GUIDELINE ANSWERS
JUNE 2024 EXAMINATION
BANKING –LAW & PRACTICE
MODULE 3 ELECTIVE PAPER 9.1
PROFESSIONAL PROGRAMME
(SYLLABUS 2017)

Question Paper Weblink	https://www.icsi.edu/media/webmodules/examination/june2024/441.pdf

Answer to Question No. 1(a)

A Vostro Account is an account that a domestic bank holds on behalf of a foreign bank. In this case, it allows the foreign bank to act as an agent or facilitator for its customers to receive money in Indian rupees from domestic banks. Vostro Accounts are typically used to facilitate international trade and remittance transactions.

Special Rupee Vostro Accounts are specifically tailored for trade settlements and other transactions denominated in Indian Rupees.

Yes, for opening of Special Rupee Vostro Account, prior approval of RBI would be required. The bank is willing to open Special Rupee Vostro Account for the bank of the partner country should have a good level of business resilience and financial health. Second, they need to have experience in facilitating trade/investment transactions and the capability to provide other financial services. Third, Authorized Dealer Banks should have good correspondent relationships with banks in partner countries.

The RBI issues guidelines detailing the procedures, documentation, and conditions for opening and operating Vostro accounts. Banks must adhere to these guidelines to ensure proper authorization and regulatory compliance. The RBI conducts a thorough review of the application and the accompanying documentation to ensure that the opening of the Vostro Account complies with Indian banking regulations, foreign exchange management laws, and Anti-Money Laundering (AML) standards. Based on the review, the RBI either grant or deny approval for opening the Vostro account. If approved, the domestic bank can proceed with the account opening and must ensure ongoing compliance with RBI regulations.

Answer to Question No. 1(b)

Correspondent Banking refers to a banking arrangement where one bank (the correspondent bank) provides services on behalf of another bank (the respondent bank) in a different location or country. This relationship allows banks to access various financial services and conduct transactions efficiently across different jurisdictions.
The Term Correspondent Banking relationship acts as an intermediary or agent, facilitating wire transfers, conducting business transactions, accepting deposits and gathering documents on behalf of another bank. Correspondent Banks are most likely to be used by domestic banks to service transactions that either originate or are completed in foreign countries.
Domestic Banks also use Correspondent Banks to gain access to foreign financial markets and to serve international clients without having to open branches abroad. The correspondent bank offers

a range of services to the respondent bank, including payment processing, foreign exchange, trade finance, and liquidity management. Services offered are clearing and settlement of payment transactions, Foreign Exchange, Trade Finance, Cash management etc. Correspondent banking relationships are subject to strict regulatory scrutiny, particularly regarding Anti-Money Laundering (AML), Combating the Financing of Terrorism (CFT), and sanctions compliance.

Answer to Question No. 1(c)

The Authorised Dealer Bank approaching the Reserve Bank of India for seeking approval for opening of Special Rupee Vostro Account must submit the following information along with their proposal/request:

(i) The details of the arrangement between Authorised Dealer Bank and correspondent bank from the trading partner country along with the funds flow.
(ii) A brief write-up on the foreign banks seeking correspondent relationship tor Special Rupee Vostro Account.
(iii) Copy of the request letter of the correspondent bank to Authorised Dealer Bank.
(iv) Confirmation from Authorised Dealer Bank that the due diligence has been carried out by Authorised Dealer Bank which establishes correspondent banking relationship as per RBI extant guidelines.
(v) Confirmation from Authorised Dealer Bank stating that the Correspondent Bank is not from a country or jurisdiction in the updated Financial Action Task Force (FATF) Public Statement on High Risk & Non-Co-operative jurisdictions on which Financial Action Task Force (FATF) has called for counter measures.
(vi) Confirmation from Authorised Dealer Bank that they shall ensure that all the transactions taking place in the Special Rupee Vostro Account of the correspondent bank are strictly in adherence to the instructions issued by Reserve Bank of India.
(vii) Financial parameters pertaining to the Correspondent Bank as required for the proposal may be obtained beforehand by email to *fedcotrade@rbi.org.in* and the same may be furnished by Authorised Dealer Bank along with the proposal.

Answer to Question No. 1(d)

The exchange rate for most currencies is determined in the Forex markets, typically against global currencies like the USD, EUR, JPY etc.

In the transition phase, when there is no market with direct exchange rates between two currencies (say INR and Sri Lankan Rupee), the exchange rate between the currencies of two trading partner countries, each of which has markets against global currencies, would be derived as a cross currency rate.

Answer to Question No. 1(e)

Yes, balances in a Special Rupee Vostro Account can be repatriated under certain conditions and with compliance to regulatory requirements.
The balance in Special Rupee Vostro Account (SRVA) can be repatriated in freely convertible currency and/or currency of the beneficiary trading partner country depending on underlying transaction i.e., for which the account was credited.
A Special Rupee Vostro Account is a specific type of Vostro account maintained by a domestic bank on behalf of a foreign bank. It is used primarily for facilitating trade settlements and other

transactions denominated in Indian Rupees (INR). These accounts are subject to regulatory oversight by the Reserve Bank of India (RBI) and must adhere to foreign exchange management regulations.

For example, for import payments through Special Rupee Vostro Account (SRVA) like any Rupee Vostro account the fund can be remitted to overseas exporter either in freely convertible currency or in domestic currency of the overseas exporter.
Balances in a Special Rupee Vostro Account can be repatriated to the foreign bank's home country to fulfil various purposes, such as:

- Settlement of trade transactions conducted in INR.
- Return of funds after completion of permissible transactions.
- Repayment of loans or investments made in compliance with Indian regulations.

Regulatory Compliance:

- Repatriation of funds from a Special Rupee Vostro Account must comply with RBI guidelines and foreign exchange management regulations.
- The foreign bank must provide documentation and justification for the repatriation, demonstrating that the funds originate from permissible transactions and comply with applicable laws.

The RBI may impose limits or restrictions on the repatriation of funds from Special Rupee Vostro Accounts, depending on prevailing foreign exchange regulations, economic conditions, and policy considerations.

Answer to Question No. 1(f)

Surplus balances of banks and financial institutions can be invested in various types of instruments and assets based on their risk appetite, liquidity needs, and regulatory constraints:

(i) *Government Securities:* Securities issued by the Government, such as Treasury Bills (T-Bills), Government Bonds, and State Development Loans (SDLs).
(ii) *Corporate Bonds:* Debt securities issued by corporations to raise capital.
(iii) *Certificate of Deposits (CDs):* Time deposits issued by banks and financial institutions with fixed maturities and interest rates.
(iv) *Money Market Instruments:* Short-term financial instruments like Commercial Papers (CPs), Treasury Bills (T-Bills), and Repurchase Agreements (Repos).
(v) *Equity Shares:* Ownership shares in publicly traded companies.
(vi) *Mutual Funds:* Investment vehicles that pool money from investors to invest in diversified portfolios of securities.
(vii) *Real Estate:* Direct investment in physical properties such as land, residential, commercial, or industrial properties.
(viii) *Bank Deposits:* Deposits placed with other banks or financial institutions, including term deposits and savings deposits.

Answer to Question No. 2(a)

In order to bring more clarity on the presentation of Reverse Repo Transactions Amount on the Bank's Balance Sheet, Reserve Bank of India on May 19, 2022 has issued an notification regarding reporting of reverse repos with Reserve Bank on the bank's balance sheet are as per the following guidelines to the Commercial Banks:

(i) All type of Reverse Repos with the Reserve Bank including those under Liquidity Adjustment Facility shall be presented under sub-item (ii) ‘In Other Accounts’ of item (II) ‘Balances with Reserve Bank of India’ under Schedule 6 ‘Cash and balances with Reserve Bank of India’.

(ii) Reverse Repos with Banks and other Institutions having original tenors up to and inclusive of 14 days shall be classified under item (ii) “Money at call and short notice” under Schedule 7 ‘Balances with banks and money at call and short notice'.

(iii) Reverse Repos with Banks and other institutions having original tenors more than 14 days shall be classified under Schedule 9 - ‘Advances’ under the following heads:

   i. A.(ii)‘Cash credits, over drafts and loans repayable on demand’.
   ii. B.(i)‘Secured by tangible assets.’
   iii. C.(I).(iii) Banks (iv)‘Others’ (as the case may be)

Answer to Question No. 2(b)

The Advantages of Future Contracts are:

(i) *Hedging against Exchange Rate Risk:* International transactions often involve dealing with multiple currencies. Exchange rate fluctuations can significantly impact the value of receivables and payables. Futures contracts allow firms to lock in exchange rates for future dates, thereby stabilizing their cash flows.

(ii) *Managing Commodity Price Risk:* Firms dealing with international trade in commodities (like oil, metals, and agricultural products) face the risk of price fluctuations. Futures contracts enable firms to lock in prices for future purchases or sales of commodities, thus protecting them against adverse price movements.

(iii) *Interest Rate Risk Management:* Firms with international financial transactions often face interest rate risk. Futures contracts on interest rates can be used to hedge against fluctuations, ensuring more predictable borrowing or investment costs.

(iv) *Speculation and Arbitrage Opportunities:* While the primary use of futures contracts is for hedging, firms can also engage in speculative activities to profit from their expectations of future price movements. This can provide an additional revenue stream.

(v) *Liquidity and Standardization:* Futures contracts are traded on exchanges with high liquidity, making it easy for firms to enter and exit positions.

(vi) *Cost Efficiency:* Compared to other financial instruments, futures contracts generally have lower transaction costs due to their standardized nature and the efficiency of the futures markets.

(vii) *Regulatory Oversight and Transparency:* Futures contracts are traded on regulated exchanges, providing a level of transparency and security that reduces counterparty risk.

Answer to Question No. 3(a)

According to the Basel Committee on Banking Supervision (BCBS) and adopted by various regulators including the Reserve Bank of India (RBI). A large exposure is defined as the sum of all exposures of a bank to a single counterparty or a group of connected counterparties that is equal to or exceeds 10% of the bank's eligible capital base (Tier 1 capital). The Reserve Bank of India (RBI) has adopted the Basel guidelines and issued detailed directives for Indian banks regarding large exposures, including definitions, limits, and reporting requirements.

Basel III Large Exposures Framework: Provides international guidelines for large exposures, focusing on measuring, controlling, and reporting large exposures to ensure banks maintain adequate diversification in their portfolios.

Single Counterparty Exposure: It refers to the total exposure a bank has to a single entity or individual. This includes all forms of on-balance sheet and off-balance sheet exposures, such as loans, advances, credit equivalents of derivatives, and investments. Banks must identify exposures that qualify as large exposures (≥10% of Tier 1 capital) and quantify these exposures accurately. The report should include detailed information on the counterparty, the nature and amount of the exposure, any collateral or guarantees, and the risk mitigation measures in place. Reporting is generally required on a quarterly basis, though it might be more frequent depending on specific regulatory requirements or the bank's internal policies.

Groups of Connected Counterparties: Entities that are economically linked or have relationships that could pose a higher risk of default due to their interconnectedness. The exposure to a group of connected counterparties is capped at 25% of the bank's eligible capital base (Tier 1 capital). For exposures to groups of connected counterparties engaged in infrastructure or core industries, the limit may be extended to 30% of the bank's eligible capital base. This extension acknowledges the strategic importance of these sectors.
By setting limits on exposures to these groups, the RBI aims to reduce the risk of significant losses arising from interconnected entities. Banks are required to identify, monitor, and report their exposures to connected counterparties, implementing robust risk management practices to ensure financial stability and compliance with regulatory standards.

The Large Exposure limits:

1. *Single Counterparty:* The sum of all the exposure values of a bank to a single counterparty must not be higher than 20 percent of the Bank's available eligible Capital Base at all times. In exceptional cases, Board of Banks may allow an Additional 5 percent exposure of the Bank's available Eligible Capital Base. Banks shall lay down a Board Approved Policy in this regard.
2. *Groups of Connected Counterparties:* The Sum of all the Exposure Values of a Bank to a Group of connected Counterparties must not be higher than 25 percent of the Bank's available eligible Capital Base at all times.
3. *Eligible Capital Base:* Typically refers to the bank's Tier 1 capital, which consists of the core capital including equity capital and disclosed reserves.

The Exposures must be measured as specified. It may be noted that the LE Limits will be modulated in case of certain counterparties. Any breach of the above Large Exposure (LE) limits shall be under exceptional conditions beyond the control of the Bank, shall be reported to RBI (DBS, CO) immediately and rapidly rectified. Under the Large Exposures Framework (LEF), the sun of all Exposure values of a Bank to a Counterparty or a Group of connected Counterparties is defined as a Large Exposure (LE), if it is equal to or above 10 percent of the Bank's eligible Capital Base (i.e., Tier 1 Capital).

Banks shall report their Large Exposures to the Reserve Bank of India (RBI), Department of Banking Supervision, Central Office, (DBS, CO), as per the reporting template. The reporting, inter-alia, will include the following:

i. All Exposures, measured as specified of this framework, with values equal to or above 10 percent of the Bank's eligible Capital (i.e., meeting the definition of a Large Exposure);

ii. All other Exposures, measured as specified of this framework without the effect of Credit Risk Mitigation (CRM), with values equal to or above 10 percent of the Bank's Eligible Capital Base;
iii. All the Exempted Exposures (Except Intraday Inter-Bank Exposures) with values Equal to or above 10 percent of the Bank's eligible Capital Base;
iv. 20 Largest Exposures included in the scope of application, ii respective of the values of these exposures relative to the Bank's eligible Capital Base.

Answer to Question No. 3(b)

The Prompt Corrective Action (PCA) Norm is a supervisory tool and is imposed when a bank breaches certain regulatory thresholds on Capital to Risk Weighted Assets Ratio (CRAR), Net NPAs and Return on Assets (RoA) etc. Prompt Corrective Action (PCA) is a framework under which Financial Institutions with Weak Financial Metrics are put under watch by the Reserve bank of India (RBI). Earlier, the RBI had imposed PCA only on Banks. Now, PCA framework is extended to NBFCs also.

RBI’s common menu for selection of Discretionary Corrective Actions' in respect of the following areas are:

(i) Governance related Actions:

(a) RBI to actively engage with the bank's Board on various aspects as considered appropriate.
(b) RBI to recommend to Owners (Government/ Promoters/ Parent of Foreign Bank Branch) to bring in New Management / Board.
(c) RBI to remove managerial persons under Section 36AA of the Banking Regulation Act, 1949 as applicable.
(d) RBI to supersede the Board under Section 36ACA of the Banking Regulation Act, 1949 / recommend supersession of the Board as applicable.
(e) RBI to require bank to invoke claw back and malus clauses and other actions as available in regulatory guidelines, and impose other restrictions or conditions permissible under the Banking Regulation Act, 1949.
(f) Impose restrictions on directors' or management compensation, as applicable.
(g) Strengthening the audit committee functions to ensure better internal controls and risk management.

(ii) Capital related Actions:

(a) Detailed Board level review of capital planning.
(b) Submission of plans and proposals for raising additional capital. Requiring the bank to bolster reserves through retained profits. Restriction on investment in subsidiaries/ associates.
(c) Restriction in expansion of high risk-weighted assets to conserve capital. Reduction in exposure to high-risk sectors to conserve capital.
(d) Restrictions on increasing stake in subsidiaries and other group companies.
(e) Adjusting the risk weights on certain assets to ensure better capital adequacy ratios.

(iii) Credit Risk related Actions:

(a) Preparation of time bound plan and commitment for reduction of stock of NPAs. Preparation of and commitment to plan for containing generation of fresh NPAs. Higher provisions for NPAs/NPIs and as part of the coverage regime.
(b) Strengthening of loan review mechanism.
(c) Restrictions/reduction in total credit risk weight density (example: restriction/reduction in credit for borrowers below certain rating grades, restriction/reduction in unsecured

exposures, etc.).

(d) Reduction in loan concentrations; in identified sectors, industries or borrowers.

(e) Sale of assets.

(f) Action plan for recovery of assets through identification of areas (geography wise, industry segment-wise, borrower-wise, etc.) and setting up of dedicated Recovery Task Forces, Adalats etc.

(g) Prohibition on expansion of credit/ investment portfolios other than investment in government securities / other High-Quality Liquid Investments.

(h) Intensifying efforts on the recovery of non-performing assets (NPAs) through legal and strategic measures.

Answer to Question No. 4(a)

Calculation of Yield Rate of Commercial Paper:

Face Value Rs. 6,00,000/-

Brokerage and other Charges - 4%.

Sale Price Rs. 5,70,000/-

Brokerage = 5,70,000X0.04 = 22,800

Adjusted Sales Price = 5,70,000+22,800 = 5,92,800

Maturity Period =120 days.

Yield = 6,00,000-5,92,800 = 7,200

$$\text{Yield Rate of Commercial Paper} = \frac{(\text{Face Value} - \text{Adjusted Sale Price})}{\text{Adjusted Sale Price}} \times \frac{360}{\text{Maturity Period}} \times 100$$

$$= \frac{(6,00,000-5,92,800)}{5,92,800} \times \frac{360}{120} \times 100$$

Therefore, the Yield Rate of Commercial Paper is 3.644%

Answer to Question No. 4(b)

The Banks rely on three Ratios while sanction Term Loans to know a viability of Business Firm. They are:

(i) *Leverage Ratio:* Leverage ratio is calculated by dividing Total Business Liabilities by Total Business Equity. Leverage Ratio over 4 to 1 would significantly reduce the chances of securing a Bank Term Loan. The Basic idea is that lender doesn't want to simply Borrow in order to grow the Business.

- A high leverage ratio indicates that a firm relies heavily on debt financing, which increases financial risk. Banks prefer firms with moderate leverage as it suggests a balance between debt and equity financing.
- This ratio helps assess a firm's long-term solvency and its ability to meet long-term obligations. A lower leverage ratio implies greater financial stability and lower default risk.
- It indicates the firm's capacity to take on additional debt. Firms with lower leverage are

often in a better position to obtain new loans as they have more room to accommodate new debt.

(ii) *Loan to Value Ratio (LTV):* Loan to Value Ratio is calculated by the Total amount of the loan divided by the appraised value of Collateral. Most Banks require the appraised value of Collateral to be higher than the loan amount. The lender is looking at this Ratio to see how much breathing room they have. If the business is to default on the loan and the bank ends up with the Collateral, the bank wants to make sure they can sell the collateral for a value high enough to recover the entire balance of the loan.

- A lower LTV ratio indicates that the loan is well-collateralized. It provides the bank with a buffer against potential declines in asset value, reducing the risk of loss if the borrower defaults.
- Higher LTV ratios are associated with higher credit risk as they suggest that the borrower has less equity in the asset. Banks typically prefer lower LTV ratios to minimize risk exposure.
- LTV ratios can influence the terms of the loan, including interest rates. Lower LTV ratios often qualify borrowers for more favorable loan terms and lower interest rates because the risk to the lender is lower.

(iii) *Debt Service Coverage Ratio (DSCR):* This Ratio is important when applying for a Term Loan. Calculate Debt Service Coverage Ratio by Dividing Annual Net Income by Annual Debt Service. Debt Service is a way of saying Term Loan Instalment Payments. This Ratio tells the lender, how many times could make the loan payment with Net Income. If firm could make the loan payment 10 times with firm Net Income each year, firm have plenty of Leverage. If only wake the loan payments 1.25 times per year, the bank is going to be nervous that if there is any negative downtrend with firm business, firm won't be able to make firm’s loan instalment payments.

- A higher DSCR indicates that the firm generates sufficient income to cover its debt payments, signifying strong repayment capacity. Banks typically look for a DSCR greater than 1, meaning the firm has more income than is required to service its debt.
- This ratio provides insight into the overall financial health and operational efficiency of the firm. It indicates whether the firm’s core business operations are profitable enough to support debt payments.
- A low DSCR suggests higher risk, as the firm may struggle to meet its debt obligations. This could lead to loan default. Banks use the DSCR to ensure that the firm’s cash flow is stable and sufficient to cover future debt payments.

Answer to Question No. 4(c)

The Service Providers are to comply with the following requirements of the Reserve Bank of India:

(i) Offline payments may be made using any channel or instrument like cards, wallets, mobile devices, etc.
(ii) Offline payments shall be wade in proximity (face to face) mode only.
(iii) Offline payment transactions may be offered without an Additional Factor of Authentication (AFA).
(iv) Payment instructions shall be enabled for offline transactions based on explicit consent of the customer. Such transactions using cards shall be allowed without a requirement to switch on the contactless transaction channel.
(v) The upper limit of an offline payment transaction shall be Rs.200. The total limit for off-

line transactions on a payment instrument shall be Rs.2,000 at any point in time. Replenishment of the used limit shall be allowed only in online mode with AFA.

(vi) The issuer shall send transaction alerts to users as soon as transaction details are received. There is no compulsion to send an alert for each transaction; however, details of each transaction shall be adequately conveyed.

(vii) The acquirer shall incur all liabilities arising out of technical or transaction security issues at merchant's end.

(viii) Offline payments shall be covered under the provisions of RBI's limited customer liability circulars of Master Direction on Prepaid Payment Instruments dated August 27, 2021.

(ix) The customers shall have recourse to the Reserve Bank-Integrated Ombudsman Scheme, as applicable, for grievance redressal.

(x) Reserve Bank retains the right to stop or modify the operations of any such payment solution that enables small value digital payments in offline mode.

Answer to Question No. 5(a)

(i) e₹ is a form of money, a digital representation of physical currency, whereas UPI or other fund transfer modes (NEFT/RTGS/IMPS) are forms of payment. Therefore, usage of e₹ is not limited to payments. e₹ also serves the purpose of 'unit of account' and importantly, 'Store of Value' as it represents a claim on the Reserve Bank's balance sheet. Moreover, e₹ will have additional attributes specific to currency which will be tested in future pilots by the Reserve Bank of India.

(3 Marks)

(ii) No, e₹ is digital form of currency notes and has intrinsic value as it represents a claim on the Reserve Bank's balance sheet. e₹ is issued by the Reserve Bank and is a legal tender. Crypto products such as bitcoin on the other hand do not exhibit any features of a currency, do not have any intrinsic value, are not backed by assets and are not issued by a central trusted authority, such as RBI.

The e-Rupee may use Distributed Ledger Technology (DLT) or traditional centralized databases, depending on the design chosen by the RBI. Bitcoin uses blockchain technology, a decentralized ledger that records all transactions across a network of computers.

The e₹ value is stable and directly linked to the fiat currency (the Indian Rupee). The e-Rupee is not subject to the same volatility as cryptocurrencies. Bitcoin's value is highly volatile, influenced by market demand, investor sentiment, regulatory news, and other factors.

Answer to Question No. 5(b)

(i) A remote and automated lending process, largely by use of seam less digital technologies for customer acquisition, credit assessment, loan approval, disbursement, recovery, and associated customer service.

Digital lending refers to the process of providing credit or loans through digital platforms and channels, utilizing technology to facilitate the entire lending lifecycle, from application to disbursement and repayment. This concept encompasses a variety of financial products and services offered by traditional banks, non-banking financial companies (NBFCs), and fintech firms. The regulatory framework for digital lending ensures that these activities are conducted in a transparent, secure, and fair manner, protecting both consumers and the financial system.

The regulatory framework for digital lending is designed to ensure that digital lending practices adhere to established financial standards, promote consumer protection, and maintain the integrity of the financial system

a. *Licensing and Registration:* Digital lending entities, whether traditional banks, NBFCs, or fintech firms, must obtain the necessary licenses and registrations from relevant regulatory authorities.
b. *Consumer Protection:* Regulations mandate clear disclosure of loan terms, interest rates, fees, and repayment schedules to borrowers.
c. *Fair Lending Practices:* Lenders must adhere to fair lending practices, avoiding predatory lending, discrimination, and unfair treatment of borrowers.
d. *Risk Management:* Digital lenders are required to implement robust risk management frameworks to handle credit, operational, and cybersecurity risks.
e. *Technology and Security Standards:* Regulations emphasize the use of secure and reliable technology platforms for digital lending operations.
f. *Transparency and Reporting:* Lenders must maintain transparency in their operations and provide regular reports to regulatory authorities.

(ii) The parts of a lending transaction that need to be digital or contactless in order to be called digital lending is subjective but must involve, at least to a significant extent, the use of digital technologies as part of lending processes involving customer procurement, credit assessment and loan approval, loan disbursement, loan repayment, and customer service., Financial Facilities typically covered under digital lending are Personal Loans, Consumer Loans, Small Business Loans, Credit Lines, Peer-to-Peer (P2P) Lending, Payday Loans, Education Loans.

Answer to Question No. 6(a)

Reserve Bank of India mandated Risk Based Internal Audit (RBIA) framework for the following Non-Banking Financial Companies (NBFCs), Primary (Urban) Co-operative Banks (UCBs) and Housing Finance Companies (HFCs):

(1) All deposit taking NBFCs, irrespective of their size;
(2) All non-deposit taking NBFCs (including Core Investment Companies) with asset size of Rs. 5,000 crore and above; and
(3) All UCBs having asset size of Rs. 500 crore and above

In addition to the above, Housing Finance Companies (HFCs) fulfil the following stipulations are also required to implement Risk Based Internal Audit (RBIA):

(1) All deposit taking HFCs, irrespective of their size
(2) Non-deposit taking HFCs with asset size of Rs. 5,000 crore and above.

Answer to Question No. 6(b)

Objectives and Scope of RBIA in NBFCs, UCBs and HFCs:

(i) An effective Risk-Based Internal Audit (RBIA) is an audit methodology that links an organisation's overall risk management framework and provides an assurance to the Board of Directors and the Senior Management on the quality and effectiveness of the organisation's internal controls, risk management and governance related systems and processes.
(ii) The internal audit function should broadly assess and contribute to the overall improvement of the organization's governance, risk management, and control processes using a systematic and disciplined approach. The function is an integral part of sound corporate

governance and is considered as the third line of defence.

(iii) Historically, the internal audit system in NBFCs / UCBs / HFCs has generally been concentrating on transaction testing, testing of accuracy and reliability of accounting records and financial reports, adherence to legal and regulatory requirements, etc. However, in the changing scenario, such testing by itself might not be sufficient. Therefore, Supervised Entities (SEs) will have to move towards a framework which will include, in addition to selective transaction testing, an evaluation of the risk management systems and control procedures in various areas of operations. This will also help in anticipating areas of potential risks and mitigating such risks.

(iv) While the Risk Management Function should focus on Identification, Measurement, Monitoring, and Management of Risks, Development of Risk Policies and Procedures, use of Risk Management Models, etc., RBIA should undertake an independent risk assessment for the purpose of formulating a risk-based audit plan which considers the inherent business risks emanating from an activity / location and the effectiveness of the control systems for monitoring such inherent risks.

Answer to Question No. 6(c)

The Board of Directors (the Board) / Audit Committee of Board (ACB) of NBFCs and the Board of UCBs are primarily responsible for overseeing the internal audit function in the organization. The RBIA policy shall be formulated with the approval of the Board and disseminated widely within the organization. The policy shall clearly document the purpose, authority, and responsibility of the internal audit activity, with a clear demarcation of the role and expectations from Risk Management Function and Risk Based Internal Audit Function. The policy should be consistent with the size and nature of the business undertaken, the complexity of operations and should factor in the key attributes of internal audit function relating to independence, objectivity, professional ethics, accountability, etc. The RBIA policy must be reviewed periodically.

The internal audit function shall be carried out effectively so as to ensure that it adds value to the organization. For the purpose, the ACB/Board shall approve a RBIA plan to determine the priorities of the internal audit function based on the level and direction of risk, as consistent with the entity’s goals. The risk assessment of business and other functions of the organization shall at the minimum be conducted on an annual basis. Every activity / location, including the risk management and compliance functions, shall be subjected to risk assessment by the RBIA. The policy should also lay down the maximum time period beyond which even the low risk business activities / locations would not remain excluded for audit.

The ACB/Board is expected to review the performance of RBIA. The ACB/Board should formulate and maintain a quality assurance and improvement program that covers all aspects of the internal audit function. The quality assurance program may include assessment of the internal audit function at least once in a year for adherence to the internal audit policy, objectives and expected outcomes. Further, ACB/Board shall promote the use of new audit tools/ new technologies for reducing the extent of manual monitoring / transaction testing / compliance monitoring, etc.