer education literature in their branches by means of posters and/or other appropriate media.
- Further, it shall also be ensured that their front-line officers educate borrowers about all these concepts, with respect to loans availed by them, at the time of sanction/disbursal/renewal of loans.

10.4 Classification of Assets

As per prudential guidelines, banks are required to classify their assets into following two major heads.

A. Standard or Performing Assets: An asset which generates income regularly to the bank and which does not pose more than normal risk attached to the business of banking.

B. Non-Performing or Impaired Assets: An asset is said to be non-performing when it ceases to generate income for the bank and poses more than normal risk. An asset which displays significant problems with a diminished possibility or no possibility of any recovery, it is said to be an impaired or non-performing asset.

The above-mentioned classification is based on an objective criterion. The criterion is primarily based on whether the asset generates income to the bank or not. In other words, whether a borrower, regularly services or pays instalment/interest on a loan is the prime determining factor for classification of an asset. Accordingly, a loan asset is classified as non-performing (NPA) if interest and/or instalment of principal have remained unpaid for a specific period of time. Currently, as per the extant RBI guidelines, a loan or advance is classified as impaired or non-performing if the interest and/ or principal remains unpaid for 90 days.

Non-Performing Assets (NPAs) are further classified under three broad heads based on the time period, for which they have remained non-performing viz.:

a) **Sub-Standard Asset:** An asset is said to be sub-standard if it remains non-performing for a period equal to or less than 12 months.
b) **Doubtful Asset:** An asset is classified as doubtful if it remains non-performing for more than 12 months. Doubtful assets are further sub-classified as Doubtful-I,

Doubtful-II, and Doubtful-III depending upon the period for which they have remained in doubtful category.

c) **Loss Asset:** An asset in which there is no possibility of any recovery/ considered uncollectible or there is a threat to its recovery is classified as a loss asset.

The banks should recognize income on an accrual basis only for a performing asset and not recognize the same, on an accrual basis in the case of a non-performing asset. In the case of NPAs, income is to be recognized only when it is actually received (realization or cash basis). Moreover, any interest income on advances credited to P&L account on accrual basis should be reversed by debit to the P&L account once the account is classified as NPA.

10.5 Provisioning norms on Standard and Non-Performing Assets:

Once the assets are classified as per the above norms, banks are required to set aside a certain portion of their profits, as provisions, for the impaired assets referred as ‘Bad & Doubtful Debt Reserve (BDDR) in UCBs. The provisions should be created by charging to the P&L account of the banks.

Further, the banks also have to make provision for standard or performing assets. As per the extant norms, the provisioning requirement is summarized in the following table:

Classification	Time Period	Provisioning requirement
Standard Asset or Performing Asset	Performing and existing until maturity of the loan, or advance.	Direct advances in Agriculture and SME sectors: All UCBs: 0.25%
		Commercial Real Estate (CRE) sector: All UCBs: 1.00% CRE-Residential Housing Sector (CRE-RH): All UCBs: 0.75%
		All other loans and advances other than the ones mentioned above. 0.40%. (The erstwhile Tier I UCBs which are currently maintaining standard asset provision of 0.30% for such loans will make provision of 0.35% by September 30, 2024 and of 0.40% by March 31, 2025).
Non-Performing Assets (NPAs)		
Substandard Asset	If it remains as non-performing for a period less than or equal to 12 months from the date of classification.	10% of the balance outstanding without making any allowance for ECGC. Provisioning of 10% is irrespective of security available in the account.
Doubtful Asset		
Doubtful I	If it remains non-performing for more than 12 months but less than or equal to	20% of the secured portion and 100% of the unsecured portion.

	24 months from the date of classification.	
Doubtful II	If it remains non-performing for more than 24 months but less than 36 months.	30% on the secured portion and 100% on the unsecured portion
Doubtful III	More than three years in the doubtful category or more than four years as NPA from the date of classification.	100% of the balance outstanding irrespective of the value of security available.
Loss asset	No time limits. If there is a threat to the recovery of the asset or there is a fraud in the borrower account which is likely to impede recovery. If any of the above conditions are met, an asset can be straightaway classified as a loss without passing them through the various stages of classification.	. Loss assets should be written off after obtaining approval from the competent authority and as per the provisions of the Co-operative Societies Act/ Rules. If the assets are permitted to remain in the books ofr any reason, 100% of the outstanding should be provide for.

Adherence to 'IRAC & P' norms

If the banks do not follow the IRAC and provisioning norms, then either during the bank's audit (concurrent or statutory) or during RBI inspection, there is a likelihood of adverse comments being made in the audit/ inspection reports on non-adherence to the norms. Moreover, the Tier-I capital worked out by the bank would be adversely affected to the extent of non-provisioning/ interest income wrongly recognized in the case of NPA accounts. These will be adjusted from the Tier-I capital during statutory inspections for assessment of the real capital (CRAR) and net worth of the bank.

Chapter XI

Credit Appraisal

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Credit Appraisal

11.1 Credit Appraisal

Accurate measurement and assessment of credit risk are critical as the quality of credit exposure is one of the riskiest areas for banks. Accordingly, credit assessments have to be sophisticated, directed and streamlined. Correct pricing and management of credit risk exposures hinge on their proper assessment. There are many frameworks to assess credit risk. One of the simplest yet time-tested one is that of the five “C”s. The “C”s stand for:

1. Character
2. Capital
3. Capacity
4. Collateral
5. Conditions/ Cycle

Character

The character stands for the behavioural, ethical and moral values of a borrower. UCBs should carry out required due diligence process to “know their customer” quite well, especially the real persons behind the legal person. Generally, the character is reflected in the credit history of the prospective borrower and signals, to a large extent, towards the risk of non-repayment due to inherent traits of the prospective borrower.

Capital

Capital means the own funds of the borrower. A bank normally funds the majority of the funds requirement of the borrower. However, once the funding is done, the bank does not get to actively control the day to day decisions of the borrower. In other words, the bank contributes the funds but practically has no say in the running of the borrower entity. This is a recipe for recklessness on the part of the borrower. This risk is reduced drastically if significant losses accrue to the borrower first. This is achieved by insisting that some capital is brought in by the borrower as well. We also call it ‘margin’. The capital being own funds is not contractually bound and whenever any losses hit the business, those can be shaved off from the capital. Therefore, more the capital more the cushion for losses before it hits the banks’ lending.

Capacity

It is the cash flow assessment of the borrowers so as to understand their ability for repayment. While assessing the cash flows, banks need to be aware of the fact that accounting profit is the outcome of not only cash flows but also valuations of assets and liabilities in the balance sheet (take for instance depreciation of fixed assets). Banks should carefully analyze the financial statements to get an idea of the borrowers’ capacity to repay. The assessment should keep in mind that historical performances may not be replicated in future. Therefore, we need a forecast of cash flows and our appraisal is as good as how good we can predict the future.

Collateral

Primary security is the asset generated out of the loan given whereas collateral is mostly an asset coming from the accumulated wealth of the borrower. It is more of a moral suasion rather than a source of timely cash flow. One need to be careful with collateral especially in terms of valuation, as many times it is observed that market value is not realized when the bank puts the collateral for sale.

Conditions / Cycle

The borrowers operate in an environment which exerts significant influence on their performance. The basic tenets of economics like demand and supply, and forces of competition do have their effects on borrowing entity's performance. While preparing the credit appraisal notes, these effects are studied under the head conditions and cycle. Business and economic environment is full of uncertainties, therefore, assessing conditions during the credit appraisal of the borrowers is the second most difficult aspect after the 'Character'.

Simple though in appearance and structure, the above model is at the core of any credit assessment methods and if the questions regarding the five "C"s are answered by the credit assessment system, we can to a high degree of confidence say that the system is robust.

11.2 Financial Statement Analysis for Credit Appraisal

A significant portion of the data used in credit assessment comes from financial statements. Credit assessment is a forward-looking process and projections of business along with past trends give the banker a reasonable idea of the prospects of the business. The two "C"s of 'Capital' and 'Capacity' are to a large extent assessed using financial statements. As such a fundamental understanding of the financial statements is an essential skill for credit analysts/ officers of the banks involved in the credit appraisal process.

Three financial statements normally available are: (i) the Balance Sheet, (ii) Profit and Loss Statement and (iii) the Cash Flow Statement. We need to understand that the double entry or mercantile system of accounting is a model based on many assumptions and it differs from our day to day view of our personal finances which is basically cash based. One of the key assumptions of double entry system is that every transaction is to be recorded as a 'source' of funds and 'use' of funds. The source of fund is indicated by the notation "Cr-Credit" and the use of funds is indicated by the notation "Dr-Debit".

Another assumption used is the "accrual basis" of accounting. As per this assumption, any 'income or expense' is accounted for in the books in the period in which they have been 'earned or incurred' irrespective of the fact whether the 'cash flow' pertaining to that 'income or expense' has occurred during that particular period or not. This flows from another assumption "the going concern" wherein one is sure that the institution is going to operate further into the future and the owner has no intention of winding it up. The accrual basis of accounting tends to 'over' or 'under'-estimate the real flow of cash during the accounting period. Another important point is regarding the "cost". Cost is recorded at historical values and the impact of the change in valuation of assets and liabilities during the current period is again assessed using various models like "fair value". The balance sheet provides a position of an enterprise only for that "point of time", it is like a snapshot or photograph of a running train. It does not give any information about the flow of money but only about the stock of assets and liabilities on a particular day. The common public many a times misunderstands the balance sheet as the performance during the period and it gives fraudsters/ manipulators a chance to artificially boost the assets and liabilities figures only for a particular date and show a rosy picture. This process is called "window dressing".

The balance sheet comes along with the "Profit and Loss" statement and they are interrelated. The profit and loss statement provides us with information regarding the income and expenditure of an enterprise 'during' the accounting period. Unlike the balance sheet, the profit and loss statement captures the flow of money during the period under consideration. It is like a video of the enterprise's income and expenditure. The 'profit or loss' arrived at in this statement are carried forward to the balance sheet in the 'liabilities or assets' side respectively.

The third and most important statement from a banker's perspective is the cash flow statement. As we know that 'income and expenses' are accounted on an accrual basis and one needs to adjust them for notional 'inflows and outflows' of money to arrive at the real cash flow during the period. The cash flow statement as such provides information on cash inflows and outflows. The sources of these cash flows are divided into three viz. (i) Operating activities, (ii) Investment activities and (iii) Financing activities.

Operating activities are related to the sales activities of an enterprise and include purchase of stock, expenses on labour and sales. It is the core income generation activity of the enterprise. An excess of cash inflow over cash outflow is called a positive cash flow and vice versa. A positive operating cash flow is the most fundamental requirement of bank finance. In other words, sales should cover the expenses of operating activities. This will happen only when the enterprise is able to sell its products and services above the cost of producing them. A negative operating cash flow is a significant danger signal for an established enterprise and is called a 'cash burn' situation.

Investing activities involve the purchase of capital goods like plant and machinery as well as land/ premises and their sale. One can imagine that the profits from operating activities being channeled by an enterprise to broaden their existing business or start other ventures. A negative investment cash flow indicates more money being invested in capital assets and positive investment cash flow indicates the sale of capital assets.

Financing activities indicate those activities through which the business raises money for itself. One can imagine money being brought in by the owner as 'equity capital' and the remaining being raised as a 'debt' of various forms. Dividend payments and interest payments are the outflows for financing activities.

Now let us move onwards to the analysis of a financial statement. The idea is to simplify the complex statements and bring out relationships which are of interest to us. Figures expressed in percentages are easy for us to understand. As such, the first step in percentage analysis is to convert the financial statements as a percentage of a common factor. Normally, balance sheet items are expressed as a percentage of total assets whereas profit and loss statement is expressed as a percentage of sales/ operating income/turnover. For our study purposes, let us use a simplified balance sheet and profit and loss statement to apply the concepts.

Income Statement (in ₹ thousand)		
Item	**Amount**	**% of operating income**
Operating income	4300	100
(-)Operating cost	3100	72.09
(-)Business Tax and surcharges	0	0
(-)Operating Expenses	250	5.81
(-) General and administrative expenses	200	4.65
(-) Financial Expenses	130	3.02
Operating Profit	620	14.42
Income Tax	100	2.33
Net Profit	520	12.09

Balance Sheet (in ₹. thousand)					
Asset	**Amount**	**% of total asset**	**Liabilities**	**Amount**	**% of total**
Current Asset			Current Liability		
Cash	1720	18.07	Short term	2100	22.06
Accounts	1300	13.66	Accounts Payable	800	8.40
Prepaid accounts	150	1.58	Wages Payable	0	0
Inventory	500	5.25	Total Current	2900	30.46
Total Current Asset	3670	38.55	Non-Current		
			Long-term loans	3000	31.51
Non-Current Asset		61.45	Bonds payable	0	0
Long-term	0	0	Shareholders' equity	3620	38.03
Fixed Asset	5700	59.87	Capital Stock	3200	33.61
Intangible and other	150	1.58	Additional paid-in	0	0
			Surplus reserve	0	0
			Retained Earnings	420	4.41
Total Assets	9520	100	Total liabilities and	9520	100

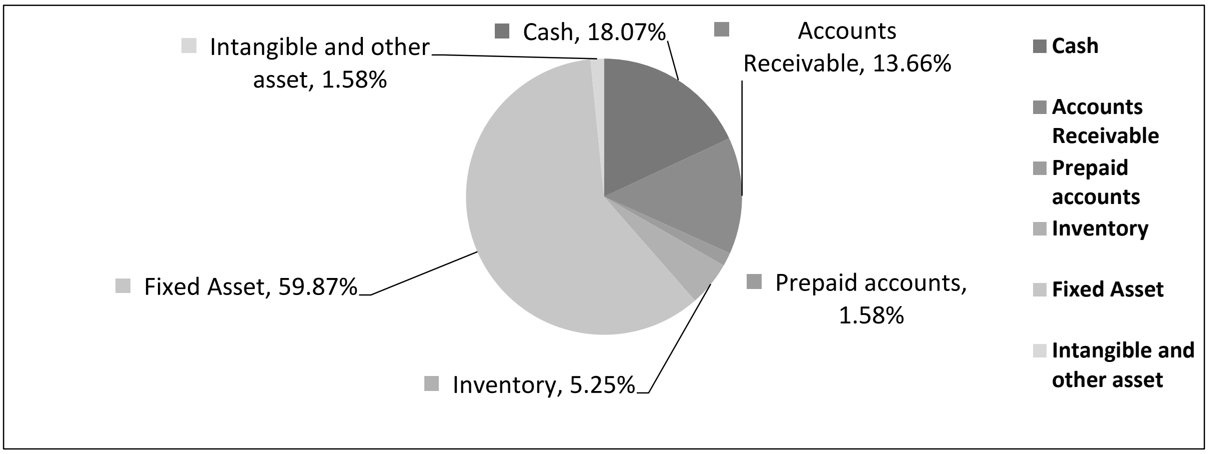


Figure 1: Asset Composition (Sample Analysis)

The above pie diagram (figure 1) depicts the asset side of the balance sheet as a percentage of total assets. Usually, the asset side is divided into current assets and non-current assets. We observe that current assets are composed of cash, account receivables, prepaid accounts, inventory etc., whereas non-current assets are comprised of fixed assets, intangible, goodwill etc. The logic of the separation needs a bit of explanation.

Non-current assets, as we noted is comprised mostly of fixed assets and these are not for sale but for producing the goods and services. Current assets, on the other hand, get converted to the final product or service and earn revenue. We note that cash is the output of cash sales, account receivables that of credit sales. Inventory gets transformed from raw material to semi-finished goods (stock in the process) and finally to finished goods. Prepaid accounts are those services for which money has already been paid and would be used up shortly. From the above diagram, we can guess that this is most probably a capital-intensive unit as around 60% of the assets are locked up in fixed assets. Current assets hold a central position in working capital finance and the assumption is that current assets pay back current liabilities like overdraft, cash credit, working capital term loan etc.

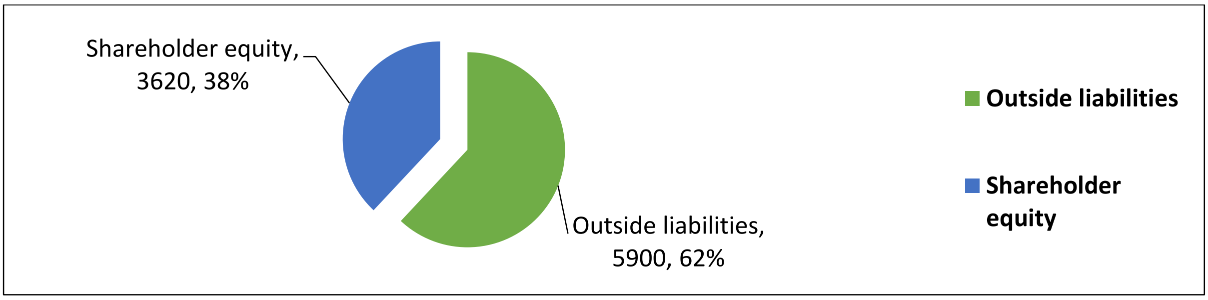


Figure 2: Liabilities Composition (Sample Analysis)

In the pie diagram above (figure 2), we have expressed the liability side of the balance sheet as a percentage of total assets. The diagram gives the source of funds for the operations. We observe that 38% of the funds are "owned funds" and the remaining 62% is "borrowed funds". This figure also gives the debt and equity (margin) proportions of the unit. We note that the ratio of debt to equity or leverage has a huge predictive value in the long-term survival rate of the unit, the lower the ratio the better.

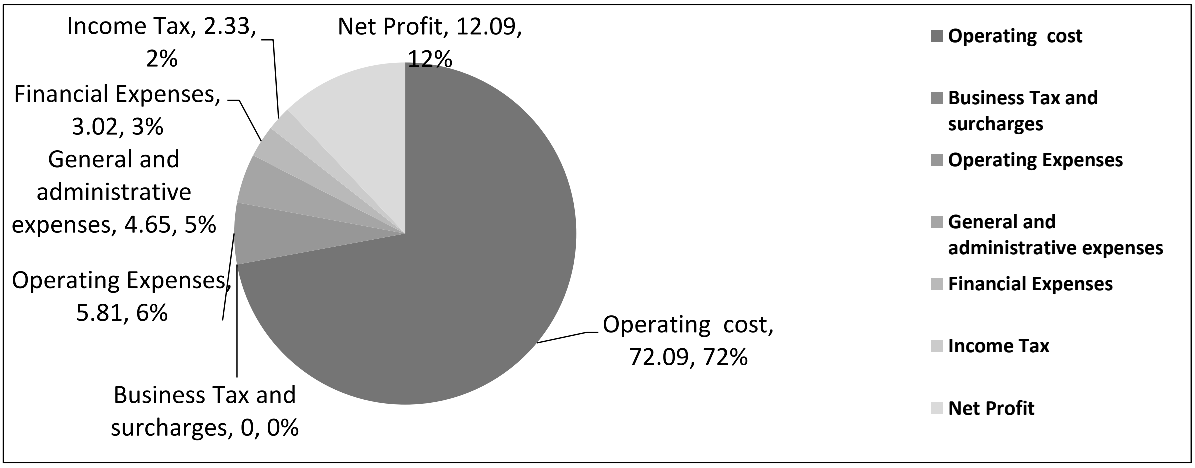


Figure 3: PL Composition (Sample Analysis)

In the pie diagram above (figure 3), the items of profit and loss statement as a percentage of sale/operating income/ turnover are shown. The diagram provides a simple and powerful visual analysis of how the income of the company gets distributed or used up. We note that for every hundred Rupees of income, around Rupees seventy-two is spent on cost. Operating cost is the expenses till the finished product is created. We also know that sales minus cost is gross profit. In percentage terms, we calculate the ratio as gross profit to sales and the ratio is called "gross profit margin". Further, expenses eat up the gross profit, these expenses include operating expenses, which are the expenses from the finished products till their sale. We also have general and administrative expenses which are generally the expenses of the staff function (corporate office, legal, secretarial etc.) rather than line function and financial expenses which are the cost of borrowing. We arrive at the operating profit after deducting from operating income all the expenses except income tax. When we express operating profit as a percentage of sales we call it "operating profit margin".

11.3 Profitability/ Margin Analysis

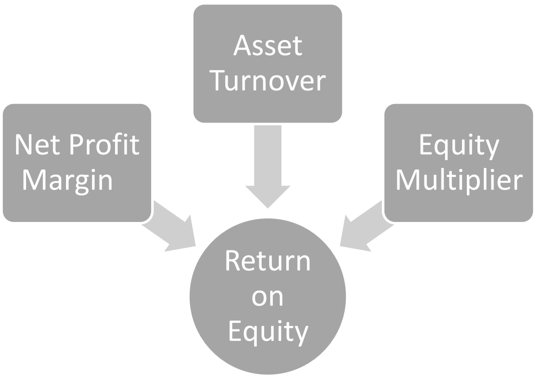
Assessment of profitability is another step in the credit appraisal process of the prospective borrower/ borrowing unit. In our example, the operating profit margin is 14.42%. In other words, the unit can make an operating profit of ₹14.42 from every ₹100.00 of sale. Operating profit is a key metric which every investor and credit analyst keenly watches as it gives the core income generating the strength of the business. One needs to note that the sale of investments is not an operating activity and is not included in operating profit. These items are added after operating profit to arrive at the profit before tax. We reduce income tax from profit before tax and the enterprise's net profit after tax (Profit after Tax – PAT) is obtained.

Net profit expressed as a percentage of operating income is one of the most crucial ratios in percentage analysis and is called "net profit margin" or simply net margin. Net profit margin indicates how much of the sales income is retained by the unit and therefore, it also indicates the financial effectiveness of the unit. The three margin ratios viz., gross profit, operating profit and net profit should be monitored 'over the years' and should also be compared with 'peers' of the borrowing unit/ prospective borrower. A rising trend and a trend above the peers indicate the higher financial effectiveness of the unit 'over the years' as well as 'over the peers'.

The margin ratios give the relationship between sales and profit. We need to drill deep into how efficiently sales are generated. The assumption is that assets are created in the business so that they generate sales. The speed with which sales are generated from assets is captured by the "asset turnover ratio". The asset turnover ratio gives how much of the assets got converted into sales during the accounting period. This ratio is calculated by dividing 'sales' by 'average total assets'. This ratio is a bridge between the two financial statements viz. Balance Sheet and P&L statement. As we are having only a single year's financial statements let us calculate the asset turnover ratio using total assets. We note that by deploying total assets of ₹95.20 lakh the unit generated sales of ₹43 lakh and therefore the ratio is worked out to be 45.17%. It can be interpreted as follows: the unit can generate sales of ₹45.17 for every ₹100 of assets deployed. This ratio indicates the efficiency of the unit in generating sales.

Now that we have come across two important ratios: the asset turnover and net profit margin, let us see how they are connected together. Asset turnover ratio gives an idea of sales generated from assets and net profit margin gives an idea of the amount retained as profit from sales. Naturally, if we take a product of these two ratios, we get an idea of the profits generated from assets deployed. As such, we can calculate the "return on assets" (ROA) as the product of asset turnover and net profit margin ratios. ROA is the ratio of profit to average total assets. In our example, product of net profit margin (12.09%) and asset turnover ratio (45.17%) shows that the ROA of the unit is 5.46%. In simple terms, the unit is able to generate a profit of rupees 5.46 per rupees hundred of assets deployed. Therefore, the institutions can play with both the ratios to improve their profits. One can attempt to increase sales by improving the asset turnover ratio. For example shampoos in sachets, expensive chocolates in lower weight packaging are efforts by enterprises to increase their profits by increasing their sales. Similarly, margins can be increased by reducing operating costs, operating expenses, business expenses, financial expenses etc. as well as by marketing exercises like branding, advertising etc.

The third factor affecting profitability other than net profit margin and asset turnover is “leverage”. Leverage is the ability of the unit to borrow money compared to its own funds. This can be measured as a ratio of debt to equity or the ratio of total assets to total shareholder equity. The ratio of total assets to total shareholder equity is also called equity multiplier. In our example, we note that total asset to total shareholder equity is 2.63 times (9520/3620). Leverage is a twin-edged sword, as ROA multiplied by equity multiplier provides the return on equity (own funds). In other words, if the unit makes a positive ROA, the return on equity (ROE) will be equity multiplier times ROA. Similarly, if the ROA is negative (losses) the erosion of capital will be ROA multiple times equity multiplier. In our example, the ROA is 5.46% and equity multiplier is 2.63 times, therefore the ROE of the unit is 14.36%. The shareholders of the unit are able to earn a return of ₹14.36 per hundred of their equity capital. Leverage has converted an ROA of 5.46% to an ROE of 14.36%. Imagine the erosion in capital if the ROA had a negative sign. It is exactly for the double-edged sword nature of the leverage, the banks tend to limit leverage of their borrowers. Any dilution in margin conditions tends to multiply the risks assumed by banks. The above analysis, called the “Du Pont Analysis”, is a comprehensive way of assessing the profitability of any unit. We summarize here the ratios that we had used to evaluate the profitability of a unit.



No.	Ratio	Formula
1.	Gross profit margin	Gross Profit/Sales*100
2.	Operating profit margin	Operating Profit/Sales*100
3.	Net profit margin	Net Profit/Sales*100
4.	Asset Turnover	Sales/ Average Total Assets*100
5.	Return on Assets	Net Profit Margin*Asset Turnover*100 or Net Profit/Average Total Asset*100
6.	Equity Multiplier	Average Total Assets/ Average Shareholder Equity
7.	Return on Equity	Net Profit Margin*Asset Turnover* Equity Multiplier*100 or ROA* Equity Multiplier or Net Profit/ Average Shareholder Equity

11.4 Solvency and Working Capital Analysis

11.4.1 Now that we have covered profitability analysis, let us move towards an analysis of short-term solvency of the borrowing units in the credit appraisal process. Short-term solvency can be assumed to be the ability of the unit to pay off short-term debts like working capital finance and interest servicing of long-term loans, let us say during the next year.

Let us start with the concept of "working capital cycle". We have noted that assets are classified into current assets and non-current (or fixed) assets and we know that fixed assets aid in the production of goods and services. All those activities which directly go into the production of goods and services and ultimately their sales are covered in what we call working capital cycle. The owner has to deploy cash to purchase inventory which goes through the production/ processing cycle, becomes the finished product ready for sales, and on selling

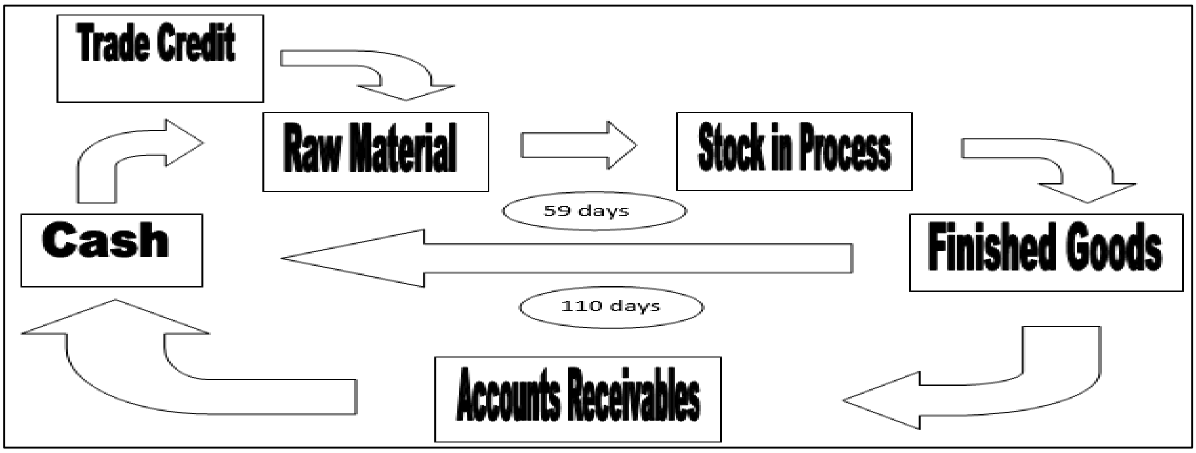


Figure 4: Operating Cycle

them & realizing the sales proceeds, the business unit gets cash. This is also called 'cash to cash' cycle. In essence, we are looking at the operating activities of the business unit. Any finance provided for carrying out the operating activities of the unit is called working capital finance. The lender needs to know/ estimate 'how much' and for 'how long' the money is required by the business units during the working capital cycle.

Closely associated with the assessment of the working capital cycle is the assessment of the operating cycle. In the operating cycle (figure 4), we try to determine the time taken for each working capital cycle. As we have noted inventory and accounts receivables are the key components of current assets which go through the "cash to cash" cycle. How fast these transformations take place can be computed using turnover ratios. We have already studied the asset turnover ratio. The time taken by inventory to become cash can be found out from the "inventory turnover ratio". Inventory turnover ratio computes how fast inventory becomes sales. We know that sales include cost of goods plus profit and as profit does not need finance we exclude it from our calculations. As such inventory turnover ratio is calculated as 'cost of goods sold' divided by 'inventory'.

In our example, inventory turnover ratio computed in this manner comes to 6.2 times (3100/500). In other words, in a year inventory gets converted to sales 6.2 times. We can, therefore, say one cycle of inventory is around 59 days (365 days/6.2 times). Similarly, "accounts receivables turnover" ratio also can be computed as 'credit sales' divided by 'accounts receivables'. In many cases, credit sales figures may not be available and this ratio is computed as sales divided by accounts receivables. In our example, accounts receivables ratio is around 3.3 times (4300/1300) and a single accounts receivables cycle is about 110 days (365/3.3). In all, we see that the operating cycle of inventory and accounts receivables add up to 169 days (59+110).

No.	Ratio	Formula
1.	Inventory Turnover	Cost of Goods Sold/ Inventory
2.	Accounts Receivables Turnover	Credit Sales/ Accounts Receivables

One of the major assumptions of working capital finance is that repayment of the bank's loan happens through the disposal of current assets which form the primary security. As such, current asset requirement for a business/ borrowing unit's assessment is the key task. For this, the bank needs to know the past sales of the borrower/ prospective borrower. This should be ascertained through a diligent study of the borrower's sales credits routed through the bank's current or cash credit accounts. Further, a close scrutiny of monthly stock statements which need to be correlated with the audited financials as well as random stock audit should be carried out. If discrepancies in reported figures are there and accounting quality is suspect, sufficient buffers in the assessment of current assets need to be negotiated with the borrowers. An incorrect sales and current asset requirement lead to margin dilution or even no margin on the part of the borrower which needs to be avoided to prevent syphoning of funds or lax management practices on the part of the borrower. The current ratio is generally used to assess the amount of net-working capital (NWC) i.e., owner's own contribution in the business. It is the ratio of current assets to current liabilities.

We have calculated the time element of the working capital cycle by using the turnover ratios. However, we need to estimate also how much of inventory and account receivables are being held by the unit during the year. For this "holding period" of both current assets and current liabilities are computed. For this, holding period ratios are utilized. A sum of the holding periods of the individual components of current assets and current liabilities give us an estimate of the amount of current assets required. The sum total of the time of the holding period also is treated as an estimate of the working capital cycle. The formulae for computing the various holding period ratios (in terms of a number of days) is as follows:

No.	Holding Ratio	Formula
1.	Raw Material	(Raw Material Stock/ Annual Consumption of Raw Material)*365
2.	Stock in Process	(Stock in Process/ Cost of Production)*365
3.	Finished Goods	(Finished Goods Level/Cost of Goods Sold)*365
4.	Account Receivables	(Accounts Receivables/Annual Credit Sales)*365
5.	Advances paid to suppliers	(Advances paid to suppliers/Annual Purchase)*365
6.	Trade Creditors	(Trade Creditors/ Annual Credit Purchase)*365
7.	Advances received from sales	(Advances received/Annual Gross Sale)*365

Banks can prescribe “standard” of “benchmark” holding periods of different industrial activities which can be used by their credit officers during the credit appraisal process. The bank also needs to find cash flow generated by the unit to cover its liabilities. These are generally calculated through the “interest coverage” ratios. The source of liquidity is generally assumed to be earnings before interest tax depreciation and amortization (EBITDA). Two variants of this ratio are (i) interest coverage ratio and (ii) debt service coverage ratio (DSCR). The ratio of EBITDA to interest gives the interest coverage ratio <u>*whereas*</u> EBITDA to total debt gives the debt service coverage ratio.

Once the current asset requirement is validated using the above methods, we proceed to determine the bank’s share of finance. Here, the key concern is “Capital” or “Margin” which is one of the fundamental building blocks of credit appraisal is ensured. The Tandon and Chore committee of 1974 had provided three methods of determining margin requirements. Of that, two methods which are commonly followed are discussed. The methods are about balancing the source of funds and use of funds for building up to current assets. Three primary sources of funds are identified, they are the (a) owner’s contribution also called Net Working Capital (NWC), (b) the bank finance and (c) all other current liabilities except bank finance, also called Other Current Liabilities (OCL). OCL normally comprises of trade creditors, funds from relatives, friends, other financial institutions etc.

The difference between the current assets required and OCL is called Working Capital Gap (WCG). This needs to be funded now by the owner/s and the bank. The key idea is to ensure a certain minimum amount of Net Working Capital (i.e., owner's contribution or margin) and the difference between WCG and NWC is called Maximum Permissible Bank Finance (MPBF).

In the first method, the margin or NWC is prescribed as 25% of WCG and in the second method, the margin or NWC is prescribed as 25% of Current Assets. Let us look at the calculations using a simple example.

	METHOD-I	**METHOD-II**
CURRENT ASSETS (CA) REQUIRED	1000	1000
OCL AVAILABLE	200	200
WCG (CA-OCL)	800	800
MARGIN (NWC)	200 (25% OF WCG)	250 (25% OF CA)
MPBF	600	550

The bank has now assessed the current asset required, the margin to be called for but it also looks at the security cover the current assets provide. Banks treat current assets as their security. Now as with every security certain margins are demanded. These margins are insisted on because there could be a substantial price cut when there is a distress sale and significant costs could be associated with disposing of the security. The margins are prescribed based on the ease of recoverability of bank's money through the disposal of current assets. It is generally observed that raw material and finished goods vanish from the balance sheets whenever there is a crisis indicating comparative ease of disposal of these assets whereas semi-finished goods and book debts are difficult to recover. As such, one observes that generally margins of around 25% being prescribed for raw material and finished goods and higher amounts of semi-finished goods and book debts. The bank will try to ensure that the amount after deducting the margins from the current assets cover the working capital limits sanctioned by the it. This limit arrived at after deducting the margins from the current asset is called drawing power (DP).

Now the bank brings together its assessment of operating cycle, sales routing through its accounts, the summation of holding periods of current assets, information from stock statements and audited financials to arrive at the needed current assets level. Once this is done, the finances can be tied up among the owners (NWC), bank (MPBF) and others (OCL).

A simple method of working capital finance which is quite popular also is the "Projected Turnover" method suggested by Nayak Committee. In this method, the working capital cycle is assumed to be 90 days and finance is provided at 20% of turnover. As there are four cycles in a year this gets translated to a bank finance of a minimum of 80% of the requirement. As sales include profit which does not require finance the actual finance is normally far above 80%. This is a liberal and easy method of determining working capital finance.

11.4.2 RBI Regulatory Guidelines for UCBs related to Working Capital Assessment

11.4.2.1 The assessment of working capital requirement of borrowers, other than MSEs, requiring fund based working capital limits up to ₹1 crore and MSEs requiring fund based working capital limits up to ₹5 crore from the banking system may be made on the basis of their projected annual turnover. The banks may, at their discretion, carry out the assessment based on projected turnover basis or the traditional method. If the credit requirement based on traditional production / processing cycle is higher than the one assessed on projected turnover basis, the same may be sanctioned, as borrower must be financed up to the extent of minimum 20 per cent of their projected annual turnover.

11.4.2.2 Drawals against the limits should be allowed against the usual safeguards including drawing power and it is to be ensured that the same are used for the purpose intended. Banks will have to ensure regular and timely submission of monthly statements of stocks, receivables, etc., by the borrowers and also periodical verification of such statements vis-à-vis physical stocks by their officials.

11.4.2.3 In respect of borrowers other than MSEs, requiring working capital limits above ₹1 crore and for MSEs requiring fund based working capital limits above ₹5 crore, UCBs may determine the working capital requirements according to their perception of the credit needs of borrowers. UCBs may adopt turnover method or cash budgeting method or any other method as considered necessary.

11.4.2.4 Loan System for Delivery of Bank Credit

In the case of borrowers enjoying working capital credit limits of ₹10 crore and above from the banking system, the loan component should normally be 80% and the remaining Cash Credit component. UCBs have been given freedom to change the composition of working capital by increasing the cash credit component beyond 20 per cent or increase the loan component beyond 80 per cent, as the case may be, if they so desire. UCBs are expected to appropriately price each of the two components of working capital finance, taking into account the impact of such decisions on their cash and liquidity management. In the case of borrowers with working capital (fund based) credit limit of less than ₹10 crore, banks may persuade them to go in for the Loan System by offering an incentive in the form of lower rate of interest on the 'loan component' as compared to the 'cash credit component' The actual percentage of 'loan component' in these cases may be settled by the bank with its borrower clients.

11.4.2.5 Ad hoc Credit Limit

The release of ad hoc / additional credit for meeting temporary requirements may be considered by the financing bank only after the borrower has fully utilised / exhausted the existing limit. Banks are expected to have a detailed Board approved policy on methodology and periodicity for review/renewal of credit facilities within the overall regulatory guidelines and adhere to the same strictly. Further, timely and comprehensive review/renewal of credit facilities should be an integral part of the Board approved loan policy and credit risk management framework, and banks should avoid frequent and repeated ad-hoc / short review/renewal of credit facilities without justifiable reasons. Banks are also advised to capture all the data relating to regular as well as ad-hoc/short review/renewal of credit facilities in their core banking systems/management information systems and make the same available for scrutiny as and when required by any audit or inspection by Auditors/RBI. Moreover, the processes governing review/renewal of credit facilities should be brought under the scope of concurrent/internal audit/internal control mechanism of banks with immediate effect.

11.5 Long-Term Strategic Assessment

So far our discussions were centered on short-term finance. However, whenever long-term loans are to be assessed, the long-term strategic assessment of the unit becomes necessary. There are many frameworks to assess long-term survival of the unit. One of them which is discussed here is Porter's five forces[37] which are normally used in credit appraisals by the banks.

Figure 5: Porter's Five factor Model

Even though Porter used to assess the competitiveness of an industry using the above model, credit appraisal models include the above as they provide a framework to assess the long-time viability of the unit also.

- **The threat of new entry**: In recent times, this can be understood by the effect of Reliance Jio on the existing telecom operators like Airtel, Idea, Vodafone, etc.

[37] https://research-methodology.net/wp-content/uploads/2015/06/Google-Porter's-Five-Forces.png

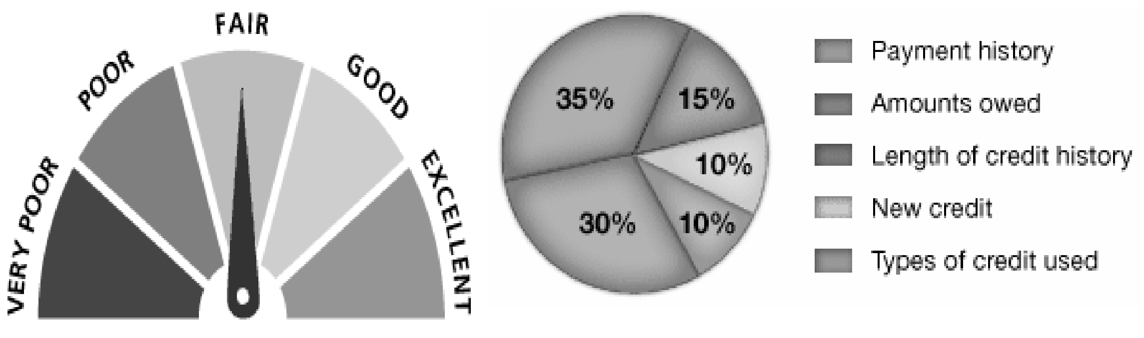
- **Supplier power**: If the raw material that the business unit/ borrower require is exclusive, the supplier holds significant power. Chinese control of rare earth (used in electronic industry), bulk drug raw material, etc. bring out the point.
- **The threat of substitution**: Copper industry went out of business as it was replaced by the optical fiber in the telecom industry.
- **Buyer power**: If a single buyer is there, any decision by him to reduce or reject the services of borrower could harm its interest. Suppliers of car manufacturers are an example who rely mostly on a single buyer.

The above factors should be looked at by the banks during the credit appraisal process and factored into/ brought into their credit rating model.

11.6 Credit-Rating and Credit-Scoring

Although credit-rating and credit-score may be used interchangeably, in some cases, there is a distinction between these two phrases. A credit 'rating', often expressed as a letter grade, conveys the creditworthiness of a borrower or a government or even a security (bond/ debenture, etc.). A credit 'score' is also an expression of creditworthiness, but it is expressed in numerical form and only used for individuals. Both, credit ratings and scores, are designed to show creditors a borrower's likelihood of repaying a debt.

A credit score is a typical number generated by a mathematical algorithm using information in an individual's credit report. It's designed to predict risk, specifically, the likelihood that one may become seriously delinquent on one's credit obligations in the next one or two years. Banks should either assess/ calculate the credit rating/ score as per their internal models or extensively use the rating/ score provided by the approved credit rating agencies during the credit appraisal/ credit review process of their prospective/ existing borrowers.



Source: myFICO.com

Figure 6: Credit Scoring Models

11.7 Altman Z-Score[38]

Professor Edward Altman developed the Altman Z-score formula in 1968. It was the output of a credit-strength test that gauges a publicly traded manufacturing company's likelihood of bankruptcy. It is a linear discriminant model.

- The Altman Z-score is based on five financial ratios that can be calculated from data found on a company's annual report.
- It uses profitability, leverage, liquidity, solvency, and activity to predict whether a company has a high degree of probability of being insolvent.
- Altman's pioneer study is based on a sample of 66 publicly traded, manufacturing firms.
- Thirty-three of the firms had filed for bankruptcy and all had assets over $1 million. His model correctly predicts financial failure for 95% of the firms, one year prior to their demise.
- Accuracy decreases to 72% two years out and to 52% three years prior to insolvency (Altman, 1968). Type I errors, those that predict a bankruptcy that does not occur, are shown for 6% of the firms analyzed. Type-II errors also were shown for 6% of the firms analyzed. Type II errors predict a solvent firm that files bankruptcy (Altman, 1993).

11.7.1 Z-Score = $1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 1.0X_5$

Where:

- X_1 = working capital / total assets
- X_2 = retained earnings / total assets
- X_3 = earnings before interest and tax / total assets
- X_4 = market value of equity / total liabilities
- X_5 = sales / total assets

Z-Score Interpretation

- Z – Score >= 2.99 …………… 'No Default' (Low Risk)
- 1.81 < Z – Score < 2.99 …….. 'Zone of Ignorance' (Medium Risk)
- Z – Score < 1.81 ………………….'Default… Bankruptcy' (High Risk)

11.7.2 Altman revised model for privately held firms

In 1983, Altman developed a revised Z-score model for privately held firms as the original model was only applicable to publicly traded entities (since X_4 requires stock price data). The revised Z-scores substituted the book value of equity for the market value in X_4).

The revised Z-score formula follows -

[38] **http://altmanzscoreplus.com/**

$Z= 0.717(X_1) +0.847(X_2) + 3.107(X_3) +0.420(X_4) + 0.998(X_5)$

The new Z-score model ratios are listed below:

X_1= Working capital/total assets

X_2= Retained earnings/total assets

X_3= EBIT/total assets

X_4= N.W. (book value)/total liabilities

X_5= Sales/total assets

Altman revised model Interpretation

- scores of <1.23 indicate bankrupt firms
- scores of >2.90 are indicators of non-bankrupt firms
- scores between 1.23 and 2.90 are determined to exist in the grey area or zone of ignorance

Altman's new sample produces similar results as the original Z-score model, indicating 90.9% accuracy in bankruptcy forecasting at least one year prior to actual failure. Firms with scores over 2.90 have a 97% chance of continuing operations with financial health.

11.7.3 Altman further revised model

In 1993, Altman's continued research produced a further revised model, one that eliminates variables X_5, sales/ total assets. Eliminating sales/totals assets minimizes the potential industry effect.

Here, the Z-score model is represented as -

$Z=6.56(X_1) + 3.26 (X_2) + 6.72 (X_3) + 1.05 (X_4)$

Where,

X_1= Working capital/total assets

X_2= Retained earnings/total assets

X_3= EBIT/total assets

X_4= N.W. (book value)/total liabilities

Altman further revised model interpretation

- Bankrupt firms< 1.10
- Non bankrupt firms>2.60
- Grey area= 1.10-2.60

Altman calculated that the median Altman Z-score of companies in 2007 was 1.81. These companies' credit ratings were equivalent to B. This indicated that 50% of the firms should have been rated lower, and they were highly distressed and had a high probability of becoming bankrupt. Altman's calculations led him to believe that a crisis would occur and there would be a meltdown in the credit market. Altman believed the crisis would stem from corporate defaults, but the meltdown began with mortgage-backed securities (MBS). However, corporations soon defaulted in 2009 at the second-highest rate in history.

11.8 Altman Z-score Plus

In 2012, Professor Edward Altman released an updated version called the Altman Z-score Plus. The new Altman Z-score Plus now also covers Non-US companies, including those in emerging markets such as China, India. It provides interpretation for non-manufacturing firms, both public and private and privately-held industrial manufacturing firms. However, this a proprietary model.

11.9 To conclude, establishing an appropriate credit risk environment, operating under a sound credit granting process, maintaining an appropriate credit administration, measurement and monitoring process and ensuring adequate controls over credit risk are the series of inter-related and inter-dependent steps for ensuring successful management of credit risk. Sound credit analytics plays a significant role in this process.

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Chapter XII

Priority Sector Lending and PSLCs

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Priority Sector Lending and PSLCs

Priority Sector Lending (PSL) guidelines are issued by the Reserve Bank of India (RBI) and mandate the banks to direct a certain portion of their lending to the marginalised, needy and weaker sections of society/ economy. Such guidelines are prevalent in many other countries also in form of directed lending that banks undertake as part of their social and environmental responsibilities. In India, PSL guidelines are amongst the earliest regulatory interventions for securing financial inclusion and enabling bank credit at the bottom of the pyramid.

12.1 Evolution of the Priority Sector Lending Guidelines in India

PSL guidelines are close to 50 years old. In the meeting of the National Credit Council held on July 24, 1968, it was emphasized that commercial banks should increase their commitment to financing the priority sectors of the economy, comprising agriculture and Small-Scale Industry. Further emphasis on the same was reflected in the RBI's credit policy for the year 1967-68. The description of the priority sectors was formalised in 1972 based on the report of Informal Study Group on statistics relating to advances to the Priority Sectors. Although initially no specific target was fixed for priority sector lending, in November 1974 the banks were advised to raise the share of these sectors in their aggregate advances to the level of 33.33% by March 1979 (Internal Working Group to Review Agricultural Credit, 2019).

At a meeting of the Union Finance Minister with the Chief Executive Officers of public sector banks held in March 1980, it was agreed that banks should aim at raising the proportion of their advances to priority sector to 40% by March 1985. Subsequently, based on the recommendations of the Working Group on the Modalities of Implementation of Priority Sector Lending and the Twenty Point Economic Programme by Banks (Chairman: Dr. K. S. Krishnaswamy), all commercial banks were advised to achieve the target of priority sector lending at 40% of aggregate bank advances by 1985. Sub-targets were also specified for lending to agriculture and the weaker sections within the priority sector (Master Circular, Priority Sector Lending Guidelines for UCBs, July 2015)

Since then, the scope of priority sector lending and its targets and sub-targets has undergone several changes as per the recommendation of various committees and working groups set up by RBI and Government, from time to time. There were different set of PSL guidelines prevalent for various bank groups such as commercial banks, foreign banks, RRBs and UCBs etc. However, RBI consolidated the guidelines and a comprehensive master direction on PSL were issued for all the bank groups in September 2020.

12.2 Revised Priority Sector Guidelines for the UCBs

RBI comprehensively reviewed the PSL guidelines vide its Master Direction no. FIDD.CO.Plan.BC.5/04.09.01/2020-21, dated September 04, 2020, to harmonize various instructions issued to Commercial Banks, SFBs, RRBs, UCBs and LABs and to align these guidelines with emerging national priorities and bring a sharper focus on inclusive development. The review also considered the recommendations made by the 'Expert Committee on Micro, Small and Medium Enterprises (Chairman: Shri U.K. Sinha) and the 'Internal Working Group to Review Agriculture Credit' (Chairman: Shri M. K. Jain) apart from having widespread discussions with all the stakeholders.

The Master Directions on PSL have been issued by the RBI, in the exercise of the powers conferred by Sections 21 and 35A read with Section 56 of the Banking Regulation Act, 1949, and comes into effect from September 4, 2020. These Directions apply to the Commercial Banks [including Regional Rural Bank (RRB), Small Finance Bank (SFB), Local Area Bank] and Primary (Urban) Co-operative Bank (UCB) other than Salary Earners' Bank licensed to operate in India by the Reserve Bank of India. Under these guidelines, the banks are responsible to ensure that loans extended under priority sector are used for approved purposes and end-use is continuously monitored.

12.2.1 Categories under Priority Sector Lending

There are following eight categories under PSL;

(i) Agriculture
(ii) Micro, Small and Medium Enterprises
(iii) Export Credit
(iv) Education
(v) Housing
(vi) Social Infrastructure
(vii) Renewable Energy
(viii) Others

12.2.2 Targets /Sub-targets for Priority sector for UCBs

The PSL targets and sub-targets for the UCBs have been revised vide RBI circulars dated March 13, 2020, and September 4, 2020, and the revised targets are as under. The targets have been defined in terms of Adjusted Net Bank Credit (ANBC) or Credit Equivalent of Off Balance Sheet Exposures (CEOBE).

<table>
<tr><th>Categories</th><th>Primary Urban Co-operative Banks</th></tr>
<tr><td>Total Priority Sector</td><td>40 per cent of ANBC or CEOBE, whichever is higher, in FY2019-20, which shall stand increased to 75 per cent of ANBC or CEOBE, whichever is higher, with effect from FY2025-26. UCBs shall comply with the stipulated target as per the following milestones:
<table>
<tr><th>FY2019-20</th><th>FY2020-21</th><th>FY2021-22</th><th>FY2022-23</th><th>FY2023-24</th><th>FY2024-25</th><th>FY2025-26</th></tr>
<tr><td>40%</td><td>45%</td><td>50%</td><td>60%</td><td>60%</td><td>65%</td><td>75%</td></tr>
</table></td></tr>
<tr><td>Micro Enterprises</td><td>7.5 per cent of ANBC or CEOBE, whichever is higher</td></tr>
<tr><td>Advances to Weaker Sections</td><td>12 per cent of ANBC or CEOBE, whichever is higher. The revised targets for weaker sections will be implemented in a phased manner as indicated below:
<table>
<tr><th>FY2019-20</th><th>FY2020-21</th><th>FY2021-22</th><th>FY2022-23</th><th>FY2023-24</th><th>FY2024-25</th><th>FY2025-26</th></tr>
<tr><td>10.00%</td><td>11.00%</td><td>11.50%</td><td>11.50%</td><td>11.50%</td><td>11.75%</td><td>12.00%</td></tr>
</table></td></tr>
</table>

12.2.3 Adjusted Net Bank Credit (ANBC)

UCBs need to calculate ANBC as per the process given below;

Bank Credit in India [As prescribed in item No.VI of Form `A' under Section 42(2) of the RBI Act, 1934]	**I**
Bills Rediscounted with RBI and other approved Financial Institutions	II
Net Bank Credit (NBC) **(Provisions/ accrued interest etc. not to be deducted)**	III (I – II)
Outstanding Deposits under RIDF and other eligible funds with NABARD, NHB, SIDBI and MUDRA Ltd in lieu of non-achievement of priority sector lending targets/sub-targets + outstanding PSLCs	IV
Advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for an exemption from CRR/SLR requirements, as per the Reserve Bank's circulars of 2013 & 2014	V
Face Value of securities acquired and kept under HTM category under the TLTRO 2.0 and Special Liquidity facility for MFs, extended by RBI in 2020	VI
Investments made after August 30, 2007, in permitted non SLR bonds held under 'Held to Maturity' (HTM) category	VII
Adjusted Net Bank Credit (ANBC) for UCBs =	**III + IV – V – VI + VII**

UCBs should not deduct/net any amount like provisions, accrued interest, etc. from Net Bank Credit.

UCBs should ensure that;

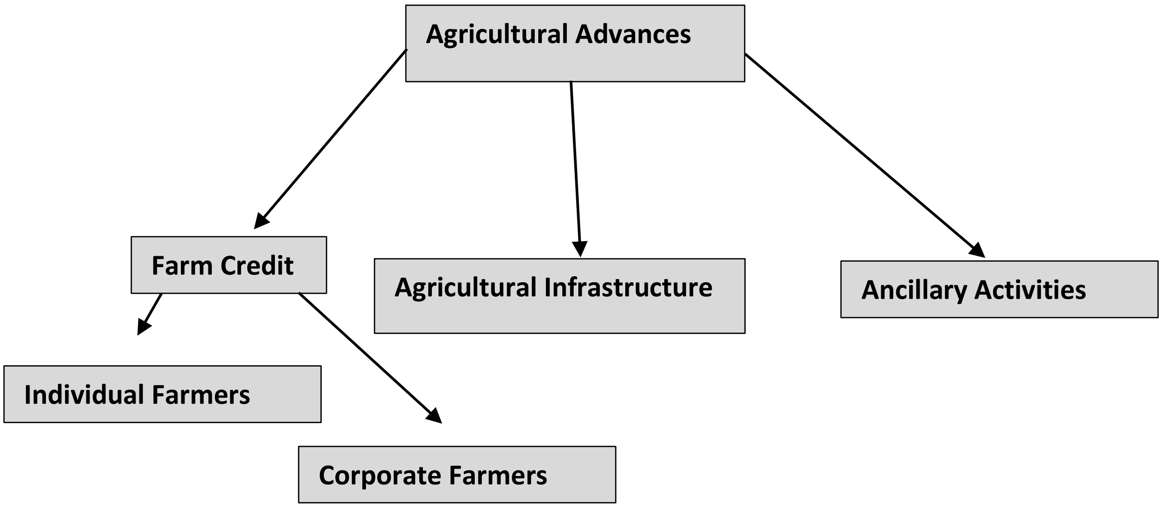
1. If banks subtract prudential write off from Net Bank Credit, it must be ensured that the credit to priority sector and all other sub-sectors so written off, should also be subtracted category wise from priority sector and sub-target achievement.

2. Wherever, investments or any other items which are treated as eligible for classification under priority sector target/sub-target achievement, the same should also form part of Adjusted Net Bank Credit.
3. Banks should continue to calculate ANBC and PSL achievements on a quarterly basis and report the same to the regional offices of RBI, within 15 days of the end of the period.

12.3 Priority Sector Lending- Categories

12.3.1 Agricultural Advances

Agricultural advances have been sub-divided into the following categories;



12.3.1.1 A. Farm Credit - Individual Farmers

This category accounts for loans to individual farmers [including SHGs/ JLGs] and Proprietorship firms of farmers, directly engaged in Agriculture and Allied Activities, viz. dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture. This includes:

i. Crop loans including loans for traditional/non-traditional plantations, horticulture and allied activities.

ii. Medium and long-term loans for agriculture and allied activities (e.g. purchase of agricultural implements and machinery and developmental loans for allied activities).

iii. Loans for pre and post-harvest activities viz. spraying, harvesting, grading and transporting of their farm produce.

iv. Loans to distressed farmers indebted to non-institutional lenders.

v. Loans under the Kisan Credit Card (KCC) Scheme.

vi. Loans to small and marginal farmers for purchase of land for agricultural purposes.

vii. Loans against pledge/hypothecation of agricultural produce (including warehouse receipt) for a period not exceeding 12 months subject to a limit up to ₹50 lakh.

viii. Loans to farmers for installation of stand-alone Solar Agriculture Pumps and for solarisation of grid-connected Agriculture Pumps. (new addition)

ix. Loans to farmers for installation of solar power plants on barren/fallow land or in stilt fashion on agriculture land owned by a farmer. (new addition)

12.3.1.1 B. Farm Credit - Corporate farmers, FPOs/ FPC Companies of Individual Farmers, Partnership firms;

(a) Loans for the following activities will be subject to an aggregate limit of ₹2 crores per borrowing entity:

(i) Crop loans to farmers including traditional/non-traditional plantations and horticulture and loans for allied activities.

(ii) Medium and long-term loans for agriculture and allied activities (e.g. purchase of agricultural implements and machinery and developmental loans for allied activities).

(iii) Loans for pre and post-harvest activities viz. spraying, harvesting, grading and transporting of their own farm produce.

(b) Loans up to ₹50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months.

(c) Loans up to ₹5 crores per borrowing entity to FPOs/FPCs undertaking farming with assured marketing of their produce at a pre-determined price. (new addition)

12.3.1.2 Agricultural Loans – Agricultural Infrastructure

Loans for agriculture infrastructure subject to an aggregate sanctioned limit of ₹100 crore per borrower from the banking system is eligible under this head;

1. Loans for construction of storage facilities, (warehouse, market yards, godowns and silos) including cold storage units/cold storage chains designed to store agriculture produce/products.

2. Soil conservation and watershed development.

3. Plant tissue culture and agri-biotechnology, seed production, production of bio-pesticides, bio-fertilizer, and vermicomposting.

4. Loans for construction of oil extraction/ processing units for production of biofuels, their storage and distribution infrastructure along with loans to entrepreneurs for setting up Compressed Bio-Gas (CBG) plants. (new addition)

12.3.1.3 Agricultural Loans – Ancillary Activities

1. Loans up to ₹50 crores to Start-ups, as per definition of Ministry of Commerce and Industry, Govt. of India that are engaged in agriculture and allied services. (new addition)
2. Loans for Food and Agro-processing up to an aggregate sanctioned limit of ₹100 crores per borrower from the banking system.
3. Outstanding deposits under RIDF and other eligible funds with NABARD on account of priority sector shortfall.
4. Loans for setting up of Agri-clinics and Agri-business centres.
5. Loans to Custom Service Units managed by individuals, institutions or organizations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake farm work for farmers on a contract basis.

12.3.1.4 Small and Marginal Farmers (SMFs)

For the commercial banks, there is a separate sub-target for lending to small and marginal farmers (SMFs), within the target of Agriculture, however, no such targets are prescribed for the UCBs. UCBs can lend to SMFs under overall PS lending. SMFs include;

a) Farmers with landholding of up to 1 hectare (Marginal Farmers).

b) Farmers with a landholding of more than 1 hectare and up to 2 hectares (Small Farmers).

c) Landless agricultural labourers, tenant farmers, oral lessees and share-croppers whose share of landholding is within the limits prescribed for SMFs.

d) Loans to SHGs/ JLGs, i.e. groups of individual SMFs directly engaged in Agriculture and Allied Activities.

e) Loans up to ₹2 lakh to individuals solely engaged in Allied activities without any accompanying land holding criteria.

f) Loans to FPOs/FPC of individual farmers directly engaged in Agriculture and Allied Activities where the land-holding share of SMFs is not less than 75 per cent.

12.3.2 Micro, Small and Medium Enterprises (MSMEs)

A large part of the PSL portfolio of UCBs consists of the lending to MSMEs, and UCBs also have a sub-target of 7.5% for lending to the Micro enterprises. Criteria for identification as MSMEs has been revised vide Government of India Gazette notification dated June 26, 2020, and the new classification is applicable since July 1, 2020 (RBI circular dated July 2, 2020). New criteria for identification as MSMEs is as under.

Type of enterprise	Investment in plant and Machinery or equipment	Turnover
Micro-Enterprise	Not more than ₹1 cr	Not more than ₹5 cr
Small Enterprise	Not more than ₹10 cr	Not more than ₹50 cr
Medium Enterprise	Not more than ₹50 cr	Not more than ₹250 cr

A composite criterion has now been adopted for classification of an entity as MSME. As per the gazette notification, if an enterprise crosses the ceiling limits specified for its present category in either of the two criteria of investment or turnover, it will cease to exist in that category and be placed in the next higher category. But no enterprise shall be placed in the lower category unless it goes below the ceiling limits specified for its present category in both the criteria of investment as well as turnover.

All units with Goods and Services Tax Identification Number (GSTIN) listed against the same Permanent Account Number (PAN) shall be collectively treated as one enterprise and the turnover and investment figures for all of such entities shall be seen together and only the aggregate values will be considered for deciding the category as a micro, small or medium enterprise. (Gazette Notification, June 2020).

Further, in terms of the RBI circular dated August 21, 2020, following clarifications were provided regarding classification of MSMEs

i) All enterprises are required to register online and obtain ‘Udyam Registration Certificate’. All lenders may, therefore, obtain ‘Udyam Registration Certificate’ from the entrepreneurs.

ii) The existing Entrepreneurs Memorandum (EM) Part II and Udyog Aadhaar Memorandum (UAMs) of the MSMEs obtained till June 30, 2020, would remain valid till March 31, 2021. Further, all enterprises registered till June 30, 2020, would file new registration in the Udyam Registration Portal well before March 31, 2021.

iii) ‘Udyam Registration Certificate’ issued on self-declaration basis for enterprises exempted from filing GSTR and/or ITR returns were valid up to March 31, 2021.

iv) The online form for Udyam Registration captures depreciated cost as on 31st March each year of the relevant previous year. Therefore, the value of Plant and Machinery or Equipment for all the enterprises shall mean the Written Down Value (WDV) as at the end of the Financial Year as defined in the Income Tax Act and not cost of acquisition or original price, which was applicable in the context of the earlier classification criteria.

Regarding financing the MSMEs, UCBs may also note that :

a) Loans to KVI (Khadi and Village Industry) sector is eligible under sub-target of 7.5% for Micro Enterprises.

b) Loans up to ₹50 crores to Start-ups, as per definition of Ministry of Commerce and Industry, Govt. of India, that conform to the new definition of MSME.

c) Loans to entities involved in assisting the decentralized sector in the supply of inputs and marketing of output of artisans, village and cottage industries.

d) Credit outstanding under General Credit Cards (including Artisan Credit Card, Laghu Udyami Card, Swarojgar Credit Card and Weaver’s Card etc. in existence and catering to the non-farm entrepreneurial credit needs of individuals).

e) Overdraft to PMJDY account holders as per limits and conditions prescribed by the Ministry of Finance will qualify as an achievement of the target for lending to Micro Enterprises.

f) Outstanding deposits with SIDBI and MUDRA Ltd. on account of priority sector shortfall.

12.3.3 Export Credit

Only export credit (other than in agriculture and MSME) is allowed to be classified as a priority sector. Only incremental export credit over the corresponding date of the preceding year, up to a limit of 2% of ANBC or CEOBE whichever is higher, can be reckoned under PSL, subject to a sanctioned limit of up to ₹40 crores per borrower.

12.3.4 Education Loans

Education Loans (including vocational courses) to individuals, not exceeding ₹20 lakh are eligible for a PSL classification. Loans currently classified as priority sector can continue as PS loan till maturity.

12.3.5 Housing Loans

Limits of Housing Loans eligible for PSL have been revised as under;

Centre	Overall cost of dwelling unit	Housing Loan	Loans for repairs to damaged dwelling units
Metropolitan Centre (Population =>10 lakhs)	Upto ₹45 lakh	Upto ₹35 lakh	Upto ₹10 lakh
Non - Metropolitan Centre (Population <10 lakhs)	Upto ₹30 lakh	Upto ₹25 lakh	Upto ₹6 lakh

UCBs may note that;

1. Housing loans to banks' own employees will not be eligible for classification under the priority sector.
2. Since Housing loans which are backed by long term bonds are exempted from ANBC, banks should not classify such loans under priority sector.
3. Investments made by UCBs in bonds issued by NHB / HUDCO on or after April 1, 2007 shall not be eligible for classification under priority sector.
4. Bank loans to any governmental agency for construction of dwelling units or for slum clearance and rehabilitation of slum dwellers subject to dwelling units with carpet area of not more than 60 sq.m.
5. Bank loans to HFCs (approved by NHB for their refinance) for on-lending, up to ₹20 lakh for individual borrowers, for purchase/construction/ reconstruction of individual dwelling units or for slum clearance and rehabilitation of slum dwellers.
6. Outstanding deposits with NHB on account of priority sector shortfall will also be eligible under PSL.

12.3.6 Social Infrastructure

Bank loans for social infrastructure will be eligible for PSL classification, subject to the following limits.

1. Bank loans up to a limit of ₹5 crores per borrower for setting up schools, drinking water facilities and sanitation facilities including construction/ refurbishment of household toilets and water improvements at the household level, etc. and

2. Loans up to a limit of ₹10 crores per borrower for building health care facilities including under ‘Ayushman Bharat’ in centres with a population of less than one lakh.

12.3.7 Renewable Energy

Bank loans for renewable energy will be eligible for PSL classification, subject to the following limits.

1. Bank loans up to a limit of ₹30 crores to borrowers for purposes like solar-based power generators, biomass-based power generators, wind-mills, micro-hydel plants and for non-conventional energy based public utilities, *viz*., street lighting systems and remote village electrification etc.

2. For individual households, the loan limit will be ₹10 lakh per borrower.

12.3.8 PSL loans – Others

Following loans will be eligible in ‘others’ category of PSL.

1. Loans provided directly by banks to individuals and individual members of SHG/JLG satisfying the criteria as prescribed in Master Direction on Regulatory Framework for Microfinance Loans Directions, dated March 14, 2022, and

2. Loans not exceeding ₹2.00 lakh provided directly by banks to SHG/JLG for activities other than agriculture or MSME, viz., loans for meeting social needs, construction or repair of house, construction of toilets or any viable common activity started by the SHGs.

3. Loans to distressed persons [other than distressed farmers indebted to non-institutional lenders] not exceeding ₹1.00 lakh per borrower to prepay their debt to non-institutional lenders.

4. Loans sanctioned to State Sponsored Organisations for SCs/ STs for the specific purpose of purchase and supply of inputs and/or the marketing of the outputs of the beneficiaries of these organisations.

5. Loans up to ₹50 crores to Start-ups, as per definition of Ministry of Commerce and Industry, Govt. of India that are engaged in activities other than Agriculture or MSME.

12.4 Weaker sections

Weaker sections is not a separate category in PSL guidelines, but Priority Sector loans to the following category of borrowers will be considered as lending under ‘Weaker Sections’:

1. Small and Marginal Farmers

2. Artisans, village and cottage industries where individual credit limits do not exceed ₹1 lakh.

3. Beneficiaries under Government Sponsored Schemes such as National Rural Livelihood Mission (NRLM), National Urban Livelihood Mission (NULM) and Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS).

4. Scheduled Castes and Scheduled Tribes

5. Beneficiaries of the Differential Rate of Interest (DRI) scheme

6. Self Help Groups

7. Distressed farmers indebted to non-institutional lenders

8. Distressed persons other than farmers, with loan amount not exceeding ₹1 lakh per borrower to prepay their debt to non-institutional lenders

9. Individual women beneficiaries up to ₹1 lakh per borrower (For UCBs, existing loans to women will continue to be classified under weaker sections till their maturity/repayment.)

10. Persons with disabilities

11. Minority communities as may be notified by Government of India from time to time.

Overdraft availed by PMJDY account holders as per limits and conditions prescribed by Department of Financial Services, Ministry of Finance from time to time may be classified under Weaker Sections.

In States, where one of the minority communities notified is, in fact, in majority, item 11 above will cover only the other notified minorities. These States/ Union Territories are Punjab, Meghalaya, Mizoram, Nagaland, Lakshadweep and Jammu & Kashmir.

12.5 Non-achievement of PSL targets

The PSL guidelines have certain disincentives inbuilt for non-achievement of the prescribed targets by the banks;

1. Banks having any shortfall in lending to priority sector shall be 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 Reserve Bank from time to time.

2. With effect from March 31, 2023, all UCBs (excluding those under all-inclusive directions) will be required to contribute to Rural Infrastructure Development Fund (RIDF) established with NABARD and other funds with NABARD / NHB / SIDBI / MUDRA Ltd., against their priority sector lending (PSL) shortfall vis-à-vis the prescribed target.
3. The interest rates on banks' contribution to RIDF or any other funds, tenure of deposits, etc. shall be fixed by Reserve Bank of India from time to time.
4. The mis-classifications reported by the IOs of RBI would be adjusted/ reduced from the achievement of that year, to which the amount of misclassification pertains, for allocation to various funds in subsequent years.
5. Non-achievement of priority sector targets and sub-targets will be taken into account while granting regulatory clearances/approvals for various purposes.

12.6 Common guidelines for PSL

a) Service Charges

No loan related and adhoc service charges / inspection charges should be levied on priority sector loans up to ₹25,000. In the case of eligible priority sector loans to SHGs/ JLGs, this limit will be applicable per member and not to the group as a whole.

b) Receipt, Sanction / Rejection / Disbursement Register

A register/ electronic record should be maintained by the bank, wherein the date of receipt, sanction/ rejection/ disbursement with reasons thereof, etc., should be recorded. The register/ electronic record should be made available to all inspecting agencies.

c) Issue of Acknowledgement of Loan Applications

UCBs should provide acknowledgement for loan applications received under priority sector loans. Bank Boards should prescribe a time limit within which the bank communicates its decision in writing to the applicants.

12.7 Priority Sector Lending Certificates (PSLCs)

As we have seen above, banks need to achieve a certain target of lending to the priority sector on a year-on-year basis. It is however, found that many banks are not able to achieve this target, while there are some other banks which overachieve this benchmark. In this scenario, a need was felt that the banks overachieving the PSL targets should be able to sell some part of their PSL achievements to the banks not fulfilling the targets for a commission. This will enable the underachieving banks to achieve their PS lending to the extent of the regulatory requirement. This will also enable the banks that have overachieved, to earn some additional income on the PSL portfolio by way of commission. With this objective, a new instrument of Priority Sector Lending Certificates (PSLCs) have been launched for the banks.

Government of India, vide Notification dated February 04, 2016 have specified "Dealing in PSLCs in accordance with the Guidelines issued by RBI" as a form of business under Section 6(1)(o) of the Banking Regulation Act, 1949. Accordingly, RBI issued a circular on April 7, 2016 recognising PSLC as a valid tool achievement of PSL targets. To facilitate trading in PSLCs, RBI has also provided a trading platform through the CBS portal (e-Kuber).

12.7.1 Eligible Sellers & Buyers :

Scheduled Commercial Banks, Regional Rural Banks, Local Area Banks, Small Finance Banks and UCBs are eligible to participate in PSLC trade.

12.7.2 Types of PSLCs : There are four kinds of PSLCs :-

S. No.	Type of PSLCs	Representing	Counting for
1.	PSLC Agriculture	All eligible Agriculture loans except loans to SF/ MF for which separate certificates are available	Achievement of agriculture target and overall PSL target
2.	PSLC - SF/ MF	All eligible loans to small/ marginal farmers	Achievement of SF/ MF sub-target, agriculture target and overall PSL target
3.	PSLC -Micro Enterprises	All PSL Loans to Micro Enterprises	Achievement of micro-enterprise sub-target and overall PSL target
4.	PSLC - General	The residual priority sector loans i.e. other than loans to agriculture and micro enterprises for which separate certificates are available	Achievement of overall PSL target

Thus, a bank having shortfall in achievement of any sub-target (e.g. SF / MF, Micro), will have to buy the specific PSLC to achieve the target. However, if a bank is having shortfall in achievement of the overall target only, it may buy any of the available PSLCs.

12.7.3 Computation of PSL achievement :

Banks are required to achieve the PSL targets on the reporting date by the following formula;

PSL achievement = O/s priority sector loans + nominal value (PSLCs Purchased – issued)

12.7.4 The amount eligible for the issue :

a) Normally PSLCs should be issued against the underlying assets. However, to develop a strong and vibrant market for PSLCs, banks can issue PSLCs up to 50 per cent of previous year's PSL achievement without having an underlying asset.

b) However, as on the reporting date, the bank must have met the priority sector target by way of the above formula.

12.7.5 Nature of Instruments :

a) **Lot Size**: The PSLCs have a standard lot size of ₹ 25 lakh and multiples thereof.

b) **Credit Risk**: There is no transfer of credit risk on the underlying as there is no transfer of tangible assets or cash flow. Therefore, the credit risk and the responsibility of servicing, asset classification etc. of the underlying loan continues to remain with the selling bank

c) **Settlement**: The settlement of funds is done through the e-kuber platform.

d) **Expiry date**: All PSLCs will expire by March 31st and will not be valid beyond the reporting date (i.e. March 31st), irrespective of the date it was first bought/sold.

e) **Value and Fee**: The nominal value of PSLC represents the equivalent of the PSL that is deducted from the PSL portfolio of the seller and added to the PSL portfolio of the buyer. The buyer pays a fee to the seller which is market-determined. No floor/ ceiling has been prescribed by RBI in this regard.

12.7.6 Accounting: The fee paid for the purchase of the PSLC would be treated as an 'Expense' and the fee received for the sale of PSLCs would be treated as 'Miscellaneous Income'. Both seller and buyer banks should report the amount of PSLCs (category-wise) sold and purchased during the year in the 'Disclosures to the Balance Sheet'.

References:

1) Gazette Notification, June 26, 2020, Ministry of Micro, Small and Medium Enterprises, Government of India.

2) Internal Working Group to Review Agricultural Credit, September 2019, Reserve Bank of India

3) Master Circular on Priority Sector Lending Guidelines for the UCBs, July 2015, Reserve Bank of India.

4) Master Direction Reserve Bank of India (Priority Sector Lending – Targets and Classification) Directions, 2020, September 4, 2020.

5) RBI circular no. FIDD. MSME & NFS.BC.No.4/06.02.31/2020-21 dated August 21, 2020.

6) RBI circular no. FIDD.MSME & NFS.BC.No.3/06.02.31/2020-21 dated July 2, 2020.

7) Reserve Bank of India CO FIDD circular no. FIDD.CO.Plan.BC.23/04.09.01/2015-16, dated April 7, 2016

MODULE IV

Primary (Urban) Co-operative Banks
Systems, Control, and Risk Management

Following is a set of five chapters which provide discussions on highly critical areas connected with systems and control, and risk management besides highlighting the importance of MIS. An up to date coverage of KYC and AML framework along with a compilation of best practices complements and completes the coverage of this module.

Chapter XIII

Systems and Control

Chapter XIII

Systems and Control

13.1 Need for adequate Systems and Control

A good governance structure requires sound internal systems and control for the efficient functioning of any organization. A good internal auditor or inspector is like a family physician who promptly cures the ailment in the initial stage itself. This also develops and influences the attitude and ultimately percolate as the culture of the organisation. It enforces a higher degree of discipline, enables lesser flaws, inadequacies or inconsistencies in the system.

13.2 Internal Control – Attributes

A sound system of internal control involves the following attributes:

- Appropriate segregation of functional responsibilities, system authorization and record procedures adequate to provide reasonable accounting controls over assets, liabilities, revenues and expenses
- Sound practices to be followed in the performance of duties and functions in each department
- A degree of quality of trained personnel commensurate with the responsibilities/ accountabilities

A properly structured internal control system should:

- Help to promote effective and efficient operation
- Provide reliable financial information
- Safeguard assets
- Minimise the operating risk of loss from irregularities, fraud and error
- Ensure effective risk management system, and
- Ensure compliance with relevant laws, regulations and internal policies.

The internal control system should thus cover the following:

- High-level controls, including clear delegation of authority, written policies and procedures, separation of critical functions (marketing, accounting, settlement, audit, compliance)
- Controls relating to major functional areas – credit and investment. Such controls should include segregation of duties, authorization and approval, limit monitoring, physical excess controls
- Controls relating to financial accounting (review of suspense and nominal a/c), management reporting and compilation of prudential returns to regulator
  Controls relating to compliance with statutory and regulatory requirements

- Controls relating to the prevention of money laundering

13.3 Internal Audit and Control – Scope

The scope of internal audit and control is to ensure checking of any loss that may arise from waste, fraud, error, inefficiency, carelessness, casualty or untoward happenings and is generally dependent on

a. Administrative Controls and
b. Accounting Controls

13.3.1 Administrative Controls require:

- neatly codified responsibility areas,
- job functions,
- selection and training of personnel,
- supervision,
- accountability,
- division of duties (i.e. separation of personnel who deal with operations on assets from those who maintain relevant accounting and records),
- independent custodianship,
- a system of periodical checks and balances,
- rotation of duties,
- a system of authorization at various levels,
- Periodical internal auditing and independent examination.

13.3.2 Accounting Controls require:

- a complete and integrated system of accounting,
- written manual,
- forms and documentation,
- authorization standards,
- Controls to verify the accuracy of accounting inputs and outputs as well as operational results.

A good internal control mechanism aims to ensure that no individual employee is in a position to make significant errors or perpetrate significant irregularities without timely detection and thereby envisaging that the business operations of the bank are on sound lines, both from administrative and accounting angles. Its scope is to see whether –

- books and records are maintained as per instructions received from Head Office from time to time,
- an accurate and correct record of liabilities and assets of the branch is shown in its books,

- assets shown in the books physically exist or are otherwise identifiable or satisfactorily realizable,
- documents obtained by a branch from borrowers are complete and enforceable,
- a proper record of Head Office instructions received from time to time is kept and the extent to which they have been complied with,
- advances granted and expenses incurred have proper sanctions,
- internal checks and controls as prescribed are being properly operated and returns to Head Office / Controlling Office and statutory returns are being correctly complied as also regularly and promptly submitted

A bank's internal audit function should, among other things, perform periodic checking on whether the policies approved by the Board are properly implemented and the established control procedures are complied with. The internal controls should be examined and tested periodically. The scope and frequency of audit may vary but should be increased if there are significant weaknesses or major changes or new products are introduced.

13.4 Internal Controls – Critical Components

13.4.1 Control Environment

It is the foundation for all other components. It provides discipline and structure for the bank's entire operations. The elements of a controlled environment include:

- Integrity and ethical values of people
- Commitment to work
- Board and Audit Committee
- Overall influence of management philosophy and operating style
- Appropriate and adequate organisational structure
- Clear assignment of authority and responsibility
- Effective human resource policies and practices

13.4.2 Risk Assessment

Risk-taking is an integral part of the banking business. Each bank has to find a balance between the level of risk it is willing to take and the level of return it desires. An effective risk management system that is commensurate with the size and complexity of the operations needs to be in place to ensure that the risks undertaken are well managed within the bank's risk appetite and that it achieves the intended results. The risk management existent in the bank should refer to its policies, procedures and limits which are put in place to identify, measure, monitor and control the various types of risk a bank is exposed to. A critical element to support an effective risk management system is the existence of a sound internal control system. While risk management systems may vary among banks, the basic elements contributing to a sound risk management environment are:

a. Appropriate Board and senior management oversight
b. Adequate organizational policies, procedures and limits to manage different aspects of risk arising from the business activities
c. Adequate risk measurement, monitoring and reporting systems to support the business activities, and
d. Well-established internal control and comprehensive audits to detect any deficiency in the internal control environment in a timely fashion.

13.4.3 Control Activities

It includes policies, procedures and practices established to help ensure that bank staff carries out Board and management directives. Policies governing control activities should ensure that bank officers who perform internal control functions in addition to operational duties do not evaluate their own work. Control activities include:

- **Operational performance reviews**

Review of actual performance VS budgets, forecast and prior-period performance – reasons for significant variations and to decide whether any action should be readjusted

- **Information processing**

Accuracy and completeness of transaction and whether they are properly authorized.

- **Physical controls**

These ensure the physical security of bank assets. It includes safeguarding assets and records, limiting access to computer programmes and files and periodically comparing actual asset, liability values with those shown on records.

13.5 Accounting, Information and Communication Systems

These systems identify capture and exchange information in a form and time schedule that enables bank personnel to carry out their responsibilities. Accounting system includes methods that identify, classify, record and report a bank's transactions

- Information systems produce reports on operations, finance, risk management and compliance that enable Board and management to run the bank.
- Communication systems impart information throughout the bank and to external parties such as regulators, supervisors, members and customers.

13.6 Self-Assessment

A significant indicator of good internal controls and systems is reflected by the existence of a system of self-assessment since it can provide oversight of a bank's control system performance. The Management monitors internal controls to ascertain whether they are operating as intended and that they are modified when conditions change. Self-assessment, in the form of periodic evaluation of a department's control by a person responsible for that area, is one type of oversight mechanism.

13.7 Audits and Internal Control Alarming Signals

A focused internal audit programme can be a key defence against control breakdowns or fraud by providing an independent assessment of the internal control quality and effectiveness.

Banks need to have early warning signals and indicators in place to address potential problems in a timely and non-disruptive manner. Some of the suggestive alarming signals are indicated as under:

- Internal audit staff reporting to other than the Board of Directors or its Audit Committee.
- Unexplained or unexpected change of external auditor or significant changes in the audit program.
- Frequent change in the internal audit staff.
- Employees in key or influential positions who never take leave or otherwise absent themselves for consecutive weeks during the year.
- Audit reports that do not address specific internal control weaknesses.
- The inability of management to provide timely and accurate financial, operational and regulatory reports.
- Unreconciled differences between trial balances, subsidiary ledgers, and the general ledger.
- A qualified, adverse or disclaimer report from an external auditor.
- An external auditor or audit firm that has a financial interest in the bank, loan from the bank, or another conflict of interest.
- An external auditor or audit firm that performs both financial audit services and other non-audit services,
- An external audit leads audit partner who has performed external audit services for the bank for more than five consecutive years.

13.8 Concurrent Audit Systems:

Concurrent Audit should be introduced at large branches and the treasury department to help in adherence to prescribed systems and procedures and timely detection of lapses/irregularities. The concurrent audit is an examination, which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible. It attempts to shorten the interval between a transaction and its examination by an independent person not involved in its documentation. There is an emphasis in favour of substantive checking in key areas rather than test checking. A concurrent auditor may not sit in judgement of the decision taken by bank/branch Manager or an authorised official. However, the auditor will necessarily have to see whether the transactions or decisions are within the policy parameters laid down by the Board of Directors and they do not violate the instructions or policy prescriptions of the Reserve Bank of India. The auditors must verify whether the decisions are within the delegated authority and in compliance with the terms and conditions for the exercise of delegated authority.

13.8.1 Coverage of business/branches

The Departments/Divisions at the Head Office dealing with treasury functions viz. investments, funds management including inter-bank borrowings, bill rediscount, stock-invest scheme, credit card system and foreign exchange business are to be subjected to concurrent audit. Besides, all branch offices undertaking such business, as also large branches and dealing rooms have to be subjected to continuous audit. A large cooperative bank having several branches may cover the problem branches, which are continuously getting a poor or very poor rating in the bank's annual inspection/audit and where the housekeeping is extremely poor. Banks may also include additional branches at their discretion based on need and their professional judgement about the overall functioning of the branches.

13.8.2 Types of activities to be covered

The main role of the concurrent audit is to supplement the efforts of the bank in carrying out a simultaneous internal check of the transactions and other verifications and compliance with the procedures laid down. In particular, it should be seen that the transactions are properly recorded/documented and vouched. The concurrent auditors may broadly cover the following items:

A. Cash

- Daily cash transactions with particular reference to any abnormal receipts and payments.
- Proper accounting of inward and outward cash remittances.
- Proper accounting of currency chest transactions (if any), its prompt reporting to Reserve Bank of India
- Expenses incurred by cash payment involving sizeable amount.

B. Investments

- Ensure that in respect of purchase and sale of securities, the bank has acted within its delegated power having regard to its Head Office instructions.
- Ensure that the securities held in the books of the bank are physically held by it.
- Ensure that the bank is complying with the RBI/Head Office/Board guidelines regarding BRs, SGL forms, delivery of scrips, documentation and accounting

- Ensure that the sale or purchase transactions are done at rates beneficial to the bank.

C. Deposits

- Check the transactions about deposits received and repaid.
- Percentage check of interest paid on deposits including calculation of interest on large deposits
- Check new accounts opened. Operations in new Current/SB accounts may be verified in the initial period itself to see whether there are any unusual operations. Examine whether the formalities connected with the opening of new accounts have been followed as per RBI instructions on KYC.

D. Advances

- Ensure that loans and advances have been sanctioned properly (i.e. after due scrutiny and appraised at the appropriate level).
- Verify whether the sanctions are in accordance with delegated authority.
- Ensure that securities and documents have been received and properly charged/ registered.
- Ensure that post disbursement, supervision and follow-up are proper, such as receipt of the stock statement, instalments, renewal of limits, etc.
- Verify whether there is any misutilization of the loans and advances and whether there are instances indicative of diversion of funds.
- Check whether the letters of credit issued by the branch are within the delegated powers and ensure that they are for genuine trade transactions.
- Check the bank guarantees issued, whether they have been properly worded and recorded in the bank’s register. Whether they have been promptly renewed on the due dates.
- Ensure proper follow-up of overdue accounts.
- Verify whether the classification of advances has been done as per RBI guidelines.
- Verify whether the submission of claims to ECGC is on time.
- Verify that instances of exceeding delegated powers have been promptly reported to Controlling/Head Office/Board by the branch and have been got confirmed or ratified at the required level
- Verify the frequency and genuineness of such exercise of authority beyond the delegated powers by the concerned officials.

E. Foreign Exchange transactions (applicable to Authorised Dealers)

- Check foreign bills negotiated under letters of credit.
- Check FCNR and other non-resident accounts, whether the debits and credits are permissible under the rules.

- Check whether inward/outward remittance has been properly accounted for.
- Examine extension and cancellation of forward contracts for purchase and sale of foreign currency. Ensure that they are duly authorised and necessary charges have been recovered.
- Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the Bank.
- Ensure that the overbought/oversold position maintained in different currencies is reasonable, taking into account the foreign exchange operations.
- Ensure adherence to the guidelines issued by RBI/HO of the bank about dealing room operations
- Ensure verification/reconciliation of Nostro and Vostro account transactions/ balances.

F. Housekeeping

- Ensure that the maintenance and balancing of accounts, ledgers and registers including clean cash and general ledger are proper.
- Ensure prompt reconciliation of entries outstanding in the inter-branch and inter-bank accounts, Suspense Accounts, Sundry Deposits Account, Drafts Accounts, etc. Ensure early adjustment of large value entries.
- Carryout a percentage check of calculations of interest, discount, commission and exchange.
- Check whether debits in income account have been permitted by the competent authorities.
- Check the transactions of staff accounts.
- In case of difference in the clearing, there is a tendency to book it in an intermediary suspense account instead of locating the difference. Examine the day book to verify as to how the differences in clearing have been adjusted. Such instances should be reported to Head Office/Board of Directors in case the difference persists.
- Detection and prevention of revenue leakages through close examination of income and expenditure accounts/transactions.
- Check cheques returned/bills returned register
- Checking of inward and outward remittances (DDs. MTs and TTs).
- Ensure that the branch gives proper compliance to the internal inspection/audit reports.
- Ensure that customer complaint are dealt with promptly
- Verification of statements, HO returns statutory returns.

The above list is illustrative and not exhaustive. The banks may, therefore, add other items to the list, which in their opinion are useful for the purpose of proper control of the branch operations. In the context of volume of transactions in the large branches, it may not be always possible for the concurrent auditors to do a cent percent check. In certain areas, such as off-balance sheet items (LCs and BGs), investment portfolio, foreign exchange transactions, fraud-prone/sensitive areas, advances having outstanding balances of more than ₹ 5 lakhs, if any unusual feature is observed, the concurrent auditors may conduct cent percent check. In the case of areas such as income and expenditure items, inter-bank and inter-branch accounting, interest paid and interest received clearing transactions, and deposit accounts, the check can be restricted to 10 to 25 percent of the number of transactions.

If any branch has performed poorly in certain areas or requires close monitoring in housekeeping, loans and advances or investments, the concurrent auditors may carry out intensive checking of such areas. Concurrent auditors may concentrate on high-value transactions having a financial implication for the bank rather than those involving lesser amount, although number-wise they may be large. If any adverse remark is required to be given, the concurrent auditors should give reasons for the same. Concurrent auditors may themselves identify problem areas at branch level/bank and offer their suggestions to overcome them.

13.9 Appointment and Remuneration of Concurrent Auditor

The option to consider whether the concurrent audit should be done by the external auditors (professionally qualified Chartered Accountants) or its own staff may be left to the individual banks. In case bank decides to appoint external auditors for the purpose, the terms of their appointment and remuneration to be paid may be fixed by the banks within the broad guidelines approved by the Board and/or by the Registrar of Co-operative Societies of the State concerned.

The audit firms will be responsible for any omissions or commissions in respect of transactions seen by them. In case any serious act of omission or commission is noticed in the working of the concurrent auditors (external), the bank may consider terminating their appointment and a report may be made to the Institute of Chartered Accountants of India for such action as they deem fit under intimation to RBI/RCS.

In case the bank prefers to entrust the audit to its own officers, the bank has to ensure that these officers are well experienced and of sufficient seniority in order to exercise necessary independence and objectivity while conducting a concurrent audit. It would be desirable and necessary to rotate the auditors, whether internal or external, periodically. Progressively, it may be considered whether reliance on external auditors may be reduced as soon as requisite skills for audit work is developed by the proper selection and training of officers from within.

13.10 Reporting System

13.10.1 The concurrent auditors may report the minor irregularities, wrong calculations etc. to the Branch Manager for an on-the-spot rectification and compliance.

13.10.2 If these irregularities are not rectified within a reasonable period of time say a week, these may be reported to the head office. If the auditors observe any serious irregularities, these should be straight away reported to Head Office immediately. The auditor must lay emphasis on the propriety aspect of the audit. Banks may institute an appropriate system of follow-up of the reports of the concurrent auditors. There must be a system of an annual review of the working of concurrent audit. While instituting the concurrent audit system or internal audit system the attempt should be to integrate the same with other systems of internal audit/inspections, which are already in existence. One of the drawbacks hitherto has been non-integration of the different systems of internal audit and inspections and lack of response to audit objections/qualifications. It is necessary that the entire system of audit, inspection and their follow-up is properly documented and the performance of the integrated audit system is reviewed from time to time.

13.11 Risk-Based Internal Audit (RBIA)[39]

The introduction of Risk-Based Internal Audit (RBIA) system has been mandated for all All UCBs having asset size of ₹500 crore and above. The framework was to be implemented by March 31, 2022 in accordance with the Guidelines on Risk-Based Internal Audit provided by RBI. The implementation of the RBIA guidelines has to be done under the oversight of the Board. The broad principle is to align internal the audit systems in banks while keeping in mind the principle of proportionality.

13.11.1 Expectations on the roles and responsibilities of Board of Directors / Audit Committee of Board for internal audit framework:

The Board of Directors (the Board) / Audit Committee of Board (ACB) are primarily responsible for overseeing the internal audit function in the organization. The RBIA policy shall be formulated with the approval of the Board. The policy shall clearly document the purpose, authority, and responsibility of the internal audit activity, with a clear demarcation of the role

[39] Only for UCBs having asset size of ₹500 crore and above. The UCBs having asset size less than ₹500 crore, all Salary Earners UCBs, Unit UCBs and UCBs under All Inclusive Directions shall continue to be covered under the extant internal audit requirements as prescribed in Master Circular DCBR.CO.BPD.(PCB).MC.No. 3/12.05.001/2015-16 dated July 1, 2015.

and expectations from Risk Management Function and Risk Based Internal Audit Function. The policy should be consistent with the size and nature of the business undertaken, the complexity of operations and should factor in the key attributes of internal audit function relating to independence, objectivity, professional ethics, accountability, etc. ACB/Board shall approve a RBIA plan to determine the priorities of the internal audit function based on the level and direction of risk. The risk assessment of business and other functions of the organization shall at the minimum be conducted on an annual basis. Every activity / location, including the risk management and compliance functions, shall be subjected to risk assessment by the RBIA. The policy should also lay down the maximum time period beyond which even the low risk business activities / locations would not remain excluded for audit. The ACB/Board should review the performance of RBIA. There should be assessment of the internal audit function at least once in a year for adherence to the internal audit policy, objectives and expected outcomes. Further, ACB/Board shall promote the use of new audit tools/ new technologies for reducing the extent of manual monitoring / transaction testing / compliance monitoring, etc.

13.11.1.2 Key attributes of RBIA Function

Authority, Stature, Independence and Resources: The internal audit function must have sufficient authority, stature, independence and resources thereby enabling internal auditors to carry out their assignments properly. The Head of Internal Audit (HIA) shall be a senior executive with the ability to exercise independent judgement. The HIA and the internal audit functionaries shall have the authority to communicate with any staff member and get access to all records that are necessary to carry out the entrusted responsibilities.

Competence: Requisite professional competence, knowledge and experience of each internal auditor is essential for the effectiveness of internal audit function. The areas of knowledge and experience may include banking/financial entity's operations, accounting, information technology, data analytics, forensic investigation, among others.

Rotation of Staff: Board should prescribe a minimum period of service for staff in the internal audit function. The Board may also examine the feasibility of prescribing at least one stint of service in the internal audit function for those staff possessing specialized knowledge useful for the audit function, but who are posted in other areas, so as to have adequate skills for the staff in the internal audit function.

Tenor for appointment of Head of Internal Audit: HIA shall be appointed for a reasonably long period, preferably for a minimum of three years.

Reporting Line: The HIA shall directly report to either the ACB/Board/ MD & CEO/Whole Time director (WTD). In case the Board of Directors decide to allow the MD & CEO or a WTD to be the 'Reporting authority', then the 'Reviewing authority' shall be the ACB/Board and the 'Accepting authority' shall be the Board in matters of performance appraisal of the HIA.

Further, in such cases, the ACB/Board shall meet the HIA at least once in a quarter, without the presence of the senior management (including the MD & CEO/WTD). The HIA shall not have any reporting relationship with the business verticals and shall not be given any business targets.

Remuneration: The remuneration of internal audit staff should not be linked to the financial performance of the business lines for which they exercise audit responsibilities. The remuneration policies should be structured in a way to avoid creating conflict of interest and compromising audit's independence and objectivity.

Reference –

1. DCBR.CO.BPD. (PCB).MC.No. 3/12.05.001/2015-16 dated July 01, 2015
2. DoS.CO.PPG./SEC.05/11.01.005/2020-21 February 03, 2021

Chapter XIV

Risk Management

Chapter XIV

Risk Management

14.1 Banking is an inherently risky business due to its structure, nature, and functions. Modern day banking, commercial or cooperative, is more than accepting deposits for lending and investments. Being highly leveraged entities, the banks perform the tasks of credit intermediation a competitive environment. While banks, can at best minimize risk, they cannot avoid or completely eliminate risk since it is an essential part of the banking activity. A judicious risk-taking can also earn higher rewards for banks thereby boosting their Net Interest Income (Interest income minus Interest expense). However, it is also important is to understand the possible losses that a bank could incur in case things do not happen according to expectations and the bank's risk management framework to mitigate or minimize such losses.

14.2 Definition of Risk:

The risk is understood as the quantifiable uncertainty about the future outcomes. Banks are considered inherently risky due to the in-built jeopardy relating to high leverage, maturity mismatches, liquidity transformation and the business cycles. However, risk also provides an opportunity to earn higher rewards, as higher the risk taken higher would be the reward. However, as bankers deal in public money, there is no scope for mindless financial misadventure in banking. Risk taking has to be calibrated, conscious and measured.

14.3 Risks in Banking:

The major risks faced by the banks are:

1. Credit risk, which is inherent to banking.
2. Market risk, which is the adverse outcome of market movements.
3. Operational risk, due to the failure of internal processes, people and systems or external events.
4. Liquidity Risk, due to liquidity bottlenecks and/ or liquidity mis-management.
5. Reputation Risk, due to chances of loss of credibility.
6. Residual Risks, due to several other risks not recognised in the above classification.

14.4 Process of Risk Management

Banks are institutions which intermediate between the savers and investors. Since they do not use their own money to lend, there is a special responsibility thrust upon them to ensure safety of the deposits accepted by them. They operate in a well regulated environment where the regulators expect them to manage their risks and also set aside capital for the risks they take. However, meeting regulatory requirements is not the only purpose of establishing sound scientific risk management systems. Banks need reliable risk measures to direct capital to activities which give the best possible risk-reward ratio so as to ensure their financial and operational soundness. They need to estimate the size of potential losses and take adequate measures to contain them within the prudential limits. This requires putting in place efficient mechanisms to monitor risk in the various activities undertaken by the them and create incentives for prudent risk taking by the various functionaries within the bank. Risk management is a process by which the banks can satisfy the above requirements by identifying the key risks, obtaining consistent and understandable risk measures, choosing which risk to minimize, which risk to increase and by what means and also establish procedures for monitoring the end-results. Banks should identify the various types of risks which they are dealing with. They should devise methods to measure them and reduce them to quantifiable numbers. Thus, banks should develop methods to monitor and mitigate risks.

The process of risk management would involve -

1. Identifying the risk
2. Measuring the risk
3. Managing the risk
4. Monitoring the risk
5. Mitigating the risk

14.4.1 Role of Board in risk management:

The primary responsibility for establishing robust risk management systems in the bank is that of the Board of Directors. Risk management is a top-down activity and it has to be embedded in the bank's culture. Therefore, the starting point of risk management should be a robust framework laid down by the BOD of the banks. The BOD has to take a view whether their bank should take higher/ lesser risks by analyzing the maximum possible loss which their bank could be put to as also the possibility of earning a higher return in various areas of their functioning.

The BOD should lay down internal prudential ceilings, within the overall regulatory ceilings, in various areas to manage risks. The BOD should frame a sound policy for managing credit risk, market risk and operational risk. The starting point for effective risk management would be the policies and broad frameworks laid down by the top management. The BOD should set up robust audit machinery and inspection machinery within the bank to monitor and control the risks emanating from its activities. The BOD should ensure a proper MIS to keep a watch on adherence to various prudential limits/ ceilings by the bank. BOD should also ensure the adequate training of staff and improve their skills in the area of risk management.

14.5 Credit Risk

Credit risk can be defined as the possibility of a borrower or a counterparty failing to meet his/its obligation in accordance with the terms of contract/agreement. It can happen when a bank does not get back its interest or principal in time on loans or in investments. It can also occur in off-balance sheet positions. Credit risk gets accentuated if the bank takes excessive exposures to a borrower, a group of connected borrowers, certain industry or sector, which may lead to built up of credit concentration risk in the bank. Credit risk is, thus, the combined outcome of default risk and exposure risk.

14.5.1. Managing credit risk

1. **Formulating loan policy:** Formulating a comprehensive and forward-looking loan policy is the primary responsibility of the Board. The loan policy should clearly lay down the credit culture of the bank, its risk appetite, the loan appraisal techniques, post-sanction supervision systems, loan review mechanism, a mechanism for management of stressed assets and inspection & audit systems so as to identify and alert the management about built of credit risk in the bank.
2. **Delegating sanctioning powers:** The BOD should delegate loan sanctioning powers and also monitor the exercise of the delegated authority.
3. **Stipulating prudential exposure ceilings:** Setting up prudential exposure ceiling within the overall ceiling stipulated by the regulators is a must for every bank. Risk management has to be bank specific and there cannot be a one size fits all kind of approach to it. The BOD should set up exposure ceiling limit considering the size of the bank and its risk-taking ability. The RBI has stipulated an outer ceiling for individual exposure and for group exposure to prevent concentration risk. Similarly, it has also stipulated sectoral exposure ceilings. Within these broad overall limits, the BOD has to fix exposure ceilings for the bank.
4. **Setting up a credit risk rating framework for borrowers:** Risk rating of borrowers always helps in assessing and monitoring the credit risk of the borrower in an objective manner. The BOD should design a credit risk rating model for all borrowers.
5. **Risk-based pricing:** Pricing of loans as per its riskiness ensures a fair reward for the risk a bank takes. It also ensures that high-risk borrowers are not cross-subsidized by low-risk borrowers. The BOD should ensure that the pricing of loans is related to the risk rating of the borrowers.
6. **Developing an institutional mechanism for managing and controlling credit risk:**

a. Adherence to prudential guidelines issued by RBI.

b. Exercise of sanctioning powers in accordance with the delegated powers.
c. Committee approach for sanction of big loans.
d. Ensuring proper end use of funds by checking any diversion funds.
e. Regular review/ renewal of limits.
f. A good MIS (management information system) to monitor delinquencies.
g. A system of rating of the borrowers.
h. Risk sensitive pricing of loans.
i. A sound recovery policy and recovery mechanisms.

14.6 Market Risk

Market Risk is defined as the possibility of loss to the bank caused by the changes in the market variables, such as interest rates. Market risk is the risk to the bank's earnings and capital due to changes in the market level of interest rates or prices of securities, foreign exchange flows and developments in equities' market, or volatility of these variables. Market risk management requires a comprehensive and dynamic structure for measuring, monitoring and mitigating the risk.

14.7 Liquidity Risk – Inability to meet its payment obligations as and when they become due is defined as liquidity risk. Even otherwise sound banks can face tough time if their liquidity position is not properly monitored and managed.

14.8 Operational Risk:

Operational risk, according to Basel Committee on Banking Supervision (BCBS), is the "risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk but excludes strategic and reputational risk. This definition is based on the underlying causes of operational risk and not on the outcome or consequence of the risk. It seeks to identify why a loss happened and at the broadest level includes the breakdown by four causes: people, processes, systems and external factors".

- **People Risk** – Risk of loss intentionally or unintentionally caused by an employee due to errors, misdeeds or due to internal organizational problems.
- **Process Risk** – Risks related to execution and maintenance of transactions and various aspects of running a business, including products and service.
- **Relationship Risk** – Losses arising from relationships or contracts that a firm has with its clients, shareholders or third parties.
- **Technology Risk** – The risk of losses arising out of piracy, theft, failure, or disruption in technology being used in the business.

➢ **External Risk –** Risk of loss due to damage to physical assets from natural or non-natural events, as also the risk presented by external parties, such as perpetration of frauds, etc.

As the operational risk occurs mostly on account of improper systems or their non-compliance, it is necessary to have proper internal control systems in banks. From an operational risk point of view, at least, three out of these five risk classes; namely, people, process and relationship risks are primarily caused by non-existence of well-defined systems and processes or due to deliberate tampering with them by the internal people. In other words, non-existence of sound governance practices in the bank lead to higher incidence of operational risk. Even the technology risk and external risks, to some extent, could be taken care of by the sound governance systems.

14.9 Other Risks

Legal and reputation risk are other important risk factors. Needless to say that if a bank does not have sound systems it could unnecessarily have to face some legal suits or court case which amounts to a waste of time and money. Similarly, it could also lose its image and goodwill in society on account of its lax systems/procedures or due to non-compliance with the various applicable laws and the regulator's prescriptions.

14.10 Role of Other Concerned Entities

A bank's board of directors and senior management are primarily responsible and accountable for the performance of the bank. However, other concerned entities, such as, shareholders, creditors, depositors, auditors, etc., should also play their respective roles and fulfill their responsibility in making the board accountable for governing the organization effectively. The following principles are prescribed by the Bank for International Settlement (BIS) for effective governance and risk management in banks.

Principles for Governance and Risk Management	
Principle 1 Board's Overall Responsibility	The board has overall responsibility for the bank, including approving and overseeing implementation of the bank's strategic objectives, governance framework and corporate culture.
Principle 2 Board's Qualification and Composition	Board members should be and remain qualified, individually and collectively, for their positions. They should understand their oversight and corporate governance role and be able to exercise sound, objective judgment about the affairs of the bank.
Principle 3 Board's Own Structure and Practices	The board should define appropriate governance structures and practices for its own work, and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.

Principle 4 Senior Management	Under the direction and oversight of the board, senior management should carry out and manage the bank's activities in a manner consistent with the business strategy, risk appetite, remuneration and other policies approved by the board.
Principle 5 Governance of Group Structure	In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring the establishment and operation of a clear governance framework appropriate to the structure, business and risks of the group and its entities. The board and senior management should know and understand the bank group's organisational structure and the risks that it poses.
Principle 6 Risk Management Functions	Banks should have an effective independent risk management function, under the direction of a chief risk officer (CRO), with sufficient stature, independence, resources and access to the board.
Principle 7 Risk Identification, Monitoring & Control	Risks should be identified, monitored and controlled on an ongoing bank-wide and individual entity basis. The sophistication of the bank's risk management and internal control infrastructure should keep pace with changes to the bank's risk profile, to the external risk landscape and in industry practice.
Principle 8 Risk Communication	An effective risk governance framework requires robust communication within the bank about risk, both across the organisation and through reporting to the board and senior management. Development of a robust and effective 'Management Information System (MIS) is very essential for this purpose.
Principle 9 Compliance	The bank's board of directors is responsible for overseeing the management of the bank's compliance risk. The board should establish a compliance function and approve the bank's policies and processes for identifying, assessing, monitoring and reporting and advising on compliance risk.
Principle 10 Internal Audit	The internal audit function should provide independent assurance to the board and should support board and senior management in promoting an effective governance process and the long-term soundness of the bank.
Principle 11 Compensation	The bank's remuneration structure should support sound corporate governance and risk management.
Principle 12 Disclosure & Transparency	The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.
Principle 13 Role of Supervisors	Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors.
Source: Corporate Governance Principles for Banks, July 2015, BCBS, Bank for International Settlements, Basel.	

14.11 Impact of risk on the capital

UCBs are required to provide capital for credit risk and market risk as per risk weights prescribed as per RBI guidelines. Unlike commercial banks, UCBs are not required to provide capital for the operational risk as per the present capital adequacy framework applicable to them. However, it is in the interest of the UCBs to have robust systems, oversee their implementation as also re-skill their staff so that operational risk is minimized. Good internal control mechanisms will ensure that chances of frauds are strictly controlled and risk of loss of reputation to the bank are minimized.

14.12 Some good internal control measures that UCBs may implement:

- BOD to frame suitable policies & ensure procedures/ manual of instructions for various areas of functioning.
- Sub-committees of the Board may be set up for important areas like Credit, Investments, ALM, IT, Audit etc.
- BOD to ensure an appropriate MIS in the bank and go through the calendar of reviews.
- Board of Directors to ensure proper training of staff for updating of their skills.
- Control over unreconciled interbank/ inter-branch/ clearing entries.
- Balancing of books at regular intervals.
- Submission of various control returns by the branches to their H.O.
- Submission of various regulatory & statutory returns by the bank to RBI/ RCS or other agencies like FIU-IND.
- Control over sundry, suspense accounts, inoperative accounts etc.
- Control visits to branches by H.O officials and monitoring compliance of action points.
- Control over quality, coverage and conduct of audit/ inspection and also compliance with the audit/ inspection reports.
- Reporting of frauds & monitoring follow up actions as per the prescribed guidelines.
- Following KYC and AML norms prescribed by the RBI.

14.13 Appointment of Chief Risk Officer in Primary (Urban) Co-operative Banks[40]

UCBs having asset size of ₹5000 crore or above, shall appoint a Chief Risk Officer (CRO). The Board[2] must clearly define the CRO's role and responsibilities and ensure that he/she functions independently. UCBs meeting the prescribed criteria as on March 31, 2021 shall appoint / designate a CRO by March 31, 2022. UCBs which may fulfill the criteria at the end

[40] Ref. DOR.CRE(DIR).REC.26/21.04.103/2021-22 dated June 25, 2021.

of the current or subsequent financial years shall appoint / designate a CRO within a period of six months from the end of the financial year concerned.

UCBs shall strictly adhere to the following instructions in this regard:

a. The CRO shall be a senior official in the bank's hierarchy and shall have adequate professional qualification / experience in the area of risk management.

b. The CRO shall be appointed for a fixed tenure with the approval of the Board. The CRO can be transferred / removed from the post before completion of the tenure only with the approval of the Board and such premature transfer / removal shall be reported to the concerned Regional Office[3] of Department of Supervision, Reserve Bank of India.

c. The Board shall put in place adequate policies to safeguard the independence of the CRO. The CRO shall have direct reporting lines to MD/CEO or Board or Risk Management Committee of Board (RMC). In case the CRO reports to the MD/CEO, the Board or the RMC shall meet the CRO, without the presence of the MD & CEO, at least on a quarterly basis.

d. The CRO shall not have any reporting relationship with the business verticals and shall not be given any business targets. Further, there shall not be any 'dual hatting' i.e. the CRO shall not be given any other responsibility such as CEO, COO, CFO, Chief of the Internal Audit, etc.

e. In UCBs that follow committee approach in credit sanction process for high value proposals, if the CRO is one of the decision makers in the credit sanction process, he shall have voting power and all members who are part of the credit sanction process, shall individually and severally be liable for all the aspects, including risk perspective related to the credit proposal. If the CRO is not a part of the credit sanction process, his role will be limited to that of an adviser.

f. In UCBs which do not follow committee approach for sanction of high value credits, the CRO can only be an adviser in the sanction process and shall not have any sanctioning power.

g. All credit products shall be vetted by the CRO from the angle of inherent and control risks.

The CRO shall support the Board in establishing an integrated risk management system, capable of identifying, measuring and monitoring all types of risks on an ongoing basis. This will include developing the organisational risk appetite and a framework that will translate the Board's strategy into clearly laid down monitorable risk limits at the aggregate and at granular levels. The CRO shall also be involved in actual monitoring and mitigation of risks.

The primary responsibility of risk management lies with the Board. In order to focus the required level of attention on various aspects of risk management, UCBs having asset size of ₹5000 crore or above, should set up a Risk Management Committee (of the Board) by March 31, 2022. The Board shall decide the membership, scope of work and frequency of meeting of the Risk Management Committee.

Chapter XV

Management Information System

Chapter XV

Management Information System

15.1 Introduction and background

In a bank the decisions have to be taken at various levels for various management activities, i.e., planning, organizing, implementing, reviewing, monitoring, etc. For taking decisions and conducting the management activities a lot of data and information are required. In the absence of adequate information/ data, the process of correct decision making and conducting management activity gets adversely affected. The Board uses the management reports and other information systems to stay well informed and assess the risks and performance of the bank. The Board's decisions based on ineffective, inaccurate, or incomplete reports/ information may increase risk within the bank. The Board also monitors the operations of the bank through management reports. But before taking any decisions based on the information and the reports put up to it by the management, it must review and analyze them to be sure about the accuracy and reliability of these reports. They should also ensure that adequate and timely information is provided to them to help them in discharge their duties.

In the present day environment, where UCBs are competing with commercial banks for business, quick and informed decisions are of paramount importance. Decisions based on unreliable information or information culled out from old data would be of little use and sometimes be a source of reputational risk to the bank. Therefore, banks should process various information and generate reports with the help of a robust management information system. Technological developments are very rapid which are affecting the character of day-to-day banking activities. It is, therefore, necessary that the Board members keep themselves informed about the bank’s key data and critical information. They also should review whether there is any need to change the existing information system.

The information system of any bank performs two major functions, one is processing bank transactions and second is supply of report/ information to the management and the Board about various functions within the bank. The Management Information System (MIS) supplies various management information reports and it is necessary that these reports are accurate, reliable, adequate, and generated timely. In the case of outsourcing, the transactions are processed by outside vendors/parties. In such cases, the vendors or the outside agencies play an important role in the bank’s information system. The Board must ensure that the vendors' services, products, and reports meet the standards prescribed by the bank and they need to be validated before they are acted upon.

15.2 Key Features of MIS

Keeping in view the importance of the information system in managing the bank's affairs, the Board must consider whether the MIS process provides the all the information necessary to manage the bank effectively. The MIS should also support the institution's longer-term, strategy, goals and objectives. For ensuring a timely and well-informed decision-making process, the following aspects about the MIS should be looked into:

- **Timeliness –** The system should expedite the timely reporting of information. The system should promptly collect and edit data, summarise results, and correct errors.
- **Accuracy –** A system of automated and manual internal controls must exist for all information system processing activities. Information should be accurate and reliable.
- **Security and Integrity –** The information system should not be subject to unauthorised changes and manipulations.
- **Consistency –** Consistency in how data are collected and reported is extremely important. Differences in these activities can distort trend analysis and information reported to the Board.
- **Completeness –** Decision-makers must require complete information in a summarized form. Reports should be designed to eliminate clutter and voluminous detail, thereby avoiding information overload.
- **Relevance –** MIS should be relevant to the needs of Board level supervision and monitoring.

15.3 Components of an MIS

MIS generally comprises the following steps: (a) Input, (b) Analysis and processing, (c) Storage and retrieval, (d) Output, and (e) Information flow.

Both the input (i.e., data) and the output (i.e., the analyzed information) are directly related to the information requirements of the organization. To produce the output, it would be necessary to collect input data and information from different sources, have it processed and analyzed, make use of past data, have a proper storage and retrieval sub-system, and finally, a proper communication and feedback system which may ensure that data and information flow properly from one point to another without excessive time lags and distortion.

15.3.1 Designing MIS

The following steps are necessary for designing and installing an MIS:

1. **Analysis and determination of system's requirements** – Such analysis attempts to answer the points such as the objectives of the organization, types of activities to be carried out, type of evaluation required to assess impact of such activities, data to be collected by

whom and how, data to be processed by whom and how and where, accuracy and reliability of such data, and information generated to be used by whom and how etc.

2. **Design of information system** – The next step is the actual design of the information system in such a manner that it fulfils, with minimum cost and delay and in the required form, the information requirements of the management.
3. **Procurement of necessary material** – The third step is the procurement of the necessary material and the provision of required facilities so that the system could be put into operation.
4. **Installation** – The information system should be set up keeping in mind to retain as far as possible the existing procedures and systems, and to replace the other components which require change slowly.
5. **Operation and follow-up** – The output of the system is examined against the objectives for which the system was designed. Banks should try to continuously improve upon the system taking into account the changed situation.

15.4 Cost & benefit of MIS

Though a strong MIS helps in the reduction of various costs in banks, we must also appreciate that collection and analysis of information through automation involves costs to the banks. But information is the key to quick decisions, UCBs cannot afford to neglect the need for automation of their MIS.

15.5 Prevention of misuse of MIS

The Board should immediately take corrective action and comprehensively review the MIS if it finds that the information relating to the customer and/or his business operations are being disclosed unauthorisedly to other persons/ institutions. It indicates either the integrity or security of the system or the persons controlling the system has been compromised and needs to be strengthened.

15.6. Importance of MIS for submission of regulatory returns:

The Reserve Bank of India has prescribed a calendar of returns that the UCBs need to furnish at periodical intervals to RBI as well as place it before the Board of Directors. Unless the information collection, information processing, and information storing systems are robust and pass the test of integrity, accuracy, and timeliness, UCBs would not be in a position to comply with the regulatory requirement of furnish various returns. Besides, a set of monthly, quarterly, half-yearly, and annual reviews are to be prepared and submitted to the board.

For processing various transactions and producing various information and reports the bank uses the management information system. It is, therefore, necessary that the Board members keep themselves informed as much as possible about the bank's information system. They also should review whether there is any need to change the existing information system to ensure the accuracy of the data.

Chapter XVI

Know Your Customer (KYC)
and
Anti Money Laundering Framework

Chapter XVI

Know Your Customer (KYC) & Anti Money Laundering Framework

16.1. Introduction

Know Your Customer (KYC) is a process by which banks are required to follow certain customer identification procedures while undertaking a transaction either by establishing an account-based relationship or otherwise and monitor the customer transactions. RBI issues the Master Directions on KYC and AML under Sections 35A of the Banking Regulation Act, 1949, the Banking Regulation Act (AACS), 1949, and Rule 9(14) of Prevention of Money-Laundering (Maintenance of Records) Rules, 2005. Any contravention of or non-compliance with these guidelines lead to penalties under the relevant provisions of the Act. These directions apply to all the entities regulated by RBI, including the UCBs. The Board of Directors is primarily responsible to ensure that their bank adheres to the KYC/AML norms in letter and spirit and the bank is free from any tainted or laundered money.

16.2 Definition of Customer

"Customer" is a person/ entity who is engaged in a financial transaction or activity with a UCB and includes a person on whose behalf the person who is engaged in the transaction or activity, is acting.

16.3 KYC Policy

Every bank should have a Board approved comprehensive KYC policy incorporating the key elements of RBI guidelines. The Board of Directors should ensure that all the senior officials of the bank are well versed with these guidelines. The KYC policy should broadly cover the following key elements.

a. Customer Acceptance Policy;
b. Customer Identification Procedures;
c. Monitoring of Transactions; and
d. Risk Management.

Further, the KYC does not end with opening an account but it begins with it. KYC does not mean merely obtaining requisite documents and opening customer accounts but it is the continuous process of actively monitoring and reporting customer transactions.

16.4 Designated Director and Principal Officer

Every bank must appoint a designated director and a principal officer to ensure compliance with the KYC norms;

Designated Director	**Principal Officer**
(a) A “Designated Director” is a person designated by the bank to ensure overall compliance with the requirements under Chapter IV of the PML Act and the Rules, and is nominated by the Board. (b) The name, designation and contact details of the Designated Director and Principal officer must be communicated to the FIU-IND.	a) The Principal Officer is responsible for ensuring compliance, monitoring transactions, and sharing and reporting information as required under the law/regulations. (b) In no case, the same person should be nominated as ‘Principal Officer’ and 'Designated Director'.

16.5 Customer Acceptance Policy

Every bank must have a customer acceptance policy as part of its KYC policy, which should ensure the following.

a) No account is opened in anonymous or fictitious / benami name.

b) No account is opened where the bank is unable to apply requisite Customer Due Diligence (CDD) measures, either due to non-cooperation of the customer or non-reliability of the documents/information furnished by him/her.

c) The mandatory information for KYC purpose while account opening and during periodic updation should be specified.

d) 'Optional' / additional information, should be obtained with the explicit consent of the customer after the account opening.

e) Banks shall apply the CDD measures at the UCIC (Unique Customer Identification code) level.

f) In the case of joint accounts, the CDD Procedure should be applied for all the joint account holders.

g) RBI periodically circulates a ‘sanctions’ list. Banks should ensure that identity of the customer does not match with any person or entity from that list.

h) Permanent Account Number (PAN) should be verified from the verification facility of the issuing authority.

i) Where an equivalent e-document[41] is obtained from the customer, the bank shall verify the digital signature as per the provisions of the Information Technology Act, 2000 (21 of 2000).

16.6 Risk Management

Second component of a bank's KYC policy is the risk management, under which a bank should adopt risk based approach for identification, classification and monitoring of customers. Banks are required to classify their customers into 'low', 'medium' and 'high' risk categories depending on their AML risk assessment.

- Low Risk: Individuals/ entities whose identities and sources of wealth can be easily monitored.
- Medium and High Risk: Customers likely to pose a higher than average risk.

Risk categorisation must be undertaken on the basis of parameters such as customer's identity, financial/ social status, nature of business activity, reliability and availability of the information about the clients' business and their location etc. While considering customer's identity, the ability to confirm identity documents through online or other services offered by issuing authorities should also be factored in. A system of **periodic review of risk categorisation** of accounts, (at least once in six months), should be put in place by the bank. Recently, instructions on risk categorisation have been amended to include the provision that, *"Broad principles may be laid down by the REs for risk-categorisation of customers."* The indicative list of parameters for risk categorization has been expanded to include geographical risk covering customers as well as transactions, type of products/services offered, delivery channel used for delivery of products/services, types of transaction undertaken, etc. REs shall treat the risk categorization and reasons for risk categorization of customers as confidential.

16.6.1 Periodic updation of KYC

Periodic updation shall be carried out at least once in every two years for high risk customers, once in every eight years for medium risk customers and once in every ten years for low risk customers[42] as per the following procedure;

[41] An electronic equivalent of a document, issued by the issuing authority of such document with its valid digital signature including documents issued to the digital locker account of the customer as per Rule 9 of the Information Technology Rules, 2016.

[42] These time limits would apply from the date of opening of the account / last verification of KYC

a) Banks need to carry out CDD, at the time of periodic updation. However, in cases of low risk customers, when there is status quo with respect to their identities and addresses, a self-certification can be obtained.

b) Banks may **not insist on the physical presence of the customer** for of furnishing Officially Valid Documents (OVD) or Aadhaar authentication, unless there are compelling reasons that physical presence of the account holder/s is required to establish their bona-fides. Normally, OVD / Consent forwarded by the customer through means such as mail/ post, etc., shall be acceptable.

c) For Legal entities, the bank shall review the documents taken at the time of account opening and obtain fresh certified copies.

(d) Banks shall ensure to provide acknowledgment to the customer with date of having performed KYC updation.

16.7 Customer Identification Procedure (CIP)

Customer identification procedure is the third component of the bank's board approved KYC policy. Under CIP, banks should identify the customer behind the following types of transactions;

(a) Commencement of an account-based relationship with the customer.

(b) Carrying out international money/ wire transfer for a person who is not an account holder.

(c) Whenever there is doubt about authenticity/ adequacy of the customer identification, adequate and relevant data shall be obtained.

(d) Selling third party products as agents, or selling their own products, payment of credit cards dues/ sale and reloading of prepaid/ travel cards and any other product for more than ₹50,000.

(e) Carrying out transactions for a non-account based walk-in customer, where the amount involved is equal to or more than ₹50,000, whether conducted as a single transaction or several interconnected transactions.

(f) When the bank suspects that a customer (account-based or walk-in) is intentionally structuring transaction/s below the threshold of ₹50,000.

16.8 Customer Due Diligence (CDD)

CDD is the process of identifying and verifying the customer and the beneficial owner. Banks can rely on "officially Valid Documents" (OVDs) for the purpose of CDD. The Government of

India has notified following six documents as 'Officially Valid Documents' (OVDs) for the purpose of KYC;

1. Driving License,
2. Passport,
3. Proof of possession of Aadhaar number (To be submitted in such form as provided by the UIDAI)
4. Letter issued by NPR containing name & Address
5. Voters' Identity Card,
6. NREGA Job Card, duly signed by officer of state government.

16.8.1 CDD for individuals

Documents a customer may submit	CDD by the bank
1. Aadhaar number where customer is desirous of receiving any benefit or subsidy under the section 7 (meaning he wants to receive government subsidy in such a/c) of the Aadhaar Act, 2016; or he voluntarily decides to submit his Aadhaar number to a bank; or 2. the proof of possession of Aadhaar number where offline verification can be carried out; or 3. the proof of possession of Aadhaar number where offline verification cannot be carried out or 4. any OVD or the equivalent e-document thereof containing the details of his identity and address; and 5. The PAN or the equivalent e-document or Form No. 60, and 6. Such other documents including in respect of the nature of business and financial status of the client, or the	1. **In case of (1)** Bank shall carry out authentication of the customer's Aadhaar number using e-KYC authentication facility of UIDAI. 2. **In case of (2)** Bank may carry out offline verification, where ever it is possible. 3. **In case (3) i**n case proof of possession of Aadhaar number where offline verification cannot be carried out or **in case of (4)** in case of any OVD, Bank shall carry out verification through digital KYC. The RE may obtain a certified copy of the proof of possession of Aadhaar number or the OVD and a recent photograph where an equivalent e-document is not submitted. 4. For equivalent e-document of any OVD, the RE shall verify the digital signature as per the provisions of the IT Act, 2000 and take a live photo[43].

[43] The bank must ensure that the live photograph of the customer is taken by the authorized officer and the same photograph is embedded in the Customer Application Form (CAF). Further, the system Application of the RE shall put a water-mark in readable form having CAF number, GPS coordinates, authorized official's name,

equivalent e-documents thereof as may be required by the RE.	5. Equivalent e-document has also been permitted for accounts of non-individual customer.

The case of Aadhaar ;

1. In case biometric e-KYC authentication cannot be performed for an individual desirous of receiving any subsidy u/s 7 of Aadhaar Act 2016, due to injury, illness or infirmity on account of old age or otherwise, and similar causes, banks shall, apart from obtaining the Aadhaar number, perform identification either by carrying out offline verification or by obtaining the certified copy of any other OVD.

2. CDD done in this manner shall be carried out by the designated bank official and such exception handling shall also exposed to the concurrent audit.

3. Banks shall record the cases of exception handling in a centralised exception database. This database shall contain the details of reasons of granting exception, customer details, name of the designated official authorising the exception and additional details, if any. The database must be periodically subjected to internal audit/inspection by the RE and must be exposed to supervisory review.

4. Banks shall, where its customer submits a proof of possession of Aadhaar Number containing Aadhaar Number, ensure that such customer redacts or blacks out his Aadhaar number where the authentication of Aadhaar number is not required as per the provision (1) above.

16.8.2 Video based Customer Identification Procedure (V-CIP)

Video based Customer Identification Process (V-CIP)" is an alternate method of customer identification with facial recognition and customer due diligence by an authorised official of the RE by undertaking seamless, secure, live, informed-consent based audio-visual interaction with the customer to obtain identification information required for CDD purpose, and to ascertain the veracity of the information furnished by the customer through independent verification and maintaining audit trail of the process. Such processes complying with prescribed standards and procedures shall be treated on par with face-to-face CIP for the purpose of this Master Direction. REs may undertake V-CIP to carry out:

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unique employee Code (assigned by REs) and Date (DD:MM:YYYY) and time stamp (HH:MM:SS) on the captured live photograph of the customer.

i) CDD in case of new customer on-boarding for individual customers, proprietor in case of proprietorship firm, authorised signatories and Beneficial Owners (BOs) in case of Legal Entity (LE) customers.

Provided that in case of CDD of a proprietorship firm, REs shall also obtain the equivalent e-document of the activity proofs with respect to the proprietorship firm, as mentioned in Section 28, apart from undertaking CDD of the proprietor.

ii) Conversion of existing accounts opened in non-face to face mode using Aadhaar OTP based e-KYC authentication as per Section 17.

iii) Updation/Periodic updation of KYC for eligible customers.

REs opting to undertake V-CIP, shall adhere to the following minimum standards:

(a) V-CIP Infrastructure

i) The RE should have complied with the RBI guidelines on minimum baseline cyber security and resilience framework for banks, as updated from time to time as well as other general guidelines on IT risks. The technology infrastructure should be housed in own premises of the RE and the V-CIP connection and interaction shall necessarily originate from its own secured network domain. Any technology related outsourcing for the process should be compliant with relevant RBI guidelines.

ii) The RE shall ensure end-to-end encryption of data between customer device and the hosting point of the V-CIP application, as per appropriate encryption standards. The customer consent should be recorded in an auditable and alteration proof manner.

iii) The V-CIP infrastructure / application should be capable of preventing connection from IP addresses outside India or from spoofed IP addresses.

iv) The video recordings should contain the live GPS co-ordinates (geo-tagging) of the customer undertaking the V-CIP and date-time stamp. The quality of the live video in the V-CIP shall be adequate to allow identification of the customer beyond doubt.

v) The application shall have components with face liveness / spoof detection as well as face matching technology with high degree of accuracy, even though the ultimate responsibility of any customer identification rests with the RE. Appropriate artificial intelligence (AI) technology can be used to ensure that the V-CIP is robust.

vi) Based on experience of detected / attempted / ‘near-miss’ cases of forged identity, the technology infrastructure including application software as well as work flows shall be regularly upgraded. Any detected case of forged identity through V-CIP shall be reported as a cyber event under extant regulatory guidelines.

vii) The V-CIP infrastructure shall undergo necessary tests such as Vulnerability Assessment, Penetration testing and a Security Audit to ensure its robustness and end-to-end encryption capabilities. Any critical gap reported under this process shall be mitigated before rolling out its implementation. Such tests should be conducted by suitably accredited agencies as prescribed by RBI. Such tests should also be carried out periodically in conformance to internal / regulatory guidelines.

viii) The V-CIP application software and relevant APIs / webservices shall also undergo appropriate testing of functional, performance, maintenance strength before being used in live environment. Only after closure of any critical gap found during such tests, the application should be rolled out. Such tests shall also be carried out periodically in conformity with internal/ regulatory guidelines.

(b) V-CIP Procedure

i) Each RE shall formulate a clear work flow and standard operating procedure for V-CIP and ensure adherence to it. The V-CIP process shall be operated only by officials of the RE specially trained for this purpose. The official should be capable to carry out liveliness check and detect any other fraudulent manipulation or suspicious conduct of the customer and act upon it.

ii) If there is a disruption in the V-CIP procedure, the same should be aborted and a fresh session initiated.

iii) The sequence and/or type of questions, including those indicating the liveness of the interaction, during video interactions shall be varied in order to establish that the interactions are real-time and not pre-recorded.

iv) Any prompting, observed at end of customer shall lead to rejection of the account opening process.

v) The fact of the V-CIP customer being an existing or new customer, or if it relates to a case rejected earlier or if the name appearing in some negative list should be factored in at appropriate stage of work flow.

vi) The authorised official of the RE performing the V-CIP shall record audio-video as well as capture photograph of the customer present for identification and obtain the identification information using any one of the following:

a. OTP based Aadhaar e-KYC authentication
b. Offline Verification of Aadhaar for identification
c. KYC records downloaded from CKYCR, in accordance with Section 56, using the KYC identifier provided by the customer
d. Equivalent e-document of Officially Valid Documents (OVDs) including documents issued through Digilocker

RE shall ensure to redact or blackout the Aadhaar number in terms of Section 16.

In case of offline verification of Aadhaar using XML file or Aadhaar Secure QR Code, it shall be ensured that the XML file or QR code generation date is not older than 3 days from the date of carrying out V-CIP.

Further, in line with the prescribed period of three days for usage of Aadhaar XML file / Aadhaar QR code, REs shall ensure that the video process of the V-CIP is undertaken within three days of downloading / obtaining the identification information through CKYCR / Aadhaar authentication / equivalent e-document, if in the rare cases, the entire process cannot be completed at one go or seamlessly. However, REs shall ensure that no incremental risk is added due to this.

vii) If the address of the customer is different from that indicated in the OVD, suitable records of the current address shall be captured, as per the existing requirement. It shall be ensured that the economic and financial profile/information submitted by the customer is also confirmed from the customer undertaking the V-CIP in a suitable manner.

viii) RE shall capture a clear image of PAN card to be displayed by the customer during the process, except in cases where e-PAN is provided by the customer. The PAN details shall be verified from the database of the issuing authority including through Digilocker.

ix) Use of printed copy of equivalent e-document including e-PAN is not valid for the V-CIP.

x) The authorised official of the RE shall ensure that photograph of the customer in the Aadhaar/OVD and PAN/e-PAN matches with the customer undertaking the V-CIP and the identification details in Aadhaar/OVD and PAN/e-PAN shall match with the details provided by the customer.

xi) Assisted V-CIP shall be permissible when banks take help of Banking Correspondents (BCs) facilitating the process only at the customer end. Banks shall maintain the details of the BC assisting the customer, where services of BCs are utilized. The ultimate responsibility for customer due diligence will be with the bank.

xii) All accounts opened through V-CIP shall be made operational only after being subject to concurrent audit, to ensure the integrity of process and its acceptability of the outcome.

xiii) All matters not specified under the paragraph but required under other statutes such as the Information Technology (IT) Act shall be appropriately complied with by the RE.

(c) V-CIP Records and Data Management

i) The entire data and recordings of V-CIP shall be stored in a system / systems located in India. REs shall ensure that the video recording is stored in a safe and secure manner and bears the date and time stamp that affords easy historical data search. The extant instructions on record management, as stipulated in this MD, shall also be applicable for V-CIP.

ii) The activity log along with the credentials of the official performing the V-CIP shall be preserved.

16.8.3 Requirement of PAN / Form 60

1. In case of existing customers, bank shall obtain the PAN or Form No.60, or equivalent e-document by date as notified by the Central Government, failing which bank shall temporarily cease operations in the account till the time the PAN or Form No. 60 is submitted by the customer.
2. In its internal policy, the Bank may include, appropriate relaxation(s) for continued operation of accounts for customers who are unable to provide PAN/ Form No. 60 due to injury, illness or infirmity on account of old age or otherwise. Such accounts shall, however, be subject to enhanced monitoring.
3. If a customer gives in writing that he does not want to submit his PAN or Form No.60, the bank shall close the a/c and all obligations due in relation to the a/c shall be settled after establishing the identity of the customer by obtaining the identification documents as applicable to the customer.

16.8.4 Officially Valid Documents – Address Proof

In cases where the OVD submitted by the customer has his current address, the bank should not seek another address proof. However, in cases where the OVD furnished by the customer does not have updated address, the following documents or the equivalent e-documents thereof shall be deemed to be OVDs for the limited purpose of proof of address:-

i. Utility bill which is not more than two months old of any service provider, such as electricity, telephone, post-paid mobile phone, piped gas, or water bill.

ii. Property or Municipal tax receipt;

iii. Pension or family pension payment orders (PPOs) issued to retired employees by Government Departments or PSUs, if they contain the address;

iv. Letter of allotment of accommodation from employer issued by State Government or Central Government Departments, statutory or regulatory bodies, PSUs, scheduled commercial banks, financial institutions and listed companies and leave and licence agreements with such employers allotting official accommodation;

In cases of accounts opened with the above documents, the customer will be required to submit OVD with a current address within three months of submitting the above documents. However, in cases where the customer has submitted Aadhaar number as identity proof, and address in the Aadhaar number is different from his current address, the bank can obtain a self-declaration from the customer about his current address and account can be opened/ regularized.

16.8.5 Small Accounts

Banking services should not be denied even for such individuals who do not have any OVD. Banks can open 'small accounts' in such cases, subject to the following conditions;

i) The bank shall obtain a self-attested photograph from the customer.

ii) The designated officer of the bank should certify under his signature that the person opening the account affixed his signature or thumb impression in his presence.

iii) Such accounts should be opened only at CBS linked branches.

iv) Banks shall ensure that following limits are not breached;

  a) Aggregate of all credits in a financial year does not exceed ₹1 lakh;

  b) Aggregate of all withdrawals and transfers in a month does not exceed ₹10,000; and

c) Balance at any point of time does not exceed ₹50,000. Provided, that this limit on balance shall not be considered while making deposits through Government grants, welfare benefits and payment against procurements.

v) The account shall be monitored and when there is suspicion of money laundering or financing of terrorism activities or other high risk scenarios, the identity of the customer shall be established through the production of an OVD and Permanent Account Number or Form No.60, as the case may be.

vi) Foreign remittance shall not be allowed to be credited into the a/c unless the identity of the customer is fully established through the production of an OVD and Permanent Account Number or Form No.60, as the case may be.

Such accounts would remain operational initially for a period of 12 months and thereafter, for a further period of 12 months if the holder of such an account provides evidence to the bank of having applied for any of the OVD within 12 months of the opening of such account. The entire relaxation provisions shall be reviewed after 24 months.

16.9 Ongoing Due Diligence (ODD) – Monitoring of Transactions

Monitoring of transactions is the fourth component of the board approved KYC policy, and banks should be extremely vigilant on this aspect. Banks shall undertake ODD of customers to ensure that their transactions are consistent with their knowledge about the customers, customers' business and risk profile and the source of funds. The extent of monitoring shall be aligned with the risk category of the customer.

Banks need to be cautious in following types of transactions:

a) Large and complex transactions including RTGS transactions, and those with unusual patterns, inconsistent with the normal and expected activity of the customer, which have no apparent economic rationale or legitimate purpose.

b) Transactions which exceed the thresholds prescribed for specific categories of accounts.

c) High account turnover inconsistent with the size of the balance maintained.

d) Deposit of third party cheques, drafts, etc. in the existing and newly opened accounts followed by cash withdrawals for large amounts.

e) The transactions in accounts of marketing firms, especially accounts of Multi-level Marketing (MLM) Companies shall be closely monitored.

16.10 Central KYC Registry

"Central KYC Records Registry" (CKYCR) is an entity defined under Rule 2(1)(aa) of the PML (maintenance of records) Rules 2005 to receive, safeguard, store, and retrieve the KYC records in digital form of a customer. The banks need to capture the KYC information for sharing with the CKYCR in the manner as mentioned in the Rules, and as required by the KYC templates prepared for 'individuals' and 'Legal Entities'. "Know Your Client (KYC) Identifier" means the unique number or code assigned to a customer by the Central KYC Records Registry. RBI has designated CERSAI as the CKYCR.

UCBs are required to upload the KYC data pertaining to all new individual accounts opened on or after April 1, 2017 and all new Legal Entity accounts opened on or after April 1, 2021, on to CKYCR in terms of Rule 9 (1A) of the PML Rules. For all the old accounts of individuals and LEs opened prior to the dates specified above, banks need to upload the KYC data at the time of periodic updation of KYC, or earlier, when the updated KYC information is obtained/received from the customer in certain cases.

Where a customer, for the purpose of establishing an account based relationship, submits a KYC Identifier to a bank, with an explicit consent to download records from CKYCR, then such bank shall retrieve the KYC records online from CKYCR using the KYC Identifier and the customer shall not be required to submit the same KYC records or information or any other additional identification documents or details, unless –

a) There is a change in the information of the customer as existing in the records of CKYCR;
b) The current address of the customer is required to be verified;
c) Bank considers it necessary in order to verify the identity or address of the customer, or to perform enhanced due diligence or to build an appropriate risk profile of the client.

16.11 Reporting to FIU- IND

The major reports that banks need to submit to FIU–IND includes Cash Transaction Report (CTR), Counterfeit Currency Report (CRR) Suspicious Transaction Report (STR) and Non-Profit Organisation Transaction report (NTR);

i. **Cash Transaction Report (CTR)**

   Banks must report all the cash transactions of the value of more than ₹10 lakhs (including interconnected transactions) or its equivalent in foreign currency. CTR for each month should be submitted to FIU-IND by 15th of the succeeding month. In the case of no such transactions, banks should submit 'Nil' report.

ii. **Counterfeit Currency Report (CCR)**

   All cash transactions, where forged or counterfeit Indian currency notes have been used as genuine, should be reported by the Principal Officer to FIU-IND as a Counterfeit

Currency Report (CCR). These cash transactions should also include transactions where forgery of valuable security or documents has taken place.

iii. Suspicious Transaction Reports (STR)

"Suspicious transaction" means a "transaction" as defined below. It also includes an attempted transaction, whether or not made in cash, which, to a person acting in good faith:

a. gives rise to a reasonable ground of suspicion that it may involve proceeds of an offence specified in the Schedule to the Act, regardless of the value involved; or

b. appears to be made in circumstances of unusual or unjustified complexity; or

c. appears to not have an economic rationale or bonafide purpose; or

d. gives rise to a reasonable ground of suspicion that it may involve financing of the activities relating to terrorism.

While determining suspicious transactions, banks should be guided by definition of suspicious transaction contained in PMLA Rules as amended from time to time. The Suspicious Transaction Report (STR) should be furnished within 7 days of arriving at a conclusion that any transaction, whether cash or non-cash or a series of transactions integrally connected are of suspicious nature. Banks should not put any restrictions on operations in the accounts where an STR has been reported. Moreover, it should be ensured that there is no tipping off to the customer at any level.

iv. Non-Profit Organisation Transaction Report (NTR)

“Non-profit organisations” (NPO) means any entity or organisation that is registered as a trust or a society under the Societies Registration Act, 1860 or any similar State legislation or a company registered under Section 8 of the Companies Act, 2013. The report of all transactions involving receipts by non- profit organizations of value more than ₹10 lakh or its equivalent in foreign currency should be submitted every month to the Director, FIU-IND by 15th of the succeeding month in the prescribed format.

16.12 Periodic Updation

REs shall adopt a risk-based approach for periodic updation of KYC. However, periodic updation shall be carried out at least once in every two years for high risk customers, once in every eight years for medium risk customers and once in every ten years for low risk customers from the date of opening of the account / last KYC updation. Policy in this regard shall be documented as part of REs’ internal KYC policy duly approved by the Board of Directors of REs or any committee of the Board to which power has been delegated.

a) Individual Customers:

i. **No change in KYC information:** In case of no change in the KYC information, a self-declaration from the customer in this regard shall be obtained through customer's email-id registered with the RE, customer's mobile number registered with the RE, ATMs, digital channels (such as online banking / internet banking, mobile application of RE), letter etc.

ii. **Change in address:** In case of a change only in the address details of the customer, a self-declaration of the new address shall be obtained from the customer through customer's email-id registered with the RE, customer's mobile number registered with the RE, ATMs, digital channels (such as online banking / internet banking, mobile application of RE), letter etc., and the declared address shall be verified through positive confirmation within two months, by means such as address verification letter, contact point verification, deliverables etc. Further, REs, at their option, may obtain a copy of OVD or deemed OVD or the equivalent e-documents thereof, for the purpose of proof of address, declared by the customer at the time of periodic updation. Such requirement, however, shall be clearly specified by the REs in their internal KYC policy duly approved by the Board of Directors of REs or any committee of the Board to which power has been delegated.

iii. **Accounts of customers, who were minor at the time of opening account, on their becoming major:** In case of customers for whom account was opened when they were minor, fresh photographs shall be obtained on their becoming a major and at that time it shall be ensured that CDD documents as per the current CDD standards are available with the REs. Wherever required, REs may carry out fresh KYC of such customers i.e. customers for whom account was opened when they were minor, on their becoming a major.

b) Customers other than individuals:

i. **No change in KYC information:** In case of no change in the KYC information of the LE customer, a self-declaration in this regard shall be obtained from the LE customer through its email id registered with the RE, ATMs, digital channels (such as online banking / internet banking, mobile application of RE), letter from an official authorized by the LE in this regard, board resolution etc. Further, REs shall ensure during this process that Beneficial Ownership (BO) information available with them is accurate and shall update the same, if required, to keep it as up-to-date as possible.

ii. **Change in KYC information:** In case of change in KYC information, RE shall undertake the KYC process equivalent to that applicable for on-boarding a new LE customer.

c) Additional measures: In addition to the above, REs shall ensure that,

i. The KYC documents of the customer as per the current CDD standards are available with them. This is applicable even if there is no change in customer information but the documents available with the RE are not as per the current CDD standards. Further, in case the validity of the CDD documents available with the RE has expired at the time of periodic updation of KYC, RE shall undertake the KYC process equivalent to that applicable for on-boarding a new customer.

ii. Customer's PAN details, if available with the RE, is verified from the database of the issuing authority at the time of periodic updation of KYC.

iii. Acknowledgment is provided to the customer mentioning the date of receipt of the relevant document(s), including self-declaration from the customer, for carrying out periodic updation. Further, it shall be ensured that the information / documents obtained from the customers at the time of periodic updation of KYC are promptly updated in the records / database of the REs and an intimation, mentioning the date of updation of KYC details, is provided to the customer.

iv. In order to ensure customer convenience, REs may consider making available the facility of periodic updation of KYC at any branch, in terms of their internal KYC policy duly approved by the Board of Directors of REs or any committee of the Board to which power has been delegated.

v. REs shall adopt a risk-based approach with respect to periodic updation of KYC. Any additional and exceptional measures, which otherwise are not mandated under the above instructions, adopted by the REs such as requirement of obtaining recent photograph, requirement of physical presence of the customer, requirement of periodic updation of KYC only in the branch of the RE where account is maintained, a more frequent periodicity of KYC updation than the minimum specified periodicity etc., shall be clearly specified in the internal KYC policy duly approved by the Board of Directors of REs or any committee of the Board to which power has been delegated.

vi. REs shall ensure that their internal KYC policy and processes on updation / periodic updation of KYC are transparent and adverse actions against the customers should be avoided, unless warranted by specific regulatory requirements.

16.13 Foreign Account Tax Compliance Act of the United States of America (FATCA)

In 2010, USA enacted "Foreign Account Tax Compliance Act" (FATCA), a law with the objective of tackling tax evasion by obtaining information in respect of offshore financial accounts maintained by USA residents and citizens. USA and India signed an Inter-Governmental Agreement (IGA) on July 9, 2015. As per this agreement, the Indian Financial Institutes will provide necessary information to the Indian tax authorities, which will then be transmitted to the US authorities.

The UCBs are a Reporting Financial Institution (RFI) under FATCA if they have an asset size of more than USD 175 million. The spot reference rates published by Foreign Exchange Dealers' Association of India (FEDAI) is to be referred to for the purposes of identifying reportable accounts/ entities in terms of Rule 114H of the Income Tax Act, 1961. RFIs have to report all the "Reportable Financial Accounts" under FATCA, through the following steps;

a) Register on the related e-filling portal of Income Tax Department as Reporting Financial Institutions at the link https://incometaxindiaefiling.gov.in/ post login → My Account → Register as Reporting Financial Institution,

b) Submit online reports by using the digital signature of the 'Designated Director' by either uploading the Form 61B or 'NIL' report,

c) Develop a system of audit for the IT framework and compliance with Rules 114F, 114G and 114H of Income Tax Rules.

d) Constitute a "High-Level Monitoring Committee" under the Designated Director or any other equivalent functionary to ensure compliance.

16.14 Accounts opened using Non-Face-to-Face Mode (use of CKYCR information, use of digital wallets, etc.)

Certain additional enhanced due diligence measures have been added. These measures include

a) RE shall verify the current address through positive confirmation before allowing operations in the account,
b) PAN shall be obtained from the customer and shall be verified,
c) customers shall be categorized as high-risk customers and accounts opened in non-face to face mode shall be subjected to enhanced monitoring until the identity of the customer is verified in face-to-face manner or through V-CIP, etc.

16.14 The KYC – AML guidelines are extremely critical and must be followed in letter and spirit by the banks, not just because non-compliance would lead to penalties by RBI, but also because it is a tool by which banks can protect themselves from being misused by the criminals and terrorists. Banks must keep their systems and procedures updated as per the latest instructions on KYC/ AML and regularly monitor the transactions and send reports to FIU-IND.

Reference:

Master Direction DBR.AML.BC.No.81/14.01.001/2015-16 dated February 25, 2016 (as Updated).

Chapter XVII

A compilation of Best Practices in well-run UCBs

Chapter XVII

A compilation of Best Practices in well-run UCBs

There are many success stories stemming out of the ability of some of the UCBs to innovate and improve their systems and procedures on a continual basis. Such banks also learn from their mistakes and put in place mechanisms which prevent the occurrence of similar mistakes. A bank which does not regularly evaluate the efficacy of its work procedures will be caught off-guard in times of crises. Listed below are some of the best practices adopted by some of the Urban Cooperative banks. Banks which may not have any standard practice in certain situations may find this compilation useful.

17.1 Resource mobilization and deployment of resources

- Review of the fund's position and asset-liability mismatches on a regular basis through the statement of structural liquidity and interest rate sensitivity and dynamic liquidity statement. Dynamic liquidity statement helps the bank plan its liquidity over a 90-day time horizon in advance.
- Periodic review of the deposit rates and loan pricing so that they are in line with market rates and the funding cost.
- Maintaining an optimum mix of short term and long term deposits through smart interest rate management.

17.2 Asset quality maintenance and NPA management:

- Having a system of market intelligence or informal information gathering for deciding credibility of borrowers while considering loan proposals.
- Stress assets are not allowed to accumulate with vigorous recovery drive. Creating a list of Special Watch Accounts (SWA) and monitoring them continuously to prevent them from slipping into NPAs
- Well diversified loan portfolio in terms of a number of borrowers so as to avoid credit concentration risk.
- Sanction of loans only on the merit of the proposal, strengths of the borrower, the strength of the appraisal and ignoring all extraneous considerations.
- Lending for productive purposes and sanction of loans not based on security alone.
- The detailed and comprehensive format for preparing credit appraisal report for facilitating sound credit granting decisions and post disbursement supervision and follow up. vii.

Creation of a separate loan review and audit department, by an independent set of personnel to review the sanctioned loans so as to set right irregularities observed.

- Employees to be organized into groups and each group to be given a group of borrowers for monitoring or recovery. By this practice, early warning signals from the borrower can be picked up and closely followed up by the employees.
- Unique ways of letting the customer know that his loan is overdue like inviting delinquent borrowers to the branch for tea. The letter may be worded like an invitation. When the borrower arrives, they may gradually be brought to the issue of non-payment of dues.

17.3 Expenditure Control and building reserves

- Closure of loss-making branches and cutting down unnecessary expenditure on meetings, gifts, felicitations etc.
- Putting a cap on dividend payouts irrespective of the profits earned and convincing the members about the need to strengthen the reserves of the banks.

17.4 Employee Motivation and increasing business per employee

- Formulating a fair and transparent recruitment and placement policy.
- Recognizing and rewarding the deserving employee. The employee may be honoured by the Board in the presence of his family.
- Competitive remuneration commensurate with the hierarchical levels.
- Involving the family members of the employees on special occasions.
- Having a good medical coverage for the employee and his family.
- Well established training and re-training systems.
- Deputing deserving employees for advanced training.
- Having a system of information dissemination through newsletters and in-house journals.
- Creating brand image and pride through uniforms, ID cards etc.

17.5 Customer Service

- Customer-centric approach to all policies and procedures of the bank through customer friendly approach to all banking activities.
- Installation of Note counting machines outside the counters/in the banking hall for the added convenience and satisfaction of the customers.
- Providing hand-held IT-enabled device to deposit agents to ensure on-spot entry of deposits tendered by customers for quick credit in their accounts.
- Organization of regular customer and borrower meets providing a platform to voice their difficulties and problems.

- Designing of counters and study of workflow so as to minimize the queue/waiting time. Adopting single window system for customer transactions.

17.6 Systems and Control

- Maintaining the account opening forms and KYC documents at a central repository to ensure their safety.
- Account opening authority to rest with two officers which give the benefit of cross-check and counter check.
- Thanksgiving letter to be issued to both the account holder as well as the introducer to ensure confirmation of the fact of opening and introduction of account at a later stage.
- The system of surprise verification of cash, gold stock, blank FD receipt forms, DD forms, cheque books etc. held by the branches by the internal inspector.
- The inoperative accounts to be generally segregated and monitored under the supervision of the branch manager or any one of the senior officials on an annual basis and interest to be credited to the balances held under inoperative SB a/cs.
- Keeping a close watch on the entries in the inter-branch account.
- The system of delivering the confidential Login Password and Transaction password to the Internet banking users, through two different courier agencies to prevent possible misuse of crucial passwords.
- One Time Password for all financial transactions for each login. This practice, although could be an irritant, is a very good system for ensuring Internet banking security.
- Comprehensive Disaster recovery mechanism to be put in place.
- Employee training and sensitization on the importance of information security.

Reference –

Handbook for the Directors of UCBs, CAB, RBI, Pune, 2013

MODULE V

Primary (Urban) Co-operative Banks
IT, Payment Systems, and Cyber Security

The final module of this handbook includes three chapters relating to the use of information technology in banks, besides a detailed coverage of payments and settlement systems. An up to date coverage on cybersecurity provides much-needed guidance to manage vulnerabilities and prevent cyber-attacks.

Chapter XVIII

Information Technology (IT)

Chapter XVIII

Information Technology (IT)

18.1 Role of Information Technology (IT)

18.1.1 Information Technology (IT) has revolutionized the functioning of the banks the world over. It facilitated the banks to enhance their internal processes and controls to bring in efficiency and also enabled them to offer innovative value-added products and services to their customers. Implementation of Core Banking Solution (CBS) by the banks was a revolution. It helped the banks to integrate multiple facets of banking businesses happening at various branches in one place. The most remarkable change was the withdrawal of cash beyond banking hours from ATMs through debit cards. Internet banking and mobile banking are another IT revolution in the banks, which changed the way customer use their money in their accounts for online and offline purchases. In the present scenario, the banks may find it almost impossible to do the banking business without IT due to the high degree of interconnectedness between them.

18.1.2 Information technology has even become an integral part of Urban Co-operative Banks (UCBs). UCBs have also started using IT across many areas of the banking business. However, due to heterogeneity, both in business size and area of operation, the technology adoption by UCBs are at different levels, i.e., some banks are offering state of the art digital products to its customers. At the same time, some UCBs even are not having the bank-specific domain e-mail for communicating with its customers/ supervisors/ other banks.

18.2 Developments in IT-related banking activities

IT has also brought banking services at the fingertips of the people through delivery channels such as internet banking, mobile banking etc. Modern-day customer expects all banks to offer such customer convenient services. UCBs also being in the business of banking cannot afford to ignore the demands of the customers. They also need to adopt technology and improve their information systems so as to compete with other banks.

Some of the developments in the banking services leveraging on information technology are:

- Branch automation and networking to facilitate 'anytime and anywhere' banking;
- Introduction of Electronic Funds Transfer to bring about greater efficiency as also reduction in risks in funds transfer;
- Sharing of payment system delivery points so as to effectively reduce cost and simultaneously to ensure healthy competition and product differentiation;

- Introduction of Negotiated Dealing System (NDS);
- Installation of Centralised Funds Management System (CFMS);
- Implementation of Structured Financial Messaging System (SFMS);
- Operationalisation of the Real-Time Gross Settlement System (RTGS);
- Introduction of digital signatures and certification of electronic messages, IDRBT (Institute for Development and Research in Banking Technology) being the Certification authority for the banking sector.

18.3 Core Banking Solution (CBS)

15.3.1 As per the announcement made in the First Bi-monthly Monetary Policy Statement-2016-17 dated April 05, 2016, RBI introduced a scheme for providing financial assistance to certain eligible UCBs (i.e., those who have not implemented/ partially implemented CBS and who are not operating under direction u/s 35A of the BR Act, 1949 (AACS)). The scheme was made applicable from April 13, 2016 and IFTAS (Indian Financial Technology and Allied Services) was selected for the implementation of CBS. Under the scheme, for each UCB the initial capital cost for implementation (i.e. ₹4 lakh) was to be paid by RBI to IFTAS and recurring cost (i.e., ₹0.15 lakh per month for each branch) was to borne by the bank.

18.3.2 RBI listed the functional and technical requirements for the CBS running in UCBs. A comprehensive document covering these requirements was prepared by the Institute for Development and Research in Banking Technology (IDRBT) and RBI. UCBs may consider it as reference material for implementing and improving CBS in their bank and ensure implementation of standardized CBS in UCBs. These details can be accessed at the IDRBT website[44].

18.3.2 The handbook on on cybersecurity controls related to Core Banking solution and its Ecosystem for Urban Cooperative Banks shared by RBI with UCBs may be referred by the Directors for details on Cybersecurity controls related to CBS.[45]

18.4 Internet Banking and Mobile Banking

18.4.1 UCBs, satisfying the stipulated eligibility criteria, are permitted to offer internet banking services to their customer, either with 'view-only' facilities or with transactional facilities. RBI has prescribed separate criteria/ guidelines for UCBs for offering internet banking. UCBs are required to have a Board approved policy on 'Information Security (IS)'. The information security division should be different than the information technology division, who basically are

[44] http://www.idrbt.ac.in/assets/publications /Reports/CBS_Requirements_for_UCBs.pdf

[45] Handbook on cybersecurity controls related to Core Banking solution and its Ecosystem for Urban Cooperative Banks (UCBs)

responsible for the implementation of the computer systems. UCBs also have to have a designated network administrator. UCBs should clearly define the role of its network and database administrator. Internet banking server should be segregated from CBS. UCBs also need to ensure that the IS auditor are auditing their IT systems.

18.4.2 UCBs complying with the requirements need not have to obtain prior approval from RBI for offering internet banking with ‘view-only’ facilities. However, UCBs planning to offer transactional internet banking facilities have to obtain prior approval of RBI. UCBs offering internet banking are also required to comply to the guidelines issued by RBI to commercial banks on “Risks and Controls” in a computerized environment, including the recommendations of the Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds (Chairman: Shri G. Gopalakrishna, Executive Director).

18.4.3 UCBs desirous of offering mobile banking services to its customer have to obtain one-time prior approval from RBI. UCBs with the approval of Board may fix a cap, based on their risk perception, on the daily transaction for the purchase of goods/ services. UCBs have to ensure validation through a two-factor authentication for all debits to the account generated from mobile banking. One of the factors for authentication could be mPIN or any higher standard. End to End encryption is required for mPIN, and it should be stored in a secure environment. Further, UCBs have to implement encryption at the application level in mobile banking (for all stages of the transaction processing) over and above the encryption at the transport and network layers.

18.5 Other important IT related Aspects

18.5.1 In any bank, the Asset Liability Management (ALM) setup is expected to be built on three pillars, of which the first pillar is the IT systems. Unless and until the IT system in UCBs is made robust to collect/ generate data on time, the ALM setup may not work efficiently. The availability of the information and its accuracy are key to the ALM process. This will also facilitate the UCBs in taking decisions beneficial to them by use of simple gap analysis (like Statement of Structural Liquidity (SSL) for understanding the liquidity position and Interest Rate Sensitivity (IRS) statement for understanding the interest rate risk on Net Interest Income (NII)) to extremely sophisticated analysis (like Duration Gap Analysis (DAG) for monitoring /controlling the impact of the change of interest rate on the Net Worth or Market Value of Equity (MVE).

18.5.2 UCBs are required to implement system-based asset classification in their bank. According to RBI, the system-based asset classification’ means asset classification (downgrading as well as upgrading) on continuous (i.e. ongoing basis) based on the regulations. Further, it should done automatically by their CBS / computerized systems. This is expected to improve the efficiency, transparency and integrity of the asset classification process in UCBs. RBI has mandated the UCBs having total assets of ₹1000 Crore or above and the UCBs falling in the level III /IV (self-assessed classification based on circular DoS.CO/CSITE/BC.4083/31.01.052/2019-20 dated December 31, 2019, on Comprehensive Cyber Security Framework). UCBs not falling under the above mentioned categories as mentioned above are also encouraged to implement system-based assets on the voluntary basis as it will benefit them.

18.5.3 Bharat Interface for Money (BHIM) a payment interface may facilitate UCBs in offering their customers option of payment /receipt of money through their registered mobile on a real-time basis. UCBs can offer this facility without developing its own mobile application for android users. The National Payments Corporation of India (NPCI) has developed the BHIM. BHIM interconnects with the banks through Unified Payment Interface (UPI) ecosystem. UPI has also been developed by the NPCI and is built over the Immediate Payment Service (IMPS) infrastructure. UPI provides additional benefits than IMPS like it (a) provides for person to person (P2P) pull functionality, (b) simplifies merchant payments, (c) single APP for money transfer and (d) single-click two-factor authentication.

18.6 Risk Factors in IT-related Banking Services

18.6.1 IT-related risk factors in banking services could relate to (i) the IT environment, (ii) the IT operations, or (iii) the IT products/services. Technology risks have a direct impact on a bank's operation. UCBs may have to prepare themselves to deal with new challenges and issues due to use of IT like

(a) Frequent Changes or obsolescence of hardware, software, firmware
(b) Multiplicity and complexity of systems due to implementation of safe guards to address the increasing cyber risks
(c) Alignment with the changing business dimensions due to market competitions
(d) Proper alignment with regulatory requirements like system-based asset classification
(e) Selection of outsource vendors for IT services due to lack of infrastructure /manpower

18.6.2 Further, the location of technology resources is also susceptible to the risks of unforeseen events (e.g., riots and sabotage) and sometimes natural calamities (e.g., floods/earthquake etc.). Therefore, UCBs have to have a proper Business Continuity Plan (BCP) and Disaster Recovery (DR) Plan setup in place with acceptable level of Recovery Time Objective (RTO) and Recovery Point Objective (RPO).

18.6.3 Further, RBI mandates UCBs to design their systems and procedures to make customers feel safe about carrying out electronic banking transactions. Therefore, UCBs may have to put in place appropriate systems and procedures (including a robust and dynamic fraud detection and prevention mechanism) which provide assurance to the customers that electronic banking transactions carried out by them are safe and secure. Further, UCBs may have to develop a mechanism to find out the impact of the risks due to unauthorized electronic banking transactions. They should develop adequate and effective controls, including continuous customer awareness, to mitigate those risks and protect themselves.

Reference -

1. Circular DCBR.BPD.PCB.Cir.No.03/09.18.300/2017-18 dated August 16, 2017.
2. Circular DCBR.CO.PCB.Cir.No.14/09.18.300/2015-16 dated April 13, 2016.
3. Circular DCBR.BPD. (PCB/RCB) Cir. No. 6 /19.51.026/2015-16 dated November 05, 2015.
4. Circular DoR (PCB). BPD. Cir. No.1/13.05.001/2020-21 dated August 12, 2020
5. Circular DPSS.CO.PD. Mobile Banking. No./2/02.23.001/2016-2017 dated July 1, 2016 (Updated as on January 10, 2020)
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9. Circular DCBR.BPD.(PCB/RCB).Cir.No.06/12.05.001/2017-18 dated December 14, 2017.
10. FAQs on UPI available at the link https://www.npci.org.in/what-we-do/upi/faqs
11. FAQs on BHIM available at the link https://www.bhimupi.org.in/faq-s

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Chapter XIX

Payment and Settlement Systems

Chapter XIX
Payment and Settlement Systems

19.1 Introduction

Becoming "cashless" may not be practically possible for any economy or society in the world, therefore getting "less-cash" is the next most viable and desirable economic outcome for any country, especially the less developed ones. In the Indian context, a 'Less-Cash' economic system has always been the long-term policy objective of the RBI. This is evidenced in the various 'Vision Documents' issued by the RBI since 2001.

19.2 Definitions

In order to promote a less-cash society, the public should deepen and broaden the usage of digital and paper-based payment products, which are broadly known as Payment and Settlement Systems. The Payment and Settlement Systems Act, 2007 defines a 'Payment System' (Section 2 (i) of the PSS act, 2007) as;

"Payment system" means a system that enables payment to be effected between a payer and a beneficiary, involving clearing, payment or settlement service or all of them, but does not include a stock exchange;
Explanation - For this clause, "payment system" includes the systems enabling credit card operations, debit card operations, smart card operations, money transfer operations or similar operations"
The above act defines 'settlement' (Section 2 (n) of the PSS act, 2007) as

"Settlement" means the settlement of payment instructions and includes the settlement of securities, foreign exchange or derivatives or other transactions which involve payment obligations;

In simpler terms, 'payment' means a process of payment (say by a cheque or card) between two individuals or entities, while 'settlement' is a settlement of funds between the banks holding the accounts of these entities. For example, payment is said to be done if 'A' gives a cheque of ₹X to 'B', but the settlement will take place when the bank of 'B' can finally get funds from the bank of 'A'.
The importance of payment and settlement systems for any economy is famously underlined with the corollary that, if the economy of a country is taken as a human body, the payment and settlement systems are the veins and arteries that help in the smooth movement of blood (funds) in the entire body.

19.3 Need and advantages

Amid the ongoing emphasis on payment systems, it is pertinent to underline the need and advantages of these systems;

1. **Alternative of Cash –** Cash is the lubricant that galvanizes the economic activities in an economy and therefore is an integral part of our daily lives. However, cash has its own very severe ill-effects. Kenneth S. Rogoff writes that “a large part of cash is feeding tax evasion, corruption, terrorism, counterfeiting, drug trade, human trafficking, human smuggling, exploitation of migrants and money laundering, just to name a few”. He further argues that “eliminating paper currency would have numerous desirable effects, including reduced tax evasion for high-volume cash and off-book businesses and unreported wages.” Payment products such as cheques, cards, mobile payment solutions etc. act as an alternative to cash and help in reducing the intensity and usage of currency in the economy.

2. Efficiency in the system – Usage of more and more alternative modes of payments help in increasing the efficiency of the system in terms of speed, distance, value, and cost

a. **Speed** - The speed of movement of funds through various payment products is far higher than the movement of cash. On one hand, we have instruments such as cheques, ECS, NACH etc., where the fund is transferred on the T+1 basis, or NEFT where the fund is transferred on a B+2 (batch + 2) basis, while on the other hand, we also have fast payment products such as IMPS, UPI, NUUP (*99#) etc., that transfer the funds instantaneously. Therefore, these modes of payments score over cash in terms of speed of fund transfer.

b. **Geographical boundaries -** Cash is a faster and better mode of payment, if the beneficiary is face to face with the payer, but if distance comes into the scene, like if the beneficiary is located, say, 1000 km away, cash fails miserably to act as an efficient mode of payment. The e-modes of payment are extremely efficient as the distance is never an obstacle and the beneficiary receives the payment within the same time lag for any distance.

c. **Large Value transactions -** Alternative modes of payments are also suitable for transferring the large value of money to a beneficiary. For example, if A has to pay B a sum of ₹1 crore, he would prefer NEFT or RTGS transaction, rather than giving it in cash (unless it is black money), as cash involves costs in terms of handling, transferring and security etc.

d. **Cost of Operations** – Cash has a cost of printing, transportation and destruction, which is borne by the sovereign and recovered from the tax payers’ money. While, the paper and e-products also come with a cost, but it is just a fraction of the cost of cash. It, therefore, helps in improving the efficiency and cost-effectiveness of the system as a whole.

3. Safety – Carrying cash is a major security issue, in terms of law and order. The intensity of risk is directly proportional to the value of cash with an individual. Instances of loot, murder etc. for money/ cash etc. is not uncommon in almost all the countries but is more profound in less developed countries like India. The alternative payment products enable an individual to carry or transfer any amount of money without having to worry about the safety of the same. This has been one of the primary reasons for the acceptance and proliferation of alternate modes of payments in high-risk countries like Kenya, Philippines etc.

4. **Financial Stability** – It is generally found that any stress in the financial system first appears in the Payment and settlement systems, with the settlements being adversely affected due to liquidity issues being faced by the participants. Further, due to the interconnected nature of payment systems, such disturbances have the potential to affect other financial institutions as well, which is known as "Domino's effect" and tends to have adverse issues on financial stability. For this reason, the supervisors closely monitor the return or bouncing of instruments, as it throws clues about the stress faced by the individuals or institutions participating in payment systems. Payment systems are also systematically important as most of these systems process funds that are many times more than the GDP of that country.

5. **Formalization of the economy** – Cash doesn't have an audit trail. Therefore, it is difficult to trace the amount of cash held or used by an individual or entity. But the transactions done through the digital modes of payment leave a digital footprint in the account of the beneficiary and helps in the formalization of transactions. This leads to more transparency in the economy and curtailment of corruption and black money, which was one of the major objectives of the demonetisation exercise of November 2016 and governments' thrust in promoting alternate modes of payment. Deeper and broader usage of payment and settlement systems helps to broaden the tax base, in terms of lesser tax evasion and better tax compliance, leading to larger tax revenue for the government. The currency to GDP ratio is taken as a barometer for the formalization of the economy and it is found that in most of the developed countries this ratio is quite low. In the case of India, the currency to GDP ratio has been increasing and it was 12% in 2019-20, as compared to 11.3% in the previous year. (Annual Report, 2019-20, RBI)

6. **Monetary Policy transmission** – Monetary Policy is the policy in which Central bank affects the money supply in the economy by movements in the interest rate. Monetary Policy transmission is one of the critical reasons for the importance of Payment Systems as they play a major role in efficiently transmitting monetary policy signals to the markets and economy. An efficient payment and settlement system affects the velocity of circulation of money and helps in quick availability of funds to various sections of the economy, irrespective of their geographical location. The efficacy of any monetary policy measure depends to a large extent

on the efficiency and soundness of the large-value payment system, which is RTGS in case of India.

7. **Fiscal policy implementation** - Developments in Payment Systems have a bearing on the implementation of Fiscal Policy as well. The speed and quantum of government cash inflows and outflows are directly impacted by the efficiency of Payment Systems. In India, RBI is supporting the government finances and fiscal policy implementation by several payment systems such as NEFT, RTGS and NACH etc. RBI's e-kuber also plays a major role in this regard.

8. **Financial Inclusion** – Financial inclusion is defined as the process of providing banking/ financial services at a reasonable cost from formal/ authorized channels to the unbanked population. Most of such people live in the interior, far-flung areas where it is not possible or viable for the banks to set up a physical brick and mortar branch. However, it is possible to reach such populations with the help of technology or with the Payment systems. The large-scale penetration of mobiles in such interior areas has made it possible to not just reach such people virtually, but also to provide them with basic banking services such as remittance. Deposits, microcredit and insurance etc., through mobile banking services The case of M-Pesa in Kenya is a classic example of financial inclusion in interior areas using payment systems and mobile banking in particular.

19.4 Access Criteria for the Payment Systems

As seen above, the Payment Products play a very important role in the smooth functioning of an economy and critical for its stability. For this reason, access to such payment products cannot be given to weak and unstable participants. For this reason, RBI, vide it's Master Direction no. DPSS.CO.OD.No.1846/04.04.009/2016-17, dated January 17, 2017 (As updated), has set certain financial parameters, based on which, the participants are allowed to participate in the Payment Systems. These are popularly known as the access criteria for payment systems.

As per these guidelines, membership to the centralised[46] and decentralized payment systems[47] is open to all scheduled/licensed banks. Unlicensed banks can participate in the decentralized payment systems as sub-members. Co-operative societies cannot be either direct members or sub-members in any payment system. It also provides that notified institutions like Post Office Savings Bank will be eligible for membership in decentralized payment systems.

[46] Centralised Payment systems include NEFT and RTGS
[47] Such as Cheque Truncation System (CTS)

Financial and other requirements for obtaining a direct membership to the **Centralized Payment Systems** (such as NEFT/ RTGS), as under:

i. Minimum CRAR of 9% (as per the latest audited balance sheet);
ii. Net NPAs below 5% (as per the latest audited balance sheet);
iii. Minimum net-worth of ₹ 25 crore;
iv. Availability of CBS / centralised processing system;
v. Adequate technical competence and system readiness including cyber resilience
vi. Compliance to instructions on storage of payment system data.
vii. Recommendation of the concerned regulatory/supervisory department

As per the above guidelines, the requirements for obtaining membership of **Decentralized Payment Systems** such as CTS and Non-MICR centers as;

i. Minimum CRAR of 9% (as per the latest audited balance sheet);
ii. Net NPAs below 5% (as per the latest audited balance sheet);
iii. Availability of CBS / centralised processing system; and
iv. Recommendation of the concerned regulatory/supervisory department.

The banks that do not fulfil the above criteria can't participate in the payment system as a direct member, they can however, participate in the system as a sub-member to the direct member banks.

19.5 Payment Products operated by RBI – Major developments

19.5.1 Real Time Gross Settlement (RTGS)

RTGS can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis (without netting). 'Real Time' means the processing of instructions at the time they are received; 'Gross Settlement' means the settlement of funds transfer instructions occurs individually (on an instruction by instruction basis). Considering that the fund's settlement takes place in the books of the RBI, the payments are final and irrevocable.

a) Transaction limits for RTGS transactions

The RTGS system, which is also known as Large Value Payment System, is primarily meant for big ticket transactions. The minimum amount to be remitted through RTGS is Rs 2 lakh. There is no upper ceiling for RTGS transactions.

b) Time taken for effecting funds transfer under RTGS

Under normal circumstances, the beneficiary branches are expected to receive the funds in real time as soon as funds are transferred by the remitting bank. The beneficiary bank has to credit the beneficiary's account within 30 minutes of receiving the fund's transfer message.

c) Returns and customer compensation under RTGS

Funds, received by an RTGS member for the credit to a beneficiary customer's account, will be returned to the originating RTGS member within one hour of the receipt of the payment at the recipient bank or before the end of the RTGS Business day, whichever is earlier, if it is not possible to credit the funds to the beneficiary customer's account for any reason such as account does not exist, account frozen, etc. Once the money is received back by the remitting bank, the original debit entry in the customer's account is reversed. In case of any delay in returning the failed payment, the originating customer is eligible to receive compensation at current repo rate plus 2%.

d) RTGS Timings

From December 14, 2020, RTGS is available for customer and inter-bank transactions on 24x7x365 basis and India has joined a club of select countries offering Large Value Payment Systems around the clock. 24x7 RTGS would enable faster and multiple settlements of various payment systems which are dependent on RTGS for settlement.

e) RTGS Charges

With effect from July 01, 2019, the Reserve Bank has waived the processing charges levied by it for RTGS transactions and banks are required to pass on the benefit to its customers. With a view to rationalize the service charges levied by banks for offering funds transfer through RTGS system, a broad framework of charges has been mandated as under:

RTGS Transaction	**Maximum Customer Charges (exclusive of GST)**
Inward transactions	Free
Outward transactions	
₹2 lakh to ₹5 lakh	₹24.50 + applicable tax
Above ₹5 lakh	₹49.50 + applicable tax

19.5.2 National Electronic Fund Transfer (NEFT)

NEFT is a nation wise centralized retail payment system of fund transfer and operates on a Deferred Net Settlement (DNS) basis. Fund transfer transactions are settled in batches.

a) NEFT timings

With effect from December 16, 2019, NEFT has been made available on 24 x 7 x 365 basis. There are 48 half-hourly batches every day. The settlement of the first batch commences at

00:30 hours and the last batch ends at 00:00 hours. The system is available on all days of the year, including holidays.

b) NEFT transaction limits

There is no limit imposed by the RBI for funds transfer through NEFT system. However, banks may place amount limits based on their own risk perception with the approval of their Board.

c) Charges on NEFT

With effect from January 01, 2020, banks have been advised to not levy any charges from their savings bank account holders for NEFT funds transfers initiated online, i.e., through mobile or internet banking.

For other kinds of outward transactions, the maximum charges which can be levied are;

- For transactions up to ₹10,000 – max. ₹2.50 (+ Applicable GST)
- For transactions above ₹10,000 up to ₹ 1 lakh- max ₹5 (+ Applicable GST)
- For transactions above ₹1 lakh and up to ₹2 lakhs - max ₹15 (+ Applicable GST)
- For transactions above ₹2 lakh - max ₹25 (+ Applicable GST)

d) Return and compensation for NEFT

If it is not possible to afford credit to the account of the beneficiary for any reason, destination banks are required to return the transaction (to the originating branch) within two hours of completion of the batch in which the transaction was processed. If the NEFT transaction is not credited or returned within two hours after batch settlement, then the bank is liable to pay penal interest to the affected customer at the current RBI LAF Repo Rate plus two per cent for the period of delay/ till the date of credit or refund.

19.6 Risks Associated with Payment Systems

Payment Systems are sophisticated multilateral systems (with multiple players) that handle significant transaction volumes and value. Through the centralisation of certain activities, payment systems allow participants to manage their risks more effectively and efficiently, and, in some cases, reduce or eliminate certain risks. But the centralisation of activities leads to concentration of risks and creates interdependencies between the payment systems and participating institutions. Payment systems are exposed to several risks. Some of the most critical risks are as under;

i) **Settlement Risk –** The possibility that a payment system participant (bank) may not have sufficient balance in its settlement account to meet the payment obligations is called the settlement risk. This is the most common, yet critical risk faced by the payment system. Nonavailability of sufficient funds in the settlement account of one of the participants can lead to an adverse balance position in the accounts of other participants as well and can lead to a cumulative domino effect on the entire system and therefore, can blow into a full-fledged crisis for the system.

ii) **Legal Risk -** Legal risk is the risk of the unexpected application of a law or regulation, which results in a loss. Examples may include legal risk because of an unexpected application of a law that renders contracts illegal or unenforceable. Legal risk also includes the risk of loss resulting from a delay in the recovery of financial assets or freezing of positions due to a legal procedure.

iii) **Credit Risk –** Payment systems and its participants may face various types of credit risk. Credit risk is the risk that a counterparty, whether a participant or other entity, will be unable to meet fully its financial obligations when due, or at any time in the future. Credit risk can also arise from sources, such as the failure of settlement banks, custodians, or linked payment systems to meet their financial obligations.

iv) **Liquidity Risk –** Payment systems and its participants may face liquidity risk, which is the risk that a counterparty, will have insufficient funds to meet its financial obligations as and when expected, although it may be able to do so in the future. Therefore, liquidity risk has a time element. Liquidity risk is a prominent risk in Payment and settlement systems because all the parties to a clearing process are potentially exposed to liquidity risk on the settlement date. Liquidity problems may create systemic problems, particularly if they occur when markets are closed or illiquid and may snowball into full-fledged systemic risks.

v) **Operational Risks -** All Payment systems face a significant amount of operational risk. It is a risk that deficiencies in information systems or internal processes, human errors, management failures, or disruptions from external events will result in the reduction, deterioration, or breakdown of services provided by the payment system. These operational can also cause systemic risks. IT risks, that arise due to disruption in IT systems/ processes is a major component of operational risks that the banks need to guard against by having robust IT systems and redundancy plans in place. Cyber risks are the most significant IT risk and banks must put in place the cybersecurity framework prescribed by the RBI to safeguard against such risks.

19.7 Payment & Settlement system plays an extremely important role in the progress and development of any economy, in terms of achievement of the critical objectives of speed, the efficiency of the system, formalization of the economy, monetary policy transmission and financial inclusion. In the current highly competitive and technology-intensive banking landscape, no bank can afford to ignore the digitisation of its products and services. However, digitisation also exposes the banks to various risks which can be largely controlled by adoption of best cybersecurity and redundancy related practices as prescribed by RBI from time to time.

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Chapter XX

Cybersecurity Framework

Chapter XX
Cybersecurity Framework

20.1 Introduction

20.1.1. The cyber-attacks across the globe, and also in India, are continuously increasing. The banks operating in India are also susceptible to Cyber-threats. The defence against cyber-attacks requires synchronous efforts from all stakeholders, which should be a continuous and dynamic process. UCBs are a critical part of the Indian banking system and also the payment system. UCBs are therefore expected to be in full preparedness in terms of cybersecurity to defend against the cyber-attacks. The first step towards cybersecurity preparedness is to have a Board approved policy on 'Cyber-Security' Policy, which should be distinct from the IT policy and IS policy of the bank.

20.1.2. The cybersecurity policy should be comprehensive, covering the inherent risks perceived by UCBs on them due to the cyber threats. The cyber threats could be from the external entities or the internal entities. While accessing the risks, the bank needs to understand that they are not exposed to all kinds of cyber threats. For example, Distributed Denial of Service (DDoS) may not happen in a UCB which is not having public-facing IT server /interface. Therefore, UCBs depending upon technology adopted, delivery channels, digital products etc., should access the inherent risks perceived in their bank. These risks could be classified into different categories/ ratings (like very high, high, medium or low) depending upon the severity. It is expected that the policy should also cover the measures to mitigate/ reduce the identified inherent cyber risks. Further, the policy should not be viewed as a one time exercise, i.e., it should be reviewed for suitable modification/s on the occurrence of an external or internal incident(s) and the required root-cause analysis thereafter.

20.1.3. Cyber-attackers target the customer sensitive data either in transit, stored or processing stages. UCBs, therefore should put in place suitable systems and processes for the entire lifecycle of data /information to preserve its confidentiality, integrity and availability.

20.1.4. It is expected from the Board of UCBs to play a proactive role in the creation of a cyber-safe environment. Apart from framing the cybersecurity policy as mentioned in para 20.1.2 above, the Board should also establish necessary organisational processes for cybersecurity and provide adequate resources for ensuring cybersecurity in the bank. Cybersecurity awareness is key for successful implementation of the cyber-safe environment in the bank. Therefore, UCBs may spread awareness about cyber risks among their staffs, top management, board members, vendors/ service providers, customers etc.

20.2 Cybersecurity Controls

20.2.1. The implementation of cybersecurity controls requires technical skills, investment in technology, continuous manning and is, therefore, an capital intensive excercise. As stated above, all UCBs may not need all kinds of cybersecurity controls depending upon the stage of their technology adoption. In view of the above, RBI prescribed level-wise mandatory controls for the UCBs. The controls prescribed for each level are top-up /additional controls, meaning that the control prescribed for earlier levels are also applicable to the next level. Depending upon the digital depth and its interconnectedness to the payment ecosystem, UCBs are categorised into four different levels as detail below: -

A) Level I Category

i) All UCBs fall under this category. UCBs have to implement the following basic controls.

Inventory Management of Business IT Assets	Preventing execution of unauthorised software	Environmental Controls
Network Management and Security	Secure Configuration	Anti-Virus and Patch Management
User Access Control /Management	Secure mail and Messaging Systems	Removable Media
User /Employee /Management Awareness	Customer Education and Awareness	Backup and Restoration
	Vendor and Outsourcing Risk Management	

ii) Apart from the above, UCBs are also required to implement the following additional controls: -

- Implementation of bank-specific email domains. Anti-phishing / anti-malware and DMARC (Box item 18.A) control to be enforced at the email solution.

- Implementation of two-factor authentication for accessing CBS and applications connected to CBS. The second factor should be dynamic in nature.

- Qualified information security auditor should conduct a security review of computers /terminals from where critical servers /applications /network devices are accessed, including the computer /terminal used for accessing corporate internet banking applications of commercial banks.

- Employees may be given the training to avoid email phishing attacks (Box item 20.B).

- Outsourced vendor to be selected only after conducting effective due diligence.

- Continuous oversight on the functioning of the outsourced vendor.

- The outsourced agreement should include a clause, which should provide the right to audit by UCBs and rights to RBI to initiate an inspection of the outsourced vendor.

- Verification of credentials of vendor /third-party personnel accessing /managing critical assets of UCBs. They must be mandated to adhere to the cybersecurity policy of the bank and also adhere to non-disclosure norms.

B) Level II Category

i) UCBs having sub-membership of Centralised Payment Systems (CPS) and at least having one the following, falls under this level.

(a) Internet Banking facility is offered to the customers (either view only or transactional).

(b) Smartphone-based 'Mobile Banking' through an application is offered to the customer

(c) Direct membership of Cheque Truncation System (CTS) /Immediate Payment System (IMPS) /Unified Payment Interface.

ii) UCBs falling under this level have to implement some more controls in addition to the controls mentioned for level I category. A few of the critical controls are as under:-

- An official (not necessarily to be designated as CISO) need to nominated as a single point of contact. He /She should be responsible for coordinating the cybersecurity-related issues and also for framing /implementation of the policies.
- Vulnerability Assessment (VA) may be carried out at least once every six months.

- Penetration Testing (PT) of public-facing systems, as well as other critical application, may be conducted at least once in every 12 months.

- VA /PT is even mandatory for UCBs having their CBS on a shared infrastructure of an Application Service Provider (CBS-ASP).

- Implement data loss /leakage prevention solution to safeguard sensitive /confidential business /customer data/information. This is also mandated for vendor managed setup.

- Enable capturing of audit logs for all actions of a user to facilitate alert generation and forensic auditing, if needed.

- Introduce an effective ‘Incident Response’ mechanism enabling proper handling of cyber-related incidents.

C) Level III Category

i) In this category, UCBs which are either (a) direct members of CPS, (b) having their own ATM switch or (c) having SWIFT interface are to be categorised.

ii) UCBs in this category are required to implement additional controls apart from the controls listed for the level I and II categories. Few of the essential controls are: -

- Remote Desktop Protocol (RDP) may be disabled on all critical systems.

- Only authorized systems should be allowed to access the clients and servers in SWIFT and ATM switch environment. IP table may be enabled to achieve this restriction.

- Unnecessary PowerShell in servers may be disabled.

- All PowerShell in desktop may be disabled.

- Conduct of source code audits for critical business applications.

- Software /application development should adopt the principle of defence-in-depth to provide layered security mechanism.

- Implementation of centralised authentication and authorisation system (by having an Identity and Access Management Solution) for accessing critical applications, operating systems, databases, network /security devices etc.

- Use of removable media to be managed through Active Directory or Endpoint management systems.

- Advanced real-time threat defence and management solution to be implemented to avoid installation, spread and execution of the malicious code /software in the network.

- Risk-based transaction monitoring may be implemented for all delivery channels as part of the fraud management system.

C) Level IV Category

i) In this category those UCBs, which are direct members of sub-members of CPS and having either (a) own ATM switch and SWIFT interface, (b) data centre or (c) providing software support to other banks of their own or through their wholly-owned subsidiaries, are to be included.

ii) Apart from the controls listed for level I, II and III, level IV UCBs have to implement the following additional controls

- Cyber Security Operation Centre (C-SOC) may be implemented. This solution will help UCBs in continuous surveillance (real-time /near-real-time). It should be operated /handled on 24 X 7 X 365 basis, in shifts, by skilled staffs. Critical responsibilities of C-SOC should be
    - Security Incidents: Monitor, analyse and escalate
    - Response: Capable of protecting, detecting, responding and recovering
    - Facilitate Incident Management and Forensic Analysis
    - Co-ordination: All relevant stakeholders

- Participation in Cyber Drills conducted by CERT-IN, IDRBT etc.
- Separate Cybersecurity function /group in the bank to exclusively oversee the cybersecurity framework.
- Board-level IT Strategy Committee, comprising a minimum of two directors as members.

- IT Steering Committee with members from HR, IT, legal and business. The Committee should focus on the implementation of the strategy approved by the Board.
- A senior official to be designated as Chief Information Security Officer (CISO). His primary responsibility to oversee compliance with regulatory guidelines.
- Information Security Committee with CISO as member secretary. The Committee to oversee implementation information security and cybersecurity policies.
- Audit Committee of Board (ACB) to oversee issues highlighted in IS Audit, VA /PT and information security reviews.

20.3 Cyber Crisis Management Plan (CCMP)

The BCP /DR plan devised by the UCB may not adequate to handle cyber-related incidents. The handling of cyber-related incidents requires a more specific document covering cyber risks. UCBs may have to prepare a Cyber Crisis Management Plan covering the aspects viz. identity, protect, detect, response and recovery.

Aspect	Purpose
Identify	**Develop an organizational understanding to manage cybersecurity risk to systems, people, assets, data, and capabilities.**
Protect	**System /Procedure /Solution in Place to ensure continuous delivery of services**
Detect	**Develop and implement appropriate activities to identify the occurrence of a cybersecurity event.**
Response	**Activities /Action : A detected cybersecurity event**
Recovery	**Restoration Plan including Containment**

20.4 Supervisory Reporting framework

UCBs should report all unusual cybersecurity incidents immediately to RBI, Indian Computer Emergency Response Team (CERT-IN) and Indian Banks – Center for Analysis of Risk and Threats (IB-Cart) managed by Institute for Development and Research in Banking Technology (IDRBT). These cybersecurity instances could either be a successful attack or merely an attempt to attack.

20.5 Third-party ATM Switch Application Service Providers: Cyber Security controls

Many banks, including UCBs, use ATM Switch applications of third-party Application Service Providers (ASP). RBI, therefore, has mandated all these banks to include in their contract with the third-party ATM Switch ASP that they have to comply with the cybersecurity controls compulsorily. These controls need to be there on an ongoing basis. Further, the contract should also mention about the right of RBI to carry out supervision (on-site /off-site) of the third-party ATM Switch ASP. The objective behind these requirements mentioned above is to ensure the safety of the payment system landscape from cyber threats. The minimum cybersecurity controls that the third-party ATM Switch ASPs are expected to implement for the following 15 parameters: -

1. Preventing access of unauthorised software		9. Audit Logs
2. Environmental Controls		10.Incident Response and Management
3. Network Management and Security		11.Advanced Real-time Threat Defence and Management
4. Secure Configuration		12. Vulnerability Assessment and Penetration Test (VAPT)
5. Application Security Life Cycle (ASLC)		13.Forensics
6. Patch/Vulnerability and Change Management		14. Cyber Security Operation Center (C-SOC)
7. User Access Control / Management		15. Compliance with various standards
8. Data Leak prevention strategy		

20.6 Technology Vision for Cyber Security' for Urban Co-operative Banks – GUARD

20.6.1 RBI, after discussing with the various stakeholders has issued 'Technology Vision for Cyber Security' for UCBs (2020-2023). The vision statement is as under

"Enhancing the cybersecurity posture of the Urban Co-operative banking sector against evolving IT and cyber threat environment through a five-pillared strategic approach GUARD, viz., Governance Oversight, Utile Technology Investment, Appropriate Regulation and Supervision, Robust Collaboration and Developing necessary IT, cybersecurity skills set."

20.6.2 To achieve the mission, the vision 'Guard' has been mapped to 12 action points for various stakeholders, including RBI

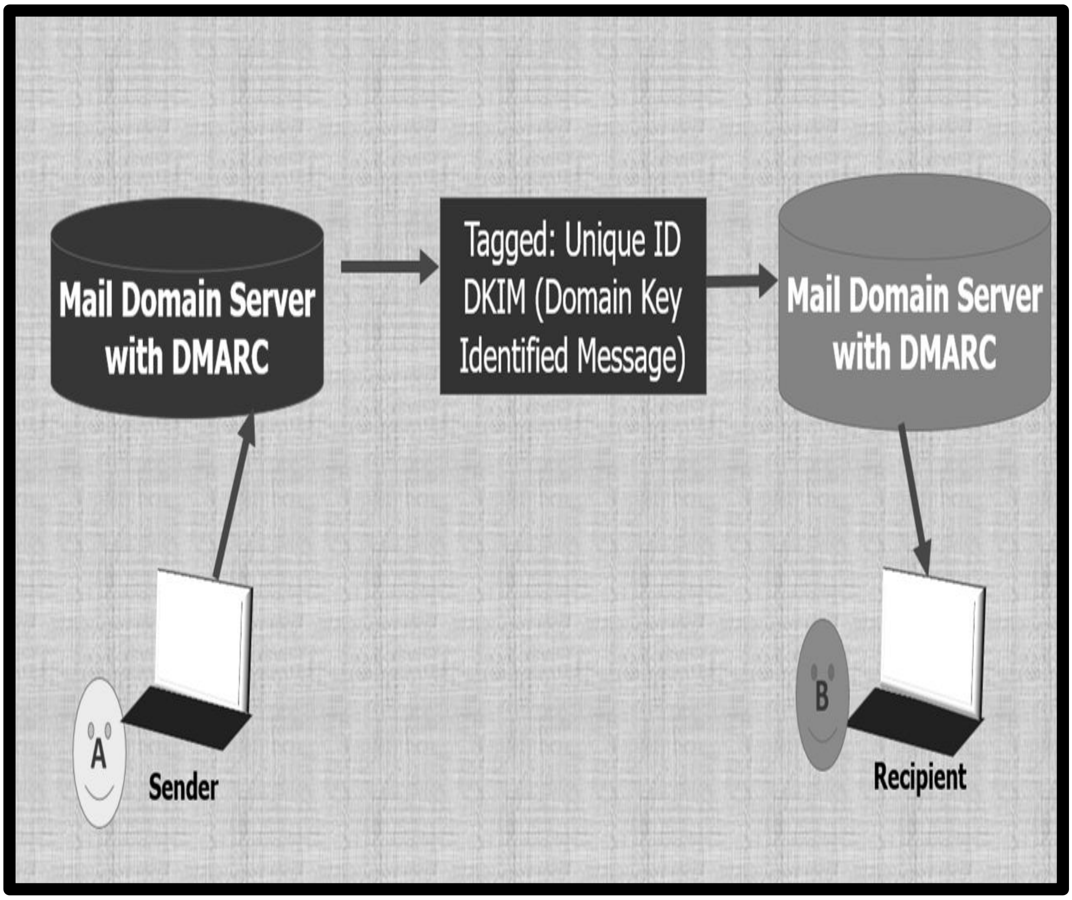
Action Points	Action for (year)
Governance Oversight	
i. Focus on Board Oversight over Cybersecurity	RBI (2020)
ii. IT Vision document	UCBs in Level 2 to 4 (2021) UCBs in Level 1 (2022)
Utile Technology Investment	
iii. Creation of reserve/ fund for implementation of IT/ cybersecurity projects	Phase I - NAFCUB and Federations of UCB: All UCBs (2022)
iv. Management of Business IT Assets	UCBs in Level 2 to 4 (2021) UCBs in Level 1 (2022)
v. Banking Services Availability	UCBs in Level 2 to 4 (2021) UCBs in Level 1 (2022)
Appropriate Regulation and Supervision	
vi. Supervisory reporting framework	RBI (2021 and 2022)
vii. Appropriate guidance in implementing secure practices	RBI (2021)
Robust Collaboration	
vii. Forum to share best practices and discuss practical issues and challenges	All Federations of UCB (2021)
ix. CISO Forum for UCBs	IDRBT (2021)
x. Adoption of Cloud Services – Phase I	Federations of UCB (2021)
Developing necessary IT, cybersecurity skills set	
xi. Imparting technical Skills to manage IT and Cyber Security	RBI (2021)
xii. Providing awareness/ training for all UCBs on cybersecurity	RBI (2021)

PS: Level 1, 2, 3, 4 as detail in Para 20.2 above

Box item 20.A

Domain-based Message Authentication, Reporting & Conformance (DMARC)

DMARC is a tool that facilitate in detection of ‘Domain Name Spoofing’ type of phishing emails. It works one level above the Simple Mail Transfer Protocol (SMTP) for authentication of email server domain. For every email sent from the DMRAC implemented email domain server, a unique ID (known as DKIM header) gets attached to the email which is read and authenticated by the DMRAC solution implemented at the email domain server at the recipient side. By this way recipient knows whether the email has come from the correct domain or not.



Box item 20.B

Email Phishing Attacks

Email phishing attacks are broadly categorized into three viz. (a) **Phishing:** is the fraudulent attempt to obtain sensitive information such as usernames, passwords and credit card details, often for malicious reasons, by disguising as a trustworthy entity in an electronic communication, (b) **Spear phishing:** Phishing attempts directed at specific individuals or companies have been termed spear phishing and, (c) **Whaling:** The term whaling has been coined for spear phishing attacks directed specifically at senior executives and other high-profile targets. Apart from anti-phishing /anit-malware and DMARC solution, adequate awareness among employees help in preventing phishing attacks. Email phishing attacks generally are of three types

(a) Display Name Spoofing: In this type, the sender sends an email to the recipient with spoofed display name. Like on behalf of 'DGM of RBI' as dgmrbi@rbi.org.in. The display name is spoofed to show that email has been send by DGM, RBI whereas the Email-ID of sender appears in angled brackets as xyz@abcdef.com. The recipient feels that this email has come from RBI and therefore opens the attachment or link. These types of attacks could be minimized if employees are made aware to cross verify email- ids of sender in angled brackets.

(b) 'Domain Name Disguise'. Here, the attacker sends an email to the targeted recipient with almost same domain same. Like 'DGM of RBI' as dgmrbi@rbii.org.in. A closer look tells that domain is rbii.org.in and not rbi.org.in. Everything else in the email looks legitimate. These types of attacks could be minimized if employees are made aware to read domain names carefully and not hurriedly.

(c) "Domain Name Spoofing". This is the most dangerous among the three that we are discussing. Here, recipient may not be able to distinguish between spoofed email and normal email as attacker email id is 100% same as the legitimate email id i.e. display name and domain name. These types of attacks are possible due to limitations in the SMTP (simple mail transfer protocol). Sometimes the language and grammar are not as per the standard followed but those aspects are also now getting perfected by the attackers. DMARC as detail in Box 20.A could be useful in preventing this type of email phishing attacks.

References

- Circular DCBS.CO.PCB.Cir.No.1/18.01.000/2018-19 dated October 19, 2018.
- Circular DoS.CO /CSITE/BC.4083/31.01.052/2019-20 dated December 31, 2019.
- DMARC and the Email Authentication Process available at https://dmarc.org/overview/
- Circular DoS.CO /CSITE/BC.4084 /31.01.052/2019-20 dated December 31, 2019.
- Press Release dated September 24, 2020, on “Technology Vision for Cyber Security’ for Urban Co-operative Banks – 2020-2023**.”**

Appendix I

Glossary of Important Banking Terminology

Glossary[48]

Leverage

Ratio of assets to capital.

Capital reserves

That portion of a company's profits not paid out as dividends to shareholders. They are also known as undistributable reserves and are ploughed back into the business.

Deferred Tax Assets

Unabsorbed depreciation and carry forward of losses which can be set-off against future taxable income which is considered as timing differences result in deferred tax assets. The Deferred Tax Assets are accounted as per the Accounting Standard 22.

Deferred Tax Liabilities

Deferred tax liabilities have an effect of increasing future year's income tax payments, which indicates that they are accrued income taxes and meet the definition of liabilities.

Subordinated debt

Refers to the status of the debt. In the event of the bankruptcy or liquidation of the debtor, subordinated debt only has a secondary claim on repayments, after another debt has been repaid.

Hybrid debt capital instruments

In this category, fall a number of capital instruments, which combine certain characteristics of equity and certain characteristics of debt. Each has a particular feature, which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital.

BASEL Committee on Banking Supervision

The BASEL Committee is a committee of bank supervisors consisting of members from each of the G10 countries. The Committee is a forum for discussion on the handling of specific supervisory problems. It coordinates the sharing of supervisory responsibilities among national authorities in respect of banks' foreign establishments with the aim of ensuring effective supervision of banks' activities worldwide.

Non-Performing Assets (NPA)

An asset, including a leased asset, becomes non performing when it ceases to generate income for the bank.

[48] https://rbi.org.in/scripts/Glossary.aspx

Net NPA

Gross NPA - (Balance in Interest Suspense account + DICGC/ECGC claims received and held pending adjustment + Part payment received and kept in suspense account + Total provisions held).

Coverage Ratio

Equity minus net NPA divided by total assets minus intangible assets.

Slippage Ratio

(Fresh accretion of NPAs during the year/Total standard assets at the beginning of the year)*100

Restructuring

A restructured account is one where the bank, grants to the borrower concessions that the bank would not otherwise consider. The restructuring would normally involve modification of terms of the advances/securities, which would generally include, among others, alteration of repayment period/ repayable amount/ the amount of installments and rate of interest. It is a mechanism to nurture an otherwise viable unit, which has been adversely impacted, back to health.

Substandard Assets

A substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. Such an asset will have well-defined credit weaknesses that jeopardize the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss if deficiencies are not corrected.

Doubtful Asset

An asset would be classified as doubtful if it has remained in the sub-standard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, - on the basis of currently known facts, conditions and values - highly questionable and improbable.

Doubtful Asset

An asset would be classified as doubtful if it has remained in the sub-standard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, - on the basis of currently known facts, conditions and values - highly questionable and improbable.

Loss Asset

A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

Off-Balance Sheet Exposure

Off-Balance Sheet exposures refer to the business activities of a bank that generally do not involve booking assets (loans) and taking deposits. Off-balance sheet activities normally generate fees, but produce liabilities or assets that are deferred or contingent and thus, do not appear on the institution's balance sheet until and unless they become actual assets or liabilities.

Total income

Sum of interest/discount earned commission, exchange, brokerage and other operating income.

Total operating expenses

Sum of interest expended, staff expenses and other overheads.

Operating profit before provisions

Net of total income and total operating expenses.

Net operating profit

Operating profit before provision minus provision for loan losses, depreciation in investments, write off and other provisions.

Profit before tax (PBT)

(Net operating profit +/- realized gains/losses on sale of assets)

Profit after tax (PAT)

Profit before tax - provision for tax.

Retained earnings

Profit after tax - dividend paid/proposed.

Average Yield

(Interest and discount earned/average interest-earning assets)*100

Average cost

(Interest expended on deposits and borrowings/Average interest-bearing liabilities)*100

Return on Asset (ROA)- After Tax

Return on Assets (ROA) is a profitability ratio which indicates the net profit (net income) generated on total assets. It is computed by dividing net income by average total assets. Formula- (Profit after tax/Av. Total assets)*100

Return on equity (ROE)- After Tax

Return on Equity (ROE) is a ratio relating net profit (net income) to shareholders' equity. Here the equity refers to share capital reserves and surplus of the bank. Formula- Profit after tax/(Total equity + Total equity at the end of previous year)/2}*100

Accretion to equity

(Retained earnings/Total equity at the end of previous year)*100

Net Non-Interest Income

The differential (surplus or deficit) between non-interest income and non-interest expenses as a percentage of average total assets.

Net Interest Income (NII)

The NII is the difference between the interest income and the interest expenses.

Net Interest Margin

Net interest margin is the net interest income divided by average interest-earning assets.

Cost income ratio (Efficiency ratio)

The cost income ratio reflects the extent to which non-interest expenses of a bank make a charge on the net total income (total income - interest expense). The lower the ratio, the more efficient is the bank. Formula: Non-interest expenditure / Net Total Income * 100.

CASA Deposit

Deposit in a bank in current and Savings account.

High-Cost Deposit

Deposits accepted above card rate (for the deposits) of the bank.

Liquid Assets

Liquid assets consist of cash, balances with RBI, balances in current accounts with banks, money at call and short notice, inter-bank placements due within 30 days and securities under "held for trading" and "available for sale" categories excluding securities that do not have a ready market.

Funding Volatility Ratio

Liquid assets [as above] to current and savings deposits - (Higher the ratio, the better)

Market Liability Ratio

Inter-bank and money market deposit liabilities to Average Total Assets

ALM

Asset Liability Management (ALM) is concerned with strategic balance sheet management involving all market risks. It also deals with liquidity management, funds management, trading and capital planning.

ALCO

Asset-Liability Management Committee (ALCO) is a strategic decision-making body, formulating and overseeing the function of asset liability management (ALM) of a bank.

Banking Book

The banking book comprises assets and liabilities, which are contracted basically on account of relationship or for steady income and statutory obligations and are generally held till maturity.

Venture Capital Fund

A fund set up for the purpose of investing in startup businesses that are perceived to have excellent growth prospects but does not have access to capital markets.

Held Till Maturity(HTM)

The securities acquired by the banks with the intention to hold them up to maturity.

Held for Trading(HFT)

Securities where the intention is to trade by taking advantage of short-term price/interest rate movements.

Available for Sale(AFS)

The securities available for sale are those securities where the intention of the bank is neither to trade nor to hold till maturity. These securities are valued at the fair value which is determined by reference to the best available source of current market quotations or other data relative to current value.

Yield to maturity (YTM) or Yield

The Yield to maturity (YTM) is the yield promised to the bondholder on the assumption that the bond will be held to maturity and coupon payments will be reinvested at the YTM. It is a measure of the return of the bond.

Convexity

This represents the rate of change of duration. It is the difference between the actual price of a bond and the price estimated by modified duration.

Foreign Currency Convertible Bond

A bond issued in foreign currency abroad giving the investor the option to convert the bond into equity at a fixed conversion price or as per a pre-determined pricing formula.

Trading Book

Investments in trading book are held for generating profits on the short term differences in prices/yields. Held for trading (HFT) and Available for sale (AFS) category constitute a trading book.

CRR

Cash reserve ratio is the cash parked by the banks in their specified current account maintained with RBI.

SLR

Statutory liquidity ratio is in the form of cash (book value), gold (current market value) and balances in unencumbered approved securities.

Stress testing

Stress testing is used to evaluate a bank's potential vulnerability to certain unlikely but plausible events or movements in financial variables. The vulnerability is usually measured with reference to the bank's profitability and /or capital adequacy.

Scenario Analysis

A method in which the earnings or value impact is computed for different interest rate scenario.

LIBOR

London Inter-Bank Offered Rate. The interest rate at which banks offer to lend funds in the interbank market.

Basis Point

Is one-hundredth of one percent. 1 basis point means 0.01%. Used for measuring the change in interest rate/yield.

Securitization

A process by which a single asset or a pool of assets are transferred from the balance sheet of the originator (bank) to a bankruptcy remote SPV (trust) in return for an immediate cash payment.

Special Purpose Vehicle (SPV)

An entity which may be a trust, company or other entity constituted or established by a 'Deed' or 'Agreement' for a specific purpose.

Credit enhancement

These are the facilities offered to an SPV to cover the probable losses from the pool of securitized assets. It is a credit risk cover given by the originator or a third party and meant for the investors in any securitization process.

Custodian

An entity, usually a bank that actually holds the receivables as agent and bailee of the trustee.

First loss facility

The first level of credit enhancement offered to an SPV as part of the process of bringing the securities issued by SPV to investment grade.

Second loss facility

Credit enhancement providing the second or subsequent tier of protection to an SPV against potential losses.

Value at Risk (VAR)

VAR is a single number (currency amount) which estimates the maximum expected loss of a portfolio over a given time horizon (the holding period) and at a given confidence level. VaR is defined as an estimate of potential loss in a position or asset/liability or portfolio of assets/liabilities over a given holding period at a given level of certainty.

Commercial real estate

commercial real estate is defined as "fund based and non-fund based exposures secured by mortgages on commercial real estates (office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction etc.)"

Primary Member (PM)

A member of NDS-OM (having Constituent Subsidiary General Ledger (CSGL) and current account with RBI) who authorizes their Gilt Account Holders to have direct access to the web-enabled NDS-OM system.

Gilt Account Holders (GAHs)

Non-NDS members who have a gilt account and current account with PMs are termed as GAHs. GAHs permitted by RBI include NBFCs, Provident Funds, Pension Funds, Mutual Funds, Insurance Companies, Cooperative Banks, Regional Rural Banks, Trusts, Corporates, Individuals etc.

Digital Certificates and e-tokens

Digital certificates are digital signatures to be obtained from any Government Recognized Certifying Authority designated by RBI, on behalf of GAH. For added security, the certificates need to be installed in an e-token as per specifications approved. The digital certificate and token specifications need to be SHA 2 (2048 bit) compliant. Without the Digital certificate and e-token, the GAH cannot log in to the NDS OM web-based module. The Primary member will be responsible for obtaining/renewal and intimating revocation to RBI/CCIL of the Digital Certificate for such GAH users.

Reference –

RBI Website, www.rbi.org.in

Appendix II

References and Further Reading

REFERENCES AND FURTHER READING

For further information and more detailed reading, the reader may refer to following guidelines/ circulars/ press release/ notifications issued by RBI, Books, Research Papers and other Publications listed below:

RBI Master Circulars/ Directions (RBI Website: www.rbi.org.in)

SN	Master Circular/ Direction	Subject Matter
1	MC DCBR.LS.(PCB)MC.No.16/07.01.000/2015-16 dated July 1, 2015	Area of Operation, Branch Authorization Policy, Extension Counters, ATMs, etc.
2	DOR.REG.No.19/07.01.000/2023-24 dated June 08, 2023	Rationalization of Branch Authorisation Policy for Urban Co-operative Banks (UCBs)
3	DOR.STR.REC.9/21.04.048/2024-25 dated April 02, 2024	Income Recognition, Asset Classification, Provisioning and Other Related Matters - UCBs
4	DOR.CAP.REC.5/09.18.201/2024-25 dated April 01, 2024	Prudential Norms on Capital Adequacy - Primary (Urban) Co-operative Banks (UCBs)
5	DoR.HGG.GOV.No.1/18.10.010/2024-25 dated April 01, 2024	Master Circular on Board of Directors - UCBs
6	DoR.CRE.REC.71/07.10.002/2023-24 dated January 16, 2024	Exposure Norms and Statutory / Other Restrictions - UCBs
7	DOR.CRE.REC.No.27/07.10.002/2023-24 dated July 25, 2023	Master Circular - Management of Advances - UCBs
8	DoR.STR.REC.3/09.27.000/2024-25 dated April 01, 2024	Guarantees, Co-Acceptances & Letters of Credit - UCBs
9	DOR.MRG.REC.01/00-00-011/2023-24 dated April 01, 2023	Classification, Valuation and Operation of Investment Portfolio of Primary (Urban) Co-operative Banks
10	Master Direction DBR.AML.BC.No.81/14.01.001/ 2015-16 dated February 25, 2016 (As Updated).	Know Your Customer (KYC) Direction, 2016

11	FIDD.CO.Plan.BC.5/04.09.01/2020-21 dated September 04, 2020 (As updated)	Priority Sector Lending by banks
12	DOR.No.RET.REC.32/12.01.001/2021-22 dated July 20, 2021 (as updated)	Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions - 2021
13	Master Direction on Financial Statements - Presentation and Disclosures - DOR.ACC.REC.No.45/21.04.018/2021-22 (Updated on Feb 20, 2023)	Disclosures in Financial Statements
14	All relevant notifications and Master Directions available on the RBI website.	

RBI Circulars (RBI Website: www.rbi.org.in)

1. Circular POT.SUCB.CIR. 9 /09.120.00/2001-02 dated 2 April 2002
2. Circular UBD. PCB. Cir. No12/12.05.001/2008-09 dated September 17, 2008
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वित्तीय क्षेत्र में क्षमता निर्माण एवं विकास

भारतीय रिज़र्व बैंक द्वारा वर्ष 1969 में ग्रामीण और सहकारी बैंकिंग में प्रशिक्षण प्रदान करने के लिए कृषि बैंकिंग महाविद्यालय (सीएबी) की स्थापना की गई। इसके बाद, भारतीय वित्तीय क्षेत्र की बदलती अपेक्षाओं को ध्यान में रखते हुए महाविद्यालय द्वारा कृषि बैंकिंग, एमएसएमई वित्तपोषण, वित्तीय समावेशन और साक्षरता, मानव संसाधन और नेतृत्व आदि जैसे अन्य क्षेत्रों में प्रशिक्षण प्रदान करने के लिए अपने दायरे का विस्तार किया गया। शैक्षणिक वर्ष 2021 से, महाविद्यालय द्वारा चार फोकस एरिया (4C) यथा कॉर्पोरेट गवर्नेंस, साइबर सुरक्षा, उपभोक्ता संरक्षण और अनुपालन प्रबंधन की पहचान की गई है ताकि वित्तीय प्रणाली में मजबूती प्रदान करने और सेवा मानकों में वृद्धि करने के लिए बैंकरों तथा फाइनेंशिअल प्रोफेशनलो की क्षमता निर्माण की जा सके।

महाविद्यालय द्वारा FAO, APRACA, CICTAB, UNDP और राष्ट्रमंडल सचिवालय जैसी अंतरराष्ट्रीय एजेंसियों के सहयोग से कार्यक्रम और अनुसंधान सम्मेलन भी आयोजित किये जाते है। महाविद्यालय द्वारा इसी के साथ राष्ट्रीय और अंतरराष्ट्रीय संस्थानों के लिए उनकी आवश्यकताओं के अनुसार कस्टमाइज्ञ प्रशिक्षण कार्यक्रम भी आयोजित किये जाते है।

वर्ष 2015 से एमएसएमई वित्तपोषण के क्षेत्र में विशेष नैमकैब कार्यशालाएं आयोजित करने के लिए नोडल संस्थान के रूप में नामित किये जाने के साथ वर्ष 2021 में मिशन 'अवतु' के अंतर्गत साइबर सुरक्षा पर शहरी सहकारी बैंकों के विभिन्न स्टेकहोल्डरों को प्रशिक्षण प्रदान करने के लिए महाविद्यालय को 'नोडल संस्थान' के रूप में नामित किया गया है।

Building & Enhancing Capabilities in the Financial Sector

Reserve Bank of India established the College of Agricultural Banking (CAB) in 1969 to provide training inputs in Rural and Cooperative Banking. Subsequently, recognising the changing needs of the Indian financial sector, the College has expanded its scope to provide training in other areas like agricultural banking, MSME financing, Financial Inclusion & Literacy, Human resources & Leadership, etc. From the Academic Year 2021, the College has further identified four areas (4Cs), namely Corporate Governance, Cyber Security, Consumer Protection, and Compliance Management, to build capacity amongst the bankers and financial professionals to enhance the robustness and service standards in the financial system.

The College also conducts programmes and research conferences in collaboration with international agencies like FAO, APRACA, CICTAB, UNDP and the Commonwealth Secretariat. The College further conducts customised training programmes for institutions, both national and international, as per their specific requirements.

The College has been nominated as the 'Nodal Institution' for imparting training to various stakeholders of UCBs on cyber security under the Mission 'AVTU' in 2021, apart from being nominated as the Nodal Institution to impart specialised NAMCABs workshops in the area of MSME financing, since 2015.

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https://cab.rbi.org.in