BANKING SYSTEM IN INDIA

A commercial bank is a type of financial intermediary as it mediates between the savers and borrowers. It does so by accepting deposits from the public and lending money to businesses and consumers. Its primary liabilities are deposits and primary assets are loans and bonds.

"Commercial bank" has to be distinguished from another type called "investment bank". Investment banks assist companies in raising funds in the capital markets (both equity and debt), as well as in providing strategic advisory services for mergers, acquisitions and other types of financial transactions. It is also called merchant bank.

The term commercial banks refers to both scheduled and non-scheduled commercial banks which are regulated under the Banking Regulation Act, 1949. The scheduled banks are those which are included under the 2nd Schedule of the Reserve Bank of India Act, 1934. The scheduled banks are further classified into: Public sector, private sector domestic banks and foreign banks. Among the public sector banks, there are nationalized banks, State Bank of India and Regional Rural Banks (RRBs).

Scheduled banks are those banks which are included in the Second Schedule of the Reserve Bank Act, 1934. They satisfy two conditions under the Reserve Bank of India Act

- paid-up capital and reserves of an aggregate value of not less than Rs 5 lakh
- it must satisfy RBI that its affairs are not conducted in a manner detrimental to the depositors.

The scheduled banks enjoy certain privileges like approaching RBI for financial assistance; refinance etc and correspondingly, they have certain obligations like maintaining certain cash reserves as prescribed by the RBI etc. Non-scheduled banks are those banks which are not included in the second schedule of the RBI Act as they do not comply with the above criteria and so they do not enjoy the benefits either. There are only 3 non-scheduled commercial banks operating in the country with a total of 9 branches. **Local Area Banks** are **Non-scheduled commercial Banks** in India. Scheduled banks comprise Scheduled Commercial Banks and Scheduled Co-operative Banks.

Currently (2017), India has 21 public sector banks that include SBI and the IDBI Bank; there are private banks and foreign banks also. Public sector banks hold over 70 percent of total assets of the banking industry. Share of public sector banks in total deposits is at 76.6 per cent.

GOI nationalized the Imperial Bank Of India in 1955 and the new bank was named as the State Bank of India. The next major nationalisation of banks took place in 1969 when the government of India nationalised an additional 14 major banks. The next round of nationalisation took place in 1980. The government nationalised six banks. The objectives behind nationalisation were:

- To break the ownership and control of banks by a few business families and thus to prevent the concentration of wealth and economic power
- To make banks into a part of socio-economic planning
- To extend banks to rural and unbanked areas
- To mobilize savings from masses from all parts of the country,

- To cater to the needs of the priority sector like weaker sections and poverty alleviation, agriculture, MSMEs etc
- From class banking to mass banking

Private Sector Banks include domestic and foreign banks.

Domestic Private Sector Banks

There are about 23 such banks. The private sector banks are divided into old and new. The old private sector banks existed prior to the nationalisation in 1969 and retained their private status because they were either too small or specialist to be nationalised. The new private sector banks came up after the liberalisation in the 1991.

The Nedungadi Bank was the first private sector bank in India.

Foreign Banks

There are more than 40 such banks operating in India.

State Bank of India

Government of India took over the Imperial Bank of India in 1955 and renamed it the State Bank of India. They were the seven regional banks of former Indian princely states, all of them were renamed with the prefix 'State Bank'. These seven banks were State Bank of Bikaner and Jaipur (SBBJ), State Bank of Hyderabad (SBH), State Bank of Mysore (SBM), State Bank of Patiala (SBP), State Bank of Travancore (SBT), State Bank of Saurashtra (SBS) and State Bank of Indore (SBI - Indore). All these banks used the same logo as its parent bank.SBI acquired the control of seven associate banks in 1960.

The plans for making SBI a mega bank with trillion dollar business by merging associate banks started in 2008 when SBS merged with SBI. The next year, SBI-Indore merged. The process for merging of 5 associate banks (State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala and State Bank of Travancore) and Bharatiya Mahila Bank) started in 2016. The merger of these six subsidiaries was done in 2017. It makes SBI one of the top 50 banks in the world.

State Bank of Bikaner and Jaipur (SBBJ), State Bank of Hyderabad (SBH), State Bank of Mysore (SBM), State Bank of Patiala (SBP) and State Bank of Travancore (SBT), besides Bharatiya Mahila Bank (BMB), merged with SBI with effect from 1 April,2017.With this merger, the bank will join the league of top 50 banks globally in terms of assets.

The total customer base of the bank will reach 37 crores with a branch network of around 24,000 and nearly 59,000 ATMs across the country. The merged entity will have a deposit base of more than Rs.26 lakh crore and advances level of Rs18.50 lakh crore.

The combined entity will enhance the productivity, mitigate geographical risks, increase operational efficiency and drive synergies across multiple dimensions while ensuring increased customer satisfaction.

Post merger, the bank will rationalise its branch network by relocating some of the branches to maximise reach. This will help the bank optimise its operations and improve profitability. Integration of treasuries of the associate banks with the treasury of SBI will bring in substantial cost saving and synergy in treasury operations.

Lok Sabha passed the bill to repeal the SBI (Subsidiary Banks) Act 1959, State Bank of Hyderabad Act 1956 and to further amend the State Bank of India Act, 1955, following the merger of five associates with the parent SBI.

Development Banks

Development Banks are those financial institutions which provide long term capital for industries and agriculture: Industrial Finance Corporation of India (IFCI); Industrial Development Bank of India (IDBI) ; Industrial Credit and Investment Corporation of India (ICICI) that was merged with the ICICI Bank in 2000; Industrial Investment Bank of India (IIBI); Small Industries Development Bank of India (SIDBI); National Bank for Agriculture and Rural Development (NABARD); Export Import Bank of India; National Housing Bank(NHB).

The commercial banking network essentially catered to the needs of general banking and for meeting the short-term working capital requirements of industry and agriculture. Specialised development financial institutions (DFIs) such as the IDBI, NABARD, NHB and SIDBI, etc., with majority ownership of the Reserve Bank were set up to meet the long-term financing requirements of industry and agriculture. To facilitate the growth of these institutions, a mechanism to provide concessional finance to these institutions was also put in place by the Reserve Bank.

The first development bank in India- IFCI- was incorporated immediately after Independence in 1948 under the Industrial Finance Corporation Act as a statutory corporation to pioneer institutional credit to medium and large-scale. Then after in regular intervals the government started new and different development financial institutions to attain the different objectives and helpful to five-year plans.

Government utilized these institutions for the achievements in planning and development of the nation as a whole. The all India financial institutions can be classified under four heads according to their economic importance that are:

- All-India Development Banks
- Specialized Financial Institutions(SIDBI)
- Investment Institutions (The Industrial Reconstruction Corporation of India Ltd., set up in 1971 for rehabilitation of sick industrial companies)
- State-level institutions(SFC)

S.H. Khan committee appointed by RBI(1997) recommended to transform the DFI (development finance institution) into universal banks that can provide a menu of financial services and leverage on their assets and talent.

Cooperative Banks

Co-operative Banks are organised and managed on the principle of co-operation, self-help, and mutual help. They function with the rule of "one member, one vote" and on "no profit, no loss" basis. Co-operative banks, as a principle, do not pursue the goal of profit maximisation.

Co-operative bank performs all the main banking functions of deposit mobilisation, supply of credit and provision of remittance facilities.

Co-operative Banks provide limited banking products and are functionally specialists in agriculture related products. However, co-operative banks are now provide housing loans also.

Urban Co-operative Banks (UCBs) are located in urban and semi-urban areas. These banks, till 1996, were allowed to lend money only for non-agricultural purposes. This distinction does not hold today. Earlier, they essentially lent to small borrowers and businesses. Today, their scope of operations has widened considerably. Urban CBs provide working capital, loans and term loan as well.

Co-operative banks are the first government sponsored, government-supported, and government-subsidised financial agency in India. They get financial and other help from the Reserve Bank of India, NABARD, central government and state governments. RBI provides financial resources in the form of contribution to the initial capital (through state government), working capital, refinance.

Co-operative Banks belong to the money market as well as to the capital market- they offer short term and long term loans.

Primary agricultural credit societies provide short term and medium term loans. State Cooperative Banks (SCBs) and CCBs (Central Cooperative Banks at the district level) provide both short term and term loans. Land Development Banks (LDBs) provide long-term loans.

Long term cooperative credit structure comprises of state cooperative agriculture and rural development bank (SCARDB) at the state level and primary PCARDBs or branches of SCARDB at the decentralised district or block level providing typically medium and long term loans for making investments in agriculture, rural industries, and lately housing. The sources of their funds (resources) are ownership funds

- deposits or debenture issues.
- central and state government
- Reserve Bank of India
- NABARD
- other co-operative institutions

Some co-operative bank are scheduled banks, while others are non-scheduled banks. For instance, SCBs and some UCBs are scheduled banks (included in the Second Schedule of the Reserve Bank of India Act).

Co-operative Banks are subject to CRR and SLR requirements as other banks. However, their requirements are less than commercial banks.

Although the main aim of the co-operative bank is to provide cheaper credit to their members and not to maximize profits, they may access the money market to improve their income so as to remain viable.

Commercial Banks And Their Weaknesses By 1991

The major factors that contributed to deteriorating bank performance upto the end of eighties were

- lack of profitability
- high SLR and CRR
- no credit discipline as there were loan melas
- lack of competition
- directed and concessional lending for populist reasons
- administered interest rates and

The reforms to set the above problems right were

- Floor and cap on CRR were removed and floor on SLR was removed in 2006
- interest rates were deregulated to make banks respond dynamically to the market conditions. Even savings bank deposit rates were deregulated in 2011
- near level playing field for public, private and foreign banks in entry
- adoption of prudential norms- Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning to make banks safer
- Basel norms adopted for safe banking
- VRS for better work culture and productivity
- FDI upto 74% is permitted in private banks
- Differentiated banking so as to cater to the unbanked and also leverage technology to reach the unreached- for the last mile access to the remotely located
- Bank consolidation
- Indradhanush comprising banking sector reforms for professionalization and strength

One of the sectors that has been subjected to reforms as a part of the new economic policy since 1991 consistently is the banking sector. The objectives of banking sector reforms have been:

- to make them competitive and profitable
- to strengthen the sector to face global challenges
- sound and safe banking
- to help them technologically modernize for customer benefit
- make available global expertise and capital by relaxing FDI norms
- inclusive banking

Narasimham Committee

Banking sector reforms in India were conducted on the basis of Narasimham Committee reports I and II (1991 and 1998 respectively), primarily the first report. The recommendations of Narasimham committee 1991 are:

- No more nationalization
- create a level playing field between the public sector, private sector and foreign sector banks
- select few banks like SBI for global operations
- reduce Statutory Liquidity Ratio(SLR) as that will leave more resources with banks for lending to businesses
- reduce Cash Reserve Ratio(CRR) to increase lendable resources of banks

- rationalize and better target priority sector lending as a sizeable portion of it is wasted and also much of it turning into non-performing asset
- introduce prudential norms for better risk management and transparency in operations
- deregulate interest rates
- Set up Asset Reconstruction Company (ARC) that can take over some of the bad debts of the banks and financial institutions and restructure them on profitable lines

Most of these reforms are implemented. SLR is 19.5% (2017) and CRR is 4%. Bank rate is aligned with MSF.Divestment in public sector banks led to their listing on the stock exchanges and their performance has improved.

Bank Loans: Good and Bad

All loans given by banks are classified as either standard or substandard loans.

Standard Assets

Standard assets are performing assets which are being serviced- repayment of principal at the interest rate that is agrred upon- as per the contract. Banks have to make a small amount of provisioning for these good loans also for security. For instance, provision for direct advance to agriculture or small and micro enterprise is 0.25% and for housing loan at teaser (low at the time of giving but sies soon) rates, it is 2%.

Substandard Assets or NPAs

When the borrower pays neither the interest nor the principal for a specified period of time, the loan is said to be non-performing. When a loan is classified as NPA it goes through several phrases as the repayment gets delayed. If the borrower does not pay dues for 90 days, the loan becomes an NPA and it is termed as "Special Mention Account". If this loan remains SMA for a period less than or equal to 12 months; it is termed as Sub-standard Asset.

A sub-standard Asset requires a provision of 15 per cent on secured portion and 25 per cent on the unsecured exposure. After 12 months as Sub-Standard Asset, it gets classified as Doubtful Asset 1(DA1) and requires a provision of 25 per cent on secured portion and 100 per cent on the unsecured portion.

Once the account crosses one year as DA1, it becomes Doubtful Asset 2 (DA2-1to 3 years) and requires a provision of 40 per cent on the Secured portion and 100 per cent on the unsecured portion.

Once it crosses three years, it becomes Doubtful Asset3 (DA3) and requires 100 per cent provision irrespective of the availability of security. It is a loss making asset, in other words. Unsecured loans such as clean loans, educational loans attract 100 per cent provision even at DA1 stage.

Accounts classified as fraud need not go through all these stages and will require 100 per cent provision as soon as it is classified as NPA. Such provisions have to be made out of the profits of the year thus, eroding the bottom line.

Stressed Assets

When an asset shows wekness and is likely to become an NPA, it is considered a stressed asset. RBI allows it to be prevented from becoming an NPA by restructuring: making terms of loan softer by rescheduling the repayment period, lower interest rate, pumping additional assistance etc. They are classified as standard assets. RBI mandated the banks to make additional disclosures regarding restructured loans, which includes the number of proposals received, and the amount involved etc.

AQR

In addition to the annual inspection of bank books of banks done by the Reserve Bank of India (RBI) a special inspection was conducted in 2015-16 called Asset Quality Review (AQR). It involves a small sample of loans being inspected to check if asset classification was in line with the loan repayment and if banks have made provisions adequately.Most of the large borrower accounts were inspected to check if classification was in line with prudential norms. The RBI believed that asset classification has to be done effectively and that banks should not resort to ever-greening of accounts, that is, lend to the loanees who are in in the NPA category to show them to be standard. Banks were postponing bad-loan classification Investors were also facing uncertainties as guidance by banks on bad loans was not proper. The impact of the AQR: banks have classified AQR-identified accounts (which were termed as stressed assets) as NPAs which resulted in an increase in provisioning to 15 per cent or more.

PAC

Prompt Corrective Action norms allow the regulator (RBI) to place certain restrictions such as halting branch expansion and stopping dividend payment on banks. It can even cap a bank's lending limit to one entity or sector. Other corrective action that can be imposed on banks include special audit, restructuring operations and activation of recovery plan. Banks' promoters can be asked to bring in new management, too. The RBI can also supersede the bank's board, under PCA. RBI revised the norms of PCA framework which came into effect in 2017.

The PCA is invoked when certain risk thresholds are breached. There are three risk thresholds which are based on certain levels of asset quality, profitability, capital and levels of NPA.

Stress Tests

Banks are exposed to a variety of risks- market, credit, liquidity etc- which need to be tested for their adequacy continuously. Its need was amply demonstrated when the great recession took place in 2008. A stress test is an analysis or simulation to determine the ability of a bank to deal with an economic or financial crisis. RBI undertakes such stress tests in India. Following tests are usual:

- If stock markets plunge by "x" %
- If rupee swings severely
- If inflation gallops
- If growth crashes
- If global commodity prices swing severely

Extent of The Problem

Total bad loans of India's 38 listed (on the stock exchange) commercial banks are about Rs 8 lakh crore by mid-2017 which accounts for nearly 11 percent of the total loans given by all the banks.Over 90 percent of these are of PSBs .The actual figure is around Rs 20 lakh crore if we include all troubled loans including reported bad loans, restructured assets, written off loans and bad loans that are not yet recognized.

NPAs can occur for a variety of reasons:

- Bad lending practices
- Slowdown in economy
- Discoms could not repay due to bad tariff policy
- Steel companies are running losses due to competition from imports
- Infrastructure companies could not get clearances due to environmental reasons, natural calamities, business cycle
- willful defaulters due to crony capitalism

High levels of NPAs means

- banks' profitability diminishes
- precious capital is locked up
- cost of borrowing will rise as lendable assets shrink
- stock prices of banks will go down and investors will lose
- investment in economy suffers
- if banks have to close down, employees and despositors lose

What Is Being Done

- provisioning
- Capital adrquacy norms according to Basel 3
- securitization law
- ARCs
- foreclosure
- one time settlement
- interest waiver
- writeoffs/writdowns
- debt recovery tribunals
- CDR
- SDR
- S4A
- IBC
- Banking Regulation Act 2017
- Recapitalization bonds

Foreclosure means taking over by the lender of the mortgaged property if the borrower does not conform to the terms of mortgage.

Securitization is the process of pooling a group of assets, such as loans or mortgages, and selling securities backed by these assets.

SARFAESI Act

To expedite recovery of loans and bring down the non-performing asset level of the Indian banking and financial sector, the government in 2002 made a new law that promises to make it much easier to recover bad loans from willful defaulters. Called the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI), the law has given unprecedented powers to banks, financial institutions and asset reconstruction/securitization companies to take over management control of a loan defaulter or even capture its assets. It was further amended in 2016 to speed up the process further.

Asset Reconstruction Company

Asset Reconstruction Companies (ARCs) have been created to bring about a system for recovering Non Performing Assets (NPAs) from the books of secured lenders and unlocking the value of Non-Performing Assets (NPA). Reserve Bank of India (RBI) provides license for ARCs and regulates them. ARCs are empowered by the SARFAESI Act. Securitisation Act (Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002). It allowed selling of the assets held by banks as collalateral in case of NPAs building up. Prior to promulgation of the Securitisation Act, 2002, banks and financial institutions had no option but to enforce their security interests through the court process, which was extremely time consuming.After the enactment of the act many asset reconstruction companies (ARCs) were formed.

ARCs being the specialized agencies have NPA resolution as the core activity.

Narasimhan Committee on Banking Sector recommend them in the 1990'. by way of creation of an "Asset Recovery Fund" to take the NPAs off the lender's books at a discount.SRFAESI Act, 2002 was made. ARC functions within the guidelines issued by RBI.

ARC has been set up to provide a focused approach to Non-Performing Loans resolution issue by:-

- isolating Non Performing Loans (NPLs) from the Financial System (FS),
- freeing the financial system to focus on their core activities and
- Facilitating development of market for distressed assets.

As per RBI, ARC performs the following functions:-

- Acquisition of financial assets
- Change or takeover of Management / Sale or Lease of Business of the Borrower
- Rescheduling of Debts
- Enforcement of Security Interest
- Settlement of dues payable by the borrower

Insolvency and Bankruptcy Code (IBC) 2016 provides opportunity for asset reconstruction companies. Non-performing assets (NPAs) were essentially productive assets which, if turned around, would not only create additional jobs but also contribute to national output.

For this to happen, timely interventions, transparent price discovery and right management were required. GOI made arious legislative and regulatory changes that have created an enabling and supportive operational environment for ARCs and for takeover of stressed assets. These include higher ceiling of 100 per cent for FDI in ARCs, pass through status to ARC trusts for income tax, exemption from stamp duty, enabling trading of security receipts etc.

Resultant collaboration between banks, ARCs and resolution professionals could pave the way to a virtuous cycle of fresh investments, new jobs and additional demand. As a result, a number of new ARCs have sought and obtained registration during recent months. The increasing number of players in the market iss indicative of an increasing interest in the sector but also presented an opportunity for banks to offload stressed assets before fully provisioning for them.

Banking Regulation (Amendment) Act 2017

It amends the Banking Regulation Act, 1949 to allow the Reserve Bank of India (RBI) to issue directions to banks for initiating recovery proceedings against loan defaulters. These proceedings will be under the recently enacted Insolvency and Bankruptcy Code, 2016 (IBC). RBI has acted on these powers and directed banks to initiate recovery proceedings against 12 defaulters who are estimated to account for 25% of India's non-performing assets (NPAs). The RBI has also identified another 488 defaulters for which banks have been directed to finalise a resolution plan within six months.

TBS Challenge

The Economic Survey devotes considerable attention to what it terms India's Twin Balance Sheet (TBS) problem - companies overborrowed and became distressed as their investments did not yield and so could not repay to the banks who thus become mired in NPAs. Thus, the balance sheets of both the borrowing companies and lending banks are under pressure. The issue is important because it is holding up private investment in the country and therefore, growth in all sectors. Many measures are introduced by the government- from Sarfaesi Act, to Asset Reconstruction Companies,. to Strategic Debt Restructuring (SDR) and the Sustainable Structuring of Stressed Assets. The steps taken so far as mentioned above did not pay off due to inherent difficulties. The Insolvency and Bankruptcy Code, 2016 (IBC).Is being put to use by the RBI in 2017 with promise of results. Recapitalisation bonds in 2017 October. The suggestion of the Economic Survey that a Public Sector Asset Reconstruction Company (PARA) be formed to buy the biggest, most complex NPAs and then dispose of them.

PARA

Economic Survey 2017 proposed that Public Sector Asset Rehabilitation Agency o(PARA) be set up to solve the NPA problem of PSBs. PARA is expected to be the special purpose vehicle that will raise money by issuing government bonds with which it will buy the big bad loans of the PSBs. The proposal has advantages of relieving the banks of NPAs; settling the issue faster than when each bank has to settle independently; get better bargain as there is only ne buyer etc. It is the 'bad bank' that the country has been debating for some years.

S4A

RBI took many steps in relation to NPAs. The S4A is one. The scheme seeks to solve the TBS challenge- rwin balance sheet, by converting a portion of large loan accounts into equity shares.For a distressed company to be eligible for S4A, the RBI has put down three conditions. The project must be operating and already generating cash. The total loans to the entity should be ₹500 crore or more.The lending banks are required to engage an independent agency to evaluate how much of the debt is 'sustainable'. For the loan to be eligible for S4A, at least 50 per cent of it should be 'sustainable'.

Strategic Debt Restructuring

The RBI in its "Framework for Revitalising Distressed Assets in the Economy – Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP)", in 2015 suggested change of management as a part of restructuring of stressed assets. RBI suggests that Joint Lenders' Forum (JLF) should actively consider such change in ownership and take necessary action.

Prudential Norms

For the safety of banking operations, they need to follow prudential norms.Prudential norms relate to

- income recognition
- asset classification
- provisioning for NPAs
- capital adequacy norms(capital to risk-weighted asset ratio, CRAR).

A proper definition of income is essential in order to ensure that banks take into account income that is actually realized (received). It helps in classifying an asset as NPA in certain cases. Once classified as NPA, funds must be set apart to balance the bank's operations so as to maintain safety of operations in case of non-recovery of NPAs. Thus, income recognition, asset classification and provisioning norms are inter-related.

Prudential norms make the operations transparent, accountable and safe.

Prudential norms serve two primary purposes: bring out the true position of a bank's loan portfolio and help in prevention of its deterioration.

Safety of Banks And Basel Norms

Banks lend to different types of borrowers and each carries its own risk. They lend the deposits of public as well as money raised from the market- equity and debt. The intermediation activity exposes the bank to a variety of risks. Cases of big banks collapsing due to their inability to withstand are many. Therefore, banks are recommended to to keep aside a certain percentage of capital as security against the risk of non-recovery. Basel committee provided the norms called Basel norms to tackle the risk.

Basel Norms

The Basel Accords is a set of recommendations for regulations for the banks. The **Basel Accords**—Basel I, Basel II and Basel III— are issued by the Basel Committee on Banking Supervision (BCBS). They are called the Basel Accords as the BCBS maintains its secretariat at the Bank for International Settlements in Basel, Switzerland and the committee normally meets there.

The aim of the Basel Accords is to ensure that banks and other financial institutions have enough capital to meet their obligations to depositors and other stakeholders and absorb unexpected losses.

Basel III

It is a global, voluntary regulatory framework on bank capital adequacy, stress testing, etc. It was agreed upon by the members of the Basel Committee on Banking Supervision in 2010–11, and was introduced in 2013 to be adopted till 31 March 2019. It was developed in response to the deficiencies in financial regulation revealed by the financial crisis of 2007–08. The major thrust area of Basel III is improvement of quantity and quality of capital of banks, with stronger supervision, risk management and disclosure standards.

Under Basel III norms, banks need to have a total capital adequacy ratio of 11.5% against 9% now.

Three Pillars

Apart from the risks which make up Pillar 1, there are two more Pillars of Basel regulations. Pillar 2 Enlarges the role of banking supervisors.Pillar 3 Defines the standards and requirements for higher disclosure by banks on capital adequacy, asset quality and other risk management processes.

Basel norms cover a variety of risks- **credit risk, market risk and operational risk.**

Credit risk: A bank always faces the risk that some of its borrowers may not repay loan, interest or both. This risk is called credit risk, which varies from borrower to borrower depending on their credit quality. Basel II requires banks to accurately measure credit risk to hold sufficient capital to cover it.

Market risk: As part of the statutory requirement, in the form of SLR (statutory liquidity ratio), banks are required to invest in liquid assets such as cash, gold, government and other approved securities. For instance, Indian banks are required to invest 19.5% of their net demand and term liabilities in cash, gold, government securities and other eligible securities to comply with SLR requirements (2017). Such investments except the government securities (which carry zero risk) are risky as prices fluctuate. It is known as the market risk as the value of the investments depends on market forces.

Operational risk :Several events that are neither due to default by third party nor because of the vagaries of the market make up the operation risk like fraud, security, privacy protection, legal risks, physical (e.g. infrastructure shutdown) or environmental risks.

Capital Adequacy Norms

Banks need to have adequate capital- profits or share capital and debt capital- to absorb a variety of risks. It is set at a certain level as Capital Adequacy Ratio (CAR) which is the same as Capital to Risk (Weighted) Assets Ratio (CRAR). It is expressed as a percentage of a bank's risk weighted credit exposures.Its purpose is to protect depositors and promote stability and efficiency of financial systems around the world.RBI mandated the CAR norms for Basel 3 for Indian banks. It is fixed at 9% which is higher than the international norm of 8%.Under Basel III norms, a countercyclical capital buffer is prescribed: keep aside capital that can be used when the cycle turns down due to slowdown or recession and the loans may turn bad.

CAR

Banks lend to different sectors. Historically, each of these sectors- agriculture, students, exporters, infrastructure etc are calculated to have certain quantified level of risk. Banks need t keep aside capital as a security in case of non-recovery. That is, all bank loans are risk-weighted assets except bogernment bonds which carry zero risk. This type of asset calculation is used in determining the capital requirement or Capital Adequacy Ratio (CAR) for a bank. Government debt is allowed a 0% "risk weighting" that is, they are subtracted from total assets for purposes of calculating the CAR.

India and CAR

As per the Reserve Bank of India direction, the Basel III capital regulation is being implemented from April 1, 2013 in India in phases, and it will be fully adopted as on March 31, 2019. India witnessed three important structural reforms demonetisation, Goods and Services Tax (GST), Real Estate Regulatory Authority (RERA) which are impacting Indian economy and the banking sector.The country's banking sector, which is the key driver of Indian economy, is currently going through challenging times due to low credit growth, deterioration in asset quality and low profitability.

Basel III norms require Indian banks to mobilise up to Rs 4,20,000 crore by 2019. PSBs can not generate profits for the reasons cited above. To raise debt or equity from the market to this extent is also very difficult as investors confidence is low. Even if the PSBs can raise equity, it will mean that the government holding in them will fall closer to 50% and the government is not ready for it. Therefore, under Indradhanush initiative, GOI is taking up recapitalization of banks. In fact the earlier commitments of 2015 under the scheme are being scaled up significantly with the issue of recapitalization and the bonds that were announced in October 2017.

BIS

The Bank for International Settlements (BIS) is an international financial institution owned by central banks which “fosters international monetary and financial cooperation and serves as a bank for central banks”. The BIS carries out its work through its meetings, programmes etc. It also provides banking services, but only to central banks and other international organizations. It is based in Basel, Switzerland. The mission of the BIS is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks. Sixty member central banks or monetary authorities are there in BIS including India.

Bank Run

There are times when people are not confident about their bank’s capacity to honour its financial commitments. They fear its insolvency for any number of reasons When a large number of such customers of a bank want to withdraw their deposits at the same time due to such concerns , the bank’s resources get even more depleted , the likelihood of default increases, thereby prompting more people to withdraw their deposits. It is known as a bank run.

Shadow Banks

There are many financial institutions that perform functions like banks- raise deposits and equity, float bonds and so on and lend them to investors and consumers – but are not covered by the stringent regulations like banks. Some of them are floated by the banks themselves like mutual funds, investment banks, housing finance bodies etc. They are refered to as shadow banking system. Because of their lax conduct, some say the sub-prime crisis of 2008 resulted.

Universal Banking in India

A **universal bank** is one that follows a " cafeteria" approach to financial services by offering all of them itself- retail, wholesale and investment banking services under one roof.It is both a commercial bank and an investment bank as well as providing other financial services such as insurance. Thus, it is a "full-service" bank providing wealth and asset management, housing and auto finance, trading, underwriting, consultancy, financial advisory etc. All commercial banks in India are universal banks. Reserve Bank of India appointed committee — Khan Working group — in 1998 recommended universal banking as was done earlier by the Narasimham Committee in 1988. It has advantages like better use of given human, financial and institutional resources. Disadvantage is that the regulatory norms not being strict for the non-banking activities, they can derail the entire bank as it happened in the sub-prime crisis in 2008 in the USA.

Writeoff, Writedown and Haircut

Hair cut in bank parlance is when an asset value is brought down as it can not be realized in full. For example, a loan that is given may not be recovered fully or at all. The first case is one of wtite down and the latter is writeoff. Both are examples of hair cut.

Insolvency and Bankruptcy Code 2016

Insolvency and Bankruptcy Code 2016 was passed in the Budget session of Parliamment in 2016 and came into effect.

Background

Till IBC came into effect, India did not have effective legal and institutional machinery for dealing with debt defaults as per the global standards. The recovery proceedings by creditors, either through the Contract Act or through special laws such as the Recovery of Debts due to Banks and Financial Institutions Act, 1993 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, has not had desired outcomes. Similarly, action through the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) and the winding up provisions of the Companies Act, 1956 were ineffective. Laws dealing with individual insolvency, the Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920, were outdated. This has hampered the confidence of the lender. The new law aims to consolidate the laws relating to insolvency into a single legislation and provide for their reorganization and resolution in a time bound manner for maximization of value of their assets. This law will thus promote entrepreneurship, availability of credit and balance the interest of all stakeholders. The Code empowers the employees, suppliers etc. also to initiate the insolvency resolution process upon non-payment of dues. In order to develop the credit market in India, in case of liquidation, financial debts owed to unsecured creditors have been kept above the Government's dues in the list of priorities. Facilitating early resolution and exit is as important as facilitating investment. When decisions are taken in a time-bound manner, there is a greater chance that the corporate entity can be saved as a going concern, and the productive resources of the economy (labour and capital) can be put to the best use. This is in complete departure from SICA regime where there were delays leading to destruction of the value of the firm.

The 2016 Code is systemic reform to address this problemand covers borrowing by firms and also by individuals.

The Code separates commercial aspects of the insolvency proceedings from judicial aspects. While Insolvency Professionals (IPs) will deal with commercial aspects such as management of the affairs of the corporate debtor, facilitating formation of committee of creditors, organising their meetings, examination of the resolution plan, etc., judicial issues will be handled by Adjudicating Authorities (National Company Law Tribunal / Debt Recovery Tribunal). One more important institution created under the Code is the 'Information Utility' which would store financial information and data and terms of lending in electronic databases. This would eliminate delays and disputes about facts when default does take place. The Code also addresses the important issue relating to cross border insolvency by providing the enabling mechanism on the subject. The Government, at an appropriate time, will come out with a detailed framework for cross border insolvency. The Code will give a big boost to ease of doing business in India.

Highlights of the Code

Insolvency is a situation when an individual/firm is unable to meet the financial obligations due to its creditors. Bankruptcy, on the other hand, is a legally-declared status that an individual/firm cannot repay debts.

The 2016 Code seeks to speed up the process of resolution and do justice to stake holders. The Code creates various institutions to facilitate resolution of insolvency. These are as follows:

- *Insolvency Professionals*: A specialised cadre of licensed professionals is proposed to be created. These professionals will administer the resolution process, manage the assets of the debtor, and provide information for creditors to assist them in decision making.
- *Insolvency Professional Agencies*: The insolvency professionals will be registered with insolvency professional agencies. The agencies conduct examinations to certify the insolvency professionals and enforce a code of conduct for their performance.
- *Information Utilities*: Creditors will report financial information of the debt owed to them by the debtor. Such system by creating a data base tracks serial defaulters.Such information will include records of debt, liabilities and defaults.
- *Adjudicating authorities*: The proceedings of the resolution process will be adjudicated by the National Companies Law Tribunal (NCLT), for companies; and the Debt Recovery Tribunal (DRT) for individuals. The duties of the authorities will include approval to initiate the resolution process, appoint the insolvency professional, and approve the final decision of creditors. The NCLT appoints an insolvency professional or 'Resolution Professional' to administer the IRP. The Resolution Professional's primary function is to take over the management of the corporate borrower and operate its business as a going concern under the broad directions of a committee of creditors. Therefore, the thrust of the Code is to allow a shift of control from the defaulting debtor's management to its creditors, where the creditors drive the business of the debtor with the Resolution Professional acting as their agent.

- *Insolvency and Bankruptcy Board*: The Board will regulate insolvency professionals, insolvency professional agencies and information utilities set up under the Code. The Board will consist of representatives of Reserve Bank of India, and the Ministries of Finance, Corporate Affairs and Law.

The Code Proposes The Following Steps To Resolve Insolvency:

Initiation: The Code makes a significant departure from the existing resolution regimen by shifting the responsibility on the creditor to initiate the insolvency resolution process against the corporate debtor. Any corporate debtor who commits a default, a financial creditor (banks and bond-holders), an operational creditor (trade creditors) or the corporate debtor or employees or shareholders may initiate corporate insolvency resolution process.

- The insolvency professional administers the process. The professional provides financial information of the debtor from the information utilities to the creditor and manage the debtor's assets. This process lasts for 180 days and any legal action against the debtor is prohibited during this period.
- *Decision to resolve insolvency*: A committee consisting of the financial creditors who lent money to the debtor will be formed by the insolvency professional. The creditors committee will take a decision regarding the future of the outstanding debt owed to them. They may choose to revive the debt owed to them by changing the repayment schedule, or sell (liquidate) the assets of the debtor to repay the debts owed to them. If a decision is not taken in 180 days, the debtor's assets go into liquidation. For firms with smaller operations, the code stipulates a fast-track IRP which will be completed within 90 days and may be extended if 75% of financial creditors consent to revival plans.
- *Liquidation*: If the debtor goes into liquidation, an insolvency professional administers the liquidation process. Proceeds from the sale of the debtor's assets are distributed in the following order of precedence: i) insolvency resolution costs, including the remuneration to the insolvency professional, ii) secured creditors, whose loans are backed by collateral, dues to workers, other employees, iii) unsecured creditors, iv) dues to government, v) priority shareholders and vi) equity shareholders.

Workers' salaries for up to 24 months will get first priority in case of liquidation of assets of a company, ahead of secured creditors.

Significance of The Code

- Speedier insolvency resolution
- More power to creditors
- Enhance ease of doing business
- Reduce bad loans
- India is a capital starved country and therefore it is essential that capital used productively. Quick resolution of bankruptcy can ensure this.

P. J. Nayak Committee

Committee for Review of Governance of Boards of Banks in India chaired by Mr. P. J. Nayak was constituted to examine the working of banks' boards, review RBI guidelines on bank ownership and representation in the board, and investigate possible conflicts of interest in board representation. Its recommendations related to PSBs and private banks. Main recommendations of the Committee are:

Ownership of Public Sector Banks (PSBs): All PSBs should be incorporated under the Companies Act, 2013. The government should transfer its holdings in PSBs to a Bank Investment Company (BIC). Some of the constraints faced by PSBs could be removed if the government reduces its holding below 50%.

Board appointments in PSBs: The process of board appointments in PSBs needs to be professionalised in a three-phase process. In the first phase, a Banks Board Bureau should advise on all board appointments. In the second phase BIC should take over the process. In the third phase, BIC should delegate these powers to PSBs' boards.

It suggested a fixed term of 5 years for the chairman/managing director of a bank and a term of 3 years for a whole-time director.

Bank Consolidation

The consolidation of PSBs , which have a market share of about 70% and account for over 80% of the bad loans in the Indian banking system, is aimed at building scale , strengthening their risk-taking ability, operational efficiency, deal better with their credit portfolio, including stressed assets, prevent duplication of bank branches in the same area and strengthens banks to deal with shocks.

The government wants that this, along with measures such as capital infusions in weak banks, will cause a revival.The government is looking to reduce the number of staterun banks to 10-15 through mergers and acquisitions In case of consolidation, GOI factors in balance sheet, integration of technology and people.

GOI in October 2017 set up a ministerial panel, headed by Union Finance Minister Arun Jaitley, to consider and oversee mergers among the country's 21 state-run banks.

SBI has merged operations of five of its associate banks and Bharatiya Mahila Bank with itself earlier this year, marking the first consolidation move in the sector following the bad loan crisis. The merger has reduced the number of state-controlled banks to 21 from 26.The government announced infusing capital in excess of the ₹20,000 crore promised as part of the Indradhanush plan over this fiscal year and the next.Under the Indradhanush scheme introduced in 2015, the government had agreed to infuse ₹70,000 crore in state-run lenders over four years. In October 2.11 lakh crores of rupees is committed for rrecapitalisation.

Critics disagree. The objections are that it is a tactical decision to address the NPA issues and so will be damaging in the long run. Employee rationalization is also worrying some.

The idea of bank mergers has been around since at least 1991, when former Reserve Bank of India governor M. Narasimham recommended the government merge banks into a threetiered structure, with three large banks with an international presence at the top. In 2014, the P. J. Nayak panel suggested that the government either merge or privatize stateowned banks.

Indradhanush

To revive the NPA-burdened public sector banks, government introduced in 2015 a seven-point plan called 'Indradhanush.'

The Indradhanush strategy consists of

- Appointments
- Bank of Board Bureau
- Capitalization
- De-Stressing Public Sector Banks
- Empowerment
- Framework of accountability
- Governance Reforms

Details

- **Appointments:** Executives from the private sector have been engaged to head state-owned banks.
- **Bank Board Bureau (given ahead)**
- **Capitalization:** Over the next four years, the government plans to inject Rs 70,000 crore.
- **De-stressing:** Due to lending to large projects turning bad, NPAs has resulted and the GOI will de-stress the banks' bad loans by a variety of means like CDR, SDR, S4A etc.
- **Empowerment:** it is about Government's non-interference in the management of banks. The Government intends to provide greater flexibility in hiring manpower to Banks.
- **Framework of Accountability:** The government also announced a new framework of key performance indicators for state-run lenders to boost efficiency in functioning while assuring them of independence in decision making on purely commercial considerations.
- **Governance Reforms:** The process of governance reforms is centered around "Gyan Sangam" - a conclave of PSBs and FIs organized at the beginning since 2015 as a Retreat for Banks and Financial Institutions" to take forward the Government's commitment to reforms in the banking and financial Sector

Banks Board Bureau

The Bureau is an autonomous body, responsible for: (i) making recommendations on heads of public sector banks and financial institutions, and (ii) helping banks with developing strategies and raising capital. The Bureau is headed by Mr. Vinod Rai, former Comptroller and Auditor General of India and six other members. A committee set up by the RBI to review the governance of bank boards, headed by P.J. Nayak, in 2014 had suggested the formation of the bureau as a the first stage in a phaseed process to empower the boards of public sector banks. BBB aims to 'professionalize and depoliticize" the appointment process.The objective of BBB is to help prepare the banks in the public sector to take on the competition, have the ability to manage risk across business cycles. The Bureau is engages with the Public Sector Banks (PSBs) to help build capacity to attract, retain and nurture both talent and technology.

Differentiated Banking

In a dynamic growth-oriented economy, the financial sector needs to keep pace with the demands of the real sector. It is crucial that the financial system is flexible and competitive to cope with multiple objectives and demands made on it by various constituents of the economy. The financial sector catering to different segments, ranging from retail to wholesale, micro-finance, nurturing specific sectors and offering specialised services and tailor-made products to niche segments, is crucial for economic growth and financial inclusion.

There has been movement towards differentiated banking in the country since Nachiket Mor Committee in 2013. Differentiated banks are distinct from universal banks as they function in a niche segment. The differentiation could be on account of capital requirement, scope of activities or area of operations. As such, they offer a limited range of services / products or function under a different regulatory dispensation. The concept is not entirely new. In fact, and in a sense, the UCBs, the PACS, the RRBs and LABs could be considered as differentiated banks as they operate in localized areas.

Reserve Bank of India (RBI) in recent years has issued licences and debated upon the need for niche banks and put new lending systems in place as it seeks to widen sources of funding in the economy.For example, in 2016 RBI gave in-principle approval to 10 small finance banks and 11 payments banks. Wholesale and Long-Term Finance (WLTF) banks are under discussion.

The Reserve Bank of India released a Discussion Paper on 'Wholesale & Long-Term Finance Banks'.As envisaged in the discussion paper, the Wholesale and Long-Term Finance (WLTF) banks will focus primarily on lending to infrastructure sector and small, medium and corporate businesses. They may have negligible retail sector exposure on asset side.

Small Finance Banks

Small finance banks are a part of differentiated banking in India focused on basic banking service of acceptance of deposits andlending for financial inclusion to sections of the economy not being served by other banks, such as small business units, small and marginal farmers, micro and small industries and unorganised sector entities.

The Small Finance Bank (SFB) is a private financial institution that can operate without any restriction in the area unlike Regional Rural Banks or Local Area Banks.The minimum capital for SFBs is prescribed at Rs. 100 crore. Foreign Investment is permitted as in the case of other private sector commercial banks.

SFBs are full spectrum banks in contrast to payments banks. Hence, they are subject to all prudential norms and regulations of RBI as applicable to existing commercial banks like maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).

SFBs are required to extend 75 per cent of credit to the sectors eligible for classification aspriority sector lending (PSL) by the Reserve Bank. At least 50 per cent of its loan portfolio should constitute loans and advances of upto Rs. 25 lakh.

SFBs can undertake other non-risk sharing financial services activities, not requiring any commitment of own fund, such as distribution of mutual fund units, insurance products, pension products, etc. SFBs can set up dealership in foreign exchange business SFBs cannot set up subsidiaries to undertake non-banking financial services activities.

There will not be any restriction in the area of operations of small finance banks; however, preference will be given to those applicants who in the initial phase set up the bank in a cluster of under-banked States / districts. It is mandatory that at least 25 per cent of its branches shall be in unbanked rural centers.

Equitas Small Finance Bank Ltd and Ujjivan Small Finance Bank Ltd are listed entities.Mumbai-based Suryoday Small Finance Bank Ltd, Varanasi based Utkarsh Small Finance Bank and Kerala based ESAF Small Finance Bank Ltd started operations by 2016. North East Small Finance Bank Limited commenced operations from 2017.

Following are ligible to apply

- Existing Non-Banking Finance Companies (NBFCs),
- Micro Finance Institutions (MFIs), and
- Local Area Banks (LABs) that are owned and controlled by residents can also opt for conversion into small finance banks.

The concept of small finance banks was one of the recommendations in the 2009 Report - A Hundred Small Steps - of the Committee on Financial Sector Reforms headed by Dr. Raghu Ram Rajan.

Payments Banks

Payments banks are a new type of bank conceptualised by the Reserve Bank of India (RBI). These banks can accept a restricted deposit, which is currently limited to ₹1 lakh per customer and may be increased further. These banks cannot issue loans and credit cards. Both current account and savings accounts can be operated by such banks. Payments banks can issue services like ATM cards, debit cards, net-banking and mobile-banking.

The bank should be fully networked from the beginning. The bank can accept utility bills. It cannot form subsidiaries to undertake non-banking activities. The bank cannot undertake lending activities. 25% of its branches must be in the unbanked rural area. The bank must use the term "payments bank" in its name to differentiate it from other types of bank. The banks will be licensed as payments banks under Banking Regulation Act, 1949, and will be registered as public limited company under the Companies Act, 2013.

India has 4 payments banks by 2017: The first such bank was Airtel Payments Bank Ltd, followed by India Post Payments Bank Ltd , Paytm Payments Bank Ltd and ,Fino Payments Bank Ltd.

India Post Payments Bank (IPPB)

n 2014, a task force was formed by GOI to study ways in which the existing postal network ould be used more, headed by T. S. R. Subramanian. It said that more services should be provided n the field of banking, insurance and e-commerce. In 2015, during the presentation of the Budget, t was announced that India Post will use its large network to set up a payments bank. IPPB ecame operational from 2017. It is the third entity after Airtel and Paytm payments bank, to get e central bank's approval and the second after Airtel Payment Bank to commence operations.

India Post Payments Bank (IPPB) is set up as a public limited company under the Department of Posts with 100 per cent government equity.

India Post has about 1,54,000 post offices, of them 90% are in rural areas. There is one post office for every 7176 people in India. India Post also has 2,96,000 agents in the rural area. About 2.2 crore people, already receive their National Rural Employment Guarantee Act (NREGA) payments by post offices. After State Bank of India, India Post has the largest deposits valued at ₹6 lakh crore.T. S. R. Subramanian Committee said that it could aid in the ongoing Pradhan Mantri Jan Dhan Yojana financial inclusion plan

D. IPPB will offer demand deposits such as savings and current accounts upto a balance of Rs 1 Lac, digitally enabled payments and remittance services of all kinds between entities and individuals and also provide access to third party financial services such as insurance, mutual funds, pension, credit products, forex, and more, in partnership with insurance companies, mutual fund houses, pension providers, banks, international money transfer organisations, etc.

The four key features of IPPB are:

Financial literacy: IPPB aims to make India prosperous by ensuring that everyone has equal access to financial information and services.

Streamlining payments: Beneficiaries can access income from government's DBT programs like MNREGA wages, Social Security Pensions and scholarships, directly from their IPPB bank account. They can also pay their utility bills, fees for educational institutions and many more from the same IPPB account.

Financial inlcusion: Hundreds of millions of Indians who don't have access to banking facilities cannot avail of government benefits, loans and insurance, and even interest on savings. IPPB will reach the un-banked and the under-banked across all cross sections of society and geographies.

Easy access: With over 1.54 lac post offices across the country, postal delivery system will make IPPB an accessible banking network. IPPB also offers services through internet and mobile banking, and prepaid instruments like mobile wallets, debit cards, ATMs, PoS and MPoS terminals etc.

MUDRA Bank

Micro Units Development Refinance Agency (MUDRA) Bank is a refinance institution for micro-finance institutions. It aims to provide the funding to the non corporate small business sector. MUDRA is conceived not only as a refinance institution and but also as a regulator for the micro finance institutions (MFIs).

The MUDRA Bank is primarily be responsible for

- Laying down policy guidelines for micro/small enterprise financing business
- Registration of MFI entities
- Regulation of MFI entities
- Accreditation /rating of MFI entities
- Promoting right technology solutions for the last mile
- Formulating and running a Credit Guarantee scheme for providing guarantees to the loans which are being extended to micro enterprises

- Creating a good architecture of Last Mile Credit Delivery to micro businesses under the scheme of Pradhan Mantri Mudra Yojana.

Union Budget 2015-16 proposed to create MUDRA with a corpus of Rs. 20,000 crore made available from the shortfalls of Priority Sector Lending. There is a credit guarantee corpus of Rs.3,000 crore for guaranteeing loans being provided to the micro enterprises. MUDRA Bank will refinance Micro-Finance Institutions through a Pradhan Mantri Mudra Yojana.

MUDRA Bank operates through regional level financing institutions who in turn connect with last mile lenders such as Micro Finance Institutions (MFIs), Small Banks, Primary Credit Cooperative Societies, Self Help Groups (SHGs), NBFC (other than MFI) and such other lending institutions.

In lending, MUDRA gives priority to enterprises set up by the under-privileged sections of the society particularly those from the scheduled caste / tribe (SC/ST) groups, first generation entrepreneurs and existing small businesses. There are estimated to be some 5.77 crore small business units in India, mostly individual proprietorship, which run small manufacturing, trading or service businesses. 62% of these are owned by SC/ST/OBC.

MUDRA Bank is proposed to be set up through an enactment of law and it will take some time. To begin with, the same is being operationalised as a subsidiary of Small Industries Development Bank of India (SIDBI). The micro finance institutions (MFIs) can become Member Lending Institutions (MLIs) with MUDRA (SIDBI) Bank for refinance and with National Credit Guarantee Trustee Company (NCGTC) for credit guarantee.

PMMY

The Pradhan Mantri MUDRA Yojana (PMMY) is a scheme launched by the Union Government in 2015 for providing loans upto Rs. 10 lakh to the non-corporate, non-farm small/micro enterprises. Under PMMY, all banks viz. Public Sector banks, Private Sector Banks, Regional Rural Banks (RRBs), State Co-operative Banks, Urban Co-operative Banks, Foreign Banks and Non-Banking Finance Companies (NBFCs)/Micro Finance Institutions (MFIs) - are required to lend to non-farm sector income generating activities below Rs.10 lakh. These loans are classified as **MUDRA loans** under PMMY.

For implementing the Scheme, government has set up a new institution named, MUDRA (Micro Units Development & Refinance Agency Ltd.), for development and refinancing activities relating to micro units, in addition to acting as a regulator for the micro finance sector, in general. MUDRA provides refinance to all banks seeking refinancing of small business loans given under PMMY. Thus, MUDRA refinances all *Last Mile Financiers* - Non-Banking Finance Companies of various types engaged in financing of small business, Societies, Trusts, Section 8 Companies [formerly section 25], Co-operative Societies, Small Banks, Scheduled Commercial Banks and Regional Rural Banks - which are in the business of lending to Micro/Small business entities engaged in manufacturing, trading and services activities.

The purpose of PMMY is to provide funding to the non-corporate small business sector. Non-Corporate Small Business Segment (NCSBS) consists of millions of proprietorship/ partnership firms running as small manufacturing units, service sector units, shopkeepers, fruits/ vegetable vendors, truck operators, food-service units, repair shops, machine operators, small industries, artisans, food processors and others, in rural and urban areas. One of the biggest hurdles to the growth of entrepreneurship in the Non-Corporate Small Business Sector (NCSBS) is lack of financial support to this sector and a vast majority belonging to this sector do not have access to formal sources of finance.

Under the aegis of PMMY, the MUDRA created its initial set of products/ schemes. The interventions have been named 'Shishu' (meaning infant), 'Kishor' (meaning child) and 'Tarun' (meaning adolescent) to signify the state of growth/development and funding needs of the beneficiary micro unit/entrepreneur and also provide a reference point for the next phase of graduation / growth to look forward to:

- *Shishu:* covering loans upto Rs. 50,000/- provided with no collateral, @1% rate of interest/month repayable over a period of 5 years
- *Kishor:* covering loans above Rs.50,000/- and upto Rs. 5 lakh
- *Tarun:* covering loans above Rs. 5 lakh to Rs. 10 lakh

To begin with, MUDRA has enrolled 21 Public Sector Banks, many private sector banks, Regional Rural banks and Micro Finance Institutions as partner institutions for channelizing assistance to the ultimate borrower.

A minimum of 60% of support would flow to enterprises in the smallest segment. Partner intermediaries of MUDRA Bank have to endeavour to adhere to the following broad framework:

- First time entrepreneurs, youth entrepreneurs (i.e. entrepreneurs aged upto 30 years) and women entrepreneurs shall be encouraged and special schemes shall be designed for such entrepreneurs.
- Emphasis shall be on cash flow based lending and not security based lending. Collateral securities, etc. shall be avoided.
- Repayment obligations shall be flexible and shall be framed keeping in view the business cash flows of the entrepreneur.

Recapitalisation

It has been in news since many years as PSBs are in need of capital both the meet basel3 norms by 2019 and also to withstand the impat of NPAs. Indradhanush in 2015 commits the government to recapitalization. The October 2017 bonds take the process further. Banks like other corporate entities have equity and debt making up their capital in a certain ratio. Changing the ratio is called recapitalization. It can happen by infusion of fresh capital or conversion of debt into shares or vice versa.

In general, the aims of recapitalization may be:

- Desire of current shareholders to partially exit the investment
- Providing support of falling share price
- Protection from a hostile takeover

October 2017

2.11 lakh crores of bank recapitalisation plan spread over 2 years, announced for the PSBs in October 2017 seeks to bail out the NPA-inflicted entities to stimulate the flow of credit to spur private investment. Out of the total commitment, Rs1.35 lakh crores will come from the sale of recapitalisation bonds. The remaining Rs76,000 crore will be through budgetary allocation and fundraising from the markets. Banks will buy the bonds with their deposits. It fetches them interest. GOI on its part will buy shares of the PSBs and infuse the equity capital into them. Today, PSBs do not have adequate capital to lend the deposits that they are sitting on. Recapitalisation will help them solve this problem. Interest will be paid from budget. Banks' health will improve as they start lending. Share prices of the banks will rise. GOI will sell these shares at a higher price to redeem the bonds. Thus, it is a win-win solution.

GOI did it in the early 1990s the PSBs saw a severe erosion in their profitability and capital base due to reckless lending to the priority sector in the preceding decade.

The advantages of the bonds are that the same money need not be raised by taxing the citizen; by borrowing directly from the banking system instead of the markets, the Centre can avoid crowding out private borrowings. Coupled with Bharatmala in 2017, it can aid "crowding in"; borrowing costs are lower for the GOI than the PSBs that are weak; banks will find the investment in these bonds safe and they just need to divert the SLR excess investment; But there are downsides too: will the banks lend again as they did, without due diligence; nation's debt-to-GDP ratio will rise; fiscal deficit calculation also matters.

It needs to he stressed that unless used to start a new chapter in PSB governance driven by recommendations selectively from PJ Nayak committee and BBB, this policy may not make much of a difference.

FDI In Banks

FDI in India banks is allowed. In PSBs, 20% of FDI is allowed and in private banks it is 74%- upto 49% it is automatic and beyond that it is on approval basis. However, voting rights are capped in national interest at 10%.

Foreign Banks: Subsidiary Vs Branch

Indian Government allows foreign banks to operate by registering as a branch office or by incorporating a subsidiary. A branch office is a considered an extension of the parent company and is not considered a separate legal entity. The assets and liabilities of branch office are considered as merged with the parent office. Subsidiary has a separate legal status; there is Indian investment; assets and liabilities are separate. It has to have a separate management in India. Any losses incurred by parent can not be offset by subsidiary's assets. This arrangement protects Indian capital and operations from external economic shocks as such outfits follow local guidelines. It can raise capital from Indian share market as a separate entity.

At present, most foreign banks operate as branches or representative offices of the parent.