


RBI Regulatory Banking Insights

September – November 2024



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Preface

The RBI, in the Monetary Policy Committee (MPC) meeting, propounded key decisions to maintain economic stability. The highlights of the meeting include lowering CRR by 50 basis points to 4%, aiming to inject INR 1.16 lakh crore into the banking system to address liquidity stress. The repo rate remains unchanged at 6.5% for the 11th consecutive time, maintaining a neutral monetary policy stance amidst rising inflation and economic uncertainties. The inflation forecast for FY25 has been revised to 4.8%, up from 4.5%, while GDP growth estimates were lowered to 6.6% from 7.2%, reflecting slow economic activity and impact of inflation on consumer demand.

At the RBI@90 High-Level Conference on “Central Banking at Crossroads,” the RBI Governor, Mr. Shaktikanta Das, emphasised the success of central banking over the decades, in spite of numerous challenges. He underlined emerging risks to overall financial stability, such as the rapid growth of private credit markets with limited regulation, the impact of higher interest rates on debt servicing costs, and financial market volatility, which, even individually, have the potential to lead to a global financial crisis. The address also underscored the importance of vigilance and proactive measures to safeguard financial stability.

October 2024 was an eventful month, as reflected in RBI’s Statement on Developmental and Regulatory Policies. The publication outlines key measures aimed at enhancing the overall regulatory framework for lending, payments, technology, and other areas. The RBI is taking action to broaden responsible lending conduct norms to include loans to micro and small enterprises (MSEs). It has issued directives for UPI, RTGS, and NEFT payments to reduce the risk of incorrect credits and related fraud. The RBI plans to introduce focused measures for capital raising for Primary (Urban) Co-operative Banks in the form of a discussion paper. Additionally, the RBI has proposed

the creation of the Reserve Bank – Climate Risk Information System (RB-CRIS) to address climate-related financial risks by providing high-quality, standardised climate data.

Earlier, in September 2024, at the ‘Financing 3.0 Summit’ organised by the Confederation of Indian Industry (CII), the RBI Deputy Governor emphasised the ‘India growth story’ powered by a robust financial sector. He outlined five strategic facets of the revolutionary contribution to aspirational growth: infrastructure financing, the MSME sector, upskilling human resources to adapt to tech transformations, climate finance, and financing digitisation initiatives.

Among other updates the RBI introduced MuleHunter, an AI and ML-based infrastructure, to combat digital fraud through mule bank accounts. This system aggregates data from banks and payment operators to identify and mitigate frauds effectively. Interest rate ceilings on Foreign Currency Non-Resident Bank [FCNR (B)] deposits have been raised to attract higher capital inflows. Small finance banks (SFBs) are now allowed to offer pre-sanctioned credit lines via UPI, following its introduction by scheduled commercial banks (SCBs) in September 2023. This initiative aims to boost financial inclusion and formal credit access.

This edition of RBI Regulatory Banking Insights covers regulatory updates from September to November 2024. Key changes include amendment to KYC guidelines and directives for supervised entities to review Gold Loan Policies, identify lacunae, and initiate remedial measures. Additionally, the RBI has issued circulars for credit institutions and credit information companies with an updated set of guidelines. Lastly, the RBI has issued a draft circular on forms of business and prudential regulation for investments. This is intended for banks, NBFCs, and financial holding companies to eliminate any potential for regulatory arbitrage.



01

Impact assessment of regulatory changes in September 2024



RBI Circular on irregular practices observed in grant of gold loans

RBI/2024-25/77 DoS.CO.PPG.SEC.10/11.01.005/2024-25

Release date: 30 September 2024

Applicability

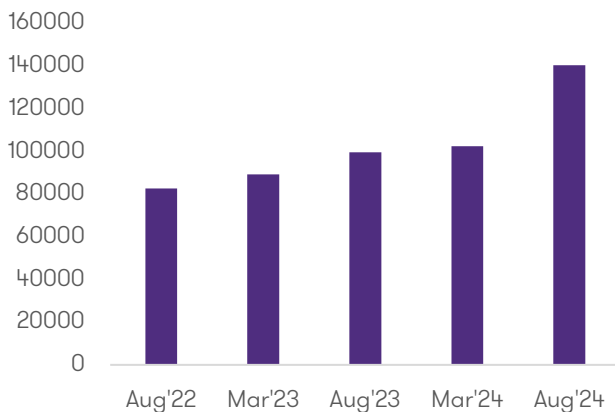
- Commercial Banks (including Small Finance Banks but excluding Regional Rural Banks and Payments Banks)
- All Primary (Urban) Co-operative Banks
- All Non-Banking Financial Companies

Background and objective

The RBI has issued a circular on 30 September 2024, highlighting irregularities in practices followed by different Regulated Entities (REs) granting loan against pledge of gold and jewelry. RBI's comprehensive onsite review, pointed out glaring deficiencies such as lapses in due diligence process, credit appraisal, inadequate monitoring of LTV ratio, insufficient end-use monitoring, irregularities in auctioning process, etc.

The introduction of this Circular follows suite, given the recent cases of irregularities around gold loan business undertaken by financial institutions. Another reason for focusing on the gold loan portfolio of REs is the upsurge in the loans against gold jewelry (LAGJ) portfolio of the banks. As per RBI's press release on Sectoral Deployment of Bank Credit – August 2024 the LAGJ portfolio of banks has witnessed a growth of 69% between August 2022 to August 2024.

LAGJ portfolio (amt in crores)



[Source: RBI's press release on Sectoral Deployment of Bank Credit – August 2024]

The increased demand for gold loans calls for robust governance and fair processes. The regulated entities are expected to implement remedial measures and report their actions within a three-month timeframe. Non-compliance to this requirement may potentially invoking severe regulatory repercussions.

Deficiencies observed and potential remedial actions

1. Loans granted through partnership with Fintech entities / business correspondents (BC):

Banks engage with BCs for procuring multitude of banking and financial services such as KYC checks, processing of loan application, monitoring, recovery. Similarly, banks can may also partner with fintech entities for sourcing borrowers, in compliance with the Guidelines on Digital Lending.

In a BC or partnership model, several deficiencies have been observed by RBI:

- Deficiency:** Valuation of gold being carried out in the absence of customer
Remedial action: As per para 2.3.11 of the Master Circular – Loans and Advances – Statutory and Other Restrictions, July 1, 2015, the practice of valuation of gold ornaments and jewelry must be standardised and transparent to borrowers. Banks must ensure that valuation is carried out fairly and in the presence of the borrower. While external evaluators may be engaged, transparency must be ensured in the valuation process.
- Deficiency:** Credit appraisal and valuation done by the BC
Remedial action: Credit appraisal is a decision-making function that cannot be outsourced; thus, it must be carried out by the bank. Regarding the valuation aspect, as mentioned above, this is usually carried out by external evaluators, which is required owing to requirement of a specific skillset. The intent of the regulation is to ensure core decision making lies with the regulated entity.
- Deficiency:** Gold stored in the custody of BC
Remedial action: Banks are required to store the pledged packets in safety vaults at their branches or centralised vaults. Suitable arrangements and internal controls must be ensured at the location of the vault for safe storage of pledged packets.



- d. **Deficiency:** Delayed and unsafe mode of transportation of gold to the branch

Remedial action: There must not be any delay in transfer of gold to the branch and the same must be done via secured mode of transportation. In-transit insurance for the packets must be done.

- e. **Deficiency:** KYC compliance being done through Fintechs

Remedial action: As per para 14 of the Master Directions on KYC, 2016, REs can rely on CDD done by a third party, subject to conditions mentioned therein. However, it must be ensured that decision making function resides within the bank.

- f. **Deficiency:** Usage of internal accounts for disbursement as well as repayment of loans as routing or pass-through account

Remedial action: This stems from the compliance requirement under Guidelines on Digital Lending. As per para 3, banks must ensure that the flow of funds is between its account and borrower's account. There must not be any routing or pass-through account of third party.

2. Absence of system for LTV monitoring:

Discrepancy: Lack of robust system for periodical LTV monitoring. Alerts generated, wherever available, are not pursued actively.

Remedial action: As per para 2.3.11 of the Master Circular – Loans and Advances – Statutory and Other Restrictions, July 1, 2015, LTV ratio of 75% must be maintained while granting loan against gold. Further, LTV ratio of 75% must be ensured at all times during the tenure of the loan.

To illustrate this: Against the value of Rs. 1,00,000 of gold, Rs. 75,000 loan can be given (loan being 75% of the value of the collateral). If the value of the gold decreases to Rs. 75,000, the LTV will increase to 100%. Additional collateral will have to be given by the customer in such a case.

Thus, monitoring of LTV is important to ensure there is no breach of the regulatory limit. There may be automated alert generation system before any possible breach of LTV ratio. System alerts may be proactively monitored and resolved.

3. Application of risk weights:

Discrepancy: Concern is around varied practices for application of risk weights.

Remedial action: Para 5.13.3 read with 7.3.4 provide for calculation of risk weight in case loans are secured by gold. Banks must ensure compliance with the said provisions for application of correct risk weights, as for banks, the pledge of “eligible collateral” is a permissible mode of credit risk mitigation.

4. Absence of end-use monitoring control:

Discrepancy: RBI has put forth concerns around absence of end-use monitoring of gold loan.

Remedial action: This is a potential challenge, as it is difficult to track the end-use. Gold loans are mostly obtained for personal use e.g. marriage, family exigency. This must be verified in conjunction with applicable LTV basis agricultural or non-agricultural use of funds.

Usually, a self-declaration is obtained from the borrowers mentioning the end-use as anticipated by them. In order to ensure monitoring around the end-use, banks may have risk categorisation parameters around the end use stipulated by the borrowers whereby end use like business or repayment can be given a high rating. Further, end-use monitoring may also be tested as a part of AML scenario.

5. Evergreening of loans and practice of rolling over:

Discrepancy: Absence of a specific identifier for top up gold loans in the Core Banking System / Loan Processing System with the SEs mostly to facilitate evergreening of loans. Absence of fresh appraisal done at the time of sanctioning these top up loans.

Remedial action: Evergreening may cause deferring of the repayment of the loans and NPA recognition. Banks must ensure that separate loan ID is created upon extending top up gold loan. Further, top up loans may be subject to fresh appraisal.

6. Loan account closure within short time from sanction:

Discrepancy: Closure of loan account in few days raising suspicion over the economic rationale for such action.

Remedial action: Closure of loan account within short duration from sanction date must be an AML scenario. System logics must be put in place for effective transaction monitoring.

7. Irregularities in gold loan auction:

Discrepancy: Average realisation from auction of gold on default by the customer is low in certain SEs than the estimated value of gold.

Remedial action: Valuation aspects must be strengthened, and auctions must be done in a fair and transparent manner.

8. Disbursement in cash:

Discrepancy: RBI observed that percentage share of gold loans disbursed in cash to total gold loans disbursed is high.

Remedial action: Banks must comply with section 269SS of the Income Tax Act, 1961. As per section 269SS, a person cannot accept a cash loan of Rs 20,000 or above i.e. banks must not disburse loan in cash more than Rs. 20,000 to a customer. Thus, it must be ensured that cash disbursements are limited to Rs. 20,000 per customer only. All the branch personnel must be made aware of the same.



9. Weak governance and transaction monitoring:

Discrepancy: RBI observed that there have been instances of weak governance leading to high number of gold loans being granted to same individual with the same PAN during a financial year.

Remedial action: Such instances must be closely monitored as a part of ML / TF monitoring. Banks must set a monthly / annual limit of disbursement per customer. Any transaction beyond the threshold must trigger enhanced monitoring from ML / TF perspective.

10. Non categorisation of gold loans as NPA:

Discrepancy: Instances of non-categorisation of gold loans as NPA in the system, evergreening by renewing overdue loans/issuing a fresh loan, inadequate monitoring by Senior Management/ Board and inadequate or absence of controls over third-party entities.

Remedial action: As called out above, evergreening of loans contribute to deferred NPA recognition in the system. The Board / Senior Management must closely monitor the gold loan portfolio of the Company to ensure there is proper NPA management. The concern may not just be specific to gold loans per se but may be prevalent in other loan products as well. Hence banks must put in place identification and monitoring measures especially from evergreening and subsequently from NPA identification and treatment standpoint.

Impact assessment

Banks and other REs are required to address the irregularities observed by RBI and provide a report to the Senior Supervisory Manager (SSM) of Reserve Bank within three months of the date of the Circular.

The broad actionable emanating would be as under:

1. Revisiting the practice of carrying out valuation of gold, storage of gold within branch/central vaulting units, etc.
2. Reviewing the activities that have been outsourced, falling under loan origination and credit appraisal and ensure that core decision-making activities are not outsourced.
3. Ensuring fund flow to be directly between borrower and lender, for instances of loan sourced through third party.
4. Strengthening the mechanism in place for LTV monitoring.
5. Enhancing the system alerts and action to be taken to cover critical areas and having appropriate documentation and implementation guidance to the same.
6. Revisiting the transaction monitoring scenarios, to include end-use of gold loan, high value of loan disbursed in a single day to a single customer and closure of loan accounts within few days from sanction date, etc.
7. Monitoring mechanism to be implemented or strengthened around renewal of gold loan to ensure top up loans are with new loan ID.
8. Establishing limits around cash disbursement and sensitisation of the same to branch personnel in the form of guidance notes, memos or trainings.

While the system level controls would take time to be implemented, steps towards the same should be initiated.





02

Impact assessment of regulatory changes in October 2024



Draft Circular on forms of business and prudential regulation for investments

RBI/2024-25/DOR.RAUG.AUT.REC.No./24.01.041/2024-25 ("Draft Circular")

Release date: 4 October 2024

Applicability

- Scheduled Commercial Banks (excluding Regional Rural Banks)
- All Non-Banking Financial Companies (including HFCs) that are group entities of SCBs
- Non-Operative Financial Holding Companies

Background and objective

The Draft Circular aims to amend the Master Direction – Reserve Bank of India (Financial Services provided by Banks) Directions, 2016 ("Master Direction"). The Master Direction outlines the activities that a bank can undertake, either independently or through its subsidiaries, and establishes investment norms.

The Draft Circular has been released for public comments. Some of the proposed amendments will take effect from the date of the final circular, while others will come into force two years thereafter.

Proposed changes

a. No overlapping of permitted business:

This requirement is put forth to ensure that there is no overlap between products offered by the bank and its group entities, particularly in lending activities. It emphasises that only one entity within a banking group can undertake a specific form of permissible business. Banks although, are allowed to engage in certain businesses such as factoring, primary dealership, and credit card operations either departmentally or through a separate group entity, subject to the conditions laid down in the precursor Master Direction.

b. Certain activities to be exclusively conducted by subsidiaries and not by bank departments:

These activities include mutual fund operations, insurance services, pension fund management, investment advisory services, portfolio management, and brokerage services, along with other risk-sharing activities that necessitate ring-fencing. While mutual fund operations and insurance services, as well as pension fund management, investment advisory services, portfolio management, and brokerage services for the commodity derivatives segment are included in the Master Directions, the draft circular highlights other activities tagged as "risk-sharing activities that require ring-fencing." The intent is to separate the bank's core business from any other form of business that may lead to potential compliance arbitrage.

c. Investments requiring prior approval of RBI – aggregate investment to be considered:

According to the Master Directions, a bank can invest more than 10% in the paid-up capital of a non-financial services company or Category I/II AIF with prior approval from the RBI. The proposed amendment increases this threshold to 20%, requiring prior approval from the RBI for investments made individually by the bank or by the bank group. This means that even if the bank itself has no investment in a non-financial services company or Category I/II AIF, prior approval from the RBI will be required if the bank group proposes to invest 20% or more in the paid-up capital of these entities.

d. Statutory limit of 30% of investee capital to include group company investments:

A significant provision of the Banking Regulation Act, 1949 [Section 19(2)] limits a bank's ownership to not more than 30% of an investee's equity capital. This limit will now encompass shares held by group companies as well.

e. Group-wide capital management policy:

The banking group is required to establish a comprehensive capital management policy that covers the entire group, detailing associated risks and outlining capital requirements.

Impact assessment

The proposed changes are clearly intended to eliminate any potential for regulatory arbitrage. Currently, several Indian banks have NBFCs that engage in activities similar to those of the banks themselves. In certain situations, such as obtaining loans secured by shares, the more flexible lending regulations applicable to Non-Banking Financial Companies (NBFCs) position them as a favoured option for financing equity investments, particularly for group holding companies. Additionally, NBFCs are not subject to the statutory ownership limit of 30% concerning pledges or mortgages of the investee company's capital. However, this level of flexibility is expected to face upcoming restrictions.

If the final circular is implemented in its current form, banks will be required to undergo significant restructuring to comply with the guidelines. Once notified, banks will have a two-year timeframe to comply with the key provisions. Banks will be required to report their as-is compliance status and summaries their plans to align with the new framework within two months from the date of the final circular.



Internal Risk Assessment guidance for money laundering/terrorist financing risks

'The Internal Risk Assessment Guidance for Money Laundering/ Terrorist Financing' ('Guidance Note')

Release date: 10 October 2024

Applicability

This Guidance Note applies to all REs regulated by the RBI, including banks, NBFCs, authorised persons, and payment system operators. It provides guidance to REs in their risk assessment and compliance efforts and aids in developing an internally robust RBA by outlining broad principles and methodologies.

Background and objective

On October 10, 2024, the Reserve Bank of India (RBI) issued a Guidance Note titled "The Internal Risk Assessment Guidance for Money Laundering/Terrorist Financing" (the "Guidance Note"). This document applies to all Regulated Entities (REs) of the RBI. As per the Master Direction on KYC, 2016, and its amendments, REs must periodically conduct a 'Money Laundering and Terrorist Financing Risk Assessment' to identify, assess, and mitigate risks related to Money Laundering (ML), Terrorist Financing (TF), and Proliferation Financing (PF).

The Guidance Note is designed for operational staff and AML/CFT/CPF practitioners within REs, aiming to enhance compliance and strengthen the financial sector's ability to detect and prevent ML/TF/PF activities by providing key principles and methodologies.

The Guidance Note is structured into three chapters:

- Chapter 1:** Introduction, applicability, and key principles for conducting an Internal Risk Assessment (IRA).
- Chapter 2:** Methodology, risk factors, assigning weights to risk factors and sub-risk factors, risk classification, internal controls, and residual risk.
- Chapter 3:** Communication of IRA results, follow-up actions, risk mitigation plans, and incorporation of proliferation financing risk in the IRA.

Summary of the chapters

Chapter 1

Foundation of internal risk assessment

This chapter discusses the evolving business environment, the introduction of new technologies and players in the financial sector, and the complexities of banking and financial

products, which increase exposure to ML/TF/PF risks. REs are mandated to follow the processes and procedures outlined in the PML Act, 2002, PML Rules, 2005, WMD Act, 2005, UAP Act, 1967, and other relevant government orders and directions. Under section 5A of the Master Direction on KYC, 2016, REs must periodically conduct an ML and TF Risk Assessment to evaluate and mitigate risks associated with ML/TF activities.

A Risk-Based Approach (RBA) is essential for managing ML/TF risks, as required by various regulatory frameworks. Effective risk management involves identifying and analyzing ML/TF risks within the bank and implementing policies and procedures that are proportionate to the identified risks.

Key principles for an internal risk assessment (IRA) exercise:

A. Dual-level IRA for ML/TF risks:

- **Business-level IRA:** The ML/TF/PF risks are linked to the type, size, and complexity of the business. Therefore, the IRA should be proportionate to these factors.
- **Individual-level IRA:** The ML/TF/PF risks are associated with establishing business relationships with customers or conducting occasional transactions for walk-in customers. When identifying risks, REs should consider relevant factors such as the customer's identity, country, specific products, services, transactions, and the channels used to deliver these products/services/transactions. Customers should be categorised into high, medium, or low-risk categories.

B. Regulated Entities (REs) should use Individual Risk Assessments (IRA) to set the level of Customer Due Diligence (CDD) based on specific situations and customer types. The results of these assessments should inform the overall business-level IRA, adjusting risk weights accordingly. High-risk customers should lead to higher risk weights, while low-risk customers should result in lower weights. Comparing client risk profiles with incidents of money laundering (ML), terrorist financing (TF), or proliferation financing (PF) can help refine this process.

C. Each risk assessment level should consist of two distinct but related steps:

- the identification of ML/TF risk factors; and
- the assessment of ML/TF risk and its impact.

D. Regulated Entities (REs) should consider the following factors while performing the IRA:



- **Inherent risk factors:** Inherent risk factors include the nature, scale, diversity, and complexity of the business; customer profiles; type of on-boarding (face-to-face or non-face-to-face); type of customer (individual, legal entity, or trust); products and services offered (e.g., cash-intensive, digital, cross-border remittances); transparency of beneficial ownership and source of funds; risks from new technology and payment methods; and the volume and size of transactions relative to usual activity and customer profiles.
- **Control risk types:** Control risk types include the ability to obtain necessary information for wire transfers, exposure to high-risk jurisdictions (e.g., those with high corruption or weak AML/CFT controls), distribution channels (e.g., ATMs, mobile apps), reliance on outsourcing and third parties, internal audit and regulatory findings, clientele with relaxed due diligence, and patterns of small transactions across different products.

E. Regulated entities (REs) should use both internal and external sources for the Individual Risk Assessment (IRA). Internal sources include data from various business verticals (e.g., fraud, cyber, IT risk management) and the RE's own assessments of threats, vulnerabilities, and future business plans. External sources include the National Risk Assessment (NRA) report, publications from international organisations like FATF, guidance from government authorities and the Reserve Bank, inputs from major events and market trends, research reports, law enforcement databases, and open-source intelligence such as news articles and market inputs.

F. To effectively understand products/services and their associated ML/TF risks, the IRA team should include officials from various departments such as product/service owners, internal audit, and compliance. Avoid a siloed approach where only the AML team is involved in the IRA exercise.

G. REs should adopt a data-oriented approach to avoid bias in the IRA exercise, ensuring high-quality data inputs for meaningful results. However, qualitative inputs and expert judgments are also important for a comprehensive assessment, including Type II errors. Interviewing product owners from other departments can provide deeper insights into products and associated risks.

H. The IRA exercise should include a group-wide assessment to address risks through unified policies and programs, as required by KYC regulations. Further, when addressing ML/TF risks in the IRA exercise, REs should also consider related risks like fraud and cyber fraud where relevant. REs should also assess residual ML/TF risk by considering inherent risk levels, control quality, and risk mitigation factors for their business and individual transactions. It also ensure the integrity of critical ML/TF risk management processes like CDD, transaction monitoring, sanction screening, alert management, and reporting.

I. When assessing TF risks, REs should note that TF funds can come from both legal and illegal sources, aim to facilitate terrorism, and often involve small transactions, which pose higher risks compared to ML. The IRA exercise should document, maintain, and communicate the methodology to relevant stakeholders, and make it available to authorities if required.

J. The IRA report should provide a comprehensive view for stakeholders, including a brief profile of the RE, an executive summary, ML/TF threats, assessed risks and vulnerabilities, assessment methodology, risk factors, applied controls, identified residual risks, outcomes, proposed mitigating measures, enforcement actions from the past five years, internal audit findings, and relevant case studies or illustrations. The results of the IRA exercise should be presented to the Board or a designated committee. They should be given enough additional information to understand and evaluate the findings.

K. REs should periodically review the IRA, especially when there are changes in business activities or new threats emerge. They can set internal triggers for these reviews, such as launching new products, expanding into new areas, receiving government reports, or noting regulatory observations.

REs must have systems to identify and assess emerging ML/TF risks, incorporating them into their risk assessments promptly. These risks can be identified through various sources, including FATF reports, FIU-INDIA, LEA alerts, UNSC resolutions, industry information, and credible sources.

An IRA that lacks detail or specificity regarding the RE's functions and associated risks may fail to achieve its objectives.

Chapter 2

Methodology and quantification of ML/TF risk assessment and control measures

A. Methodology:

There are various ways to conduct the IRA exercise by a RE. The most common approaches internationally is a 'conventional or standard methodology'. The first step is to identify the inherent risks, the second step is to determine that the 'internal controls' are sufficient or not to mitigate the Inherent risks, and the third step is to establish the residual risk that remains after applying the risk mitigants.

Broad steps of this methodology are summarised as under:

a. Define Risk Factors (RF) and Sub-Risk Factors (SRF):

- Examples of RFs: customer risk, geographic risk, product/service/transaction risk, delivery risk.
- Examples of SRFs under customer risk: type of customer, complexity of ownership, occupation, PEP status.

b. Data collection: Gather data on the identified RFs and SRFs.

c. Assign weights: Weigh RFs and SRFs based on their contribution to overall ML/TF/PF risk.

d. Map inherent risk levels: Categorise the weighted inherent risk scores into risk levels (High, Medium, Low).

e. Identify control factors (CFs): Define CFs that mitigate the inherent risks (e.g., policies, procedures, approval processes).

f. Assign weightage to CFs: Weigh CFs based on their effectiveness in mitigating risks.

g. Calculate residual risk:

- Apply the strength of control measures to the inherent risk level to determine residual risk.
- Use a residual risk matrix to derive enterprise-wide residual risk.

h. Remediation plan: Develop a plan to address and mitigate the identified residual risks.

**B. Risk factors:**

There are certain risk factors that Reporting Entities (REs) may consider in their Inherent Risk Assessment (IRA) exercise, such as

Type of Customer, Complexity of Ownership, Occupation/Industry, Politically Exposed Person (PEP) Status, Independent Information Sources, Countries and Geographical Areas, Products, Services and Transactions Risk Factors, Delivery Channel Risk Factors, and Other Risk Factors such as Outcomes of sectoral risk assessment and NRA, Planned introduction of new products/services AML compliance employees turnover etc. These factors help REs assess the risk associated with their customers and their beneficial owners.

C. Assigning weights to the risk factors and sub-risk factors:

- Reporting Entities (REs) can assign weights to risk factors (RFs) and sub-risk factors (SRFs) in their Inherent Risk Assessment (IRA) exercise such as Assigning Weights to SRFs, Assigning Weights to RFs, Differentiating Weights within RFs. This approach allows REs to tailor their risk assessments to their unique risk profiles and operational contexts.
- The relationship between the weight (W_i) and the score (S_{SRFi}) assigned to sub-risk factors (SRFs) in an Inherent Risk Assessment (IRA) exercise:
- Weight (W_i): Reflects the overall contribution of a sub-risk factor (SRFi) to the risk factor (RFa). It is based on the general assessment of the risk posed by the SRFi.
- Score (S_{SRFi}): Indicates the specific risk level of the SRFi for the RE. It can be low even if the weight is high.

For example, the “complexity of customer’s ownership” might have a high weight due to its potential risk contribution, but if only a small fraction of the customer base has complex ownership structures, the score might be low. This distinction allows REs to accurately reflect both the potential impact and the actual occurrence of risks in their assessments.

- When assigning weights to the risk factors, REs should ensure that a Balanced Weighting, High-Risk Classification, Override Mechanism, Regulatory Views should be considered to ensure a comprehensive and balanced risk assessment process.
- Where the REs are using external party/vendor for conducting IRA or uses an IT System/models to allocate the risk scores, they should have a clear understanding of the system, It should align with the REs risk understanding, it should demonstrate that the risk scores are appropriate and justified.

D. Risk classification:

REs while categorising the risk factors should use the following factors such as Categorise Risks at Various Levels, Generate Weighted Scores, Depend on Business Nature and Size, Use Appropriate Scales, Categorise Business Lines and Relationships. This ensures a structured and comprehensive approach to risk management.

E. Internal controls:

The Internal controls shall include a Governance and assurance function, Integrity of staff and compliance culture, Policies and procedures, KYC/ due diligence, Monitoring and controls, Ongoing monitoring, AML Unit/ Team, Suspicious

transaction reporting, Screening of sanctions lists, independent testing/ model validations/ audit, Record keeping/retention and Training of the staff members. The REs should document the process of identifying and evaluate the risk mitigants, classify effectiveness, and assign weights, this ensures a structured approach to managing and mitigating risks. The control factors are weighted and evaluated in the context of internal controls for mitigating ML/TF risks, should include Assign Weights to Control Factors, Determine Contribution,

Overall Effectiveness, this approach helps ensure that the most critical controls are prioritised and their effectiveness accurately assessed.

F. Residual risk

Residual Risk is the risk that remains after internal controls are applied to the inherent risks. This comes after evaluation of the overall inherent risks score and the overall effectiveness of internal controls. The residual risk indicates that the ML/TF risks within the RE are being managed adequately and effectively. REs may determine the scaling, such as high, moderate and low or alternatively as low, moderate low, moderate, moderate high and high. A residual risk matrix can be used to map inherent risks scores against control scores, and to lower such risks REs can either reduce inherent risk factors or strengthen AML/ACFT controls. This approach helps ensure that ML/TF risks are managed adequately.

Chapter 3:**A. Communication of IRA results**

The REs should communicate the result of the IRA to its Board as required under the MD on KYC, and should also be communicated to other stakeholders within the RE and business verticals, as the RE may deem appropriate to take action on the IRA exercise outcome.

B. Follow-up actions/Risk mitigation plan

Post completion of the IRA exercise, REs should act on priority areas, gaps, and deficiencies identified during the IRA, Consider residual risk in the context of the RE’s risk appetite, legal/regulatory obligations, and strategic/tactical measures, Develop a plan to reduce residual risks by lowering inherent risks and enhancing controls, Ensure strong support from senior management and relevant stakeholders.

Based on the severity of identified issues, consider conducting the next IRA review earlier than scheduled. This ensures continuous improvement in managing ML/TF risks.

C. Incorporation of proliferation financing risk in IRA

Proliferation financing risks arise from potential breaches or evasion of targeted financial sanctions. REs should have robust policies to comply with legal and regulatory requirements, incorporating best international practices and FATF standards. This includes conducting appropriate proliferation financing risk assessments and integrating these into their internal ML/TF risk assessments, ensuring effective mitigation measures. Compliance with section 12A of the WMD Act 2005 and related Government Orders is essential, with further guidance available from FATF’s June 2021 document on Proliferation Financing Risk Assessment and Mitigation.



03

Impact assessment of regulatory changes in November 2024



Amendment to the Master Direction – Know Your Customer (KYC) Direction, 2016

RBI/2024-2025/87 DOR.AML.REC. 49 /14.01.001/2024-25 (“Amendment Circular”)

Release date: 6 November 2024

Applicability

Applicable to all Regulated Entities (“REs”)

Background and objective

The Prevention of Money Laundering (Maintenance of Records) Rules, 2015 was amended vide Gazette Notification dated July 19, 2024. Since KYC Directions has its genesis from the PMLA Act and Rules, amendment has been made in the KYC Master Directions, 2016 (“KYC Directions”) to reflect the changes.

Key changes

a. Customer Due Diligence (CDD) at UCIC level:

The Master Directions already specify that the CDD has to be performed at the UCIC level. If an existing customer comes for a top-up loan or for opening another account, fresh CDD is not required to be carried out.

The Amendment Circular further specifies that if a customer desires to obtain any other product or service from the same RE, fresh CDD will not be required.

b. Onboarding and customer verification from Central KYC Records Registry (CKYCR):

Whenever the RE uses CKYC number of a customer to download information from the CKYCR, it may rely on such KYC information and may not obtain OVDs from the customer, unless:

- there is a change in the information of the customer as existing in the records of CKYCR - *this is an existing requirement*; or
- the KYC record or information retrieved is incomplete or is not as per the current applicable KYC norms - *this has been added by the Amendment Circular*; or
- the validity period of downloaded documents has lapsed - *this is an existing requirement*; or
- the RE considers it necessary in order to verify the identity or address (including current address) of the customer, or to perform enhanced due diligence or to build an appropriate risk profile of the customer - *this is an existing requirement*

c. Sharing information with the CKYCR:

- At the time of periodic updation / whenever customer updates the RE of any change in their KYC information, the RE will be required to provide updated KYC information to the CKYCR within 7 days of such updation.
- Further, CKYCR shall inform the REs regarding updation of KYC records of a particular customer. Once update is received from CKYCR, the REs will be required to retrieve the updated KYC records from CKYCR and update the KYC record maintained by it.

Impact assessment

While some of the changes are clarificatory in nature and do not require the REs to make significant changes in their systems. However, one important change is that whenever REs receive updated KYC information from CKYCR with respect to a particular customer, the REs are required to download the KYC information and to ensure that they update their own records in regard to that customer.





04

Other notifications in September



Other notifications: September 2024

Interest Equalisation Scheme (IES) on Pre and Post Shipment Rupee Export Credit

[Release date -20 September 2024]

RBI has through this circular granted extension of the Interest Equalisation Scheme for Pre and Post Shipment Rupee Export Credit ("Scheme") from September 1, 2024 to September 30, 2024.

Further, the circular has suggested below modifications to the Scheme:

- Extension applicable only for MSME manufacturer exporters
- Annual net subvention amount capped at Rs. 10 Cr. per Importer Exporter Code (IEC) for given financial year
- For non-MSME manufacturer exporters and merchant exporters, cap shall be Rs. 2.5 cr per IEC till June 30, 2024.

Implementation of Section 12A of the Weapons of Mass Destruction and their Delivery Systems (Prohibition of Unlawful Activities) Act, 2005: Designated List (Amendments)

[Release date - 19 September 2024]

RBI through this circular has instructed the Regulated Entities (REs), to strictly follow specific rules laid out in Master Direction on Know Your Customer (MD on KYC), last updated on January 04, 2024. It is mandated that REs ensure complete compliance with these updates. They are as follows:

Section 52 of the MD provides guidelines on implementing controls related to preventing illegal activities involving weapons of mass destruction.

Section 53 of the MD on KYC states that the REs must verify the list of specified sanctioned individuals and entities every day (UNSCR 1718) to ensure they are not doing business with the said restricted Individual and Entities.

The Ministry of External Affairs (MEA), has put forth the information regarding updates made to this list. The latest version of the list is available on the following URL:

<https://www.un.org/securitycouncil/sanctions/1718>

Liberalised Remittance Scheme (LRS) for Resident Individuals - Discontinuation of Reporting of monthly return

[Release date - 6 September 2024]

RBI vide this circular dated September 06, 2024, has discontinued the requirement of filing monthly return

(Return code : R089) by the AD Category - I Banks under the LRS Scheme.

Previously, the AD Category - I Banks were required to furnish information on the number of applications received and amount remitted under the LRS on a monthly basis in the CIMS portal. This requirement has now been dispensed with.

AD Category - I Banks are now only required to upload the transaction-wise information under the LRS daily return (Return code : R010) at the close of business hours of the next working day on CIMS portal. In case of no data is to be furnished, a NIL return shall be filed.

Review of Extant Instructions - Withdrawal of Circulars

[Release date - 02 September 2024]

The Reserve Bank of India (RBI) has conducted an internal review to remove outdated instructions and streamline existing guidelines. RBI vide notification dated September 02, 2024, has withdrawn certain circulars as a result of the review activity. The details can be referred at the following link:

<https://website.rbi.org.in/web/rbi/-/review-of-extant-instructions-withdrawal-of-circulars#AN1>





Other notifications: October 2024

Note Sorting Machines: Standards issued by the Bureau of Indian Standards

[Release date – 30 October 2024]

The Reserve bank of India (RBI) has issued circular dated October 30, 2024, to notify the effective date for compliance with standards published for Note Sorting Machines (NSM) – 'IS 18663: 2024' in the 'Gazette of India' as May 01, 2025. The banks must deploy only such NSM models that conform to the aforesaid Indian Standards and are duly certified by BIS.

RBI updates the Alert List of unauthorised forex trading platforms

[Release date – 22 October 2024]

The Reserve Bank of India vide notification dated October 22, 2024, updated the list of Alerts which contain names of entities which are not authorised to deal in forex under the Foreign Exchange Management Act, 1999 (FEMA) and also not authorised to operate electronic trading platform (ETP) for forex transactions. The detailed list can be referred to at: <https://website.rbi.org.in/web/rbi/-/press-releases/rbi-updates-the-alert-list-of-unauthorised-forex-trading-platforms-1>

Designation of one organisation under Section 35(1) (a) and 2(1) (m) of the Unlawful Activities (Prevention) Act, 1967 and its listing in the First Schedule of the Act- Reg.

[Release date – 19 October 2024]

The Reserve Bank of India (RBI) has instructed Regulated Entities (REs) to strictly adhere to Section 51 of the Master Direction on Know Your Customer (MD on KYC), last updated on January 4, 2024. These rules mandate compliance with Section 51A of the Unlawful Activities (Prevention) Act, 1967 (UAPA) and its amendments. REs must ensure they do not maintain accounts for individuals or entities listed under UAPA and report such accounts to FIU-IND, as well as notify the Ministry of Home Affairs (MHA) as required by the UAPA notification dated February 2, 2021. The MHA has declared "Hizb-Ut-Tahrir (HuT)" and all its manifestations and front organisations as terrorist organisations. REs are advised to take note of this designation and stay updated with any future amendments to Schedule I of the UAPA, 1967, for immediate compliance.

Reserve Bank of India (Access Criteria for NDS-OM) Directions, 2024

[Release date – 18 October 2024]

The Reserve Bank of India vide its notification dated October 18, 2024, has extended the access criteria for the Negotiated Dealing System-Order Matching (NDS-OM) electronic trading platform to a broader set of regulated entities and streamlined the process for seeking direct access. RBI has also amended the Direction "Reserve Bank of India (Access Criteria for NDS-OM) Directions, 2024" effective from the date

of notification. Detailed Directions can be referred to at: <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12742&Mode=0>

Facilitating accessibility to digital payment systems for Persons with Disabilities – Guidelines

[Release date – 11 October 2024]

The Reserve Bank of India, via its notification dated October 11, 2024, aims to promote effective access for Persons with Disabilities. Payment system participants (PSPs), including banks and authorised non-bank payment system providers, are advised to review their existing payment systems and devices for accessibility. Following this review, PSPs must make necessary modifications to ensure these systems and devices are easily accessible to persons with disabilities. PSPs may refer to the Accessibility Standards issued by the Ministry of Finance for this purpose.

PSPs are required to submit to the RBI, within one month of the date of this circular, details of the systems and devices that need modification, along with a time-bound action plan to achieve this. The action plan should be sent to the Department of Payment and Settlement Systems, Reserve Bank of India, at dpssfeedback@rbi.org.in, along with the contact details of a Nodal Officer for further queries or clarifications.

Implementation of Credit Information Reporting Mechanism subsequent to cancellation of license or Certificate of Registration

[Release date – 10 October 2024]

This directive applies to all Credit Institutions (CIs) whose licenses or Certificates of Registration (CoR) have been cancelled by the Reserve Bank of India (RBI), including commercial banks, co-operative banks, non-banking financial companies (NBFCs), asset reconstruction companies, and credit information companies.

On October 10, 2024, the RBI issued a directive mandating a Credit Information Reporting Mechanism for entities with cancelled licenses or CoRs. This aims to address the hardship faced by borrowers whose repayment history is not updated due to the cancellation of their lending institution's license or CoR.

Under the Credit Information Companies (Regulation) Act, 2005 (CICRA), only CIs can furnish credit information to Credit Information Companies (CICs). When a CI's license or CoR is cancelled, it is no longer considered a CI, and its credit information cannot be accepted by CICs. To mitigate this issue, the RBI has directed CICs and CIs to continue reporting credit information of borrowers onboarded prior to the cancellation until the loan lifecycle is completed or the institution is wound up.



Other notifications: October 2024

This directive ensures that borrowers' credit histories remain accurate and up-to-date, even if their lending institution's license is cancelled. It provides a safety net for borrowers, ensuring their repayment efforts are recognised and recorded, positively impacting their creditworthiness. This measure is expected to enhance transparency and trust in the credit reporting system, benefiting both borrowers and lenders.

Interest Equalisation Scheme (IES) on Pre and Post Shipment Rupee Export Credit

(Release date – 9 October 2024)

The Reserve Bank of India (RBI) has extended the Interest Equalisation Scheme (IES) for Pre and Post Shipment Rupee Export Credit until December 31, 2024. The extension follows a Trade Notice from the Government of India dated September 30, 2024. Total fiscal benefits for each MSME manufacturer exporter are capped at ₹50 lakhs for the financial year 2024-25. MSME manufacturer exporters who have already availed equalisation benefits of ₹50 lakhs or more by September 30, 2024, will not be eligible for further benefits during the extended period. All other terms and conditions of the scheme remain as is mentioned in RBI/2024-25/76 DOR.STR.REC.44/04.02.001/2024-25 dated September 20, 2024.

Due diligence in relation to non-resident guarantees availed by persons resident in India

(Release date – 4 October 2024)

This directive applies to all Category-I Authorised Dealer (AD) Banks in India. It specifically addresses guarantees (including Standby Letters of Credit [SBLCs] and performance guarantees) issued by non-residents in favour of persons resident in India.

The RBI has identified instances where non-resident guarantees provided to residents in India do not comply with existing FEMA regulations. To address this, AD Category-I banks are required to ensure that any guarantee contracts they advise or facilitate for their resident clients align with FEMA guidelines. Banks must also communicate the contents of this circular to their clients to enhance awareness and compliance.

Directions - Compounding of Contraventions under FEMA, 1999

(Release date – 1 October 2024)

The Reserve Bank of India's (RBI) circular on "Directions - Compounding of Contraventions under FEMA, 1999" provides guidelines for the compounding process of contraventions under the Foreign Exchange Management Act (FEMA), 1999.

The RBI is empowered to compound contraventions under FEMA. The authority to compound is delegated to various officers based on the amount involved in the contravention. Individuals or entities can apply for compounding by submitting an application along with a fee. The application must include details of the contravention and supporting documents. The compounding process involves the examination of the application, issuance of a compounding

order, and payment of the compounded amount. The RBI aims to complete the process within 180 days from the receipt of the application. Powers to compound certain contraventions have been delegated to the Regional Offices and Sub-Offices of the RBI to facilitate operational convenience. Authorised Dealers (AD) banks are required to report contraventions and ensure compliance with FEMA provisions to avoid penalties.

E-mandate Authentication through Simplified Aadhaar

(Release date – 20 October 2024)

NPCI has by way of this Circular, introduced simplified Aadhaar mandate, whereby mandate with value up to Rs. 15,000 can be registered without the requirement of Aadhaar based authentication. The simplified Aadhaar mandate will only require OTP validation on the registered mobile number of the user. Where the mandate value is above 15,000 and up to Rs. 1 cr, the existing process of obtaining UIDAI authentication shall continue to apply.

Further, both the simplified Aadhaar mandate and Aadhaar based mandate will require the banks to validate that the given Aadhaar number is linked to the account number of the user in which mandate is registered.

The immediate actionable will be to take note of the change and ensure the same is disseminated within the organisation. The process in this respect has been provided as an annexure to the Circular.

Review of guidelines on the number of posts of CGMs/GMs/DGMs/AGMs

(Release date – 20 October 2024)

The Department of Financial Services has proposed increasing the number of Chief General Managers (CGMs) in public sector banks due to their improved business performance and profitability. The current guideline of one CGM for every four General Managers (GMs) is under review, with a suggestion to give more autonomy to bank boards to determine the number of posts based on their needs. The number of CGMs, GMs, DGMs & AGMs for different banks is also mentioned in the notification.



Other notifications: November 2024

Cash retraction facility in ATMs to address shutter overlay frauds

(Release date – 4 November 2024)

The communication addresses the implementation of a cash retraction facility in ATMs to combat shutter overlay frauds, following a rise in such incidents reported by member banks. Initially, the NPCI advised disabling this feature to prevent fraud, but discussions in the NFS Steering Committee revealed the need for a solution. The RBI has now permitted banks to implement cash retraction measures based on their risk management processes, emphasising customer awareness and adherence to transaction dispute protocols. Members of National Financial Switch are urged to share this information with relevant departments to ensure proper handling of customer disputes related to cash retraction incidents.

'Fully Accessible Route' for Investment by Non-residents in Government Securities – Inclusion of Sovereign Green Bonds

(Release date – 7 November 2024)

The Reserve Bank of India (RBI) vide notification dated November 07, 2024, has designated 'Sovereign Green Bonds' of 10-year tenor issued by the Government in the second half of the fiscal year 2024-25 as 'specified securities' under the Fully Accessible Route.

Reporting of Foreign Exchange Transactions to Trade Repository

(Release date – 8 November 2024)

The Reserve Bank of India (RBI) vide notification dated November 08, 2024, has expanded the reporting requirement of All Authorised Dealers to include in the reporting foreign exchange spot (including value cash and value tom) deals in a phased manner. Hence, transactions in the following foreign exchange contracts involving INR or otherwise shall now be reported to the Trade Repository (TR) of Clearing Corporation of India Ltd. (CCIL):

- (a) foreign exchange cash;
- (b) foreign exchange tom; and
- (c) foreign exchange spot.

Operational framework for reclassification of Foreign Portfolio Investment to Foreign Direct Investment (FDI)

(Release date – 11 November 2024)

The Reserve Bank of India (RBI) has issued a circular dated November 11, 2024, addressing all Category - I Authorised Dealer Banks, drawing the attention of the said Banks towards Schedule II of the FEM (NDI) Rules, 2019, which prescribes that investment made by Foreign Portfolio Investor (FPI) along with its investor group shall be less than 10% of the total paid-up equity paid-up capital on fully diluted basis.

In case of breach of said limit the FPI's have the option to divest their holdings or reclassify them as FDI. An operational framework has been introduced by RBI through this circular for reclassification of investments by FPI into FDI. The said Banks are asked to facilitate the reporting of such transactions as per the said framework.

Introduction of new transaction code and product code for processing DBT transactions of government departments

(Release date – 16 November 2024)

NPCI has by way of this circular introduced new product type for APB and ACH, for processing DBT transactions of government departments:

1. APBS: Transaction code '95' with header code as '77'
2. ACH: Product type 'DBG'

The State and Central Government departments shall be participating in NACH with RBI as sponsor bank for presenting the transaction. All NACH member banks are required to modify their existing systems to enable processing the said transaction. A session for facilitating these transactions is most likely to commence from Nov 23, 2024.

Implementation of AES Encryption in ONMAGS Application

(Release date – 18 November 2024)

NPCI is implementing the Advanced Encryption Standard (AES) as a mandatory encryption protocol within the ONMAGS application for all authentication modes for enhancing the data security and enhancing compliance with modern encryption standard.

Further, the banks and corporate who are ready with the new encryption mode can get certificate from NPCI to move for production on or before 31st January 2025. Non-compliance may lead to action which include discontinuation of the services to the participants that are non-compliant.

Changes in Rejection Code & description in NACH

(Release date – 27 November 2024)

This Circular intends to modify the description of a few rejection reasons codes of E-mandate in NACH and further add a few codes. This aims towards clear communication to the end users in understanding reasons for rejection of mandate and the corrective actions that they are required to take.

NPCI has advised to all NACH member banks to update the rejection codes along with the description into their systems to avoid discrepancy in receiving the mandate registration response. Banks should take possible measures to reduce the TD (not exceeding 0.5%).

The updated rejection codes and description must be implemented by all the Bank by January 1, 2025. The comprehensive list of updated rejection reason codes is provided in Annexure-1 to the Circular



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