RBI 2026 Phase 2 - Finance Descriptive Writing

Q.1) What is the Economic Capital Framework (ECF) of RBI? Who recommended it, and what legal provisions govern the transfer of surplus reserves from the RBI to the Government?

(10 Marks)

> ℹ️ ***Structure***
> ***Introduction****: About ECF and its needs*
> ***Body****:*
>
> - *Recommendation and Legal Framework*
> - *Earlier and revised regulation*
> - *Data: Latest surplus transfer to the Central government*
>
> ***Conclusion****: Highlights the importance of ECF in balancing RBI's operational independence with the government's fiscal needs.*
> ***Key words:*** *Economic Capital Framework (ECF), RBI's financial resilience, Surplus transfer to Government, Dr Bimal Jalan Committee (2018), Risk-based capital framework, Contingent Risk Buffer (CRB), Realised equity, Revaluation balances, Contingent reserves, Flexibility in capital management and Section 47, RBI Act, 1934*

Answer:

The **Economic Capital Framework (ECF)** of the Reserve Bank of India (RBI) is a structured approach to determine the optimal level of capital that the central bank should hold to cover its various financial risks and to decide the **surplus amount to be transferred** to the Government of India. It seeks to maintain the **financial stability** of the RBI while ensuring that the excess funds are returned to the government in the form of **surplus or dividend**.

The need for an **Economic Capital Framework (ECF)** arose because the RBI and the Government had different views on how much reserve money the RBI should keep and how much surplus it could transfer to the Government.As per its recommendations, the RBI’s economic capital includes:

To resolve this, an expert committee was formed in 2018 under the chairmanship of **Dr Bimal Jalan**, former RBI Governor. The **Jalan Committee** submitted its report in 2019, recommending a **risk-based capital framework**.

- **Realised equity** (Contingent Risk Buffer),
- **Revaluation balances**, and
- **Contingent reserves**.

The **Jalan Committee** recommended that the RBI maintain a **Contingent Risk Buffer (CRB)** of **5.5%–6.5%** of its balance sheet. This buffer serves as a financial cushion against monetary, financial, and external sector risks.

However, in its **2024–25 Annual Report**, the RBI revised the CRB framework to **6% ± 1.5%**, allowing the CRB to range between **4.5% and 7.5%**. This range provides flexibility in deciding the amount of surplus that can be transferred to the Government, ensuring that the RBI retains adequate capital to absorb potential risks.

Thus, the revised framework seeks to strike a balance between maintaining the RBI's financial resilience and meeting the Government's fiscal requirements.

The transfer of surplus from the RBI to the Government is governed by **Section 47 of the RBI Act, 1934**. According to this provision, after setting aside funds for expenses such as bad and doubtful debts, depreciation of assets, employee welfare and pension funds, and other necessary provisions, the remaining profit of the RBI must be transferred to the **Central Government**. This provides the legal foundation for the annual surplus transfer from the RBI to the Government.

In FY 2025–26, the RBI transferred a **record surplus of ₹2.8 lakh crore** to the Government, which reflects higher earnings and optimal reserve management under the revised ECF.

Overall, the **Economic Capital Framework (ECF)** provides a transparent and rule-based mechanism for determining how much capital the RBI should retain and how much surplus can be transferred to the Government. It ensures that the RBI remains financially strong enough to manage risks and effectively perform its central banking functions, while also enabling a predictable and structured transfer of surplus to support the Government's fiscal needs. Thus, the ECF strikes a balance between **financial stability** and **fiscal requirements**.

Q.2) What is the Clean Note Policy of RBI? Highlight a few measures and initiatives by the RBI in this regard?

(10 marks)

ℹ️ ***Structure:***
Introduction*: Define Clean Note Policy and its objective*
Body*:*

- *Why was this policy needed*
- *Major initiatives and regulatory measures taken by the RBI*
- *Data / Examples where relevant*

Conclusion*: Highlight the importance of clean notes in promoting confidence in cash-based transactions and ensuring currency integrity.*
Key Words*: Clean Note Policy, Soiled notes, Currency management, Fit-for-use banknotes, Currency Chest, Note Sorting Machines, e-Banknote Clean Note (e-BCN) system, Public awareness, Polymer notes, RBI's Issue Department*

Answer:

The **Clean Note Policy** is an initiative of the **Reserve Bank of India (RBI)** aimed at providing the public with **good-quality, clean, and usable currency notes**, while withdrawing **soiled or mutilated notes** from circulation. It ensures that currency notes remain fit for use and that the public has confidence in the physical integrity of Indian currency.

The need for this policy arose because **soiled, damaged, or counterfeit notes** cause inconvenience in daily transactions and affect trust in the cash-based economy. Clean notes help in maintaining hygiene and make the machine's processing of notes smoother.

To implement the policy effectively, the RBI has taken several **regulatory and operational measures**:

- **Use of Note Sorting Machines (NSMs):** To ensure that only clean and genuine currency remains in circulation, **banks are required to use Note Sorting Machines (NSMs)**. These machines automatically identify and separate fit notes from soiled, mutilated, and counterfeit notes before currency is recirculated.
- **Restriction on Re-issuance of Soiled Notes:** Banks are prohibited from reissuing soiled notes to the public. Only notes that meet the prescribed fitness standards can be put back into circulation through bank branches and ATMs, helping maintain the quality of currency in use.
- **Uniform Note Sorting Standards:** To improve the quality of currency in circulation, the RBI has introduced uniform standards for note sorting across banks. From **November 1, 2025**, banks will be required to use only approved note-sorting machines so that fit notes are consistently recirculated while soiled and counterfeit notes are removed from circulation.
- **Efficient Currency Chest Management:** The RBI monitors and inspects currency chests to ensure the smooth circulation of clean notes. Soiled and unfit notes are withdrawn from circulation, returned to the RBI for destruction, and replaced with fresh and fit currency for public use.
- **Exchange Facility for the Public:** To encourage the withdrawal of unfit currency from circulation, the RBI allows the public to exchange soiled or damaged notes at bank branches free of charge.
- **Public Awareness Initiatives:** Through campaigns such as **"RBI Kehta Hai"**, the RBI encourages people to handle currency carefully and avoid practices such as stapling, writing on, or damaging notes, thereby improving their longevity.
- **Monitoring Note Quality through Technology:** The RBI has introduced the **e-Banknote Clean Note (e-BCN) system** to monitor the quality of notes being recirculated by banks and to ensure compliance to Clean Note Policy guidelines.
- **Proposed Introduction of Polymer Notes:** The RBI has revived its proposal to introduce **polymer (plastic) banknotes** on a pilot basis. Since polymer notes are more durable, cleaner, and resistant to wear and tear than paper notes, they can remain in circulation for longer periods, reducing the generation of soiled notes and lowering currency replacement costs.

- They also support advanced security features and have a longer circulation life, which will reduce the frequency of note replacement and the generation of soiled notes. The RBI is simultaneously working to ensure that **ATMs and cash-handling machines** can efficiently process polymer currency.

Overall, the Clean Note Policy aims to ensure that the public has access to clean, fit, and genuine currency notes. By improving the quality of notes in circulation and promoting efficient currency management, the policy enhances public confidence in the currency system and supports the smooth functioning of the economy.

Q.3) What are Universal banks? How are they different from other banks? Describe its scope, eligibility, power, advantages, and challenges.

(10 marks)

ℹ️ ***Structure:***
Introduction: *Definition, Origin, and Examples of Universal Banks*
Body:

1. ***Difference Between Universal Banks and Other Banks***
2. ***Eligibility of Universal Banks***
3. ***Scope and Power of Universal Banks***
4. ***Advantages of Universal Banks***
    - *Economies of Scale, Cost Efficiency, Diversification*
5. ***Challenges Faced by Universal Banks***
    - *Compliance Complexities, Conflict of Interest and Increased Systemic Risk*

Fact (If any): *Licensing criteria of universal banks*
Conclusion: *Universal banks offer comprehensive financial solutions, providing convenience and intermediation. A balanced approach ensures sustainable growth and financial stability.*
Key Words: *Universal Banks, Commercial banking, Investment banking, Insurance and asset management, R.H. Khan Committee, ICICI Bank merger, 2001, Product diversification, Capital market participation, Global presence, Over-diversification risk, systemic risk ("Too Big to Fail"), financial stability, Economies of scale*

Answer:

Universal Banking refers to a banking model in which a single financial institution offers diverse financial services, including commercial banking, investment banking, insurance, and asset management. The concept of Universal Banking originated from the need to provide integrated financial solutions to customers.

Before the 1990s, Indian banks mainly offered basic services like deposits and loans, with little role in investment banking. In the late 1990s, the **R.H. Khan Committee** recommended Universal Banking, allowing banks to provide a wide range of services like commercial banking, investment banking, insurance, and other financial services under one roof.

First Universal Bank: The merger of ICICI with ICICI Bank in 2001 is cited as one of the first universal banks in the country.

Difference Between Universal Banks and Other Banks:

Universal Banks differ from traditional banks in several ways:

- **Comprehensive Services:** While traditional banks mainly focus on deposits and loans, Universal Banks offer a wider range of services, including both commercial and investment banking.
- **Product Diversification:** They provide customers with multiple financial products and services such as loans, deposits, insurance, asset management, and financial advisory, all under one roof.
- **Capital Market Participation:** Universal Banks are actively involved in capital market activities, such as securities trading and raising funds through financial markets, while traditional banks are not involved in capital markets.
- **Global Presence:** Many Universal Banks operate across different countries, whereas traditional banks are often confined to a particular region or country.

Eligibility for Licensing of Universal Banks in the Private Sector:

- The minimum **initial capital** for the bank is **₹500 crore (5 billion**)
- The individuals, groups, or companies that establish the bank (Promoters) must initially hold at least **40% of the bank's equity**. This stake will be **locked in for 5 years**, meaning it cannot be sold during this period. Over time, their shareholding must be reduced to **15% within 15 years**.
- **Foreign investors** can own up to **74% of the bank's shares**, as permitted under India's Foreign Direct Investment (FDI) policy.
- The bank is required to get its shares listed on stock exchanges within **6 years of starting operations**.
- At least **25% of the bank's branches** must be opened in **unbanked rural areas** to promote financial inclusion.
- The bank must comply with **priority sector lending (PSL) norms**, just like other scheduled commercial banks.
- To ensure good corporate governance, the **Board of Directors** should have a **majority of independent directors**.

Universal Banks play an important role in the financial system by providing a wide range of financial services under one roof. They make banking more convenient for customers, improve efficiency, and help strengthen the financial sector. However, because of their large size and diverse activities, proper regulation and supervision are necessary to manage risks and ensure their smooth functioning.

Q.4) Explain the concept and role of All India Financial Institutions (AIFIs) in India's financial system. Why were they established, and how many such institutions are currently operating in India?

(10 Marks)

ℹ️ ***Structure***:
Introduction: *Definition of AIFIs and their importance in the Indian financial architecture*
Body:

- ***Legal basis of AIFIs, differences from*** *commercial banks, and their broad classification*
- ***Purpose and Need for Establishment (Long-term financing, economic development)***
- ***Current AIFIs in India and their respective functions***
- ***Facts/Example:*** *If any.*

Conclusion: *AIFIs as catalysts of long-term development and their continued relevance and evolving role*
Key words: *All India Financial Institutions (AIFIs), Development finance institutions (DFIs), Long-term finance, Sector-specific financing, Priority sectors, RBI regulation and refinance, No demand deposits, Market borrowings and government funding, National development goals and NABARD, SIDBI, EXIM Bank, NHB.*

Answer:

All India Financial Institutions (AIFIs) are apex financial bodies, mostly backed by the government and regulated by the RBI, that provide long-term finance for development needs.

Problem: After independence, India faced a gap in long-term funding because commercial banks mainly focused on short-term lending.

Solution: To address this, AIFIs were set up to provide long-term credit for sectors like industry, infrastructure, and agriculture. Their main objective is to support capital formation and promote balanced and inclusive economic growth by financing areas that are important for national development.

AIFIs vs Commercial Banks:

- **Purpose:** AIFIs focus on long-term development financing, while commercial banks primarily operate for profit and daily banking needs.
- **Type of credit:** AIFIs provide long-term funding for projects, whereas banks mainly offer short- to medium-term loans.
- **Deposits:** AIFIs do not accept public deposits, but commercial banks do.
- **Sources of funds:** AIFIs depend on borrowings, government support, and RBI assistance, while banks rely mainly on customer deposits.
- **Focus areas:** AIFIs support development and priority sectors, whereas banks serve individuals, businesses, and the wider economy.

There are 5 major AIFIs:

1. **National Bank for Agriculture and Rural Development (NABARD):** The NABARD was established in 1982 under the NABARD Act, 1981. NABARD is the apex development financial institution for agriculture and rural development in India.
    - It supports rural credit systems by refinancing cooperative banks and regional rural banks, and also promotes rural infrastructure, and financial inclusion in villages.
2. **Small Industries Development Bank of India (SIDBI):** The SIDBI was set up in 1990 under the SIDBI Act, 1989. SIDBI is the principal financial institution for promoting and developing Micro, Small, and Medium Enterprises (MSMEs).
    - It provides direct loans to MSMEs, refinances banks and NBFCs, supports venture capital funding, and also undertakes development programs to strengthen the MSME ecosystem.
3. **Export-Import Bank of India (EXIM) Bank:** The Exim was established in 1982 under the EXIM Bank Act, 1981. EXIM Bank supports India's foreign

trade.

- It provides export credit, buyer's and supplier's credit, guarantees, and advisory services to help Indian companies expand globally and strengthen export competitiveness.

4. **National Housing Bank (NHB):** The NHB was founded in 1988 under the NHB Act, 1987. NHB is the apex authority for housing finance in India.
   - It regulates and supervises housing finance companies and also provides refinance support to banks and housing finance institutions to improve availability of home loans at affordable rates.
5. **National Bank for Financing Infrastructure and Development (NaBFID):** The NaBFID was established in 2021 under the NaBFID Act, 2021. NaBFID is a specialised development financial institution focused on infrastructure financing.
   - It provides long-term funding for large infrastructure projects such as roads, railways, energy, water supply, and urban development, helping bridge the long-term funding gap in the infrastructure sector.

AIFI play a vital role in India's long-term economic growth by supporting sectors needing patient capital and focused development. Despite universal banks and NBFCs, AIFIs remain essential in rural credit, MSME financing, affordable housing, and export support. Their role will continue to evolve with India's development priorities and financial inclusion goals.

Q.5) Explain the evolution and importance of the payment system in India. Discuss the key regulatory and legal frameworks governing it.

(10 Marks)

ℹ️ ***Structure***:
Introduction: *Definition of the payment system and its Importance in the economy and financial inclusion. Showing its emphasis, stating its Growth.*
Body:

- ***Background***: *The historical evolution (barter → hundis → cheques → digital)*
  - *Then Introduction of NI Act, PSS Act.*
  - *Current legal framework of Payment system along with PRB.*

Conclusion: *Payment system is important for smooth transactions in the economy and helps in financial Inclusion but this requires continued innovation, regulation, and public trust.*
Example/Data (If any): *Data from the Payment System Report and Annual Report.*
Keywords: *Payment systems, financial transactions, digital payments, financial inclusion, Negotiable Instruments Act 1881, electronic fund transfer, PSS Act 2007, RBI, BPSS, PRB, legal framework, regulation, settlement systems, cheque, promissory note, hundis, computerised banking, fintech evolution.*

Answer:

A **payment system** is any system used to settle Financial transactions through the transfer of Monetary Value. This includes the institutions, payment instruments such as Payments Cards, people, rules, procedures, standards, and Technologies that make its exchange possible.

Importance: Payments are the backbone of any economy. They ensure money flows smoothly across different sections of society and help with **financial inclusion.**

Growth: As per the evolved financial system, digital payments in India have grown at an **explosive rate** over the past decade:

Data from the Payment System Report (December 2025), by the RBI:

- **UPI** drives **high-volume** retail payments with a share of **85.5%** while, **Real Time Gross Settlement (RTGS)** handles **high-value** settlements with a **68.6% share.**

- **Credit cards and debit cards continued to grow**, indicating increasing adoption of formal digital payment instruments.

Data from the Annual Report (2025-26), by the RBI:

- Cashless transactions continued to grow strongly in 2025-26. India's payment ecosystem is becoming more digital.
- In 2025–26, total digital payments reached **28.17 lakh crore transactions** in volume, with a total value of **₹3,251 lakh crore**.
- The volume of digital payments grew by **26.8%**, showing that more people are using digital payment systems.
- The value of digital payments increased by **13.2%**. This suggests that while the number of transactions increased, the transaction size may have become smaller.

Evolution of Payment systems:

Payments evolved from ancient barter to currency-based systems, shifting from a 'promise to pay' to 'an order to pay.' India saw the use of hundis, informal bills of exchange without legal backing.

1. **Introduction of the Negotiable Instruments (NI) Act, 1881:** As banking activities increased, the government introduced the NI Act to provide a proper legal framework for payments like cheques and promissory notes. This law gave legal recognition to non-cash payment methods and still governs paper-based payments in India today.
2. **Emergence of Electronic Payments:** With the advancement of **computerized banking,** RBI introduced **Electronic Fund Transfer (EFT) services in the 1990s**, allowing interbank money transfers.
3. **Payments and Settlement Systems Act, 2007 (PSS Act): PSS Act, 2007** is a key legislation in India that regulates and supervises payment systems to ensure their safety, efficiency, and stability.

Legal Framework of Payment Systems: The **RBI** is responsible for regulating and supervising payment systems. It does this through the **Payments and Settlement Systems Act, 2007 (PSS Act)**.

1. After the enactment of the **PSS Act (2007) and BPSS Regulations (2008)**, BPSS started operating within the legal framework of the Act.

2. Now, BPSS is replaced the **Payment Regulatory Board (PRB)** of the RBI, from **May 9, 2025**. The PRB held it's 1st meeting in January, 2026. The RBI operates through this board and the board is chaired by the RBI governor.
3. The **Payments Regulatory Board (PRB)** is statutorily required to hold its meetings **at least twice a year**. It is established under the Payment and Settlement Systems Act, 2007. Its role is to oversees digital, retail, and wholesale payment systems.

India's payment system has grown from barter and hundis to a tech-driven one. It is legally backed by laws like the NI Act and PSS Act. It is regulated by RBI and ensures secure and inclusive transactions. However, continued innovation, regulation, and trust are key to its role in financial inclusion and growth.

Q.6) Describe risk in the banking business. Explain risk management tools for banks to mitigate risks.

(15 marks)

💡 ***Structure:***
Introduction:

- *Definition of Risk and Risk Management in Banking*
- *Importance of Risk Management in Banking*

Body:

1. ***Types of Risks in Banking:***
    - *Credit Risk, Market Risk, Operational Risk, Liquidity Risk, Compliance and Legal Risk, and Reputational Risk*
2. ***Risk Management Tools for Banks:***
    - *Credit Risk Management Tools*
    - *Market Risk Management Tools*
    - *Operational Risk Management Tools*
    - *Liquidity Risk Management Tools*
    - *Compliance and Reputational Risk Management Tools*

Conclusion:
Effective risk management is essential for maintaining financial stability and ensuring long-term growth. Banks use a combination of advanced models, internal controls, and regulatory compliance to mitigate risks.
Key Words:
Risk in banking, Financial loss, Profitability, Financial stability, Credit appraisal, Loan monitoring, Credit scoring models, Value at Risk (VaR), Stress testing, Derivatives, System failures, Fraud detection, High-Quality Liquid Assets (HQLA), Cash flow management, Risk management framework.

Answer:

Risk in the banking business refers to the possibility of financial loss or reduced profitability due to unforeseen circumstances. Banks face various types of risks that can affect their financial stability.

Risk management in banking is the process of identifying, assessing, monitoring, and mitigating these risks to ensure that the bank operates safely and remains financially sound.

Importance of Risk Management:

1. **Protects Financial Health:** It helps banks remain financially strong and stable.
2. **Promotes Credit Discipline:** It encourages banks to lend carefully and manage loans properly.
3. **Improves Decision-Making:** It helps banks take better strategic and operational decisions.
4. **Ensures Regulatory Compliance:** Banks must follow risk management rules set by regulators like the RBI and Basel III.

Types of Risks in Banking:

1. **Credit Risk:** Credit risk arises when borrowers fail to meet their debt obligations. It is the most significant risk for banks that provide loans and credit facilities.
2. **Market Risk:** Market risk results from adverse changes in market prices, interest rates, exchange rates, or commodity prices.
3. **Operational Risk:** This includes losses due to system failures, fraud, or external events. Poor internal controls and a lack of risk awareness can increase operational risk.
4. **Liquidity Risk:** Liquidity risk occurs when a bank cannot meet its short-term financial obligations due to sudden withdrawal of deposits or inadequate access to funding
5. **Compliance and Legal Risk:** Non-compliance with laws, regulations, or ethical standards can lead to legal penalties
6. **Reputational Risk:** Negative publicity, customer dissatisfaction, or unethical behavior can harm a bank's brand and market value.

Risk Management Tools for Banks: Effective risk management is essential for protecting the interests of customers, investors, and other stakeholders. It also helps maintain public confidence and ensures the stability and smooth functioning of the banking system.

1. **Credit Risk Management Tools:**

- **Credit Appraisal and Monitoring:** Before giving loans, banks carefully check the borrower's financial condition and repayment capacity. They also regularly monitor loans after sanctioning them.
- **Credit Scoring Models:** Banks use data and technology-based models to assess the creditworthiness of borrowers and predict the chances of loan default.
- **Diversification:** Banks reduce risk by giving loans to different sectors and industries instead of concentrating lending in one area.

2. **Market Risk Management Tools:**
   - **Value at Risk (VaR):** Banks use VaR models to estimate the possible loss they may face due to market movements under normal conditions.
   - **Stress Testing:** Banks test how their investments and portfolios would perform during difficult situations like economic crises or sharp market changes.
   - **Hedging:** Banks use financial instruments such as options and futures to reduce or protect themselves from market risks.
3. **Operational Risk Management Tools:**
   - **Internal Controls and Risk Self-Assessments:** Banks regularly check their internal policies and day-to-day operations to identify weaknesses and manage risks effectively.
   - **Regular Audits:** Independent audits help detect gaps in systems and processes and ensure that banks comply with regulatory rules and standards.
4. **Liquidity Risk Management Tools:**
   - **Asset-Liability Management (ALM):** Banks manage the timing of their assets and liabilities carefully to maintain enough liquidity and prevent cash shortages.
   - **High-Quality Liquid Assets (HQLA):** Banks maintain enough liquid assets to meet sudden cash needs and customer withdrawals easily.
5. **Compliance and Reputational Risk Management Tools:**
   - **Governance Framework:** Banks set clear policies, rules, and responsibilities to ensure proper management and ethical functioning.

- **Compliance Programs:** Banks regularly monitor regulatory changes and reporting requirements to ensure they follow all laws and regulations properly.

Risk management is an important part of banking operations. By using strong risk management systems and modern tools, banks can protect themselves from financial losses and maintain stability and public confidence.

Q.7) Evaluate the role and evolution of RRBs and discuss their current challenges and prospects in the Financial Ecosystem.

(15 Marks)

ℹ️ ***Structure***:
Introduction:

Definition of RRBs and their foundational objective of bridging the rural credit gap.

Body:

- ***Evolution and Legal Framework:*** *Origin in 1975 under the RRB Act, 1976; NABARD oversight*
- ***Role in Financial Ecosystem:*** *Rural credit, support to agriculture, MSMEs, SHGs; role in DBT, PMJDY, digital inclusion; branch penetration in rural areas.*
- ***Current Challenges:*** *Dual control (RBI & sponsor banks), low profitability, high NPAs, limited tech adoption, lack of skilled workforce, and regional disparities.*
- ***Reforms and Recent Measures:*** *Capital infusion, amalgamation into stronger entities, push for digital expansion and governance reform.*
- ***Future Prospects:*** *Leveraging fintech, boosting financial literacy, expanding product base.*

Facts/Example:

- ***Established:*** *1975 (Golden Jubilee in 2025)*
- ***As of 2024:*** *43 RRBs operating after multiple rounds of amalgamation*
- ***Coverage:*** *Over 21,000 branches, mostly in rural and semi-urban areas*
- ***28 RRBs*** *across* ***26 States and 2 Union Territories****.*

Conclusion: *RRBs have been key to rural financial deepening for 50 years. To remain relevant, they must evolve with innovation, professionalism, and policy support while retaining their development mandate.*

Key Words: *Regional Rural Banks (RRBs), Rural credit, Priority sector lending, NABARD, RRB Act 1976, Financial inclusion, NPAs, DBT, PMJDY, Amalgamation, Digital banking.*

Answer:

Regional Rural Banks (RRBs) were set up in 1975 under the RRB Act, 1976 to provide credit in rural areas. They provide small loans and basic banking services to farmers and villagers at the local level. Because they operate within villages and communities, they have a strong local reach, meaning they are easily accessible to rural people. Their main aim is to promote financial inclusion by giving loans to farmers, artisans, and other people in rural areas. In 2026, India marks 51 years of RRBs.

Role of RRBs in the Financial System:

- **Credit delivery to underserved population:** RRBs have a wide rural network with over 21,000 branches, to ensure banking services reach remote and underserved areas.
- **Financial inclusion:** RRBs mainly provide loans to small and marginal farmers, Self-Help Groups (SHGs), and rural artisans.
- **Support to government schemes:** RRBs act as key implementation agencies for schemes like **Pradhan Mantri Jan Dhan Yojana (PMJDY)**, **Pradhan Mantri Fasal Bima Yojana (PMFBY)**, **Kisan Credit Card (KCC)**, and **Direct Benefit Transfer (DBT)**.
- **Agriculture and MSME financing:** They play an important role in providing credit to agriculture and rural MSMEs, supporting income generation and rural development.

Evolution of RRBs:

In the 1970s, even though commercial banks and cooperative banks existed, rural areas still did not get enough credit and most lending was focused in cities.

- To solve this, there was a need for **low-cost banking with a strong local presence** to serve unbanked rural people.
- The **Narasimham Committee on Rural Credit (1975)** recommended setting up a hybrid system that combines the **local reach of cooperatives** with the **professional management and strong resources of commercial banks**.

Below are the phases in RRBs are evolved over time:

1. **First Phase (1975–1986):**
   - **Formation and Expansion:** In the first phase, the initial **5 Regional Rural Banks (RRBs)** were set up, and their number increased to **196 by 1987**, with support from public sector banks. The main focus was on **priority sector lending** and promoting rural development.
   - **Ownership pattern:** RRBs were jointly owned by the **Government of India (50%)**, **Sponsor Banks (35%)**, and **State Governments (15%)**.
2. **Second Phase (1987–1999):**
   - **Performance concerns and financial stress:** RRBs faced problems like high Non-performing Assets (NPAs) (bad loans), limited income sources, and dual control by multiple authorities. This made their financial position weak. To address this, many RRBs were merged to create bigger and stronger institutions with better financial stability and performance.
3. **Third Phase (2000–2010):**
   - **Restructuring and consolidation:** The government merged smaller RRBs in each state that were supported by the same commercial bank, called the sponsor bank, into bigger banks. This helped reduce the number of small RRBs and made them easier to manage, more efficient, and financially stronger.
   - **First phase of consolidation (2006–10):** The number of RRBs was reduced from **196 to 82** through amalgamation.
   - **Core Banking Solution (CBS):** RRBs were shifted to a centralized digital banking system that allows customers to access services from any branch. CBS was made mandatory from **2011** and was fully implemented by around **2016**.
   - **Non-target lending allowed (2009):** RRBs were allowed to use up to **40% of their total loans** for non-priority lending, such as loans to small businesses, traders, housing, and consumer needs.
4. **Fourth Phase (2010–present):**
   - **Digitalisation and Capitalisation:** RRBs are improving their services through better use of technology. They are also helping in financial inclusion through schemes like **Pradhan Mantri Jan Dhan Yojana (PMJDY)** and **Direct Benefit Transfers (DBTs)**.

- The government has provided financial support through recapitalisation plans.
- There is also a proposal to convert RRBs into **Scheduled Commercial Banks** or list the profitable RRBs in the stock market.

Consolidation of RRBs:

To make RRBs stronger and more efficient, the number of RRBs has been reduced through mergers:

- **Phase 2 (2013–15):** Number reduced from 82 to 56
- **Phase 3:** Reduced from 56 to 43
- **Phase 4 (2025):** Reduced from 43 to 28
- After consolidation, **28 RRBs** will operate across **26 States and 2 Union Territories**.
- These RRBs together will have **more than 22,000 branches** covering around **700 districts** across India.

Current Challenges:

1. **Weak Financial Condition:** Many RRBs are not financially strong and continue to face losses.
2. **High NPAs:** RRBs give many small loans, especially to farmers and rural borrowers. Due to crop failures, low incomes, and weak recovery systems, many loans turn into NPAs.
3. **Too Many Authorities:** RRBs are controlled by RBI, NABARD, sponsor banks, and both the central and state governments. This creates confusion and delays in decision-making.
4. **Technology Issues:** Compared to commercial banks, RRBs are still behind in digital banking services and fintech adoption.
5. **Staff-Related Problems:** Many RRBs face shortage of skilled employees and do not have attractive incentives or promotion opportunities.

Future Prospects and Reforms Needed:

- **Complete Amalgamation Process:** As part of the consolidation process, further mergers can help RRBs become larger, stronger, and more efficient. This will reduce costs and improve operations.

- **Improve Capital and Profits:** The government should continue providing financial support to RRBs and help well-performing RRBs get listed in the stock market.
- **Better Governance:** To improve governance, unnecessary control by multiple authorities should be reduced, and professional management should be given more power to take better and faster decisions in RRBs.
- **Use Better Technology:** RRBs should invest more in digital banking, mobile banking, fintech partnerships, and modern technologies like AI/ML for loan assessment.
- **Expand Services:** RRBs should not focus only on loans. They should also provide insurance, pension schemes like Atal Pension Yojana, savings, and investment products to rural customers.

RRBs continue to play an important role in providing banking and credit services in rural India. However, old problems and operational challenges still affect their performance. With reforms in governance, technology, and capital support, RRBs can become stronger and more efficient banks that support inclusive and sustainable growth in India's financial system.

Q.8) What are Mutual Funds? What are the types of Mutual Funds based on maturity period, investment objective and risk? Describe any two types of Specialized Mutual Funds.

(15 marks)

> 💡 ***Structure:***
> ***Introduction:***
>
> - *Definition and Importance of Mutual Funds*
>
> ***Body:***
>
> 1. ***Types of Mutual Funds:***
>   - ***Based on the Maturity Period***
>   - ***Based on Investment Objective***
>   - ***Based on Risk***
> 2. ***Specialized Mutual Funds:***
>   - *Definition, Purpose and example of Specialized Mutual Funds*
> 3. ***Explanation of Two Types of Specialized Mutual Funds:***
>   - ***Sectoral Funds***
>   - ***Index Funds***
>
> ***Conclusion:***
> *Mutual funds offer diverse options, including specialized funds for higher returns with risks, and investors should choose based on their financial goals and risk tolerance.*

Answer:

Mutual Funds are investment options where money from many investors is collected and invested in different assets such as shares, bonds, and other securities. These funds are managed by professional fund managers, making them a popular choice for both new and experienced investors.

When investors buy stocks directly, they have to manage their own portfolios and take buying or selling decisions based on market research and analysis. However, nowadays many investors prefer mutual funds over direct stock investments because of the following benefits:

- **Professional Management:** Mutual funds are managed by expert fund managers who take investment decisions on behalf of investors.

- **Diversification:** Mutual funds invest in different securities, which helps reduce investment risk.
- **Affordable Investment:** Investors can start investing with a small amount through SIPs. Some mutual funds allow investments starting from just ₹100.
- **Liquidity:** Open-ended mutual funds allow investors to withdraw their money easily whenever needed.
- **Transparency and Regulation:** Mutual funds are regulated by SEBI and provide regular updates about fund performance and investments.
- **Convenience:** Investors do not need to monitor the market regularly. Even people with limited knowledge of financial markets can invest easily.
- **Tax Benefits:** Certain mutual fund schemes provide tax benefits under Section 80C of the Income Tax Act.
- **Balanced Risk and Return:** Mutual funds offer different options ranging from low-risk debt funds to high-risk equity funds, according to the investor's risk appetite.

Types of Mutual Funds:

Mutual Funds can be categorised based on different criteria:

1. **Based on Maturity Period:**
    - **Open-Ended Funds:** Investors can invest or withdraw money at any time. These funds are flexible and easy to access.
    - **Close-Ended Funds:** These funds are available for investment only for a limited period at the beginning. Investors usually get their money back after the fixed maturity period.
    - **Interval Funds:** These funds allow investors to buy or sell units only during specific time periods decided by the fund house.
2. **Based on Investment Objective:**
    - **Equity Funds:** These funds mainly invest in shares of companies. They can give higher returns but also involve higher risk.
    - **Debt Funds:** These funds invest in fixed-income instruments like bonds and treasury bills. They usually provide stable returns with lower risk.
    - **Hybrid Funds:** These funds invest in both shares and fixed-income securities, helping balance risk and return.

- **Solution-Oriented Funds:** These funds are designed for specific goals such as retirement or children's education and usually have a lock-in period.

3. **Based on Risk:**
   - **Low-Risk Funds:** These include debt and liquid funds that offer stable returns with lower risk.
   - **Moderate-Risk Funds:** These funds invest in both equity and debt instruments, providing balanced risk and return. They are suitable for conservative investors who want growth along with safety.
   - **High-Risk Funds:** These include equity and sectoral funds that have the potential to give higher returns but also carry higher risk and market fluctuations. For example, a technology sector fund may give high returns when the IT sector performs well.

Specialized Mutual Funds:

Specialized Mutual Funds focus on specific sectors, themes, or investment strategies. These funds are suitable for investors who are willing to take higher risk or want to invest in particular industries or market trends. Since they invest in limited sectors or themes, they usually carry higher risk compared to regular diversified mutual funds.

Two Types of Specialised Mutual Funds:

1. **Sectoral Funds:**
   - Sectoral Funds invest only in a specific sector such as information technology, pharmaceuticals, or banking.
   - These funds can give high returns when that particular sector performs well, but they may also face losses if the sector performs poorly.
   - Therefore, investors should carefully study the growth and future prospects of the sector before investing.
2. **Index Funds:**
   - These funds invest in the same companies that are part of a market index like the Nifty 50 or Sensex, with the aim of giving similar returns as the index.
   - These funds are passively managed, so they usually have lower management costs and fees.

- They are suitable for investors who want stable market-linked returns with comparatively lower risk.

Mutual Funds are a flexible investment option that suits different financial goals and risk levels. They offer various types of funds based on investment period, objectives, and risk preference, helping investors create wealth over time. Specialized Mutual Funds, such as Sectoral Funds and Index Funds, allow investors to invest in specific sectors or benefit from overall market growth. While Sectoral Funds can provide high returns when a sector performs well, Index Funds offer a low-cost and long-term investment option linked to market performance. Investors should choose mutual funds according to their financial goals, risk-taking ability, and investment period.

Q.9) NBFCs have traditionally been referred to as "shadow banks" in India. In this context, explain the concept of NBFCs, examine the Scale-Based Regulatory (SBR) framework introduced by the RBI, along with recent developments in the sector.

(15 Marker)

💡 ***Structure:***

Introduction:

*The RBI introduced the **Scale-Based Regulatory (SBR) framework** in 2021–22 to strengthen supervision of Non-Banking Financial Companies (NBFCs) by aligning regulation with their size, risk, and systemic importance.*

Body:

1. NBFC Categorisation under SBR:

NBFCs are classified into four layers based on risk and size:

- ***Base Layer (BL), Middle Layer (ML), Upper Layer (UL), Top Layer (TL)***

2. NBFCs as Shadow Banks:

3. Recent Developments in the NBFC Sector (2021–2025):

4. Dual Role of NBFCs:

Conclusion:

*The SBR framework has significantly strengthened NBFC regulation by making it **risk-based and structured**. While large NBFCs are tightly regulated, smaller NBFCs still play a shadow banking role in promoting financial inclusion. The effectiveness of this framework depends on continuous monitoring and proper implementation by the RBI.*

Keywords:

NBFC, Shadow Banking, Financial Inclusion, Digital Lending, Demand Deposits, Payment and Settlement System, Scale-Based Regulation (SBR), Risk-Based Regulation, Base Layer (BL), Middle Layer (ML), Upper Layer (UL), Top Layer (TL), Systemically Important NBFCs, RBI Supervision, NPA Norms, 90-Day NPA Recognition, Deposit-Taking NBFCs, Net Owned Funds (NOF), Credit Rating, Branch Expansion, Asset Size Threshold, Government-Owned NBFCs, State Government Guarantees, Credit Risk Transfer, Type I NBFCs, Type II NBFCs, Unregistered Type I NBFCs, Financial Stability, Credit Delivery, RBI Regulatory Framework.

Answer:

Non-Banking Financial Companies (NBFCs) are financial institutions that provide various financial services such as loans, advances, asset financing, investment activities, and wealth management, but they do **not hold a banking licence**. That is why they are called **Shadow banks.**

Unlike banks, NBFCs **cannot accept demand deposits** and are not part of the payment and settlement system.

Today, many NBFCs use digital platforms to provide loans and financial services to people in rural and underserved areas, helping them access credit even where traditional banks have limited presence.

Scale-Based Regulatory (SBR) framework:

The RBI introduced the **Scale-Based Regulation (SBR)** in 2021–22 to regulate NBFCs based on their size and risk. These layers are based on the **size, risk level, and nature of activities** of an NBFC. It means big and risky NBFCs have stricter rules, while small NBFCs follow simpler rules.

Under this framework, NBFCs are categorised into 4 **layers**—

- **Base Layer (BL):** Small and low-risk NBFCs with simple regulations.
- **Middle Layer (ML):** Medium-sized NBFCs with moderate risk and regulation.
- **Upper Layer (UL):** Large and systemically important NBFCs with stricter rules and closer RBI monitoring.
- **Top Layer (TL):** Highest-risk NBFCs identified by RBI for the strictest supervision, normally expected to remain empty.

Recent developments under NBFC:

1. **NBFC Presence:** There are approximately 9,500 registered NBFCs in India.
2. **GDP Share:** As per the RBI, NBFCs now provide credit equal to **around 15% of India's GDP**.
3. **90-day NPA recognition norm:**
    - By **March 31, 2026**, all Base Layer NBFCs must classify a loan as an **NPA (Non-Performing Asset)** if the payment remains overdue for more than **90 days**, similar to the rule followed by banks.
4. **Relaxation in opening branches:**
    - Most NBFCs can now open branches anywhere in India **without taking prior approval from the RBI**, unless the RBI has specifically imposed restrictions on them.

- For **deposit-taking NBFCs,** that is, NBFCs that accept public deposits, branch expansion depends on their **financial strength (Net Owned Funds - NOF)** and **credit rating**.
- However, if an NBFC wants to open a **representative office outside India**, it must first obtain **prior approval from the RBI**.

5. **Simplified Identification of Upper Layer NBFCs:**
   - **Earlier**, RBI used a complex methodology to identify Upper Layer NBFCs, including the top 10 NBFCs based on asset size and a scoring model that considered factors such as size, risk, interconnectedness, and complexity.
   - **Now**, RBI has introduced a simpler rule: any NBFC with **assets of ₹1 lakh crore or more** will automatically be classified as an **Upper Layer (UL) NBFC**.
   - However, the **₹1 lakh crore threshold is not permanent** and will be **reviewed by the RBI every 5 years**.
6. **Equal Treatment for Government-Owned NBFCs:**
   - **Earlier**, government-owned NBFCs were generally not included in the **Upper Layer (UL)** category.
   - **Now**, they will be treated in the same way as private NBFCs.
   - If a government-owned NBFC has **assets of ₹1 lakh crore or more**, it will also be classified as an **NBFC-UL**.
7. **Use of State Government Guarantees:**
   - NBFC-ULs can now use **State Government guarantees.**
     - **State Government guarantees** mean a **promise by a State Government** that if a borrower (like an NBFC or its customer) fails to repay a loan, the **State Government will repay it instead**.
   - This helps in **reducing risk**, but it will be allowed **with certain conditions.**
8. **Unregistered Type I NBFCs:**
   - Under the new RBI framework, certain low-risk NBFCs will no longer require RBI registration.

- These are NBFCs that **do not take public money**, **do not deal with customers**, and have **assets below ₹1,000 crore**.
- Such entities will now be called **"Unregistered Type I NBFCs."**
- **Type I NBFCs** are **low-risk NBFCs** that do **not accept public funds** and do **not deal with customers**.

  → Under the new draft, **Type I NBFCs are split into two**:

  - **Registered Type I NBFCs** → if assets are **₹1,000 crore or more**
  - **Unregistered Type I NBFCs** → if assets are **below ₹1,000 crore**

    (These are **now** exempt from registration with the RBI)
- **Type II NBFCs** are NBFCs that **accept public funds and/or have a customer interface** and therefore **must be registered with the RBI**.

Overall, NBFCs play an important role in India's financial system by providing loans and financial services, especially where banks have limited reach. The RBI's Scale-Based Regulation ensures that NBFCs are regulated based on their size and risk. This means bigger and riskier NBFCs face stricter rules, while smaller ones have simpler regulations. Recent changes aim to improve financial stability while also making it easier for small NBFCs to operate and support financial inclusion.

Q.10) Discuss the origin and evolution of the Reserve Bank of India (RBI), discuss its organisational structure, its functions and duties in maintaining monetary and financial stability in India.

(15 Marks)

ℹ️ ***Structure***:
Introduction: *About RBI and its establishment.*
Body:

1. ***History, Origin, Nationalisation, and Evolution of RBI***
2. ***Organisational Structure of RBI:*** *Central Board of Directors, Committees and departments, Role of Governor and Deputy Governors and Regional offices and hierarchy*
3. ***Functions and Duties of RBI:*** *Monetary authority, Regulator of the financial system, Issuer of currency, Custodian of foreign exchange reserves, Banker to the Government and Developmental and promotional role*

Conclusion: *RBI's role in macroeconomic stability and its evolving role in a dynamic financial landscape*
Keywords: *RBI Act 1934, Hilton Young Commission 1926, Central Board of Directors, Governor and Deputy Governors, Monetary Policy Committee (MPC), Currency issuance, Coins minting, Foreign exchange management, Government's banker, Development role (financial inclusion, NABARD, UPI), Regional Offices (33 locations), price stability and inflation control.*

Answer:

The Reserve Bank of India (RBI), established on April 1, 1935, is India's central bank and apex monetary authority. It regulates the banking system, maintains monetary stability, controls inflation, ensures credit flow, and supports economic development.

1. **Origin:** The idea of a central bank for India was first proposed by the **Hilton Young Commission (Royal Commission on Indian Currency and Finance) in 1926.** Based on its recommendations, the RBI Act, 1934, was enacted. This Act lays down the **functions, powers, and governance structure** of the RBI.

   Establishment: Under **Section 3 of the RBI Act 1934,** RBI was established in 1935 as a private shareholders' bank to manage the country's **currency** and carry out **banking operations** as per the rules of this Act. It started operations in **Kolkata** and later moved to **Mumbai**. The initial paid-up c**apital of the RBI was 5 crore rupees**.

In 1949, after India gained independence, the RBI was nationalised through the **Reserve Bank (Transfer to Public Ownership) Act.**

Evolution of RBI: Post-nationalisation, RBI began to take a more active developmental role in building the Indian economy, especially in agriculture and rural credit. Over the decades, RBI's functions have expanded in response to economic liberalisation, financial sector reforms, and global integration.

2. **Organisational Structure of RBI:** The organisational structure of the RBI is designed to facilitate effective decision-making and policy implementation. It comprises the following key components:
   - **Central Board of Directors:** The highest decision-making body of RBI, constituted under Section 8 of the RBI Act, 1934. It includes:
     - 1 Governor
     - 4 Deputy Governors
     - 4 directors nominated by the central government (one each from the 4 local boards)
     - 10 other directors and 2 government officials

     Under Section 13 of the RBI Act, 1934, the Central Board must meet **at least 6 times in a year**, and **at least once in each quarter**.
   - **Governor and Deputy Governors:** The Governor is the RBI's chief executive, assisted by four Deputy Governors who manage areas like monetary policy, regulation, markets, and supervision.
   - **Departments and Committees:** RBI operates through specialised departments (like the **Monetary Policy Department (MPD), Department of Banking Regulation (DBR), Department of Supervision (DoS), Department of Currency Management (DCM), and Foreign Exchange Department (FED), etc.).**
     - Some of the key committees are the **Monetary Policy Committee (MPC), the Payment Regulatory Board (PRB), the Committee of the Central Board, etc.**
   - **Regional Offices:** The RBI operates through its regional offices located across major cities in India. The RBI has offices at 33 locations.
3. **Functions and Duties of RBI:**

- **Monetary Authority:** The RBI formulates and implements India's monetary policy with the objective of maintaining price stability while supporting economic growth. Through the Monetary Policy Committee (MPC), it decides key policy rates such as the Repo Rate.
- **Issuer of Currency:** Under Section 22 of the RBI Act, the RBI has the sole authority to issue currency notes in India. It ensures an adequate supply of clean and genuine currency across the country. Coins are minted by the Government of India at mints located in **Mumbai, Hyderabad, Kolkata, and Noida**, and are put into circulation through the RBI.
- **Banker, Agent and Adviser to the Government:** The RBI manages the banking transactions of the Central and State Governments, handles public debt, and provides financial and economic advice to the government whenever required.
- **Banker to Banks and Lender of Last Resort:** The RBI acts as the banker to commercial banks by maintaining their reserve balances and facilitating inter-bank transactions. During periods of financial stress, it serves as the **Lender of Last Resort**, providing emergency liquidity support to banks facing temporary shortages of funds.
- **Regulator and Supervisor of the Financial System:** The RBI regulates and supervises banks and various financial institutions to ensure the safety, soundness, and stability of the financial system while protecting depositors' interests.
- **Manager of Foreign Exchange:** Under the provisions of FEMA, 1999, the RBI regulates and manages India's foreign exchange market and facilitates orderly development of external trade and payments.
- **Custodian of Foreign Exchange Reserves:** The RBI maintains and manages India's foreign currency assets, gold reserves, and other reserve assets to ensure confidence in the country's external sector and exchange rate stability.
- **Regulator of Payment and Settlement Systems:** The RBI oversees and regulates payment systems such as UPI, NEFT, RTGS, and other digital payment mechanisms to ensure they remain safe, secure, and efficient.
- **Developmental Role:** Beyond its regulatory functions, the RBI promotes financial inclusion, strengthens rural and agricultural credit, supports

institutional development, and encourages innovation in the financial sector through initiatives such as UPI and support for institutions like the National Bank for Agriculture and Rural Development.

As India's central bank, the RBI performs multiple functions that are essential for the smooth functioning of the economy. Whether it is maintaining price stability, regulating the financial sector, managing foreign exchange reserves, or promoting efficient payment systems, the RBI remains at the heart of India's economic and financial framework.