

Evolution of the Role of Reserve Bank of India: Current framework of imposition of penalties and need to enhance supervisory mechanism

As the central banking institution and regulator of the financial system in India, the Reserve Bank of India (RBI) plays a crucial role as the primary regulator of the financial sector. Since its establishment under the RBI Act, 1934, the scope of RBI's regulatory authority has expanded significantly, evolving in response to the growing complexities of the Indian economy and the global financial system.

Initially tasked with managing the country's monetary policy and issuing currency, the RBI's powers now cover a wide range of financial institutions, including commercial banks, Non-Banking Financial Companies (NBFCs), payment systems, and asset reconstruction companies. Over time, as financial markets have evolved, so has the regulatory framework, equipping the RBI to oversee not just traditional banking entities but also entities involved in foreign exchange transactions, payment systems, and even cybersecurity practices.

As the apex financial regulator in India, the **Reserve Bank of India** performs a variety of functions aimed at ensuring the stability, efficiency, and development of the country's financial system.

Below are some of the major activities and functions carried out by RBI:

Monetary Policy Management

- Formulates and implements monetary policy to regulate money supply, control inflation, and ensure liquidity in the economy. It uses instruments such as the repo rate, reverse repo rate, cash reserve ratio (CRR), and statutory liquidity ratio (SLR) to influence the banking sector and maintain economic stability.
- Inflation targeting: The RBI targets inflation under the Monetary Policy Framework Agreement, currently aiming for an inflation rate of 4% (with a tolerance band of +/- 2%).

Bank Supervision and Regulation

- Monitors and regulates the functioning of commercial banks, NBFCs, cooperative banks, and payment banks. It ensures that these entities comply with financial norms and prudential guidelines.
- Conducts inspections and audits to check the health of the banking system, ensuring compliance with regulatory guidelines on capital adequacy, risk management, and asset quality.

Financial Inclusion and Development

- Financial inclusion by expanding access to banking services, especially in rural and underserved areas, through initiatives such as the Pradhan Mantri Jan Dhan Yojana (PMJDY) and the issuance of licenses to Small Finance Banks (SFBs) and Payment Banks.
- Priority Sector Lending (PSL) norms are prescribed to ensure that banks extend credit to sectors like agriculture, small businesses, and affordable housing.

Currency Management

- The RBI has the sole authority to issue currency notes and manage the country's currency reserves. It ensures the smooth circulation of money and the availability of currency across the country.
- RBI also manages the design, production, and distribution of currency notes through various currency chests.

Foreign Exchange Management

- Foreign Exchange Management Act (FEMA), 1999, the RBI regulates the inflow and outflow of foreign exchange. It manages foreign exchange reserves and ensures that India's external trade and payment systems remain stable.

- RBI also regulates and manages foreign exchange transactions to prevent currency volatility and stabilize the Indian Rupee.

Developmental Role

- RBI promotes the development of the financial infrastructure in India through policies aimed at improving banking services, payment systems, and financial market structures.
- Digital banking, online payments, and other FinTech initiatives through the promotion of the Unified Payments Interface (UPI) and National Electronic Funds Transfer (NEFT) systems.

Consumer Protection

- The RBI ensures consumer protection in the banking and financial sector through ombudsman schemes and guidelines on grievance redressal.
- It also issues guidelines on transparency and disclosure norms to ensure that customers are fully informed about financial products and services.

Financial Stability

- One of RBI's key roles is to maintain the overall financial stability of the country by monitoring systemic risks and ensuring that the banking sector remains resilient to economic shocks.
- It conducts stress tests and implements the Prompt Corrective Action (PCA) framework for banks that fall short of regulatory norms on capital adequacy, asset quality, and profitability

Major Initiatives and Changes Introduced by RBI in the Banking Sector:

Over the years, RBI has introduced several **initiatives** and made significant **regulatory changes** to enhance the efficiency, resilience, and inclusiveness of the Indian banking sector. Some key reforms and initiatives are:

Unified Payments Interface (UPI)

- **Unified Payment Interface was developed by the National Payments Corporation of India (NPCI) which was established by the Reserve Bank of India and Indian Banks Association. Launched in 2016¹**, UPI has revolutionized digital payments in India, enabling instant money transfers between bank accounts through mobile devices. It has made India one of the global leaders in digital payments, with billions of transactions processed monthly.

Prompt Corrective Action (PCA) Framework²:

- This framework imposes restrictions and corrective actions on banks that do not meet certain financial thresholds related to **capital adequacy**, **asset quality**, and **profitability**. PCA has helped the RBI address the issue of **Non-Performing Assets (NPAs)** in the banking sector.

Financial Inclusion through Payment Banks and Small Finance Banks³:

- RBI licensed **Payment Banks** and **Small Finance Banks (SFBs)** to further financial inclusion by providing basic banking services in rural and semi-urban areas. These banks focus on offering savings accounts, remittance services, and small-scale lending to underserved populations.

Digital Payment Ecosystem – NEFT, RTGS, IMPS⁴:

- RBI has built a robust **digital payment infrastructure** through the introduction of **NEFT (National Electronic Funds Transfer)**, **RTGS (Real-Time Gross Settlement)**, and **IMPS (Immediate Payment Service)**. These systems have made interbank transfers seamless, fast, and accessible to all sections of society.

¹ <https://www.npci.org.in/what-we-do/upi/product-overview>

² <https://www.rbi.org.in/commonperson/English/Scripts/Notification.aspx?Id=2523>

³ <https://www.rbi.org.in/commonman/Upload/English/Notification/PDFs/NOTI1406072017.PDF>

⁴ <https://www.rbi.org.in/commonman/English/Scripts/FAQs.aspx?Id=274>

Cybersecurity Guidelines

- To combat rising cyber threats, RBI has issued **cybersecurity frameworks** for banks and financial institutions⁵. These guidelines require banks to adopt robust cybersecurity measures and frameworks to protect their digital infrastructure from threats.

Asset Quality Review (AQR)⁶

- Introduced in **2015**, AQR required banks to clean up their balance sheets and identify hidden NPAs. This initiative brought transparency to bank financials and was instrumental in recognizing stressed assets that needed resolution.

Liquidity Adjustment Facility (LAF)⁷:

- RBI introduced the **LAF** as a tool to manage liquidity in the banking system. Under LAF, banks can borrow money from the RBI using **repo** and **reverse repo** operations, thereby ensuring sufficient liquidity to meet market needs.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002⁸:

- The SARFAESI Act gave RBI powers to regulate **Asset Reconstruction Companies (ARCs)** and enabled banks to recover non-performing assets (NPAs) more efficiently by enforcing security interest without court intervention (RBI Circular No DNBS.PD.CC 1/SCRC/10.30/2002-03 dated April 23, 2003). Latest guidelines were issued in 2024 by RBI by way of Circular no. DoR.FIN.REC.16/26.03.001/2024-25 dated April 24, 2024⁹.

Implementation of Basel III Norms¹⁰:

- RBI has adopted the **Basel III framework** to strengthen risk management and capital adequacy norms in Indian banks. The objective is to improve the resilience of the banking sector against financial and economic stress.

Foreign Exchange Liberalization:

- Under FEMA, RBI has gradually **liberalized foreign exchange rules**, making it easier for Indian companies and individuals to engage in foreign trade and investments. This move has significantly enhanced India's position in global trade and finance.

Regulatory Sandbox for FinTech Innovation¹¹:

- RBI launched a **Regulatory Sandbox** for **FinTech** startups, allowing them to test their products in a controlled environment with relaxed regulatory norms. This initiative promotes innovation in the financial services industry, particularly in areas like digital lending, payments, and blockchain technology.

Repo Rate and Reverse Repo Rate as Policy Tools:

- RBI actively uses the **repo rate** and **reverse repo rate** to influence the cost of borrowing in the economy, manage inflation, and control liquidity. This monetary policy tool has become central to regulating economic growth and inflation in India.

Digital Lending Guidelines¹²:

- In response to the rapid growth of **digital lending platforms**, RBI has introduced guidelines to regulate **digital lenders** and protect consumers from predatory lending practices. These guidelines ensure greater transparency in digital loan processes.

⁵ <https://www.rbi.org.in/commonperson/English/Scripts/Notification.aspx?Id=1721>

⁶ <https://pib.gov.in/PressReleasePage.aspx?PRID=1578985>

⁷ <https://www.rbi.org.in/commonperson/english/Scripts/PressReleases.aspx?Id=2219>

⁸ <https://www.rbi.org.in/CommonPerson/english/Scripts/Notification.aspx?Id=761#:~:text=The%20Reserve%20Bank%20of%20India%2C%20having%20considered%20it%20necessary%20in,or%20Reconstruction%20Company%20from%20being>

⁹ https://rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12669

¹⁰ https://rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=7413

¹¹ <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=938>

¹² <https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12382&Mode=0>

Introduction of Indian Banking Codes and Standards Board of India (BCSBI)¹³:

- The RBI helped set up **BCSBI** to establish **standards of banking practices** for ensuring fair treatment to customers. It helps enhance transparency in customer services and fosters accountability in banking operations.

Standardizing Credit Information Sharing Formats¹⁴

- RBI introduced guidelines in **2014** to standardize the **data formats for reporting credit information** across various institutions such as banks, NBFCs, and housing finance companies. This standardization streamlined the process of data submission and harmonized the classification of accounts and payment history reporting.

Comprehensive Reporting of Defaulters¹⁵

- The RBI mandated that banks and financial institutions report **non-suit filed accounts** of willful defaulters (₹25 lakh and above) and defaulters (₹1 crore and above) to **Credit Information Companies (CICs)**. This information dissemination has improved the transparency and accountability of borrowers across the financial system.

Making CIC Membership Mandatory¹⁶

- To avoid data silos and enhance the sharing of credit information, the RBI directed all credit institutions to become members of **all CICs**. This initiative was aimed at ensuring that comprehensive credit information is available across all CICs, thus enhancing the depth of data and minimizing information asymmetry for financial institutions.

Creation of the Central Repository of Information on Large Credits (CRILC)¹⁷

- RBI set up **CRILC** in 2014 to collect and disseminate information on large credits (₹50 million and above) of banks and **systemically important NBFCs**. This system helps reduce information asymmetry, assists in supervisory risk assessments, and identifies risk concentration in credit exposure to large borrowers.

Central Registry of Securitisation and Reconstruction of Financial Assets and Security Interest (CERSAI)¹⁸

- CERSAI ensures the registration of transactions involving securitization, asset reconstruction, and mortgage by the deposit of title deeds to prevent fraud. This initiative has also been extended to **NBFCs**.

RBI Ombudsman Scheme¹⁹:

- RBI also runs Ombudsman Scheme for redressal of grievance of banking customers. It integrated its three erstwhile Ombudsman Schemes viz. (i) the Banking Ombudsman Scheme, 2006, (ii) the Ombudsman Scheme for Non-Banking Financial Companies, 2018, and (iii) the Ombudsman Scheme for Digital Transactions, 2019, into one Scheme - 'The Reserve Bank - Integrated Ombudsman Scheme, 2021 with effect from November 12, 2021. The Scheme simplifies the grievance redress process at RBI by enabling the customers of Regulated Entities like banks, Non-Banking Financial Companies (NBFCs), Payment System Participants and Credit Information Companies to register their complaints at one centralised reference point.

RBI Public Awareness Initiatives:

- RBI has undertaken several **public awareness initiatives** aimed at promoting financial literacy, protecting consumer interests, and encouraging responsible banking behaviour. Some key initiatives include the launch of the **RBI Kehta Hai²⁰** campaign, a multimedia public awareness to educate the public on safe banking practices, digital transactions, and fraud prevention. Additionally, RBI has established **Financial Literacy Centers (FLCs)** across the country to provide free financial education²¹, particularly in rural areas. The RBI frequently publishes **Booklets and FAQs** on topics like

¹³ <https://www.iba.org.in/retail-banking/bcsbi-write-up.html>

¹⁴ <https://www.rbi.org.in/commonman/Upload/English/Notification/PDFs/52MBFC010714F.pdf>

¹⁵ RBI Master Circular No. DBR.No.CID.BC.57/20.16.003/2014-15 dated July 1, 2014

¹⁶ <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=9485>

¹⁷ <https://rbi.org.in/Scripts/NotificationUser.aspx?Id=8744&Mode=0>

¹⁸ <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11439&Mode=0>

¹⁹ <https://www.rbi.org.in/commonperson/english/scripts/FAQs.aspx?Id=3407>

²⁰ <https://www.rbi.org.in/commonperson/English/Scripts/rbikehtahai.aspx>

²¹ <https://www.rbi.org.in/FinancialEducation/>

digital payments, interest rates, and grievance redressal to empower consumers with knowledge on their rights and responsibilities in financial transactions.

The RBI's regulatory powers are drawn from a variety of statutes, including:

The Banking Regulation Act, 1949, which governs banks and financial institutions.

The RBI Act, 1934, which provides general oversight and management powers.

Other laws

Payment and Settlement Systems Act, 2007,

Foreign Exchange Management Act (FEMA), 1999,

the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

Evolution of Regulatory Powers:

RBI's regulatory role has evolved with increasing focus on:

- **Compliance:** Ensuring that regulated entities follow prudential norms.
- **Supervision:** Through both on-site inspections and off-site surveillance, RBI monitors the health of banks and NBFCs to prevent systemic risks.
- **Penalties:** The RBI has the authority to impose fines and penalties for non-compliance under various acts, such as Sections 46 and 47A of the Banking Regulation Act and Section 58B of the RBI Act.
- It also regulates asset reconstruction and payment systems, imposing penalties for breaches under SARFAESI and Payment Systems Acts.

As India's financial landscape has become more digitized and complex, RBI has expanded its powers to cover areas such as cybersecurity and money laundering, issuing guidelines and ensuring that banks maintain standards across these evolving risk domains. The RBI's Prompt Corrective Action (PCA) framework provides further supervisory oversight to ensure institutions adhere to financial and operational thresholds.

Inspections and Penalties:

The RBI has a well-defined structure for conducting inspections and imposing penalties on regulated entities. Under the current regime:

- The RBI can inspect books, accounts, and records of banks and NBFCs.
- Non-compliance with regulatory directives can result in both monetary penalties and restrictive actions such as limitations on operations.
- For serious breaches, RBI can invoke Section 47A of the Banking Regulation Act, which allows it to impose penalties ranging from fines up to ₹1 crore or twice the amount involved in the contravention.

However, as the banking sector becomes more complex, regulatory mechanisms are increasingly focused on preventive measures such as AI-driven real-time monitoring, compliance rating systems, and enhancing board-level accountability.

Powers of RBI to impose Penalties:

The Reserve Bank of India has several powers to impose penalties and take punitive action against regulated entities under various laws and regulations. Under the current framework, RBI can impose financial penalties through various provisions such as Section 46 and Section 47A of the Banking Regulation Act, 1949, which allows the imposition of fines for non-compliance or contravention of regulatory guidelines. Section 58B of the RBI Act, 1934, which outlines penalties for failure to comply with the provisions. Additionally, FEMA also empowers RBI to impose penalties in respect of foreign exchange transactions. Section 30A of the SARFAESI Act and provisions of the Payment and Settlement Systems Act (Section 26) give RBI the authority to impose financial penalties.

Below are the key provisions, circulars, orders, provisions, and enactments under which the RBI can impose punishment:

Banking Regulation Act, 1949

The Banking Regulation Act, 1949, provides RBI with broad powers to regulate, supervise, and impose penalties on banks and other regulated entities.

- Section 35A: Power of the RBI to issue directions in the public interest or to prevent the affairs of any banking company from being conducted in a manner detrimental to the interests of the depositors or to secure proper management of the banking company. Non-compliance can lead to penalties.
- Section 46: Offences and penalties for companies failing to comply with directions or violating provisions of the Act, such as submitting false information, not maintaining required reserves, etc. Imprisonment and/or fines can be imposed.
- Section 47A: Empowers the RBI to impose penalties for contraventions of provisions of the Act or non-compliance with directions issued by the RBI. Penalties may include monetary fines.
- Section 45J to 45L: Gives the RBI powers to regulate Non-Banking Financial Companies (NBFCs) and impose penalties for violations of its directions or orders.

RBI Act, 1934

- Section 58B: This provision provides the RBI with powers to impose penalties on companies for failure to comply with provisions relating to currency chest operations, financial reporting, and various operational activities of regulated entities.
- Section 46: Penalties for issuing false statements, failing to furnish required information, or non-compliance with RBI guidelines.

Payment and Settlement Systems Act, 2007

This Act gives RBI regulatory oversight over payment systems in India.

- Section 26: Empowers the RBI to impose penalties for violations related to payment systems, including those for operating payment systems without authorisation or for non-compliance with the RBI's directions.

Foreign Exchange Management Act (FEMA), 1999

- The RBI regulates foreign exchange transactions in India under FEMA. It can impose penalties for non-compliance with its rules relating to foreign exchange transactions.
- Section 13: Allows for penalties up to thrice the sum involved in contraventions, or imprisonment in cases of serious violations.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002

- Under the SARFAESI Act, RBI regulates Asset Reconstruction Companies (ARCs).
- Section 30A: Penalty for non-compliance with directions issued by RBI regarding the functioning of ARCs.

Circulars and Master Directions

RBI frequently issues circulars and directions providing guidelines and imposing penalties for non-compliance. Some key circulars and directions include:

- Master Directions on Prudential Norms: For Non-Banking Financial Companies (NBFCs), RBI's prudential norms mandate penalties for inadequate risk management or failure to maintain capital adequacy.

Prevention of Money Laundering Act (PMLA), 2002

- Section 12: Mandates that banks, NBFCs, and other financial institutions maintain records of transactions to prevent money laundering. Failure to comply can lead to penalties under the Act.

RBI Circulars and Guidelines on Cyber Security

- RBI has issued several circulars mandating the implementation of cyber security frameworks by banks and NBFCs. Non-compliance can result in penalties under Section 46 of the Banking Regulation Act.

Guidelines on Prompt Corrective Action (PCA)

- The PCA framework is imposed on banks that fail to meet financial thresholds (e.g., capital adequacy, asset quality). RBI can impose penalties, restrictions, and other punitive measures under this framework

The RBI has traditionally relied on **inspections, audits**²², and **surveillance mechanisms** (on-site and off-site)²³ to ensure that regulated entities comply with prescribed norms. Financial penalties are just one aspect, and there is an increasing emphasis on **corrective actions** that focus on enhancing compliance rather than just imposing fines.

It is understood that there is proposal to revise the penalties. The revised penalties, even if increased, may still not have a significant impact unless they are proportionate to the size of the institution and the severity of the violation. Penalty amounts could be linked to total revenue from that segment, or assets under management (AUM) or profits of the institution to increase effectiveness. Institutions that are repeat offenders should face progressively harsher penalties.

This could also be tied to the institution's compliance rating. RBI could enhance public disclosure of non-compliance and penalties, making it mandatory for institutions to disclose significant regulatory breaches in their financial reports. Periodic reports on compliance could be issued by RBI, ranking institutions on compliance, risk management, and governance. Similarly, the existing system could further be strengthened to increase the personal accountability of directors for regulatory violations. RBI could also review its existing powers and if required seek additional powers in the light of technological advancement and operational complexities keeping in mind the future of banking operations.

Regulators in other major economies are increasingly moving away from their reliance on **financial penalties** as they are adopting more robust **compliance rating systems, board-level accountability measures**, and incorporating **technological advancements** such as **real-time monitoring** through AI and big data analytics to detect violations early. With **AI-driven automation** expected to dominate future financial transactions, regulators are exploring frameworks that focus not only on penalizing infractions but also on **preventing non-compliance** through predictive algorithms and automated compliance checks. RBI may also leverage AI and technology such as Regulatory Technology (RegTech) Solutions to pre-emptively address risks, enhance surveillance, and adopt advanced compliance methodologies (including periodic stress testing, resilience against cyberattacks and other operational risks) that foster accountability and transparency in a rapidly digitizing financial landscape.

Thus, RBI plays a pivotal role in regulating and supervising the financial sector in India. Over the years, it has adapted to the growing complexities of the Indian economy and global financial systems through various **initiatives and reforms** aimed at enhancing the stability, transparency, and efficiency of the financial sector. The RBI's framework for imposing penalties, conducting inspections, and ensuring compliance has evolved significantly, particularly in areas like cybersecurity, digital banking, and credit information sharing. However, as India's banking sector continues to grow in scale and complexity, there is a pressing need for further reforms, especially in linking penalties to the size and financial strength of institutions, strengthening compliance mechanisms, and leveraging emerging technologies such as **AI-driven monitoring** and **RegTech solutions**²⁴.

We trust you will find this an interesting read. For any queries or comments on this update, please feel free to contact us at insights@elp-in.com or write to our authors:

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²² <https://www.rbi.org.in/commonman/Upload/English/Content/PDFs/89795.pdf>

²³ <https://www.rbi.org.in/commonman/English/Scripts/DeptofBS.aspx#:~:text=The%20Banking%20Regulation%20Act%2C%201949,in,pection%20and%20off%20site%20surveillance.>

²⁴ RegTech solutions refer to the use of advanced technology, such as AI, big data, and machine learning, to help organizations streamline and automate regulatory compliance processes, reducing costs and enhancing efficiency in meeting legal and regulatory requirements.