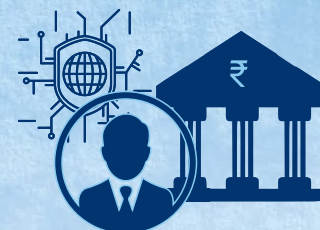


7

Supervisory Role of NABARD



“Adventure is the life of commerce, but caution is the life of banking.”

—Walter Bagehot

- 7.1 Holistic and value-added supervision
- 7.2 Supervisory activities in FY2022
- 7.3 Output >> Outcomes >> Impact
- 7.4 Amendments to Banking Regulation Act: Shaping the new paradigm
- 7.5 Strengthening RFIs through supervision

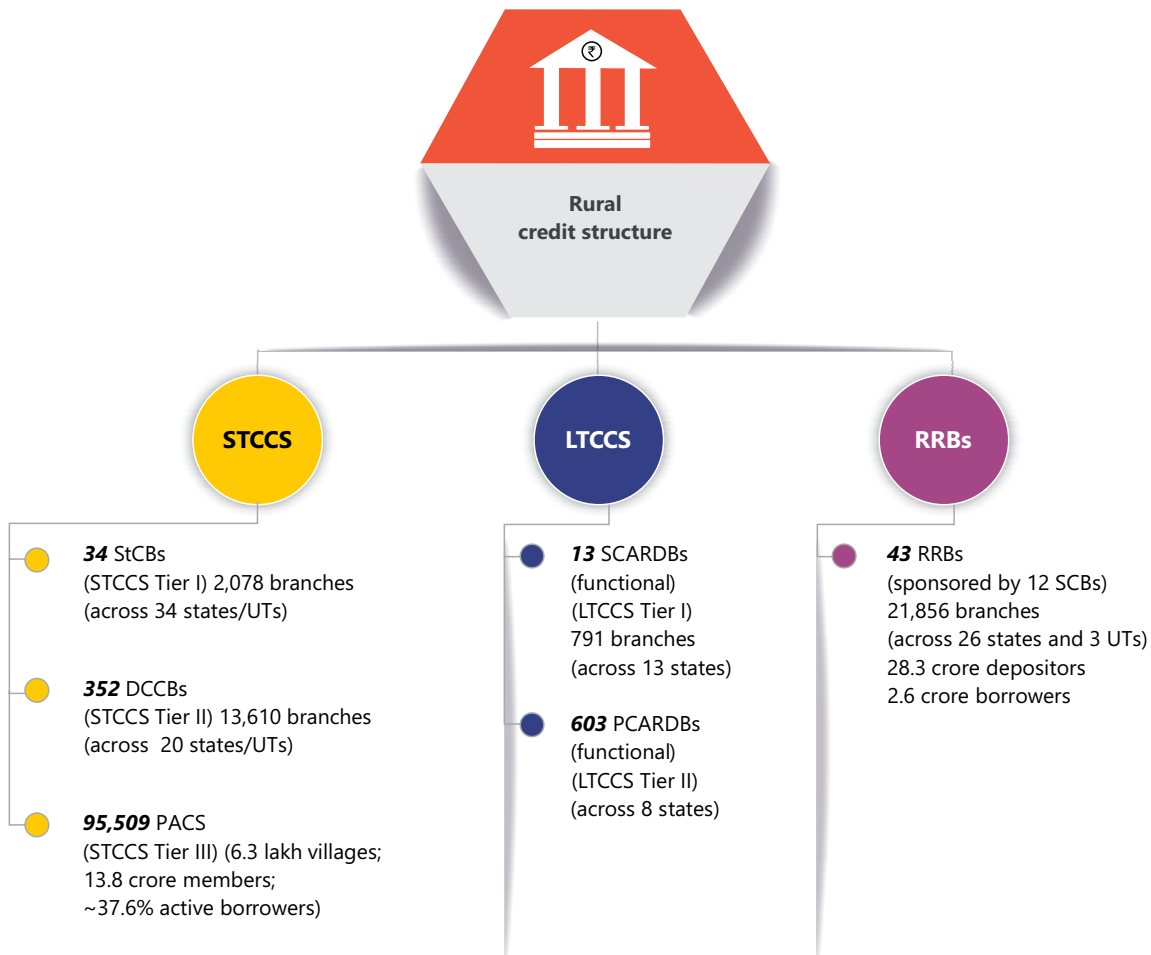
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At the core of the financial system of any economy, public (and business) confidence in the soundness and functioning of banks is paramount. This necessitates regulation and effective supervision.

The Reserve Bank of India (RBI)¹ oversees commercial banks and urban cooperative banks as their supervisor to proactively prevent systemic failure and preserve public confidence in the banking system. As RBI's counterpart for rural financial institutions (RFIs), NABARD similarly supervises

- regional rural banks (RRBs);
- rural cooperative banks (RCBs) including state and district central cooperative banks (StCBs and DCCBs);
- primary agricultural credit societies (PACS);
- primary cooperative agriculture and rural development banks (PCARDBs); and
- state cooperative agriculture and rural development banks (SCARDBs).

Figure 7.1. displays the supervised entities (SEs) of NABARD. Bank supervision has evolved over time and a few milestones/developments in NABARD's supervisory framework are summarised in Figure A7.1.

FIGURE 7.1: Entities supervised by NABARD in the rural credit structure**Notes:**

1. DCCB = District Central Cooperative Bank; LTCCS = Long-Term Cooperative Credit Structure; PACS = Primary Agricultural Credit Societies; PCARDB = Primary Cooperative Agriculture and Rural Development Bank; RRB = Regional Rural Bank; SCARDB = State Cooperative Agriculture and Rural Development Bank; SCB = Scheduled Commercial Bank; StCB = State Cooperative Bank; STCCS = Short-Term Cooperative Credit Structure; UT = Union Territory.
2. Number of supervised entities (other than PACS) as on 31 March 2021.
3. Number of PACS is as on 31 March 2020. (Source: National Federation of State Cooperative Banks or NAFSCOB)
4. StCBs
 - a. 24 (of the 34) are Scheduled StCBs in the Second Schedule of the Reserve Bank of India Act, 1934.
 - b. Includes Daman & Diu StCB (license pending).
5. DCCBs include Tamil Nadu Industrial Cooperative Bank Ltd.
6. There are variations in the cooperative structure across states. Not all STCCS are three-tiered. For example, while Andhra Pradesh has a three-tiered STCCS, Manipur has only StCB and PACS as two tiers.
7. Of the 13 functional SCARDBs, there are
 - a. Unitary (5), i.e., lend directly: Gujarat, Jammu & Kashmir, Puducherry, Tripura, and Uttar Pradesh;
 - b. Federal (6), i.e., lend through PCARDBs: Haryana, Karnataka, Kerala, Punjab, Rajasthan, and Tamil Nadu; and
 - c. Mixed (2), i.e., lend through PCARDBs and directly: Himachal Pradesh and West Bengal.
8. LTCCS
 - a. These institutions are not governed by the Banking Regulation Act, 1949.
 - b. They do not have access to low-cost deposits. Therefore, they depend heavily on borrowed funds for lending.
9. RRBs
 - a. 3 union territories = Puducherry, Jammu & Kashmir, Ladakh
 - b. 92% of the RRB branches are in rural/semi-urban areas.

7.1 Holistic and value-added supervision

Supervision of financial institutions has been evolving with the growing complexities and risks in the financial system in India and abroad such as coordinated response action by major central banks and Basel norms. A supervisory role encompasses statutory compliances and fraud prevention for SEs. The complex responsibilities are discharged in a mostly unregulated dynamic external environment.

NABARD's supervisory role is even more challenging. It needs to not only ensure safety of the business and soundness of the health of the SEs but also support financial inclusion and business expansion roles that the institution must play for rural India. Its supervisory goals are to ensure resilience and sustainability of SEs. NABARD's supervisory activities are designed to protect the interests of the depositors; enable stability and growth of the financial system; and ascertain compliance with regulatory guidelines.

NABARD maintains a degree of surveillance to prevent and quickly respond to fraud, malpractice, other mala fide intent, and poor regulatory compliance and governance. Supervision also informs remedial action and pathway for the bank to return to business as usual (Figure 7.2).

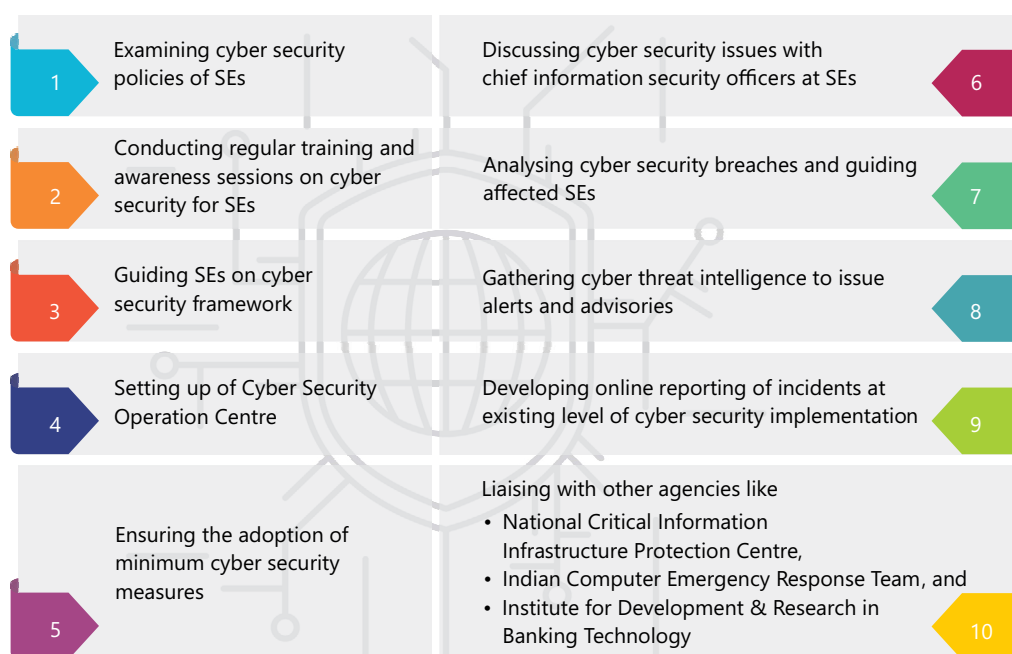
FIGURE 7.2: Objectives of NABARD supervision



Note: GOI = Government of India; RBI = Reserve Bank of India; SE = Supervised Entity.

In recent years, greater emphasis has been on proactive fraud prevention. Accordingly, NABARD instituted vulnerability indices to quantify fraud (VINFRA²) and cyber risks (VICS³) on RFIs and introduced a matrix of policies for these SEs in FY2020. 'SuperSoft' was launched as a pilot to digitalise supervisory process in the next fiscal and so was C-SITE⁴ cell (Figure 7.3). In the current year, NABARD launched

FIGURE 7.3: Activities of the cyber-security information technology examination cell



Note: SE = Supervised Entity.

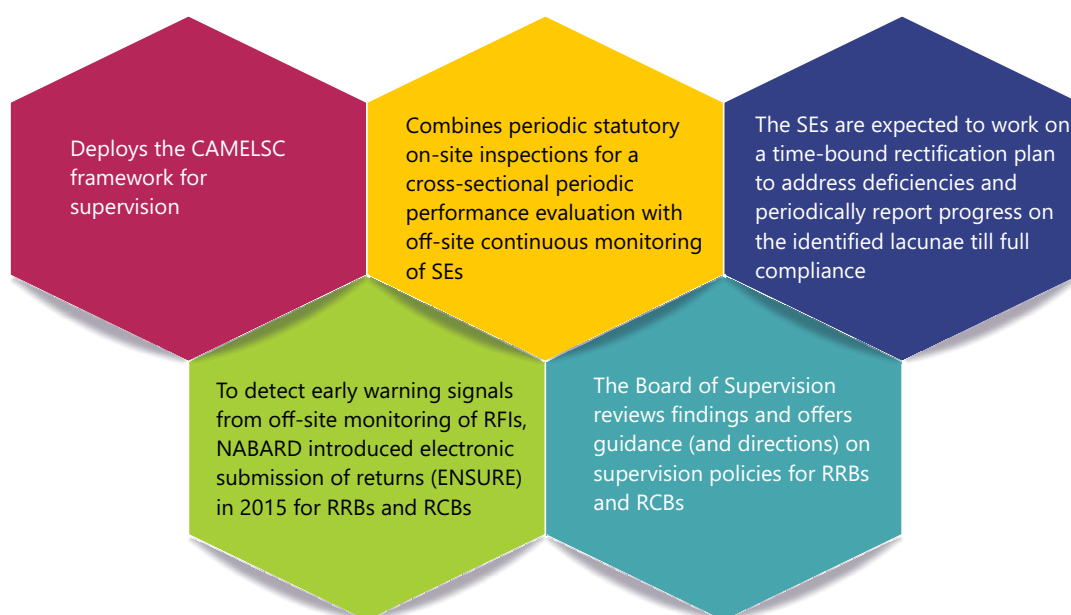
a complaints management system (see Figure A7.1 for key milestones in supervision). During the pandemic, NABARD adapted processes to maintain supervisory intensity, effectiveness, and efficiency despite remote working with limited mobility or contact.

With the aim of maximising benefits for SEs and the customers they serve, NABARD not only offers 360° coverage against real threats and perceived risks but also goes beyond the basic supervisory mandate (Figures 7.4 and 7.5).

Before introducing risk-based supervision (RBS) for SEs, NABARD will introduce an enhanced CAMELS⁵ with compliance or CAMELSC⁶ framework featuring additional quantitative and qualitative indicators.

NABARD's 'supervision plus' strengthens SEs through guidance on better risk management; compliance to exposure norms; adherence to investment guidelines; and issuing alerts and advisories to SEs on cyber incidents.

FIGURE 7.4: NABARD's 360° supervision



Notes:

1. CAMELS = Capital adequacy, Asset quality, Management, Earning, Liquidity, and System & control CAMELSC = CAMELS with Compliance; RCB = Rural Cooperative Bank; RFI = Rural Financial Institution; RRB = Regional Rural Bank; SE = Supervised Entity.
2. The Board of Supervision is an internal committee set up in 1999 reporting to the NABARD Board of Directors.

FIGURE 7.5: NABARD's 'supervision plus approach'



^a For instance, matrix of policies; indices on vulnerabilities (cyber security and frauds), governance, performance assessments, etc.

Note: CEO = Chief Executive Officer; GOI = Government of India; RBI = Reserve Bank of India; RCB = Rural Cooperative Bank; RFI = Rural Financial Institution; RRB = Regional Rural Bank; SE = Supervised Entity.

7.2 Supervisory activities in FY2022

- NABARD conducted 331 statutory and voluntary inspections overcoming the physical and logistical challenges imposed by the pandemic last year (compliance status given in Figure A7.3).
- The newly created C-SITE cell
 - issued 45 advisories and 11 alerts in FY2022;
 - created cyber security awareness for top management and employees;
- issued standard operating procedures to respond to advisories and alerts;
- guided banks on 26 incidents and 76 vulnerabilities (cumulative); and
- conducted eight workshops (~600 participants) for chairpersons of RRBs and chief executive officers and managing directors of RCBs.
- Advisories were issued to RRBs on automation of income recognition, asset classification, and

provisioning processes and to RCBs on sharing of complaints, FIRs, etc. with the Central Economic Intelligence Bureau among other routine ones (see Box A7.1).

- Digital inspections of the financial position of two RRBs and one DCCB were undertaken for FY2021 using NABARD's supervisory application, SuperSoft, on a pilot basis.

7.3 Output >> Outcomes >> Impact

- The RBI, GOI, and state governments rely on NABARD's important findings and financials, viz. CRAR⁷, erosion, core banking solution, frauds and other supervisory concerns to inform key decisions regarding banking institutions.
- Corrective steps taken on the basis of deficiencies observed in statutory inspections improved the overall functioning of the SEs.
- Inspection report observations and supervisory concerns raised by NABARD have institutionalised democratically elected boards in many RCBs.
- Based on NABARD's inspection report observations, state governments have initiated
 - ◊ capitalisation of RCBs and
 - ◊ guaranteed financial support to banks for certain cooperative ventures.
- Upon NABARD's recommendation, RRBs were permitted to amortise pension liability over a period of five years to reduce the financial burden.
- The C-SITE cell helped strengthen the cyber security preparedness of SEs through
 - ◊ guidelines on cyber security framework,
 - ◊ incident management advisories, and
 - ◊ self-assessment tool (VICS).

7.4 Amendments to Banking Regulation Act: Shaping the new paradigm

The Banking Regulation Act, 1949 (BR Act, 1949) was amended by the Banking Regulation (Amendment) Act, 2020 (Act 39 of 2020) which came into force on 29 September 2020. The Act was passed to bring additional areas of functioning of cooperative banks under the regulatory purview of the RBI. The major provisions of the amendment pertain to areas that include the following:

- The BR Act, 1949 was enacted to consolidate and amend the law related to banking. It was extended to cooperative banks with effect from 1 March 1966 by the insertion of Section 56 by amending Act 23

of 1965, subject to certain modifications (additions/deletions/alterations). Further, the amendments were made applicable to StCBs and DCCBs by the central government with effect from 1 April 2021.

- The amendments aim to improve the management and regulation of cooperative banks, thus protecting the interests of the depositors by increasing professionalism, enabling access to capital, improving governance, and ensuring sound banking. It also enables the RBI to formulate a scheme to achieve this aim. The provisions of the amended Act have overriding effect over other laws.
- The RBI is in the process of issuing guidelines with respect to the amended provisions.

The RBI can now leverage the deeply entrenched network of co-operative banks to offer services to the last mile customer in an efficient manner. This will reinforce the RCBs by streamlining the process and help in dissemination of institutional credit to rural areas.

7.5 Strengthening RFIs through supervision

NABARD has identified its FY2023 plan which includes:

- supervisory inspections to cover 307 banks viz., 221 DCCBs, 43 RRBs, 34 StCBs, 8 SCARDBs, and the Tamil Nadu Industrial Cooperative Bank;
- pilot inspections to be undertaken from August 2022 with a view to roll out an enhanced CAMELSC framework from April 2023 as a prelude to RBS;
- digitalisation of its entire supervisory process (SuperSoft) by FY2023.

In its supervisory function, NABARD is taking steps towards fulfilling a few other long-term objectives.

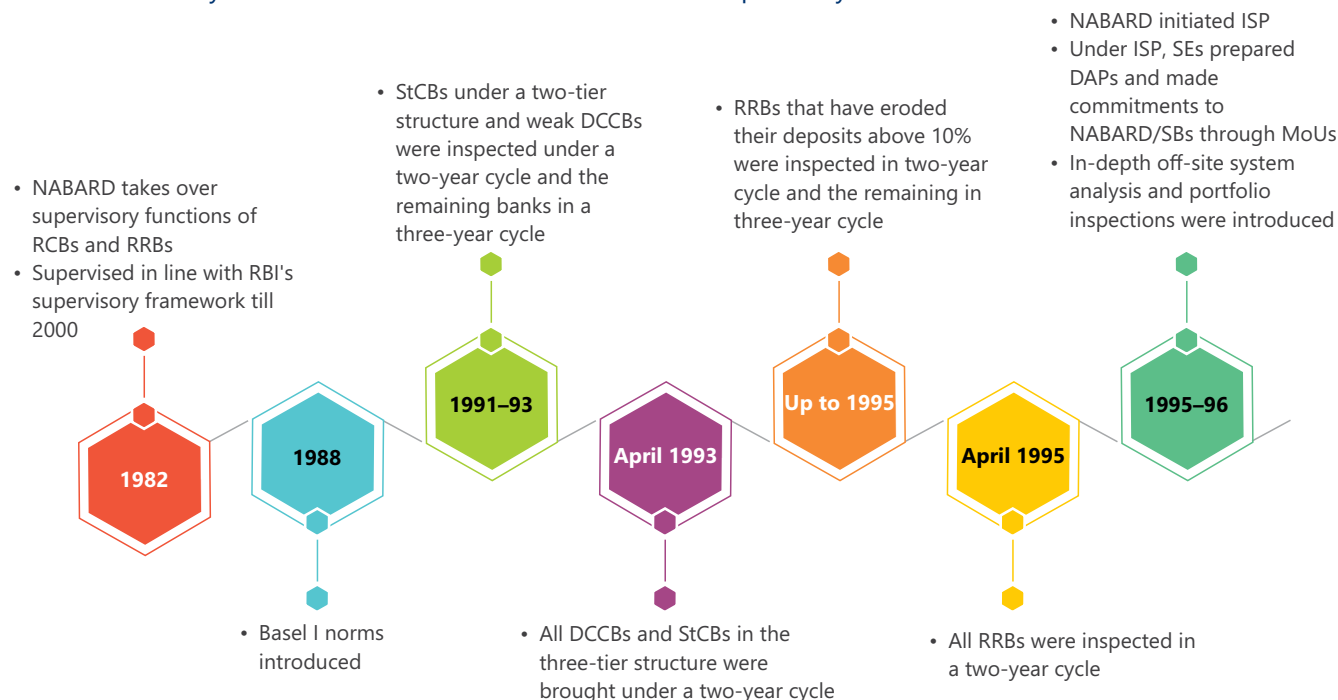
- Building on the role of a supervisory relationship manager as a nodal interface between NABARD and an SE will ensure continuity, better utilisation of supervisory resources, and greater customisation of oversight and remedial action.
- Complete digitalisation and greater financial inclusion will enable data analytics for customer services, corporate governance, risk management, fraud detection, and cyber security to benefit the SEs and their customers.
- Replacing static and compliance-based data with continuous, automated (proactive) data flow from the SEs will help NABARD migrate to the dynamic RBS framework.

Notes

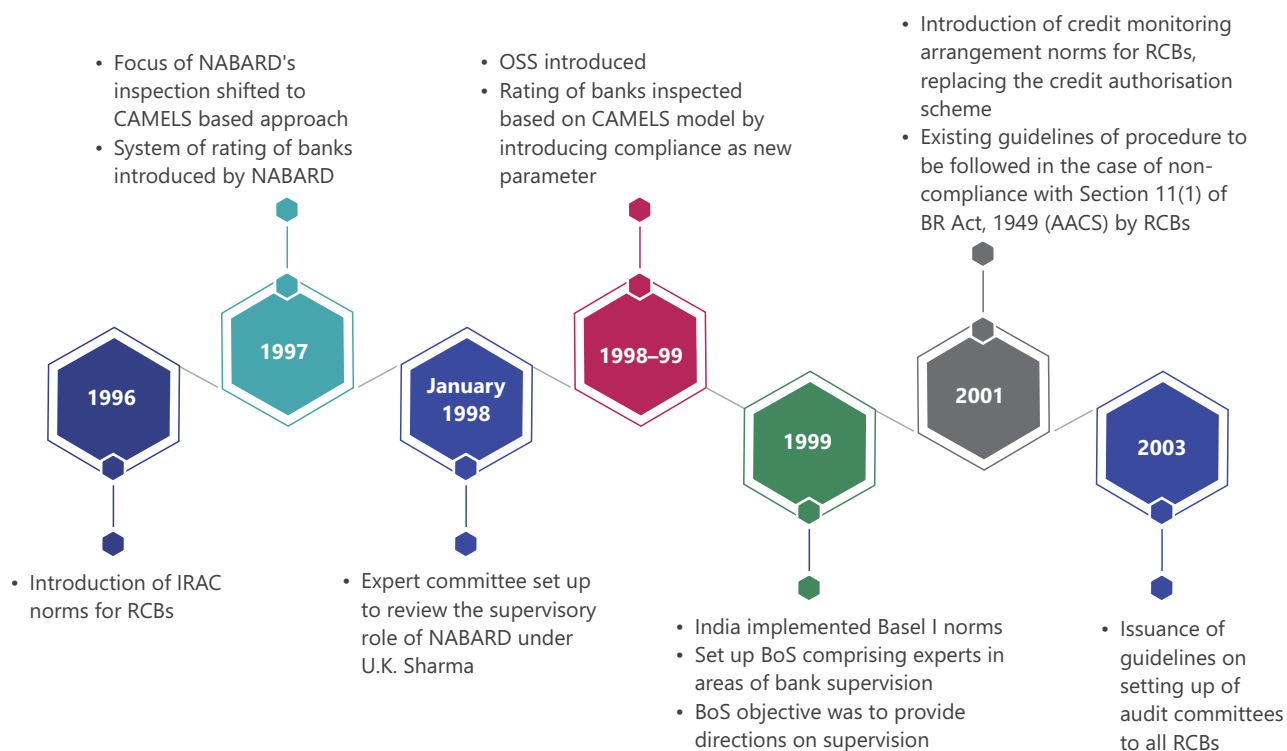
1. In India, RBI is the overarching regulator of the entire banking system. NABARD functions as the supervisor of rural financial institutions (RFIs)—both regional rural banks (RRBs) and rural cooperative banks (RCBs)—by virtue of the powers conferred to it under Section 35 (6) of Banking Regulation Act, 1949 (AACS).
2. VINFRA = Vulnerability index on frauds.
3. VICS = Vulnerability index on cyber security.
4. C-SITE = Cyber-security information technology examination.
5. CAMELS = Capital adequacy, Asset quality, Management, Earning, Liquidity and System & control.
6. CAMELSC = CAMELS with Compliance.
7. CRAR = Capital to Risk (Weighted) Asset Ratio.

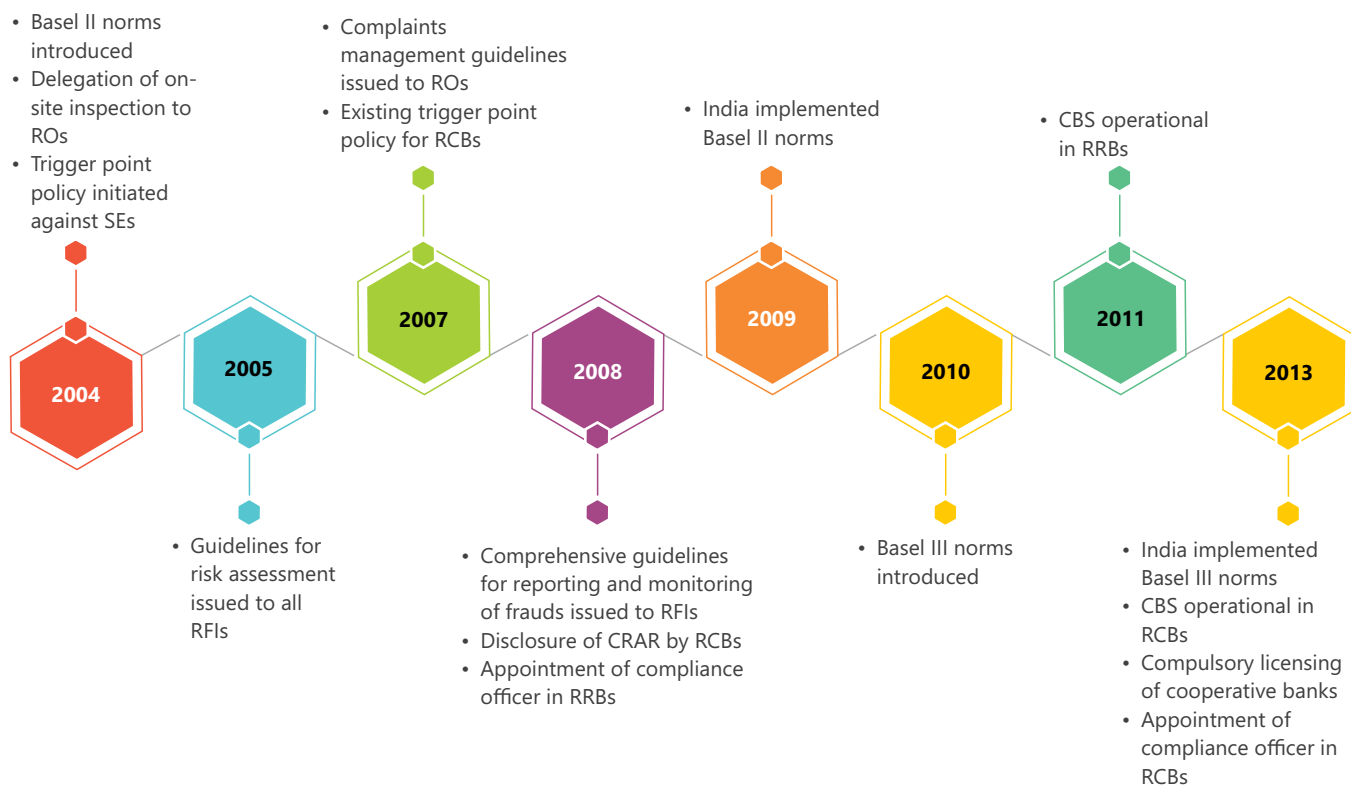
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FIGURE A7.1: Key milestones in the evolution of NABARD's supervisory framework

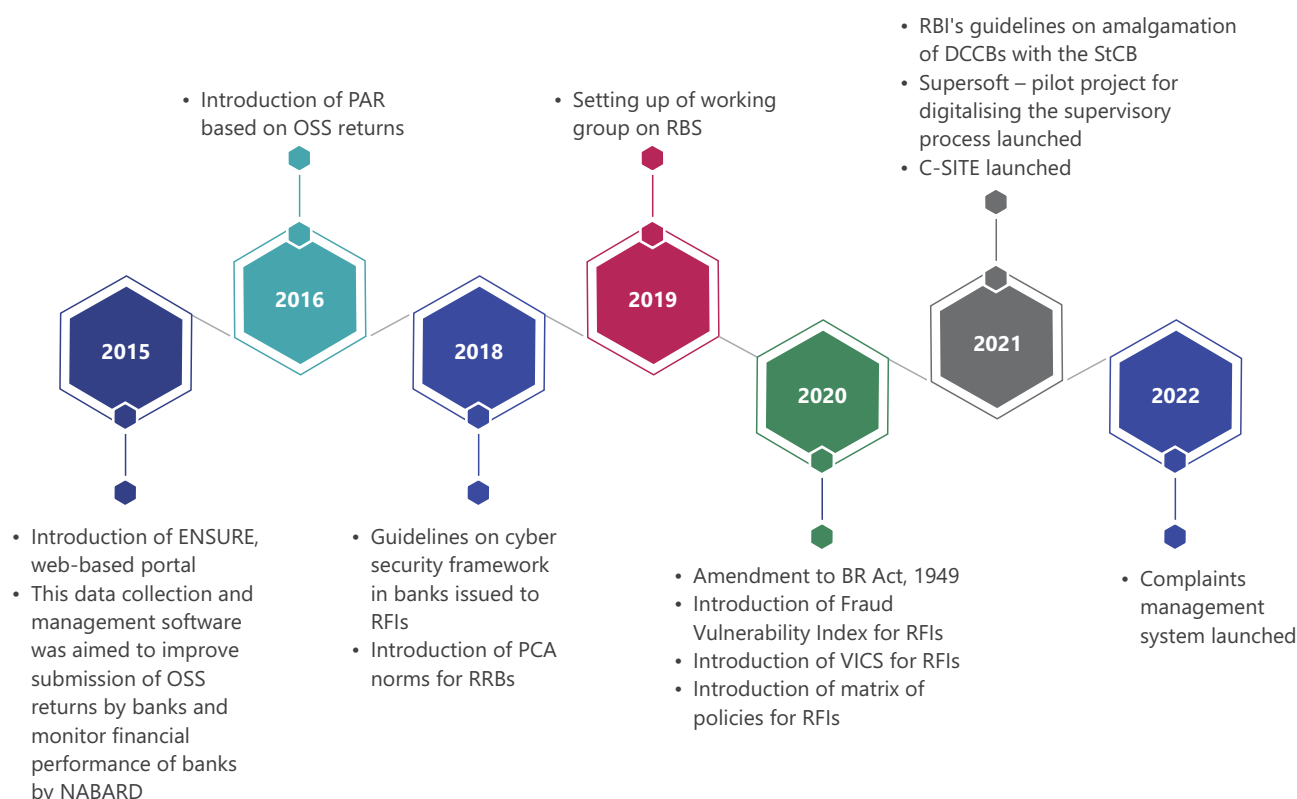


KEY MILESTONES

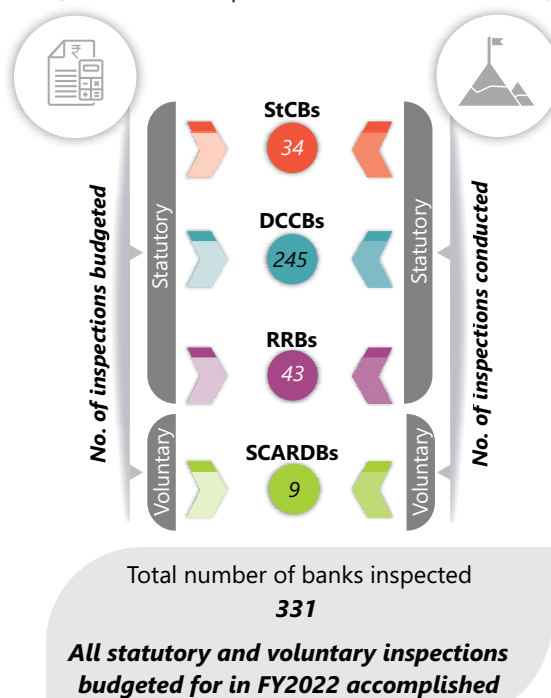




KEY MILESTONES

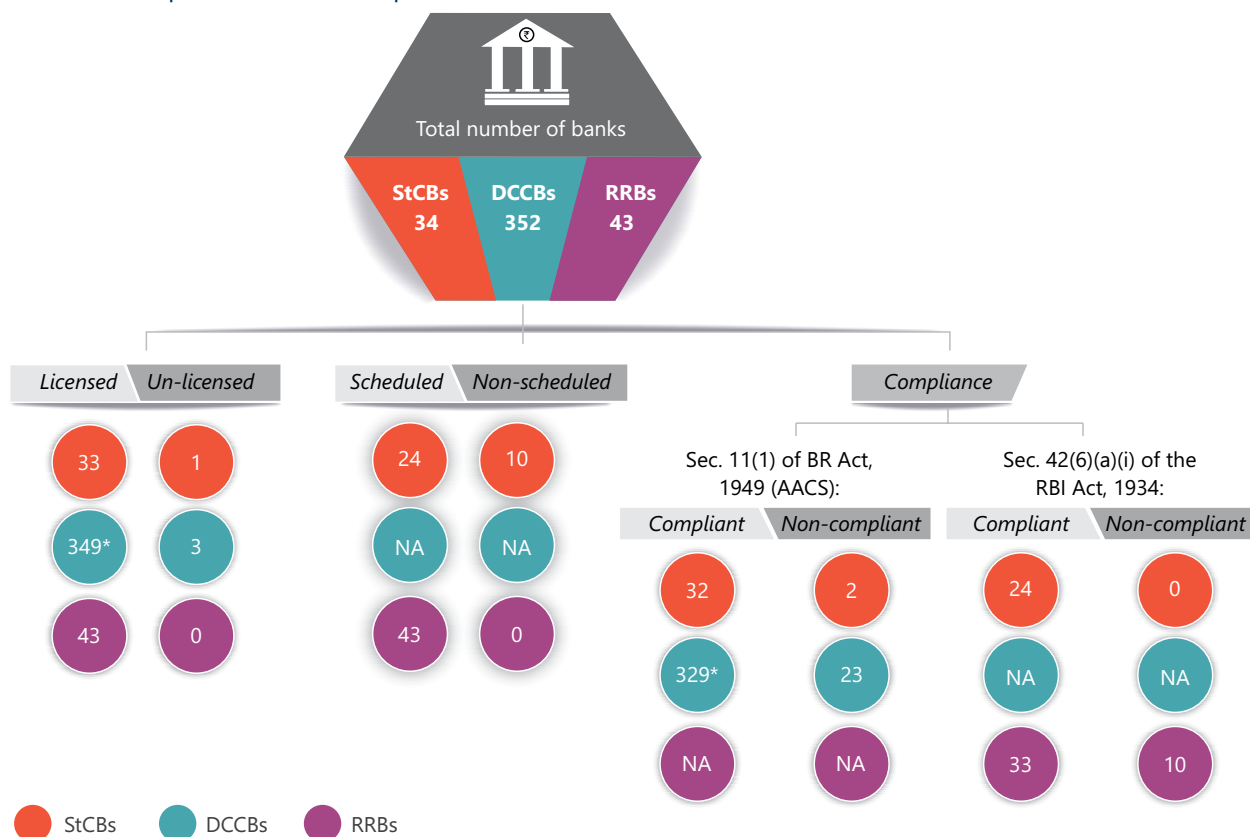


Note: BoS = Board of Supervisors; BR Act = Banking Regulation Act; CAMELS = Capital adequacy, Asset quality, Management, Earning, Liquidity, and System & control; CBS = Core Banking Solution; CRAR = Capital to Risk (Weighted) Asset Ratio; C-SITE = Cyber-Security Information Technology Examination; DAP = Development Action Plan; DCCB = District Central Cooperative Bank; ENSURE = Electronic Submission of Returns; IRAC = Income Recognition and Asset Classification; ISP = Institutional Strengthening Programme; MoU = Memorandum of Understanding; OSS = Off-site Surveillance System; PAR = Performance Average Rating; PCA = Prompt Corrective Action; RBI = Reserve Bank of India; RBS = Risk-Based Supervision; RCB = Rural Cooperative Bank; RFI = Rural Financial Institution; RO = Regional Office; RRB = Regional Rural Bank; SB = Sponsor Bank; SE = Supervised Entity; StCB = State Cooperative Bank; VICs = Vulnerability Index for Cyber Security.

FIGURE A7.2: Inspections in FY2022 (w.r.t. financial position on 31 March 2021)

Notes:

1. DCCB = District Central Cooperative Bank; RRB = Regional Rural Bank; SCARDB = State Cooperative Agriculture and Rural Development Bank; StCB = State Cooperative Bank.
2. DCCBs includes Tamil Nadu Industrial Cooperative Bank Ltd (TAICO Bank).

FIGURE A7.3: Compliance status of supervised entities in FY2022

* DCCBs include Tamil Nadu Industrial Cooperative Bank Ltd (TAICO Bank).

Note: AACS = As Applicable to Cooperative Societies; BR Act = Banking Regulation Act; DCCB = District Central Cooperative Bank; NA = Not Applicable; RBI = Reserve Bank of India; RRB = Regional Rural Bank; StCB = State Cooperative Bank.

Source: Data from ENSURE portal, NABARD.

Box A7.1: Supervisory instructions to RRBs and RCBs in FY2022

RRBs and RCBs were advised on

- new due dates for submission of off-site surveillance system / fraud management system returns on ENSURE portal;
- submission of new return named 'OSC-10' to capture information on qualitative parameters and a few other audited / unaudited data on a quarterly-basis;
- submission of financial information and information on assets in relation to which any security has been created, to information utility;
- reporting of cyber incidents in the CSIR-01 return on ENSURE portal within six hours and reporting further updates on the incident in the CSIR-02 return 'as-and-when';
- initiating urgent and definite steps to reconcile all outstanding entries pending for more than six months;
- transferring unclaimed balances to Depositor Education and Awareness Fund and reiteration of instructions contained in the RBI circulars for complying with the provisions of Sections 26 and 26A of the BR Act, 1949;
- strengthening of the controls of payment ecosystem by restricting reconciliation of transactions and restricting fund transfer request through email communication if the email originated from a different domain; and
- submission of CS-01 and CS-02 returns within 15 days from period end date.

RRBs were further advised on

- automation of income recognition, asset classification, and provisioning processes.

RCBs were further advised on

- reiterating instructions on compliance to Section 19 of BR Act, 1949 (AACS) and extant instructions on investment in the shares of other cooperative societies/institutions stipulated by the RBI;
- sharing of complaints and FIRs in the matter of financial scams, bank frauds / forgery / loan diversions by fraudulent means lodged with the police / CBI / Anti-Corruption Bureau by RCBs, StCBs, DCCBs, etc. with the Central Economic Intelligence Bureau; and
- disposal of non-banking assets as per amendment to Section 9 of the BR Act, 1949 (AACS).

Note: AACS = As Applicable to Cooperative Societies; BR Act = Banking Regulation Act; CBI = Central Bureau of Investigation; DCCB = District Central Cooperative Bank; ENSURE = Electronic Submission of Returns; RBI = Reserve Bank of India; RCB = Rural Cooperative Bank; RRB = Regional Rural Bank; StCB = State Cooperative Bank.

FIGURE A7.4: Number of banks by performance indicators (as on 31 March)

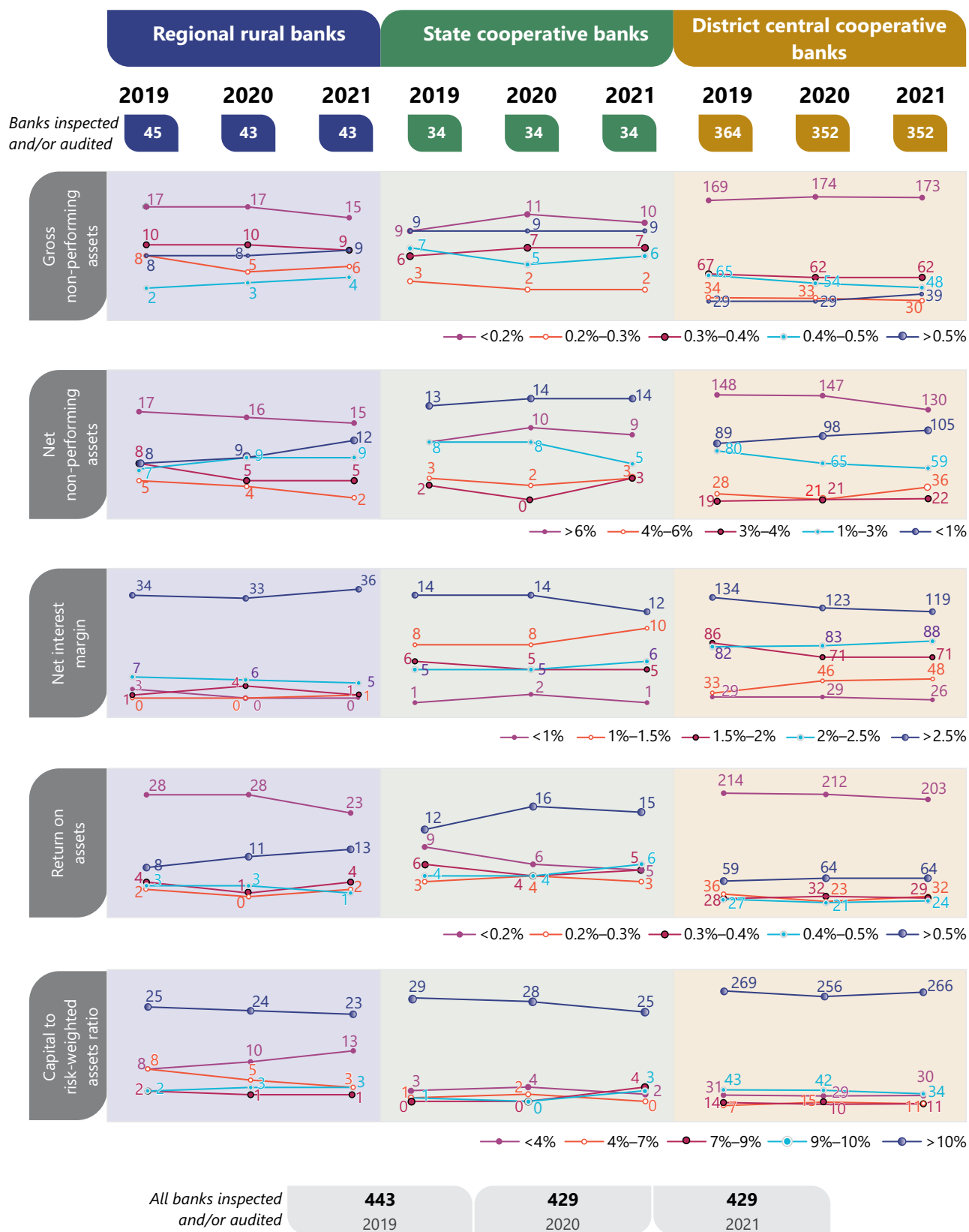
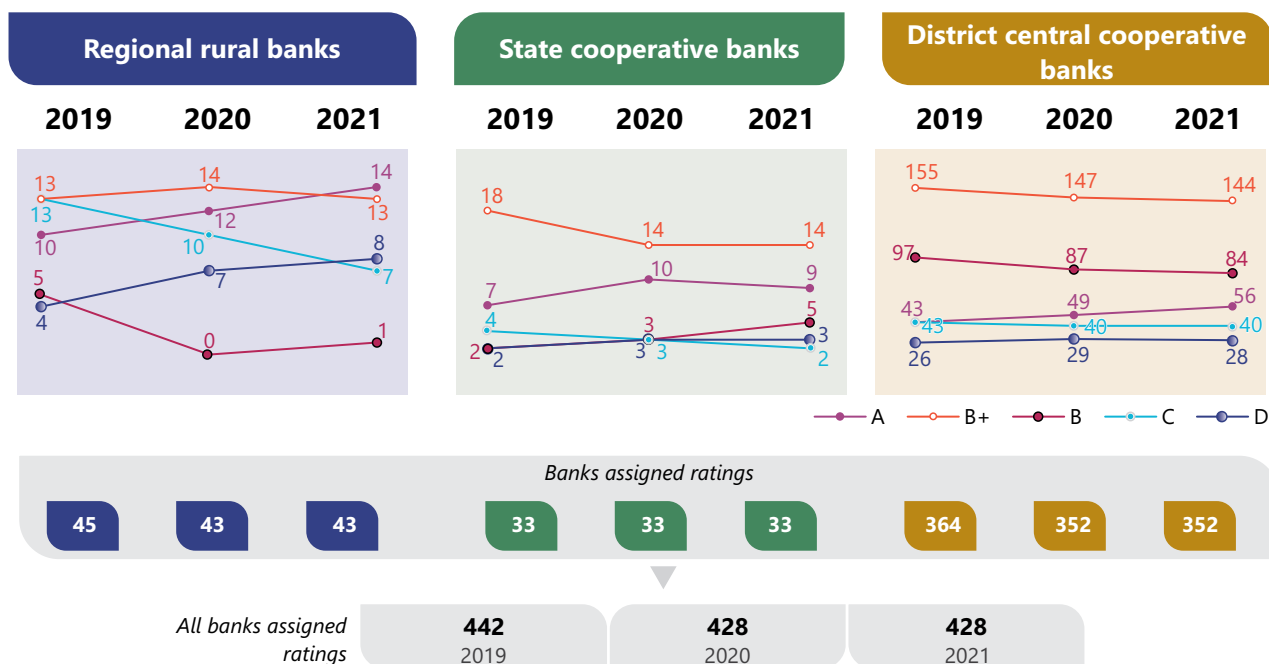


FIGURE A7.5: Number of banks by ratings (as on 31 March)



Notes to Figures A7.4 and A7.5:

- Percentage ranges in the legend in each figure pertain to the specific performance indicator of that figure. For example, in the figure for gross non-performing assets, the percentage ranges relate to gross NPAs.
- Data furnished in respect of RRBs and StCBs is as per inspections.
- Data furnished in respect of DCCBs is as per inspections or audit, except in the figure related to capital to risk-weighted assets ratio.
- Wherever DCCBs were not inspected during the year, previous rating has been repeated.
- In Figure A7.5, rating excludes Daman & Diu StCB.

Source: Data from ENSURE portal, NABARD.