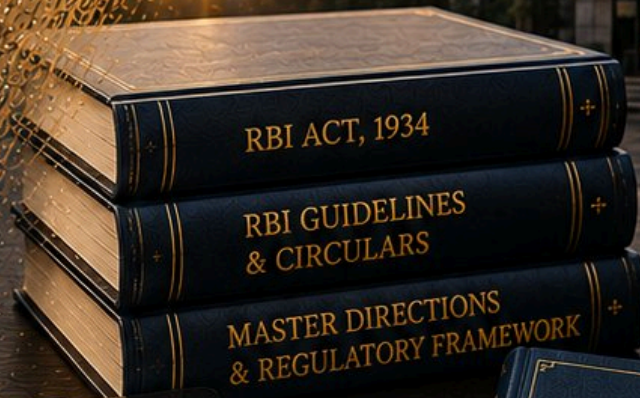


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# RBI Regulatory Risk



# RBI Regulatory Risk

*Inspections, Directions, Licence Cancellation, NBFC Regulation, Payment Systems & Judicial Review of Central Bank Action — The Complete Practitioner's Guide*

Booklet VI of VI — Indian Banking & Finance Sector Legal Series

Advocates & Legal Consultants — Ultra-Premium Client Advisory Series

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## CHAPTER ONE

# RBI Inspection and Supervisory Action: Risk-Based Supervision, Inspection Reports & Prompt Corrective Action

*RBI Act 1934 Sections 35 and 36, Risk-Based Supervision Framework, Annual Financial Inspection, Inspection Report Response Strategy & PCA Trigger Framework*

*An RBI inspection — whether the Annual Financial Inspection (AFI) conducted under Section 35 of the RBI Act, or a targeted inspection under Section 35(1A) prompted by supervisory concerns — is the most consequential regulatory event in the annual calendar of a bank or large NBFC. The Inspection Report that emerges from the AFI contains findings on: the adequacy of the bank's*

*capital and provisioning; the quality of its credit portfolio (including GNPA and NNPA levels, the adequacy of specific provisions, and the classification of restructured accounts); the strength of its internal controls and corporate governance; and compliance with the extensive web of RBI Master Directions, Circulars, and Guidelines that govern banking operations. A bank that receives an Inspection Report with significant adverse findings faces a regulatory imperative to respond substantively and remediate effectively — the RBI's escalation pathway from adverse inspection findings moves, in sequence, from supervisory letters, to moral suasion, to formal directions under Section 35A, to the Prompt Corrective Action (PCA) framework, and ultimately — for the most severely non-compliant institutions — to licence cancellation or forced amalgamation. The management of the inspection response, and the strategic engagement with the RBI's supervisory concerns at the earliest possible stage, determines whether the bank's regulatory trajectory moves toward resolution or escalation.*

### **1.1 The AFI Process: Scope, Duration and Information Demands**

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The Annual Financial Inspection of a scheduled commercial bank — conducted by a team of RBI inspection officers typically over a period of 4-6 weeks on-site at the bank's head office and selected branches — examines: the bank's loan portfolio (including review of individual large loan accounts, assessment of NPA classification accuracy, and evaluation of restructured account performance); treasury and investment portfolio (assessment of HTM/AFS/HFT classification appropriateness, market risk measurement, and compliance with SLR and CRR requirements); capital adequacy (CRAR computation, Basel III compliance, and adequacy of Tier 1 capital); governance and internal controls (quality of board oversight, audit committee functioning, internal audit coverage, and risk management framework effectiveness); and compliance (adherence to KYC/AML requirements, priority sector lending targets, MSME lending norms, and the extensive operational guidelines in the Master Directions). The inspection team has broad information access — requesting any document, register, record, or system access that it considers relevant to its examination — and the bank's designated inspection co-ordination team must respond to information requests promptly and completely. Delays in providing requested information, production of documents that appear to have been created after the inspection began, or inconsistencies between documents provided to the inspection team and documents available in the bank's own systems are serious issues that the inspection report will note as adverse governance findings. Banks under inspection must maintain a real-time log of all information requests and responses, and ensure that all produced documents are authenticated and consistent with the bank's book records.

### **1.2 Inspection Report Response: The Compliance Submission Strategy**

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The RBI's inspection report is issued to the bank's Board in the form of a Draft Inspection Report (DIR) — a confidential document that the bank must not disclose — accompanied by a requirement for the bank's compliance submission within a specified period (typically 30-45 days). The compliance submission — signed by the bank's MD and CEO and reviewed by the

Board's Audit Committee — is the bank's formal, record-creating response to each finding in the DIR. The strategic imperatives of the compliance submission are: accept findings that are factually accurate and legally correct; dispute findings that are factually inaccurate or reflect an incorrect regulatory interpretation; and for every accepted finding, commit to a specific, time-bound remediation action that is ambitious enough to satisfy the RBI but realistic enough to be actually implemented. A compliance submission that blanket-accepts all findings and makes aspirational commitments without implementation plans is worse than a submission that disputes specific findings on solid grounds — the RBI's supervisory team tracks the bank's compliance submission commitments against actual implementation, and repeated non-compliance with submitted commitments is itself an adverse supervisory finding in the next inspection. Legal counsel reviewing the compliance submission should focus particularly on: findings that could lead to PCA designation; findings that may trigger RBI directions under Section 35A; and findings that mischaracterise factual situations in ways that could adversely affect the bank's public record or expose it to regulatory action beyond the scope of normal supervisory engagement.

#### KEY PROVISION

Section 35(1), RBI Act 1934: "The Reserve Bank may, at any time, and shall, at least once in each year, cause an inspection to be made by one or more of its officers of any bank and its books and accounts; and it shall be the duty of every officer, employee, and other member of staff of the bank to produce to the officers of the Reserve Bank making the inspection, all books, accounts and other documents in his custody and to furnish them with such statements and information relating to the affairs of the bank as they may require within such time as they may specify."

### 1.3 Prompt Corrective Action: Triggers, Restrictions and Exit Pathway

The RBI's Prompt Corrective Action (PCA) framework — revised in 2021 to extend to large NBFCs in addition to scheduled commercial banks — imposes automatic operating restrictions on banks that breach specified financial thresholds: CRAR falling below the regulatory minimum; NNPA ratio exceeding 6 per cent; and Return on Assets (RoA) being negative for two consecutive years. PCA-designated banks face restrictions on dividend distribution, branch expansion, management compensation, and in the most severe cases, on new lending to specific categories of borrowers. For a bank that has been placed under PCA — a designation that is publicly disclosed and creates immediate commercial reputational damage, accelerates deposit withdrawals, and triggers covenant defaults in the bank's own borrowing agreements — the exit pathway requires: sustained improvement in the financial parameters that triggered PCA; a credible capital augmentation plan (typically through promoter infusion, government capital injection for PSU banks, or a rights issue for private banks); and a demonstrated improvement in the credit portfolio quality through accelerated NPA resolution. Legal counsel for a PCA bank's Board must ensure: that the compliance submission to the RBI's PCA supervision team is

strategically framed to demonstrate credible progress; that the Board's corporate governance improvements are genuinely implemented and documentable; and that any regulatory approvals required for capital augmentation transactions are pursued on a priority basis with the RBI's Department of Regulation.

# RBI Directions and Restrictions: Moratorium Orders, Payment Restrictions & Section 35A Directions

*RBI Act Sections 35A, 45, 45IE, Moratorium under Section 45, Directions Regime, Operational Restrictions & Judicial Challenge Framework*

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## 2.1 Section 35A Directions: Scope and Immediate Operational Impact

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Section 35A of the Banking Regulation Act, 1949 empowers the RBI to issue directions to any banking company — requiring it to act or refrain from acting in any specified manner — "in the public interest, or in the interest of banking policy, or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company." The breadth of this power — which covers essentially any aspect of a bank's operations — makes Section 35A the RBI's most versatile supervisory intervention tool. In practice, Section 35A directions have been used to: restrict a bank from opening new branches; prohibit dividend payments; cap remuneration of key managerial personnel; restrict lending to specified categories of borrowers; direct changes in the bank's governance structure (removal of directors, appointment of additional directors nominated by RBI); and, in the most extreme cases, impose complete payment restrictions on a bank's depositors (the "directive" variety that preceded moratorium orders in cases like Lakshmi Vilas Bank and Punjab and Maharashtra Co-operative Bank). The immediate operational impact of a Section 35A direction — particularly a payment restriction direction — on depositors, the bank's market standing, and its contractual relationships with counterparties is severe, and the bank's counsel must act immediately on receipt of any direction to: assess the direction's legal scope; identify any aspects of the direction that exceed the RBI's Section 35A authority; and evaluate the prospects for a writ challenge in the High Court or Supreme Court.

## 2.2 Moratorium and Amalgamation: The Existential Regulatory Action

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A moratorium order under Section 45 of the Banking Regulation Act — imposing a freeze on deposit repayments and other payments — is the penultimate regulatory action before licence cancellation or forced amalgamation, used by the RBI for banks that are systemically at risk of failure and whose depositors require protection from a disorderly run. The Lakshmi Vilas Bank moratorium (November 2020) — which resulted in the forced amalgamation of Lakshmi Vilas Bank into DBS Bank India Limited within thirty days of the moratorium order — is the most recent high-profile use of this mechanism. The moratorium procedure: the RBI makes a recommendation to the Central Government; the Central Government issues the moratorium

notification under Section 45(1); the moratorium takes effect immediately and suspends all payment obligations of the bank for the moratorium period (not exceeding three months, extendable); and the RBI simultaneously prepares a scheme of amalgamation or reconstruction that is approved by the Central Government and implemented before or concurrent with the moratorium's expiry. For a bank's legal counsel and Board, the receipt of a communication from the RBI indicating that moratorium proceedings are under consideration is a moment requiring immediate legal and strategic response: while the RBI's power to recommend a moratorium is substantively unchallengeable where the bank is genuinely failing, the procedural aspects of the moratorium recommendation — notice to the bank, opportunity to remediate, and adequacy of the amalgamation terms — are subject to judicial review, and the High Court writ petition is the only available forum for a bank whose Board believes the RBI has acted precipitately or whose amalgamation terms are substantively unfair.

# NBFC Regulation: Registration, Classification Changes, PCA Framework & Scale-Based Regulation Compliance

*RBI NBFC Scale-Based Regulation Framework 2021, NBFC-BL/ML/UL Classification, Enhanced Regulatory Requirements for NBFC-UL & PCA Triggers*

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## 3.1 Scale-Based Regulation: The Four-Tier Architecture

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The RBI's Scale-Based Regulation (SBR) framework for NBFCs — implemented with effect from October 2022 — classifies all NBFCs into four tiers based on their size, activity, and systemic risk: NBFC-Base Layer (NBFC-BL — smaller NBFCs below the Medium Layer threshold, subject to the existing light-touch regulation); NBFC-Middle Layer (NBFC-ML — NBFCs with asset size above Rs. 1,000 crore, and all Deposit-Taking NBFCs, subject to enhanced regulatory requirements); NBFC-Upper Layer (NBFC-UL — the top 25 NBFCs identified by the RBI as systemically important "too big to fail" institutions, subject to near-bank-level regulation); and NBFC-Top Layer (NBFC-TL — a reserve category for NBFCs whose continued classification in the Upper Layer raises systemic risk concerns, subject to the most stringent regulatory requirements including potential mandatory conversion to banks). The SBR framework's most commercially significant provision for large NBFCs is the NBFC-UL designation — the 25 systemically important NBFCs (identified by the RBI's risk assessment methodology covering size, interconnectedness, and substitutability) are subject to requirements that were previously applicable only to banks: CET1 capital requirements, leverage ratios, liquidity coverage ratios, net stable funding ratios, and enhanced disclosure obligations. For NBFCs that are on the borderline of NBFC-UL designation — or that have been designated NBFC-UL and are assessing the regulatory burden — legal counsel's role includes: advising on the implications of each new regulatory requirement; assessing the operational changes required to meet CET1, LCR, and NSFR requirements; and advising on any available structural mechanisms to manage the regulatory classification (such as whether partial demerger or reduction of asset size can result in de-designation from NBFC-UL).

# Licence Cancellation and Winding Up: Grounds, Show-Cause Procedure & Writ Challenge Strategy

*Banking Regulation Act Sections 22, 36A, 36AA, Licence Cancellation Grounds, Show-Cause Procedure, Constitutional Challenge & Judicial Review Standard*

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## 4.1 Licence Cancellation: Grounds and the Show-Cause Obligation

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The RBI's power to cancel a bank's licence — under Section 22(4) of the Banking Regulation Act — is among the most drastic regulatory actions available to any Indian regulatory authority, extinguishing the bank as a going concern and triggering the liquidation or acquisition of its assets and liabilities. The grounds for licence cancellation under Section 22(4) include: the bank ceasing to carry on banking business; the bank failing to comply with conditions subject to which the licence was issued; the bank being unable to pay its depositors; and the bank's continuation being prejudicial to the interests of its depositors. Before cancelling a licence, the RBI is required to give the bank an opportunity to make a representation — a requirement derived both from the statutory language of Section 22 and from the constitutional principles of natural justice applicable to any quasi-judicial action affecting fundamental rights. The adequacy of the RBI's show-cause process in licence cancellation matters — specifically, whether the bank was given sufficient notice, adequate time to respond, and a meaningful opportunity to present its case — has been the primary subject of judicial review in licence cancellation challenges. The Supreme Court in *Kerala State Co-operative Agricultural and Rural Development Bank Ltd. v. State of Kerala* (2021) held that the natural justice requirement in licence cancellation proceedings is not merely formal — the RBI must actually consider the bank's representation on its merits, and a cancellation order that does not engage with the substance of the representation is procedurally defective.

# Payment System Operators: PSO Authorisation, RBI Enforcement & UPI Compliance Failures

*Payment and Settlement Systems Act 2007, PSO Authorisation Requirements, System Audit Obligations, UPI Compliance Framework & NPCI Regulatory Interface*

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## 5.1 PSO Authorisation: The Regulatory Threshold and Renewal Obligations

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Any entity operating a "payment system" in India — defined broadly in the Payment and Settlement Systems Act, 2007 (PSSA) to include any system that enables payment transactions to be effected between a payer and a beneficiary — requires authorisation from the RBI under Section 7 of the PSSA. The scope of "payment system" under the PSSA encompasses: card networks; payment aggregators (entities that facilitate payment collection for merchants by providing a unified interface to multiple banks' payment systems); payment gateways (technology intermediaries that process payment transactions); prepaid payment instrument (PPI) issuers; and entities operating account-based fund transfer systems. The RBI's authorisation of PSOs is not a one-time grant — it is subject to periodic renewal (with the RBI publishing new guidelines for authorisation that PSOs must comply with at renewal) and ongoing compliance requirements that include: quarterly transaction reporting; annual system audit by a CERT-In empanelled auditor; compliance with the RBI's Payments Infrastructure Development Fund; and adherence to the data localisation requirement (all payment data involving Indian customers must be stored exclusively in India). For fintech companies and payment aggregators — a segment of intense commercial activity in Gujarat's emerging digital economy — the PSO authorisation framework represents both a commercial gateway (no authorised PSO status means no legal payment operations) and a sustained compliance obligation that requires dedicated regulatory and legal counsel.

## 5.2 RBI Enforcement Against Payment Aggregators: The 2022 Guidelines and Their Aftermath

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The RBI's Guidelines on Regulation of Payment Aggregators and Payment Gateways (March 2020, effective July 2021, with revised guidelines in 2022) imposed a comprehensive regulatory framework on payment aggregators — previously operating with minimal RBI oversight — requiring them to: obtain formal PSO authorisation; maintain a minimum net worth of Rs. 25 crore (increasing to Rs. 50 crore by 2026); maintain an escrow account with a scheduled commercial bank for merchant settlement float; implement comprehensive KYC on all merchants onboarded onto the platform; conduct transaction monitoring for fraud and money laundering; and comply with data security standards (PCI-DSS compliance for card data handling). The RBI's

enforcement of the 2022 PA Guidelines against non-compliant payment aggregators has been active: aggregators operating without authorisation, aggregators that have failed net worth requirements, and aggregators that have been found to onboard merchants without adequate KYC have been subject to directions under the PSSA and, in cases of deliberate non-compliance, to licence cancellation. For a fintech payment aggregator seeking to operate in India — or defending against RBI enforcement action — legal counsel must maintain current knowledge of the PA Guidelines' specific requirements, which are frequently updated through RBI circulars, and must build compliance verification processes that document compliance with each requirement against each RBI update.

# Co-operative Banks and Dual Regulation: RBI vs State Registrar Jurisdiction & Amalgamation Proceedings

*Banking Regulation (Amendment) Act 2020, RBI Supervisory Jurisdiction over UCBs, Dual Regulation Framework, State Co-operative Registrar Role & Multi-State Co-operative Bank Regulation*

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## 6.1 The 2020 Amendment: RBI's Extended Jurisdiction Over Urban Co-operative Banks

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The Banking Regulation (Amendment) Act, 2020 — enacted in the aftermath of the Punjab and Maharashtra Co-operative (PMC) Bank crisis — significantly expanded the RBI's regulatory jurisdiction over Urban Co-operative Banks (UCBs), which had previously operated in a regulatory gap between the RBI (which regulated banking activities) and the State Registrar of Co-operative Societies (which regulated the co-operative governance of UCBs). Pre-2020, the dual jurisdiction created a situation where the RBI could regulate a UCB's banking operations but could not direct changes in its management or governance — a gap that allowed the PMC Bank's management to conceal massive related-party lending through false accounting for years without either the RBI or the State Registrar being able to effectively intervene. The 2020 Amendment resolved this gap by: extending the Banking Regulation Act's supersession of management provisions (Section 36AAA) to UCBs; enabling the RBI to appoint an administrator to take over management of a UCB (without requiring the State Government's concurrence); and authorising the RBI to frame a scheme of amalgamation or reconstruction for UCBs independently of the State Government's approval. For UCBs across Gujarat — a state with one of India's largest urban co-operative banking sectors — the 2020 Amendment creates a fundamentally changed regulatory environment: the RBI's audit team now has unrestricted access to UCB management and governance information, UCB Boards now face the same Section 35A direction and moratorium powers that apply to commercial banks, and UCB management that conceals loan classifications or related-party exposures from the RBI faces the same enforcement consequences as commercial bank management.

## 6.2 Related-Party Lending in UCBs: Governance Failures and Regulatory Consequences

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The predominant governance failure in Indian co-operative banking — including in Gujarat's urban co-operative banks — is related-party lending: the extension of loans to members of the bank's committee of management, their families, their associated businesses, and entities controlled by influential members, often without adequate security and at concessional rates. The RBI's exposure limits for UCBs — restricting aggregate related-party lending as a percentage of the bank's capital — are significantly stricter than the pre-2020 framework, and

the RBI's inspection teams now specifically examine related-party lending concentrations as a primary risk indicator. For a UCB that is discovered to have a related-party lending concentration above regulatory limits — or where related-party loans have been classified as standard assets despite being in de facto default — the consequences under the post-2020 framework are: RBI direction under Section 35A to cease new related-party lending; mandatory write-off or accelerated provisioning for misclassified accounts; and where the losses are of systemic significance, appointment of an RBI administrator and initiation of amalgamation proceedings. For members of UCB committees of management — who bear personal liability for committee decisions that violate the Banking Regulation Act — the 2020 Amendment's extended RBI jurisdiction means that regulatory violations that were previously addressed through the relatively lenient co-operative registration enforcement mechanism are now subject to the RBI's full enforcement arsenal, including criminal prosecution under Section 46 of the Banking Regulation Act.

**Booklet VI Complete Summary:** RBI supervisory risk — through inspection responses, PCA framework compliance, Section 35A directions, NBFC scale-based regulation, PSO authorisation management, and UCB dual regulation — represents the existential regulatory risk for India's banks, NBFCs, and payment companies. The post-2020 strengthening of RBI's supervisory powers over UCBs, the NBFC-UL near-bank regulatory burden, and the PSO authorisation framework for payment aggregators create the highest-value regulatory mandates in the financial sector legal market. Practitioners advising financial institution clients — whether on routine inspection response strategy or on extraordinary matters like moratorium orders, licence cancellation proceedings, or PMLA attachment of a bank's assets — must combine deep knowledge of the RBI Act, Banking Regulation Act, PSSA, and FEMA with the practical experience of RBI supervisory process that allows them to navigate these proceedings at the speed and sophistication that an ultra-premium financial institution client demands.