CHAPTER

12

BANKING IN INDIA

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*Banks are perhaps the most important financial intermediary. In the nineteenth century, banks mainly lent money to firms to help finance their inventories – which were held as collateral – in the cases of defaulters banks seized them. Gradually, banks expanded their lending activities – to finance houses and commercial real estates – holding the buildings as collateral. Emergence of the information technology has presented special problems to these traditional forms of finance – if the idea does not pan out, the firm may go bankrupt, but there is no collateral – there is little of value that the creditor can seize.**

** See Joseph E Stiglitz and Carl E Walsh, **Economics**, W W Norton, New Yok, USA, 4th Edition, 2006, p. 205.*

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INTRODUCTION

The sense in which we today use the term banking has its origin in the western world to which India was introduced by the British rulers, way back in the 17th century. Since then, enough water has flown and today Indian banks are considered among the best banks in the developing world and its attempts to emerge among the best in the world is going on.

BANK & NON-BANK INSTITUTIONS

A financial institution which accepts different forms of deposits and lends them to the prospective borrowers as well as allows the depositors to withdraw their money from the accounts by cheque is a ***bank***.

If the financial institution has all the same functions but does not allow depositors to issue cheque and withdraw their money from deposits then it is a ***non-bank institution.***

NON-BANKING FINANCIAL COMPANIES (NBFCs)

A non-banking financial company (NBFC) is a company[1] registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/ debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but ***does not include*** any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/ construction of immovable property.

A non-banking institution which is a company and which has its principal business of receiving *deposits* under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (residuary non-banking company, i.e., RNBC).

NBFCs are doing functions akin to that of banks, however there are a few differences:

(i) An NBFC cannot accept demand deposits (which are payable on demand), like the *savings* and *current accounts*.

(ii) It is not a part of the payment and settlement system and as such *cannot issue cheques* to its customers; and

(iii) Deposit insurance facility is not available for NBFC depositors unlike in the case of banks. (It means the public deposits with them are 'unsecured'. In case an NBFC defaults in repayment of deposit, the depositor can approach Company Law Board or Consumer Forum or file a civil suit to recover the deposits).

Under the RBI Act, 1934, the NBFCs have to get registered with the RBI. However, to obviate ***dual regulation***, certain category of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI such as:

(i) venture capital fund, merchant banking companies, stock broking companies register with SEBI;

(ii) insurance company holding a valid certificate of registration issued by IRDA;

(iii) *nidhi* companies under the Companies Act, 1956;

(iv) chit companies under the Chit Funds Act, 1982;

(v) housing finance companies regulated by National Housing Bank (of the RBI).

A company incorporated under the Companies Act, 1956 and desirous of commencing business of the NBFC should have a minimum net owned fund (NOF) of Rs. 25 lakh (raised to Rs. 2 crore

1. The discussion here is based on the updated informations released by the ***RBI,*** May 11, 2012.

from April 21, 1999). NBFCs registered with RBI have been reclassified (since 2006) as Asset Finance Company (AFC), Investment Company (IC), and the Loan Company (LC). ***Provisions*** for accepting deposits are:

(i) There is ceiling on acceptance of public deposits, an NBFC maintaining required NOF and CRAR, and complying with the prudential norms can accept public deposits maximum upto 4 times of NOF;

(ii) Can offer the maximum 11 per cent rate of interest;

(iii) Minimum investment grade credit rating (MIGR) is essential (may get itself rated by any of the four rating agencies namely, CRISIL, CARE, ICRA and FITCH Ratings India Pvt. Ltd.);

(iv) Allowed to accept/renew public deposits for a minimum period of 12 months and maximum period of 60 months; and

(v) Effective from April 2004, cannot accept deposits from NRIs except deposits by debit to NRO account of NRIs provided such amount do not represent inward remittance or transfer from NRE/FCNR (B) account, however, the existing NRI deposits can be renewed *(**Note:** different foreign currency accounts opened by the Indian banks have been given as the last sub-topic of this Chapter).*

There is no ceiling on raising of deposits by RNBCs, but every RNBC has to ensure that the amounts deposited and investments made by the company are not less than the aggregate amount of liabilities to the depositors. To secure the interest of depositors, such companies are required to invest in a portfolio comprising highly liquid and secured instruments, viz., central/state government securities, fixed deposit of scheduled commercial banks (SCB), certificate of deposits of SCB/FIs, units of Mutual Funds, etc. The amount payable by way of interest, premium, bonus or other advantage, by whatever name called by them in respect of deposits received shall not be less than the amount calculated at the rate of 5 per cent (to be compounded annually) on the amount deposited in lump sum or at monthly or longer intervals; and at the rate of 3.5 per cent (to be compounded annually) on the amount deposited under daily deposit scheme. Further, an RNBC can accept deposits for a minimum period of 12 months and maximum period of 84 months from the date of receipt of such deposit. Like the NBFCs they cannot accept deposits repayable on demand (it means they, too cannot open saving and current accounts).

Debenture Redemption: The norms for the NBFCs which raise capital through debentures have become stricter after the new *Company Act, 2013* came into effect (w.e.f. April 1, 2014) which are as given below:

(i) They need to create a **debenture redemption reserve** (DRR) account out of their profits, to be used only to redeem debentures. The corpus of DRR should be at least 50 per cent of the amount raised through debentures.

(ii) They need to invest or deposit a sum not less than 15 per cent of the amount in the form of deposits in banks or government or corporate bonds. This amount cannot be used for any purpose other than redeeming debentures.

The norms are aimed at minimising the risk of debenture buyers in a NBFC and check the mishaps like the *'Sahara OFCD'* [for Sahara OFCD see *Chapter 14*].

RESERVE BANK OF INDIA

The Reserve Bank of India (RBI) was set up in 1935 (by the *RBI Act, 1934*) as a private bank with two extra functions—regulation and control of the banks in India and being the banker of the government. After nationalisation in 1949, it emerged as the central banking body of India and it did not remain a 'bank' in the technical sense. Since then, the governments have been handing over different functions[2] to the RBI, which stand today as given below:

(i) It is the issuing agency of the currency and coins other than rupee one currency and coin (which are issued by Ministry of Finance itself with the signature of the Finance Secretary on the note).

(ii) Distributing agent for currency and coins issued by the Government of India.

(iii) Banker of the government.

(iv) Bank of the banks/Bank of last resort.

(v) Announces the credit and monetary policy for the economy.

(vi) Stabilising the rate of inflation.

(vii) Stabilising the exchange rate of rupee.

(viii) Keeper of the foreign currency reserves.

(ix) Agent of the Government of India in the IMF.

(x) Performing a variety of developmental and promotional functions under which it did set up institutions like IDBI, SIDBI, NABARD, NHB, etc.

Credit and Monetary Policy

The policy by which the desired level of money flow and its demand is regulated is known as the credit and monetary policy. All over the world it is announced by the central banking body of the country—as the RBI announces it in India. In India there has been a tradition of announcing it twice in a financial year—before the starting of the *busy* and the *slack* seasons. But in the reform period, this tradition has been broken. Now the RBI keeps modifying this as per the requirement of the economy, though the practice of the two policy announcements a year still continues.

In India, a debate regarding autonomy to the RBI regarding announcement of the policy started when the Narasimham Committee-I recommended on these lines. As the Governor RBI it was Bimal Jalan who vocally supported the idea. No such move came from the governments officially, but it is believed that the RBI has been given almost working autonomy in this area. In most of the developed economies, the central bank functions with autonomous powers in this area (bifurcation of politics from the economics). Though we lack such kind of officially open autonomy for the RBI, we have learnt enough by now and are better off today.

There are many tools by which the RBI regulates the desired/required kind of the credit and monetary policy—CRR, SLR, Bank Rate, Repo rate, Reverse Repo rate, PLR, Exim interest rate, Small Saving Schemes' interest rates (SSSs), interest changes for the instruments of the money market, etc.

CRR

The cash reserve ratio (CRR) is the ratio (fixed by the RBI) of the total deposits of a bank in India which is kept with the RBI in the form of cash. This was fixed to be in the range of 3 to 15 per cent.[3] A recent Amendment (2007) has removed the 3 per cent floor and provided a free hand to the RBI in fixing the CRR.

At present it is 4 per cent and a 1 per cent change in it today affects the economy with Rs. 96,000 crore[4]—an increase sucks this amount from the economy, while a decrease injects this amount into the economy.

2. Based on the ***RBI Nationalisation Act, 1949*** and further announcements of the Government of India (MoF).
3. ***RBI Act, 1934,*** sub-section (1) of Section 42.
4. ***Annual Policy Statement 2013–14,*** RBI, May 3, 2013, N. Delhi.

Following the recommendations of the Narasimham Committee on the Financial System (1991) the government started two major changes concerning the CRR:

(i) reducing the CRR was set as the medium-term objective and it was reduced gradually from its peak of 15 per cent in 1992 to 4.5 per cent by June 2003.[5]

After the RBI (Amendment) Act has been enacted in June 2006, the RBI can now prescribe CRR for scheduled banks without any floor or ceiling rate thereby removing the statutory minimum CRR limit of 3 per cent.[6]

(ii) Payment of interest by the RBI on the CRR money to the scheduled banks started in financial year 1999–2000 (in the wake of the banking slow down). Though the RBI discontinued interest payments from mid-2007.[7]

SLR

The statutory liquidity ratio (SLR) is the ratio (fixed by the RBI) of the total deposits of a bank which is to be maintained by the bank with itself in non-cash form prescribed by the government to be in the range of 25 to 40 per cent.[8]

The ratio was cut to 25 per cent (done in October 1997 after CFS suggestions).[9] It used to be as high as 38.5 per cent. The CFS has recommended the government not to use this money by handing G-Secs to the banks. In its place a ***market-based interest*** on it should be paid by the government, it was being advised. However, there has been no follow up in this regard by the governments. The Government of India has removed the 25 per cent floor for the SLR by an Amendment (2007) providing the RBI a free hand in fixing it.

Bank Rate

The interest rate which the RBI charges on its **long-term** lendings is known as the Bank Rate. The clients who borrow through this route are the GoI, state governments, banks, financial institutions, co-operative banks, NBFCs, etc. The rate has direct impact on long-term lending activities of the concerned lending bodies operating in the Indian financial system. The rate was realigned[10] with the MSF (Marginal Standing Facility) by the RBI in February 2012.

Repo Rate

The rate of interest the RBI charges from its clients on their ***short-term*** borrowing is the repo rate in India.[11] Basically, this is an abbreviated form of the 'rate of repurchase' and in western economies it is known as the 'rate of discount'.[12]

In practice it is not called an interest rate but considered a discount on the dated government securities, which are deposited by institution to borrow for the short term. When they get their securities released from the RBI, the value of the securities is lost by the amount of the current repo rate. This rate functions as the benchmark rate for the inter-bank short-term market (i.e.,

5. ***Economic Survey, 2006–07,*** MoF, GoI, N. Delhi.
6. ***RBI (Amendment) Act,*** 2006, GoI, N. Delhi.
7. ***Credit and Monetary Policy,*** April 1, 2007, op. cit.
8. ***RBI Act, 1934*** and ***Banking Regulation Act, 1949*** Section 24.
9. ***Committee on Financial System*** (CFS) headed by the then RBI Deputy Governor M. Narasimhan, 1991.
10. Through an RBI announcement on 15th Feb. 2012.
11. **RBI Act, 1934** and **Banking Regulation Act, 1949**.
12. Stiglitz and Walsh, ***Economics***, op. cit., p. 629–630.

call Money Market) in India. Banks usually use this route for one-day borrowing to fulfil their short-term liquidity crunch. Higher the repo rate costlier the loans banks forward and vice versa. It has direct impact on the *nominal interest* rates of the bank's lending. The ***repo rate*** was introduced in December 1992.

Reverse Repo Rate

It is the rate of interest the RBI pays to its clients who offer short-term loan to it. At present (July 2013) the rate is at 6.25 per cent.

It is reverse of the repo rate and this was started in November 1996 as part of liquidity Adjustment Facility (LAF) by the RBI. In practice, financial instituions operating in India park their surplus funds with the RBI for short-term period and earn money. It has a direct bearing on the interest rates charged by the banks and the financial institutions on their different forms of loans.

This tool was utilised by the RBI in the wake of over money supply with the Indian banks and lower loan disbursal to serve twin purposes of cutting down banks losses and the prevailing interest rate.[13] It has emerged as a very important tool in direction of following cheap interest regime—the general policy of the RBI since reform process started.

Marginal Standing Facility (MSF)[14]

MSF is a new scheme announced by the RBI in its Monetary Policy, 2011–12 which came into effect from May, 2011. Under this scheme, banks can borrow overnight upto 1 per cent of their net demand and time liabilities (NDTL) from the RBI, at the interest rate 1 per cent (100 basis points) higher than the current repo rate. In an attempt to strengthen rupee and checking its falling exchange rate, the RBI increased the gap between 'repo' and MSF to 3 per cent (late July 2013).

The MSF would be the last resort for banks *once they exhaust* all borrowing options including the liquidity adjustment facility by pledging through government securities, which has lower rate (i.e., repo rate) of interest in comparison with the MSF. The MSF would be a **penal rate** for banks and the banks can borrow funds by pledging government securities within the limits of the statutory liquidity ratio. The scheme has been introduced by RBI with the main aim of reducing volatility in the overnight lending rates in the inter-bank market and to enable smooth monetary transmission in the financial system.

Banks can borrow through MSF on all working days except Saturdays, between 3:30 and 4:30 p.m. in Mumbai where RBI has its headquarters. The minimum amount which can be accessed through MSF is Rs.1 crore and in multiples of Rs. 1 crore.

MSF represents the upper band of the interest corridor and reverse repo (7.25 per cent) as the lower band and the repo rate in the middle. To balance the liquidity, RBI would use the sole independent policy rate which is the repo rate and the MSF rate automatically adjusts to 1 per cent above the repo rate.

Similar to India's MSF the ECB (European Central Bank) also offers standing facilities called *marginal lending facilities* (MLF) and the Federal Reserve (the US Central Bank) has *discount window systems* (DWS). Like the MSF, the secondary credit facility made available by the Federal Reserve to the depository institutions in USA is typically overnight credit on a very short term basis at rates above the primary credit rate.

13. ***Economic Survey 2001–02,*** MoF, GoI, N. Delhi.
14. The write-up is based on the *RBI's Credit & Monetary Policy, 2011-12* (in which the Scheme was introduced); and the *European Central Bank*, Frankfurt, Germany and *Federal Reserve System* (also known as the *Federal Reserve*, and informally as the *Fed*) Washington, DC, USA

In an attempt to strengthen rupee and checking its falling exchange rate, the RBI increased the gap between 'repo' and MSF to 3 per cent (late July 2013). The effectiveness of standing facilities in reducing volatility have been examined by many scholars and certain studies have pointed out that in the Federal Reserve System in the United States, the design of the facility decreases a bank's incentive to participate actively in *interbank market* (i.e., India's call money market) due to the perceived stigma from using such facility. This in turn reduces the effectiveness of standing facility in reducing interest rate volatility.

Bank Rate Realigned with MSF

The RBI on February 15, 2012 increased the Bank Rate by 350 basis points from 6 per cent to 9.50 per cent and realigned the Bank Rate with Marginal Standing Facility (MSF) rate, which, in turn, is linked to the policy repo rate.[15] Henceforth, whenever there is an adjustment of the MSF rate, the RBI will consider and align the bank rate with the revised MSF rate.

Being the discount rate, the bank rate should technically be higher than the policyrepo rate. The bank rate has, however, been kept unchanged at 6 per cent since April 2003. This was mainly for the reason that monetary policy signalling was done through modulations in the reverse repo rate and the repo rate till May 3, 2011, and the policy repo rate under the revised operating procedure of monetary policy from May 3, 2011 onwards.

Moreover, under the revised operating procedure, MSF, instituted at 100 basis points above the policy repo rate, has been in operation, which more or less served the purpose of the bank rate. At present, the repo rate is 8.50 per cent, reserve repo 7.50 per cent and MSF 9.50 per cent. Repo rate is the rate at which banks borrow funds from the RBI and reverse repo rate is the rate at which banks park their funds with the RBI. Under the MSF, banks are permitted to avail themselves of funds from the RBI on overnight basis.

The bank rate acts as the **penal rate** charged on banks for shortfalls in meeting their reserve requirements (CRR and SLR). The bank rate is also used by several financial institutions as a reference rate for indexation purposes.

BASE RATE

Base Rate is the interest rate below which Scheduled Commercial Banks (SCBs) will lend no loans to its customers—its means it is like prime lending rate (PLR) and the benchmark prime lending Rate (BPLR) of the past and is basically a floor rate of interest. It replaced[16] the existing idea of BPLR on July 1, 2010.

The BPLR system (while the existing system was of PLR), introduced in 2003, fell short of its original objective of *bringing transparency* to lending rates. This was mainly because under this system, banks could lend below BPLR. This made a bargaining by the borrower with bank- ultimately one borrower getting cheaper loan than the other, and blurred the attempts of bringing in transparency in the lending business. For the same reason, it was also difficult to assess the transmission of *policy rates* (i.e., repo rate, reverse repo rate, bank rate) of the Reserve Bank to lending rates of banks. The Base Rate system is **aimed at** enhancing transparency in lending rates of banks and enabling better assessment of transmission of monetary policy. To look into this matter, the RBI constituted a Working Group on Benchmark Prime Lending Rate (chaired Deepak Mohanty) to review the present benchmark prime lending rate (BPLR) system and suggest changes to make credit pricing more transparent—report

15. ***RBI Announcement,*** RBI, MoF, GoI, New Delhi, Feb. 15, 2012.
16. ***RBI Announcement,*** RBI, MoF, GoI, New Delhi, Apr.5, 2010.

submitted in October 2009 and accordingly the idea of base rate was implemented.

Now, all categories of loans are priced with reference to the base rate only, except (a) differential rate of interest (DRI) loans (b) loans to banks' own employees, and (c) loans to banks' depositors against their own deposits. Since the base rate will be the minimum rate for all loans, banks are not permitted to resort to any lending below this rate—accordingly, the provision of lending below the BPLR to a customer by banks if the loan amount is not less than Rs. 2 lakh has been withdrawn. It is expected that the above **deregulation** of lending rate will increase the credit flow to small borrowers at reasonable rate and direct bank finance will provide effective competition to other forms of high cost credit. For export credit, RBI announces the floor rate, separately. Banks are required to review the base rate at least once in a quarter and publish the same for the general public.

C & M Policy – New Initiatives

The last Bi-monthly Credit & Monetary Policy of the RBI was announced on February 3, 2015—as per which the rates and ratios stans as follows:

Policy Rates: Bank Rate 8.5 per cent; Repo Rate 7.5 per cent; Reverse Repo Rate 6.5 per cent and MSF Rate 8.5 per cent.

Reserve Ratios: CRR 4 per cent and SLR 21.5 per cent.

Lenidng /Deposit Rates: Base Rate from 10.00–10.25 per cent; Saving Deposit Rate 4.0 per cent (relates to 5 major banks) and Term Deposit Rate from 8.00–8.75 per cent.

The RBI has started some **new things** in the C & M Policy, in recent times—major ones are as given below:

- Transition to a *bi-monthly* monetary policy cycle.
- Recognition of the *glide path for disinflation* – the recommendation of *Urjit R. Patel Committee* report have been implemented, including adoption of the new **CPI-C** as the key measure of inflation.
- A *Monetary Policy Framework* has been put in place—an agreement in this regard was signed between the GoI and the RBI late February 2015. Under the framework, the RBI is to *'target inflation'* at 4 per cent with a variations of 2 per cent. It means, the 'range of inflation' to be between 2 to 6 per cent.
- Progressive *reduction* in access to overnight liquidity at the fixed repo rate, and *increase* in access to liquidity through term repos (the liquidity provided under 7-day and 14-day term repos have been *increased* from 0.5 per cent of the banking system to 0.75 per cent, and the liquidity provided under overnight repos has been *decreased* from 0.5 per cent to 0.25 per cent (done in pursuance of the Urjit R. Patel Committee's recommendations). This aims to improve the transmission of policy impulses across the interest rate spectrum.
- Introduction of longer-tenor *term repos* as well as *term reverse repos*.

REVISED LMF

In August 2014, the RBI announced a revised Liquidity Management Framework (LMF) as a way to check volatility in the inter-bank call money markets, where banks lend to each other, and also allow the lenders to manage their liquidity needs better. Major features of the LMF is as given below:

- RBI started conducting 14-day *term repurchase* auctions four times a fortnight, up to an aggregate amount equal to 0.75 per cent of the system's deposit base or net demand and time liabilities (NDTL).

- Unlike earlier, RBI has announced a fixed schedule for these 14-day *term repo* operations, which are used by banks for their day-to-day liquidity requirements. One-fourth of the total amount of 0.75 per cent of NDTLs would be put up for auction in each of the four auctions, RBI said in a statement.
- No change in the amount that banks can access from the liquidity adjustment facility (LAF) window at fixed repo rate of the time. Banks are currently allowed to borrow up to 0.25 per cent of their deposit base or NDTL from the LAF window.
- Additionally, RBI conducts overnight variable rate repo auctions based on an assessment of liquidity in the system and government cash balances available for auction for the day.
- The LMF is aimed at reducing volatility in the call rate. Better interest signalling and medium-term stability in the loan market are other objectives of it.

NATIONALISATION AND DEVELOPMENT OF BANKING IN INDIA

The development of banking industry in India has been intertwined with the story of its nationalisation. Once the Reserve Bank of India (RBI) was nationalised in 1949 and a central banking was in place, the government considered the nationalising of selected private banks in the country due to the following ***major*** reasons:

(i) As the banks were owned and managed by the private sector the services of the banking were having a narrow reach—the masses had no access to the banking service;

(ii) The government needed to direct the resources in such a way that greater public benefit could take place;

(iii) The planned development of the economy required a certain degree of government control on the capital generated by the economy. Nationalisation of banks in India took place in the following two stages:

1. Emergence of the SBI

The Government of India, with the enactment of the *SBI Act, 1955* ***partially nationalised*** the three Imperial Banks (mainly operating in the three past Presidencies with their 466 branches) and named them the State Bank of India—the first public sector bank emerged in India. The RBI had purchased 92 per cent of the shares in this partial nationalisation.

Satisfied with the experiment, the government in a related move ***partially nationalised*** eight more private banks (with good regional presence) via *SBI (Associates) Act, 1959* and named them as the Associates of the SBI—the RBI had acquired 92 per cent stake in them as well. After merging the State Bank of Bikaner and the State Bank of Jaipur as well, the RBI came up with the state Bank of Bikaner and Jaipur. Now the SBI Group has a total number of six banks—SBI being one and five of its associates.

2. Emergence of Nationalised Banks

After successful experimentation in the partial nationalisations the government decided to go for complete nationalisation. With the help of the *Banking Nationalisation Act, 1969*, the government nationalised a total number of 20 private banks:

(i) 14 banks with deposits were more than Rs. 50 crore of nationalised in July 1969, and

(ii) 6 banks with deposits were more than Rs. 200 crore of nationalised in April 1980.

After the merger of the loss-making New Bank of India with the Punjab National Bank (PNB) in September 1993, the total number of nationalised banks came down to 19. Today, there are 27 public sector banks in India out of which 19 are nationalised (though none of the so-called nationalised banks have 100 per cent ownership of the Government of India).

After the nationalisation of banks the government *stopped* opening of banks in the private sector though some foreign private banks were allowed to operate in the country to provide the external currency loans. After India ushered in the era of the economic reforms, the government started a comprehensive banking system reform in the fiscal 1992–93. Three related developments allowed the further expansion of banking industry in the country:

(i) In 1993 the SBI was allowed access to the capital market with permission given to sell its share to the tune of 33 per cent through *SBI (Amendment) Act, 1993*.

At present the Government of India has 59.73 per cent shares in the SBI (*It was on July 9, 2007 that the entire equity stake of the RBI was taken over by the Government of India. Thus, the RBI is no more the holding bank of the SBI and its Associates*.).

On October 10, 2007 the government announced its proposal of selling the shares of the SBI and cutting down its stake in it to 53 per cent level so that the bank can go for capitalisation.

(ii) In 1994 the government allowed the nationalised banks to have access to the capital market with a ceiling of 33 per cent sale of shares through the *Banking Companies (Amendment) Act, 1994*.

Since then many nationalised banks have tapped the capital market for their capital enhancement—Indian Overseas Bank being the first in the row. Though such banks could be better called the public sector banks (as the GoI holds more than 50 per cent stake in them) they are still known as the nationalised banks.

(iii) In 1994 itself the government allowed the opening of private banks in the country. The first private bank of the reform era was the UTI Bank. Since then a few dozens Indian and foreign private banks have been opened in the country.

Thus, since 1993–94 onwards, we see a reversal of the policies governing banks in the country. As a general principle, the public sector and the nationalised banks are to be converted into private sector entities. What would be the minimum government holding in them is still a matter of debate and yet to be decided.[17] The policy of bank consolidation is still being followed by the government, so that these banks could broaden their capital base and emerge as significant players in the global banking competition.[18] Every delay in it will hamper their interests, as per the experts.

3. Emergence of the RRBs

The Regional Rural Banks (RRBs) were first set up on October 2, 1975 (only 5 in numbers) with the aim to take banking services to the doorsteps of the rural masses specially in the remote areas with

17. As per the ***Strategic Disinvestment Statement of 1999,*** the Government had decided to cut its holding in them to 26 percent. The policy was put on hold once the UPA Government came to power.

18. Y.V. Reddy, ***Lectures on Economic and Financial Sector Reforms in India,*** Oxford U. Press, N. Delhi, 2002, pp. 137–57.

no access to banking services with twin duties to fulfill:

(i) to provide credit to the weaker sections of the society at concessional rate of interest who previously depended on private money lending and

(ii) to mobilise rural savings and channelise them for supporting productive activities in the rural areas.

The GoI, the concerned state government and the sponsoring nationalised bank contribute the share capital of the RRBs in the proportion of 50 per cent, 15 per cent and 35 per cent, respectively. The area of operation of the RRB is limited to notified few districts in a state.

Following the suggestions of the *Kelkar Committee*, the government stopped opening new RRBs in 1987—by that time their total number stood at 196. Due to excessive leanings towards social banking and catering to the highly economically weaker sections, these banks started incurring huge losses by early 1980s. For restructuring and strengthening of the banks, the governments set up two committees—the *Bhandari Committee* (1994–95) and the *Basu Committee* (1995–96). Out of the total, 171 were running in losses in 1998–99 when the government took some serious decisions:

(i) The obligation of concessional loans abolished and the RRBs started charging commercial interest rates on its lendings.

(ii) The target clientele (rural masses, weaker sections) was set free now to lend to any body.

After the above-given policy changes, the RRBs started coming out of the red/losses. The CFS has recommended to get them merged with their managing nationalised or public sector banks and finally make them part of the would-be three-tier banking structure of India. At present there are 56 RRBs (after amalgamation) functioning in India even though the amalgamation process is going on *(RBI, April 2015)*.

FINANCIAL SECTOR REFORMS

The process of economic reforms initiated in 1991 had redefined the role of government in the economy—in coming times the economy will be dependent on the greater private participation for its development.[19] Such a changed view to development required an overhauling in the investment structure of the economy. Now the private sector was going to demand high investible capital out of the financial system. Thus, an emergent need was felt to restructure the whole financial system of India.

The three decades after nationalisation had seen a phenomenal expansion in the geographical coverage and financial spread of the banking system in the country. As certain weaknesses were found to have developed in the system during the late eighties, it was felt that these had to be addressed to enable the financial system to play its role ushering in a more efficient and competitive economy.[20] Accordingly, a ***high level*** committee on Financial System (CFS) was set up on August 14, 1991 to examine all aspects

19. Repeated by the GoI many times i.e. the ***New Industrial Policy 1991; the Union Budget 1992–93; Eighth Five Year Plan (1992–97) Draft Approach;*** etc.
20. Announced by the Government while setting up the M. Narasimham ***Committee on Finacial System*** on August 14, 1991. See also ***India 2001,*** Pub. Div., GoI, N. Delhi.

relating to ***structure, organisation, function*** and ***procedures*** of the financial system—based on its recommedations, a comprehensive reform of the banking system was introduced in the fiscal 1992–93.[21]

The CFS based its recommendations on certain ***assumptions*** [22] which are basic to the banking industry. And the suggestions of the committee became logical in light of this assumption, there is no second opinion about it. The assumption says that ***"the resources of the banks come from the general public and are held by the banks in trust that they are to be deployed for maximum benefit of the depositors".*** This assumption automatically implied:

(i) That even the government had no business to endanger the solvency, health and efficiency of the nationalised banks under the pretext of using banks, resources for ***economic planning, social banking, poverty alleviation,*** etc.

(ii) Besides, the government had no right to get hold of the funds of the banks at low interest rates and use them for financing its consumption expenditure (i.e., revenue and fiscal deficits) and thus defraud the depositors.

The recommendations of the CFS (**Narasimham Committee I**) were ***aimed*** at:

(i) ensuring a degree of operational ***flexibility;***

(ii) ***internal autonomy*** for public sector banks (PSBs) in their decision making process; and

(iii) greater degree of ***professionalism*** in banking operation.

Recommendation of CFS

The CFS recommondation[23] could be summed up under five sub-titles:

1. On Directed Investment

The RBI was advised not to use the CRR as a principal instrument of monetary and credit control, in place it should rely on open market operations (OMOs) increasingly. Two proposals advised regarding the CRR:

(i) CRR should be progressively reduced from the present high level of 15 per cent to 3 to 5 per cent; and

(ii) RBI should pay interest on the CRR of banks above the basic minimum at a rate of interest equal to the level of banks, one year deposit.

Concerning the SLR it was advised to cut it to the minimum level (i.e., 25 per cent) from the present high level of 38.5 per cent in the next 5 years (it was cut down to 25 per cent in October 1997). The government was also suggested to progressively move towards market-based borrowing programme so that banks get economic benefits on their SLR investments.

These suggestions were directed to the goal of making more funds available to the banks, converting idle cash for use, and cutting down the interest rates banks charge on their loans.

2. On Directed Credit Programme

Under this sub-title the suggestions revolved around the compulsion of priority sector lending (PSL) by the banks:

(i) Directed credit programme should be phased out gradually. As per the

21. The Narasimham Committee handed over its report in record time within 3 months after it was set up.
22. ***CFS,*** op. cit.
23. Ibid.

committee, agriculture and small scale industries (SSIs) had already grown to a mature stage and they did not require any special support; two decades of interest subsidy were enough. Therefore, concessional rates of interest could be dispensed with.

(ii) Directed credit should not be a regular programme—it should be a case of extraordinary support to certain weak sections—besides, it should be temporary, not a permanent one.

(iii) Concept of PSL should be redefined to include only the weakest sections of the rural community such as marginal farmers, rural artisans, village and cottage industries, tiny sector, etc.

(iv) The "redefined PSL" should have 10 per cent fixed of the aggregate bank credit.

(v) The composition of the PSL should be reviewed after every 3 years.

3. On the Structure of Interest Rates

The major recommendations on the structure of interest rates are:

(i) Interest rates to be broadly determined by market forces;

(ii) All controls of interest rates on deposits and lending to be withdrawn;

(iii) Concessional rates of interest for PSL of small sizes to be phased out and subsidies on the IRDP loans to be withdrawn;

(iv) Bank rate to be the anchor rate and all other interest rates to be closely linked to it; and

(v) The RBI to be the sole authority to simplify the structure of interest rates.

4. On Structural Reorganisation of the Bank

For the structural reorganisation of banks some major suggestions were given:

(i) Substantial reduction in the number of the PSBs through mergers and acquisitions—to bring about greater efficiency in banking operations;

(ii) Dual control of RBI and Banking Division (of the Ministry of Finance) should go immediately and RBI to be made the primary agency for the regulation of the banking system;

(iii) The PSBs to be made free and autonomous;

(iv) The RBI to examine all the guidelines and directions issued to the banking system in the context of the independence and autonomy of the banks;

(v) Every PSB to go for a radical change in work technology and culture, so as to become competitive internally and to be at par with the wide range of innovations taking place abroad; and

(vi) Finally, the appointment of the Chief Executive of Bank (CMD) was suggested not to be on political considerations but on professionalism and integrity. An independent panel of experts was suggested which should recommend and finalise the suitable candidates for this post.

5. Asset Reconstruction Companies/Fund

To tackle the menace of the higher non-performing assets (NPAs) of banks and financial institutions, the committee suggested setting up of asset reconstruction companies/funds (taking clue from the US experience).

The committee directly blamed the Government of India (GoI) and the Ministry of Finance for the sad state of affairs of the PSBs. These banks were used and abused by the GoI, the officials, the bank employees and the trade unions, the report adds. The recommendations were revolutionary in many respects and were opposed by the bank unions and the leftist political parties.

There were some other major suggestions of the committee which made it possible to get the following[24] things done by the government:

(i) opening of new private sector banks permitted in 1993;
(ii) prudential norms relating to income recognition, asset classification and provisioning by banks on the basis of objective criteria laid down by the RBI;
(iii) introduction of capital adequacy norms (i.e., CAR provisions) with international standard started;
(iv) simplification in the banking regulation (i.e., via board for financial supervision in 1994); etc.

BANKING SECTOR REFORMS

The government commenced a comprehensive reform process in the financial system in 1992–93 after the recommendations of the CFS in 1991. In December 1997 the government did set up another committtee on the banking sector reform under the chairmanship of M. Narasimham.[25] The objective of the committee is objectively clear by the ***terms of reference*** it was given while setting up:

"To review the progress of banking sector reforms to date and chart a programme of financial sector reforms necessary to strengthen India's financial system and make it internationally competitive"

The **Narasimham Committee-II** (popularly called by the Government of India) handed over its reports in April 1998 which included the following major suggestions:[26]

(i) Need for a stronger banking system for which mergers of the PSBs and the financial institutions (AIFIs) were suggested—stronger banks and the DFIs (development financial institutions, i.e., AIFIs) to be merged while weaker and unviable ones to be closed.
(ii) A 3-tier banking structure was suggested after mergers:
   (a) ***Tier-1*** to have 2 to 3 banks of international orientation;
   (b) ***Tier-2*** to have 8 to 10 banks of national orientation; and
   (c) ***Tier-3*** to have large number of local banks.

   The first and second tiers were to take care of the banking needs of the corporate sector in the economy.
(iii) Higher norms of Capital-to-Risk—Weighted Adequacy Ratio (CRAR) suggested—increased to 10 per cent.
(iv) Budgetary recapitalisation of the PSBs is not viable and should be abandoned.
(v) Legal framework of loan recovery should be strengthened (the government passed the *SARFAESI (Act, 2002)*.
(vi) Net NPAs for all banks suggested to be cut down to below 5 per cent by 2000 and 3 per cent by 2002.
(vii) Rationalisation of branches and staffs of the PSBs suggested.
(viii) Licencing to new private banks (domestic as well as foreign) was suggested to continue with.
(ix) Banks' boards should be depoliticised under RBI supervision.

24. Based on Y.V. Reddy, 2002, op. cit.
25. ***Economic Survey 1998–99,*** MoF, GoI, N. Delhi.
26. Based on the Report of the ***Committee on Banking Sector Reforms,*** April, 1998 (Chairman: M. Narasimham).

(x) Board for financial Regulation and Supervisions (BFRS) should be set up for the whole banking, financial and the NBFCs in India.[27]

DRI

The differential rate of interest (DRI) is a lending programme launched by the government in April 1972 which makes it obligatory upon all the public sector banks in India to lend 1 per cent of the total lending of the preceding year to ***'the poorest among the poor'*** at an interest rate of 4 per cent per annum. The total lending in 2005–06 was Rs. 351 crores.

Priority Sector Lending

All Indian banks have to follow the compulsory target of priority sector lending (PSL). The priority sector in India are at present the sectors—agriculture, small and medium enterprises (SMEs), road and water transport, retail trade, small business, small housing loans (not more than Rs. 10 lakhs), software industries, self help groups (SHGs), agro-processing, small and marginal farmers, artisans, distressed urban poor and indebted non-institutional debtors besides the SCs, STs and other weaker sections of society.[28] In 2007, the RBI included five minorities—Buddhists, Christians, Muslims, Parsis and Sikhs under the PSL. In its ***new guidelines*** of March 2015, the RBI added *'medium enterprise, sanitation and renewable energy'* under it.[29] The PSL target must be met by the banks operating in India in the following way:

(i) ***Indian Banks*** need to lend 40 per cent to the priority sector every year (public sector as well as private sector banks, both) of their total lending. There is a sub-target also—18 per cent of the total lending must go to agriculture and 10 per cent of the total lending or 25 per cent of the priority sector lending (whichever be higher) must be lent out to the weaker sections. Other areas of the priority sector to be covered in the left amount, i.e., 12 per cent of the total lending.

(ii) ***Foreign Banks*** (having less than 20 branches) have to fulfil only 32 per cent PSL target which has sub-targets for the exports (12 per cent) and small and medium enterprises (10 per cent). It means they need to disburse other areas of the PSL from the remaining 10 per cent of their total lending (***lesser burden***).

The committee on financial System (CFS, 1991) had suggested to immediately cut it down to 10 per cent for all banks and completely phasing out of this policy for the betterment of the banking industry in particular and the economy in general. The committee also suggested to shuffle the sectors covered under PSL every three years. No follow up has been done from the government except cutting down PSL target for the foreign banks from 40 per cent to 32 per cent. Meanwhile some new areas have been added to the PSL.

Revision in PSL

The Reserve Bank of India (RBI) panel on priority sector lending on February 21, 2012 proposed that the target (priority sector) for foreign banks to be increased to 40 per cent of net bank credit from the current level of 32 per cent with sub-targets of 15 per cent for exports and 15 per cent for the medium and small

27. An integrated system of regulation and supervision was suggested by the Committee so that soundness of the financial system could be ensured—the concept of a financial ***super-regulator*** gets vindicated, as opines Y. V. Reddy, 2002, op. cited, p. 38.
28. ***India 2007,*** Pub. Div., GoI, N. Delhi and the further announcements by the RBI.
29. **RBI,** *New Guidelines on the PSL*, March 2, 2015.

enterprises (MSE) sector, within which 7 per cent may be earmarked for micro enterprises. The target of domestic scheduled commercial banks for lending to the priority sector to be retained at 40 per cent of net bank credit. The ***Nair Committee,*** (under the Chairmanship of M. V. Nair, Chairman, Union Bank of India), has re-examined the existing classification and suggested revised guidelines with regard to priority sector lending and related issues. Major suggestions by the committee are as given below:

(i) The committee suggested that the sector ***'agriculture and allied activities'*** may be a composite sector within the priority sector, by doing away with the distinction between *direct* and *indirect* agriculture. However, the targets for agriculture and allied activities would be at 18 per cent.

(ii) A *sub-target for* ***small*** and ***marginal farmers*** within agriculture and allied activities is recommended, equivalent to 9 per cent, which would be achieved in stages by 2015–16.

(iii) The ***MSE*** sector may continue to be under the priority sector. Within the MSE sector, a sub-target for micro enterprises is recommended, equivalent to 7 per cent, which would also be achieved in stages by 2013–14.

(iv) The loans to ***housing*** sector may continue to be under the priority sector. Loans for construction or purchase of one dwelling unit per individual up to Rs. 25 lakh; loans up to Rs. 2 lakh in rural and semi-urban areas and up to Rs. 5 lakh in other centres for repair of damaged dwelling units may be granted under the priority sector.

(v) To encourage construction of dwelling units for economically weaker sections and low income groups, housing loans granted to these individuals may be included in the weaker sections category.

(vi) All loans to ***women*** under the priority sector may also be counted under loans to weaker sections.

(vii) The loans to ***education*** sector may continue to be under the priority sector. The limit under the priority sector for loans for studies in India may be increased to Rs. 15 lakh and Rs. 25 lakh in case of studies abroad, from the existing limit of Rs. 10 lakh and Rs. 20 lakh, respectively.

(viii) The committee has also recommended allowing non-tradable priority sector lending certificates on a pilot basis with domestic scheduled commercial banks, foreign banks and regional rural banks as market players.

NON-PERFORMING ASSETS

Non-Performing Assets (NPAs) are the *bad loans* of the banks. The criteria to identify such assets have been changing over the time. In order to follow international best practices and to ensure greater transparency, the RBI shifted to the current policy in 2004. Under it, a loan is considered NPA if it has not been serviced for ***one term*** (i.e., 90 days). This is known as *'90 day' overdue norm*. For agriculture loans the period is tied with the period of the concerned crops—ranging from two crop seasons to one year overdue norm.[30]

NPAs were classified into three types:

(a) Sub-standard: remaining NPAs for less than or equal to 18 months;

30. **Reserve Bank of India,** *'Master Circular - Income Recognition, Asset Classification, Provisioning and Other Related Matters'*, July, 2013.

(b) **Doubtful:** remaining NPAs for more than 18 months; and

(c) **Loss assets:** where the loss has been identified by the bank or internal/external auditors or the RBI inspection but the amount has not been written off.

CURRENT SCENARIO

Asset quality of the ublic sector banks (PSBs) has come under stress in recent times. As per the RBI's *Financial Stability Report-December 2014*, the situation of was—

- The gross non-performing assets (GNPAs) of scheduled commercial banks as a percentage of the total gross advances increased to **4.5** per cent in September 2014 from 4.1 per cent in March 2014.
- Stressed advances increased to 10.7 per cent of the total advances from 10.0 per cent between March and September 2014.
- Five sub-sectors—infrastructure, iron & steel, textiles, mining (including coal), and aviation—hold **54** per cent of total stressed advances of PSBs as on June 2014.
- Among bank groups, exposure of PSBs to infrastructure stood at 17.5 per cent of their gross advances as of September 2014. This was significantly higher than that of private-sector banks (9.6 per cent) and foreign banks (12.1 per cent).
- The PSBs continue to be under stress on account of their past lending. Taking GNPAs and restructured advances together, the stress on PSBs is 12.57 per cent of total advances as on September 2014.

As per the *Economic Survey 2014–15*, the stress tests suggest that the asset quality of banks may improve in the near future under expected positive developments in the macroeconomic environment and banks may be able to meet expected losses with their existing level of provisions.

The main ***reasons*** for increase in NPAs, in recent times, are as given below (*Economic Survey 2013–14 & 2014–15*):

(i) Switchover to system-based identification of NPAs;

(ii) Current macroeconomic situation in the country;

(iii) Increased interest rates in the recent past;

(iv) Lower economic growth; and

(v) Aggressive lending by banks in the past, especially during good times.

The RBI came out with a **new guidelines**[31] to resolve the NPA issue by ealry 2014. The steps taken under it are :

(a) Banks have to start acting as soon as a sign of stress is noticed in a borrower's actions and not wait for it to become an NPA. Banks to carve out as special category of assets termed special mention accounts (SMAs) in which *early signs* of stress are visible.

(b) Flexibility brought in project loans to infrastructure and core industry projects, both existing and new.

(c) *Non-cooperative* borrowers in NPAs resolution will have to pay higher interest for any future borrowing. Banks will also be required to make higher provisions for further loans extended to borrowers who are considered to be 'non-cooperative'.

31. **RBI**, *Early Recognition of Financial Distress, Prompt steps for Resolution and Fair Recovery for Lenders: Framework for Revitalizing Distressed Assets in the Economy*, January 2014.

(d) Towards strengthening recovery from *non-cooperative borrowers*, the norms for asset reconstruction companies (ARC) have been tightened, whereby the minimum investment in security receipts should be 15 per cent, as against the earlier norm of 5 per cent.

(e) Independent evaluation of large-value restructuring (above Rs. 500 crore) made mandatory.

(f) If a borrower's interest or principal payments are overdue by more than 60 days, a *Joint Lenders' Forum* to be formed by the bankers for early resolution of stress.

(g) The RBI has set up a central repository of information on large credits to collect, store and disseminate credit data to lenders. For this, banks need to furnish credit information on all their borrowers with an exposure of Rs.5 crore and above.

(h) Incentives to banks to quickly and collectively agree to a resolution plan.

SARFAESI ACT, 2002

GoI finally cracked down on the **wilful defaulters** by passing the *Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.*

The Act gives far reaching powers to the banks/FIs concering NPAs:

1. Banks/FIs having 75 per cent of the dues owed by the borrower can collectively proceed on the following in the event of the account becoming NPA:

(A) Issue notice of default to borrowers asking to clear dues within 60 days.

(B) On the borrower's failure to repay:

(i) Take possession of security and/or

(ii) take over the management of the borrowing concern and/or

(iii) appoint a person to manage the concern.

(C) If the case is already before the BIFR, the proceedings can be stalled if banks/FIs having 75 per cent share in the dues have taken any steps to recover the dues under the provisions of the ordinance.

2. The banks/FIs can also sell the security to a securitisation or Asset Reconstruction Company (ARC), established under the provisions of the Ordinance. [The ARC is sought to be set up on the lines similar to the USA, few years ago.]

DEBT RECOVERY TRIBUNALS (DRTS)

Earlier, the government had set up Debt Recovery Tribunals (DRTs) in 1993 which failed to bring about the desired change in the scenario due to:[32]

(i) DRTs are also clogged up with many cases and the judgement takes time (many months, if not years):

(ii) The sale of property can be made only through court appointed officials, adding delays;

(iii) The tribunals cannot take up the medium- or large-sized firms if they are under consideration of the BIFR due to sickness.

The praiseworthy step regarding recovery of the NPAs and allowing the setting up of the Asset Reconstruction Companies (ARCs) had an impact. Improved industrial climate and new options available to banks for dealing with bad loans helped in recovering a substantial amount of

32. ***Economic Survey 2001-02*** & ***India 2002,*** Pub. Div., GoI, N. Delhi.

NPAs. The NPAs of scheduled commercial banks (SCBs) were at 2.3 per cent of total assets as on end December 2011.[33]

WILLFUL DEFAULTER

There are many people and entities who borrow money from lending institutions but fail to repay. However, not all of them are called wilful defaulters. As is embedded in the name, a wilful defaulter is one who does not repay a loan or liability, but apart from this there are other things that define a wilful defaulter. According to the RBI, a wilful defaulter is one who—

(i) is financially capable to repay and yet does not do so;

(ii) or one who diverts the funds for purposes other than what the fund was availed for;

(iii) or with whom funds are not available in the form of assets as funds have been siphoned off;

(iv) or who has sold or disposed the property that was used as a security to obtain the loan.

Diversion of fund includes activities such as using short-term working capital for long-term purposes, acquiring assets for which the loan was not meant for and transferring funds to other entities. *Siphoning of funds* means that funds were used for purposes that were not related to the borrower and which could affect the financial health of the entity.

However, a lending institution cannot term an entity or an individual a wilful defaulter for a one-off case of default and needs to take into account the repayment track record. The default should be established to be intentional and the defaulter should be informed about the same. The defaulter should also be given a chance to clarify his stand on the issue. Also, the default amount needs to be at least Rs.25 lakh to be included in the category of wilful defaults.

If an entity's or individual's name figures in the list of wilful defaulters, the following restrictions get in action on them—

(a) Barred from participating in the capital market.

(b) Barred from availing any further banking facilities and to access financial institutions for five years for the purpose of starting a new venture.

(c) The lenders can initiate the process of recovery with full vigour and can even initiate criminal proceedings, if required.

(d) The lending institutions may not allow any person related to the defaulting company to become a board member of any other company as well.

CAPITAL ADEQUACY RATIO

At first sight bank is a business or industry a segment of the service sector in any economy. But the failure of a bank may have far greater damaging impact on an economy than any other kind of business or commercial activity. Basically, modern economies are heavily dependent on banks today than in the past—banks are today called the backbone of economies. Healthy functioning of banks is today essential for the proper functioning of an economy. As credit creation (***i.e., loan disbursals***) of banks are highly risky business, the depositors' money depends on the banks' quality of lending. More importantly, the whole payment system, public as well as private, depends on banks. A bank's failure has the potential of creating chaos in an economy. This is why governments of the world pay special attention to the regulatory aspects of the banks. Every regulatory provision for banks tries to achieve a simple equation, i.e.,

33. ***Economic Survey 2011–12,*** MoF, GoI, N. Delhi.

"how the banks should maximise their credit creation by minimising the risk and continue functioning permanently". In the banking business risks are always there and cannot be made 'zero'—as any loan forwarded to any individual or firm (irrespective of their credit-worthiness) has the risk of turning out to be a bad debt (***i.e., NPA in India***)—the probability of this being 50 per cent. But banks must function so that economies can function. Finally, the central banks of the world started devising tools to minimise the risks of banking at *one hand* and providing cushions (shock-absorbers) to the banks at the *other hand* so that banks do not go bust (i.e., shut down after becoming bankrupt). Providing cushion/ shock-absorbers to banks has seen three major developments:[34]

(i) The provision of keeping a ***cash ratio*** of total deposits mobilised by the banks (known as the CRR in India);

(ii) the provision of maintaining some assets of the deposits mobilised by the banks with the banks themselves in ***non-cash form*** (known as the SLR in India); and

(iii) The provision of the capital adequacy ratio (CAR) norm.

The capital adequacy ratio (CAR) norm has been the last provision to emerge in the area of regulating the banks in such a way that they can sustain the probable risks and uncertainties of lending. It was in 1988 that the central banking bodies of the developed economies agreed upon such a provision, the CAR—also known as the **Basel Accord.**[35] The accord was agreed upon at Basel, Switzerland at a meeting of the Bank for International Settlements (BIS).[36] It was at this time that the **Basel-I** norms of the capital adequacy ratio were agreed upon—a requirement was imposed upon the banks to maintain a certain amount of free capital (***i.e., ratio***) to their ***assets***[37] (i.e., loans and investments by the banks) as a cushion against probable losses in investments and loans. In 1988, this ratio capital was decided to be 8 per cent. It means that if the total investments and loans forwarded by a bank amounts to Rs. 100, the bank needs to maintain a ***free capital***[38] of Rs. 8 at that particular time. ***The capital adequacy ratio is the percentage of total capital to the total risk—weighted assets*** (see reference 39).

CAR, a measure of a bank's capital, is expressed as a percentage of a bank's risk weighted credit exposures:

CAR= Total of the Tier 1 & Tier 2 capitals ÷ Risk Weighted Assets

Also known as 'Capital to Risk Weighted Assets Ratio (CRAR)' this ratio is used to protect depositors and promote the stability and efficiency of financial systems around the world. Two types of capital were measured as per the **Basel II** norms

34. Through various legislations since the ***RBI Nationalisation Act, 1949*** and the ***Banking Regulation Act, 1949*** were enacted – and further ***Amendments*** to the Acts, MoF, GoI, New Delhi.

35. Simon Cox (ed.), ***Economics,*** The Economist, 2007, op. cit., p. 145.

36. The ***BIS*** is today a central bank for central bankers set up in 1930 in a round tower near Basel railway station in Switzerland as a private company owned by a number of central banks, one commercial bank (Citibank) and some private individuals. Today it functions as a meeting place for the bank regulators of many countries, a multilateral regulatory authority and a ***clearing house*** for many nations' ***reserves*** (i.e. foreign exchange). See ***Tim Hindle,*** Pocket Finance, The Economist, 2007, pp. 35–36.

37. Investments made and loans forwarded by banks are known as risky assets.

38. The capital of a bank was classified into Tier-I and Tier-II. While Tier-I comprises share capital and disclosed reserves, Tier-II includes revaluation reserves, hybrid capital and subordinated debt of a bank. As per the provision Tier-II capital should not exceed the Tier I capital. The risk-weighting depends upon the type of assets—for example it is 100 per cent on private sector loans while only 20 per cent for short-term loans.

– *Tier 1* capital, which can absorb losses without a bank being required to cease trading, and *Tier 2* capital, which can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors. The new norms (**Basel III**) has devised a third category of capital, i.e., *Tier 3* capital.

The RBI introduced the ***capital-to-risk weighted assets ratio*** (CRAR) system for the banks operating in India in 1992 in accordance with the standards of the BIS—as part of the financial sector reforms.[39] In the coming years the Basel norms were extended to term-lending institutions, primary dealers and non-banking financial companies (NBFCs), too. Meanwhile the BIS came up with another set of CAR norms, popularly known as **Basel-II**. The RBI guidelines regarding the CAR norms in India have been as given below:

(i) **Basel-I** norm of the CAR was to be achieved by the Indian banks by March 1997.

(ii) The CAR norm was raised to 9 per cent with effect from March 31, 2000 (*Narasimham Committee-II had recommended to raise it to 10 per cent in 1998*).[40]

(iii) Foreign banks as well as Indian banks with foreign presence to follow ***Basel-II norms,*** w.e.f. March 31, 2008 while other scheduled commercial banks to follow it not later than March 31, 2009. The Basel-II norm for the CAR is 12 per cent.[41]

WHY TO MAINTAIN CAR?

The basic question which comes to mind is as to why do the banks need to hold capital in the form of CAR norms? ***Two* reasons**[42] have been generally forwarded for the same:

(i) Bank capital helps to prevent bank failure, which arises in case the bank cannot satisfy its obligations to pay the depositors and other creditors. The low capital bank has a negative net worth after the loss in its business. In other words, it turns into insolvent capital, therefore, acts as a cushion to lessen the chance of the bank turning insolvent.

(ii) The amount of capital affects returns for the owners (equity holders) of the bank.

BASEL ACCORDS

The Basel Accords (i.e., Basel I, II and now III) are a set of agreements set by the Basel Committee on Bank Supervision (BCBS), which provides recommendations on banking regulations in regards to capital risk, market risk and operational risk. The purpose of the accords is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses. They are of paramount importance to the banking world and are presently implemented by over 100 countries across the world. The BIS Accords were the outcome of a long-drawn-out initiative to strive for greater international uniformity in prudential capital standards for banks' credit risk. The objectives of the accords could be summed up[43] as:

39. The RBI is a member of the Board of the BIS. The financial sector reforms commenced in India in the fiscal 1992–93 after the report submitted by the Narasimham Committee on Financial system (CFS).
40. ***Committee on Banking Sector Reforms*** (M Narasimhan Committee-II), MoF, GoI, New Delhi, April 1998.
41. ***Economic Survey 2006–07,*** MoF, GoI, N. Delhi.
42. D. M. Nachane, Partha Ray and Saibal Ghosh, ***India Development Report 2004–05,*** Oxford University Press, N. Delhi, 2005, p. 171.
43. ***IDR 2004-05,*** op. cit., p. 172.

(i) to strengthen the international banking system;
(ii) to promote convergence of national capital standards; and
(iii) to iron out competitive inequalities among banks across countries of the world.

The Basel Capital Adequacy Risk-related Ratio Agreement of 1988 (**i.e., Basel I**) was not a legal document. It was designed to apply to internationally active banks of member countries of the Basel Committee on Banking Supervision (BCBS) of the BIS at Basel, Switzerland. But the details of its implementation were left to national discretion. This is why Basel I looked G10-centric.[44]

The first Basel Accord, known as **Basel I** focuses on the capital adequacy of financial institutions. The capital adequacy risk (the risk a financial institution faces due to an unexpected loss), categorises the assets of financial institution into five risk categories (0 per cent, 10 per cent, 20 per cent, 50 per cent, 100 per cent). Banks that operate internationally are required to have a risk weight of 8 per cent or less.

The second Basel Accord, known as **Basel II**, is to be fully implemented by 2015. It focuses on three main areas, including minimum capital requirements, supervisory review and market discipline, which are known as the *three pillars*. The focus of this accord is to strengthen international banking requirements as well as to supervise and enforce these requirements.

The third Basel Accord, known as **Basel III** is a comprehensive set of reform measures aimed to strengthen the regulation, supervision and risk management of the banking sector. These measures aim[45] to:

(i) improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source be;
(ii) improve risk management and governance; and
(iii) strengthen banks' transparency and disclosures.

The capital of the banks has been classified into ***three tiers*** as given below:

Tier 1 Capital: A term used to describe the capital adequacy of a bank—it can absorb losses without a bank being required to cease trading. This is the **core measure** of a bank's financial strength from a regulator's point of view (this is the *most reliable* form of capital). It consists of the types of financial capital considered the most reliable and liquid, primarily stockholders' equity and disclosed reserves of the bank—equity capital can't be redeemed at the option of the holder and disclosed reserves are the liquid assets available with the bank itself.

Tier 2 Capital: A term used to describe the capital adequacy of a bank—it can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors. Tier II capital is secondary bank capital (the *second most reliable* forms of capital). This is related to Tier 1 Capital. This capital is a measure of a bank's financial strength from a regulator's point of view. It consists of accumulated after-tax surplus of retained earnings, revaluation reserves of fixed assets and long-term holdings of equity securities, general loan-loss reserves, hybrid (debt/equity) capital instruments, and subordinated debt and undisclosed reserves.

Tier 3 Capital: A term used to describe the capital adequacy of a bank—considered the

44. G-10 comprises Belgium, Canada, France, Germany, Italy, Japan, The Netherlands, Sweden, UK, and USA; later the group incorporated Luxembourg, Switzerland and recently Spain in its fold.
45. ***Bank of International Settlemets,*** Basel, Switzerland, May 15, 2012.

tertiary capital of the banks which are used to meet/support market risk, commodities risk and foreign currency risk. It includes a variety of debt other than Tier 1 and Tier 2 capitals. Tier 3 capital debts may include a greater number of subordinated issues, undisclosed reserves and general loss reserves compared to Tier 2 capital. To qualify as Tier 3 capital, assets must be limited to 250 per cent of a bank's Tier 1 capital, be unsecured, subordinated[46] and have a minimum maturity of two years.

Disclosed Reserves are the total liquid cash and the SLR assets of the banks that may be used any time. This way they are part of its *core capital* (Tier 1). *Undisclosed Reserves* are the unpublished or hidden reserves of a financial institution that may not appear on publicly available documents such as a balance sheet, but are nonetheless real assets, which are accepted as such by most banking institutions but cannot be used at will by the bank. That is why they are part of its *secondary capital* (Tier 2).

Basel III Provisions[47]

The new provisions have defined the capital of the banks in different way. They consider common equity and retained earnings as the predominant component of capital (as the past) but they restrict inclusion of items such as deferred tax assets, mortgage-servicing rights and investments in financial institutions to no more than 15 pen cent of the common equity component. These rules aim to improve the *quantity* and *quality* of the capital.

While the key capital ratio has been raised to 7 per cent of risky assets, according to the new norms, Tier-I capital that includes common equity and perpetual preferred stock will be raised from 2 to 4.5 per cent starting in phases from January 2013 to be completed by January 2015. In addition, banks will have to set aside another 2.5 per cent as a *contingency* for future stress. Banks that fail to meet the buffer would be unable to pay dividends, though they will not be forced to raise cash.

The new norms are based on renewed focus of central bankers on 'macro-prudential stability'. The global financial crisis following the crisis in the US sub-prime market has prompted this change in approach. The previous set of guidelines, popularly known as *Basel II* focused on 'macro-prudential regulation'. In other words, global regulators are now focusing on financial stability of the system as a whole rather than micro regulation of any individual bank.

Banks in the West, which are market leaders for the most part, face low growth, an erosion in capital due to sovereign debt exposures and stiffer regulation. They will have to reckon with a permanent decline in their returns on equity thanks to enhanced capital requirements under the new norms. In contrast, Indian banks—and those in other emerging markets such as China and Brazil—are well-placed to maintain their returns on capital consequent to Basel III. Financial experts have opined that Basel III looks changing the economic landscape in which banking power shifts towards the emerging markets.

BASEL III COMPLIANCE OF THE PSBs & RRBs

The capital to risk weighted assets ratio (CRAR) of the scheduled commercial banks of India was 13.02 per cent by March 2014 (Basel-III) falling to 12.75 per cent by September 2014. The

46. Subordinated debt ranks below other debts with regard to claims on assets or earnings (also known as a 'junior debt'). In the case of default, such creditors get paid out until after the senior debtholders were paid in full. Thus, such capitals of banks are more risky than unsubordinated debt.

47. ***Reserve Bank of India,*** MoF, GoI, New Delhi, May 5, 2012.

regulatory requirement for CRAR is **9** per cent for 2015. The decline in capital positions at aggregate level, however, was on account of deterioration in capital positions of PSBs. While the CRAR of the scheduled commercial banks (SCB) at 12.75 per cent as of September 2014 was satisfactory, going forward the banking sector, particularly PSBs will require substantial capital to meet regulatory requirements with respect to additional capital buffers.

In order to make the PSBs and RRBs compliant to the *Basel III* norms,[48] the government has been following a recapitalisation programme for them since 2011–12. A *High Level Committee* on the issue was also set up by the government which has suggested the idea of 'non-operating holding company' (HoldCo) under a special Act of Parliament (action is yet to come regarding this).

Meanwhile, the government has infused ***three tranches*** of capital into the banks (infused funds go to the RRBs, too through the PSBs under whom they fall) upto March 2015:

(i) Rs. 12,000 crore infused during 2011–12 in seven PSBs.

(ii) Rs. 12,517 crore infused in 2012–13 in 8 PSBs.

(iii) Rs.6,990 crore infused in **nine** PSBs by February 2015. But this capital infusion is based on a new criteria—efficiency parameters such as return on assets and return on equity. Efficient banks are rewarded with extra capital for their equity so that they can further strengthen their position.

In **March 2015**, the GoI specified its intention to bring down its stake in state run banks to 52 per cent to give them more avenues to raise funds, most banks are expected to approach the market to raise capital only next fiscal once the share market get some synergy.

Stock of Money

In every economy it is necessary for the central bank to know the stock (amount/level) of money available in the economy only then it can go for suitable kind of credit and monetary policy. Saying simply, credit and monetary policy of an economy is all about changing the level of the money flowing in the economic system. But it can be done only when we know the real flow of money. That's why it is necessary to first assess the level of money flowing in the economy.

Following the recommendations of the *Second Working Group on Money Supply (SWG)* in 1977, RBI has been publishing four *monetary aggregates* (component of money)– M_1, M_2, M_3 and M_4 (are basically short terms for Money-1, Money-2, Money-3 and Money-4) besides the Reserve Money. These components used to contain money of differing liquidities:

M_1 = Currency & coins with people + Demand deposits of Banks (Current & Saving Accounts) + Other deposits of the RBI.

M_2 = M_1+ Demand deposits of the post offices (i.e., saving schemes' money).

M_3 = M_1+ Time/Term deposits of the Banks (i.e., the money lying in the Recurring Deposits & the fixed Deposits).

48. **Basel III** norms prescribe a minimum regulatory capital of 10.5 per cent for banks by January 1, 2019. This includes a minimum of 6 per cent ***Tier I*** capital, plus a minimum of 2 per cent ***Tier II*** capital, and a 2.5 per cent capital conservation buffer. For this buffer, banks are expected to set aside profits made during good times so that it can be drawn upon during periods of stress.

M_4 = M_3 + total deposits of the post offices (both, Demand and Term/Time Deposits).

Now the RBI has started[49] publishing a set of new monetary aggregates following the recommendations of the *Working Group on Money Supply: Analytics and Methodology of Compilation* (Chairman, Dr. Y. V. Reddy) which submitted its report in June 1998. The Working Group recommended compilation of four monetary aggregates on the basis of the balance sheet of the banking sector in conformity with the norms of progressive liquidity: M_0 (monetary base), M_1 (narrow money), M_2 and M_3 (broad money). In addition to the monetary aggregates, the Working Group had recommended compilation of three liquidity aggregates namely, L_1, L_2 and L_3, which include select items of financial liabilities of non-depository financial corporations such as development financial institutions and non-banking financial companies accepting deposits from the public, apart from post office savings banks. The **New Monetary Aggregates** are as given below:

Reserve Money (M_0) = Currency in circulation + Bankers' Deposits with the RBI + 'Other'[50] deposits with the RBI.

Narrow Money (M_1) = Currency with the Public + Demand Deposits with the Banking System + 'Other' deposits with the RBI.

M_2=M_1 + Savings Deposits of Post-office Savings Banks.

Broad Money (M_3) = M_1 + Time Deposits with the Banking System.

M_4 = M_3 + All deposits with Post Office Savings Banks (excluding National Savings Certificates).

While the Working Group did not recommend any change in the definition of reserve money and M_1, it proposed a new *intermediate monetary aggregate* to be referred to as **NM_2** comprising currency and residents' short-term bank deposits with contractual maturity up to and including one year, which would stand in between narrow money (which includes only the non-interest-bearing monetary liabilities of the banking sector) and broad money (an all-encompassing measure that includes long-term time deposits). The new broad money aggregate (referred to as **NM_3** for the purpose of clarity) in the Monetary Survey would comprise, in addition to NM_2, long-term deposits of residents as well as call/term borrowings from non-bank sources, which have emerged as an important source of resource mobilisation for banks. The critical *difference* between M_3 and NM_3 is the treatment of non-resident repatriable fixed foreign currency liabilities of the banking system in the money supply compilation.

There are **two basic changes** in the new monetary aggregates. *First,* since the post office bank is not a part of the banking sector, ***postal deposits*** are no longer treated as part of money supply, as was the case in the extant M_2 and M_4. *Second,* the residency criterion was adopted to a limited extent for compilation of monetary aggregates. The Working Group made a recommendation in favour of compilation of monetary aggregates on residency basis. Residency essentially relates to the country in which the holder has a centre of economic interest. Holdings of currency

49. The working group was set up in December 1997 under the chairmanship of Y. V. Reddy (the then Deputy Governor, RBI) which submitted its report in June 1998.

50. 'Other' deposits with RBI comprise mainly: (i) deposits of quasi-government; other financial institutions including primary dealers, (ii) balances in the accounts of foreign Central Banks and Governments, and (iii) accounts of international agencies such as the International Monetary Fund.

and deposits by the non-residents in the rest of the world sector, would be determined by their portfolio choice. However, these transactions form part of balance of payments (BoP). Such holdings of currency and deposits are not strictly related to the domestic demand for monetary assets. It is therefore argued that these transactions should be regarded as external liabilities to be netted from foreign currency assets of the banking system. However, in the context of developing countries such as India, which have a large number of expatriate workers who remit their savings in the form of deposits, it could be argued that these non-residents have a centre of economic interest in their country of origin. Although in a macro-economic accounting framework all non-resident deposits need to be separated from domestic deposits and treated as capital flows, the underlying economic reality may point otherwise. In the Indian context, it may not be appropriate to exclude all categories of non-resident deposits from domestic monetary aggregates as non-resident rupee deposits are essentially integrated into the domestic financial system. The new monetary aggregates, therefore, exclude only non-resident repatriable foreign currency fixed deposits from deposit liabilities and treat those as external liabilities. Accordingly, from among the various categories of non-resident deposits at present, only Foreign Currency Non-Resident Accounts (Banks) [FCNR(B)] deposits are classified as external liabilities and excluded from the domestic money stock. Since the bulk of the FCNR(B) deposits are held abroad by commercial banks, the monetary impact of changes in such deposits is captured through changes in net foreign exchange assets of the commercial banks. Thus, now the new monetary aggregates NM_2 and NM_3 as well as liquidity aggregates L_1, L_2, and L3 have been introduced, the components of which are elaborated as follows:

NM_1 = Currency with the Public + Demand Deposits with the Banking System + 'Other' Deposits with the RBI.

NM_2 = NM_1 + Short Term Time Deposits of Residents (including the contractual maturity of one year).

NM_3=NM_2 + Long-term Time Deposits of Residents + Call/Term Funding from Financial Institutions.

L_1 = NM_3 + All Deposits with the Post Office Savings Banks (excluding National Savings Certificates)

L_2 = L_1 + Term deposits with Term Lending Institutions and Refinancing Institutions (FIs) + Term Borrowing by FIs + Certificates of Deposit issued by FIs

L_3 = L_2 + Public Deposits of Non-Banking Financial Companies.

Data on M_0 are published by the RBI on *weekly* basis, while those for M_1 and M_3 are available on *fortnightly* basis. Among liquidity aggregates, data on L_1 and L_2 are published *monthly,* while those for L_3 are disseminated *quarterly*. The working group advised for the quarterly publication of **Financial Sector Survey** to capture the dynamic linkages between banks and rest of the organised financial sector.

Liquidity of Money

As we move from M_1 to M_4 the liquidity (inertia, stability, spendability) of the money goes on decreasing and in the opposite direction, the liquidity increases.

Narrow Money

In banking terminology, M_1 is called narrow money as it is highly liquid and banks cannot run their lending programmes with this money.

BROAD MONEY

The money component M_3 is called broad money in the banking terminology. with this money (which lies with banks for a known period) banks run their lending programmes.

MONEY SUPPLY

In general discussion we usually use money supply to mean money circulation, money flow in the economy. But in banking and typical monetary management terminology the level and supply of M_3 is known as money supply. The growth rate of broad money (M_3), i.e., *money supply*, was not only lower than the indicative growth set by the Reserve Bank of India but it also witnessed continuous and sequential deceleration in the last 7 quarters and moderated to 11.2 per cent by December 2012. Aggregate deposits with the banks were the major component of broad money counting for over 85 per cent remaining almost stable. The sources of broad money are net bank credit to the government and to the commercial sector. These two together accounted for nearly 100 per cent of the broad money in 2012–13, compared to 89 percent in 2009–10.

MINIMUM RESERVE

The RBI is required to maintain a reserve equivalent of Rs. 200 crores in gold and foreign currency with itself, of which Rs. 115 crores should be in gold. Against this reserve, the RBI is empowered to issue currency to any extent. This is being followed since 1957 and is known as the Minimum Reserve System (MRS).

RESERVE MONEY

The gross amount of the following six segments of money at any point of time is known as Reserve Money (RM) for the economy or the government:

(i) RBI's net credit to the Government;
(ii) RBI's net credit to the Banks;
(iii) RBI's net credit to the commercial banks;
(iv) net forex reserve with the RBI;
(v) government's currency liabilities to the public;
(vi) net non-monetary liabilities of the RBI.

RM = 1 + 2 + 3 + 4 + 5 + 6

As per the *Economic Survey 2014–15*, the rate of growth of reserve money comprising currency in circulation and deposits with the RBI (bankers and others) decelerated from an average of 17.8 per cent in 2014–15 to 4.3 per cent in 2013–14. Almost the entire increase in the reserve money of Rs. 3.258 billion between the period consisted of increase in *currency in circulation*. As sources of reserve money, net RBI credit to the government and increase in net financial assets of the RBI contributed to the growth of *base money*.

MONEY MULTIPLIER

At end March 2012, the *money multiplier* (ratio of M_3 to M_0) was 5.2, higher than end-March 2015, due to cumulative 125 basis point reduction in CRR. During 2012–13, the money multiplier generally stayed high reflecting again, the CRR cuts. As on **December 31, 2014**, the money multiplier was 5.5 compared with 5.2 on the corresponding date of the previous year *(Economic Survey 2014–15)*.

CREDIT COUNSELLING

Advising borrowers to overcome their debt burden and improve money management skills is credit counselling. The first such well-known agency was created in the USA when credit granters created National Foundation for Credit Counselling (NFCC) in 1951.[51]

India's sovereign debt is usually rated by six

51. Y. V. Reddy, the RBI Gonvernor, ***The Economic Times,*** N. Delhi, September 11, 2006.

major sovereign credit rating agencies (SCRAs) of the world which are :

(i) Fitch Ratings,
(ii) Moody's Investors Service,
(iii) Standard and Poor's (S&P),
(iv) Dominion Bond Rating Service (DBRS),
(v) Japanese Credit Rating Agency (JCRA), and
(vi) Rating and Investment Information Inc., Tokyo (R&I).

As on *January 15, 2013* most of these rating agencies have put India under 'stable' category in foreign and local currencies barring Fitch and S&P which have put its foreign currency in 'negative' category. The government is taking a number of steps to improve its interaction with the major SCRAs so that they make informed decisions as the *Economic Survey 2012–13* says.

CREDIT RATING

To assess the credit worthiness (credit record, integrity, capability) of a prospective (would be) borrower to meet debt obligations is credit rating. Today it is done in the cases of individuals, companies and even countries. There are some world-renowned agencies such as the Moody's, S & P. The concept was first introduced by **John Moody** in the USA (1909). Usually equity share is not rated here. Primarily, ratings are an investor service.

Credit rating was introduced in India is 1988 by the ICICI and UTI, jointly. The major credit rating agencies of India are:

(i) *CRISIL* (Credit Rating Information of India Ltd.) was jointly **promoted** by ICICI and UTI with share capital coming from SBI, LIC, United India Insurance Company Ltd. to rate debt instrument—**debenture.** In April 2005 its 51 per cent equity was acquired by the US credit rating agency S & P—a McGraw Hill Group of Companies.
(ii) *ICRA* (Investment Information and Credit Rating Agency of India Ltd.) was set up in 1991 by IFCI, LIC, SBI and select banks as well as financial institutions to rate debt instruments.
(iii) *CARE* (Credit Analyses and Research Ltd.) was set up in 1993 by IDBI, other financial institutions, nationalised banks and private sector finance companies to rate all types of debt instruments.
(iv) *ONICRA* (Onida Individual Credit Rating Agency of India Ltd.) was set up by ONIDA finance (a private sector finance company) in 1995 to rate credit-worthiness of non-corporate consumers and their debt instruments, i.e., credit cards, hire-purchase, housing finance, rental agreements and bank finance.
(v) *SMERA* (Small and Medium Enterprises Rating Agency) was set up in September 2005, to rate the overall strength of small and medium enterprises (SMEs)—the erstwhile SSIs. It is not a credit rating agency precisely, but its ratings are used for this purpose, too. A joint venture of SIDBI (the largest share-holder with 22 per cent stake), SBI, ICICI Bank, Dun & Bradstreet (an international credit information company), five public sector banks (PNB, BOB, BOI, Canara Bank, UBI with 28 per cent stake together) and CIBIL (Credit Information Bureau of India Ltd.).

A general credit rating service not linked to any debt issue is also availed by companies—already offered in India by rating agencies—CRISIL calls such ratings as **Credit Assessment.**[52] International rating agencies such as Moody's, S &

52. S. Sundararajan, ***Book of Financial Terms,*** Tata McGraw-Hill, N. Delhi, 2004, p. 44.

P also undertake sovereign ratings, i.e., of countries—highly instrumental in external borrowings of the countries.

Individuals are also covered by credit appraisal which is on useful information for the consumer credit firms. To maintain a database on the credit records of individuals the credit Information Bureau of India Limited (CIBIL) was set up in May 2004 which makes credit informations available to banks and financial institutions about prospective individual borrowers.[53]

NON-RESIDENT INDIAN DEPOSITS

Foreign Exchange Management (Deposit) Regulations, 2000 permits Non-Resident Indians (NRIs) to have deposit accounts with authorised dealers and with banks authorised by the Reserve Bank of India (RBI) which include:[54]

(i) Foreign Currency Non-Resident (Bank) Account [FCNR(B) Account]

(ii) Non-Resident External Account (NRE Account)

(iii) Non-Resident Ordinary Rupee Account (NRO Account)

FCNR(B) accounts can be opened by NRIs and Overseas Corporate Bodies (OCBs) with an authorised dealer. The accounts can be opened in the form of term deposits. Deposits of funds are allowed in Pound Sterling, US Dollar, Japanese Yen and Euro. Rate of interest applicable to these accounts are in accordance with the directives issued by RBI from time to time.

NRE accounts can be opened by NRIs and OCBs with authorised dealers and with banks authorised by RBI. These can be in the form of savings, current, recurring or fixed deposit accounts. Deposits are allowed in any permitted currency. Rate of interest applicable to these accounts are in accordance with the directives issued by RBI from time to time.

NRO accounts can be opened by any person resident outside India with an authorised dealer or an authorised bank for collecting their funds from local bonafide transactions in Indian Rupees. When a resident becomes an NRI, his existing Rupee accounts are designated as NRO. These accounts can be in the form of current, savings, recurring or fixed deposit accounts.

There were two more NRI deposit accounts in operation, viz., *Non-Resident (Non-Repatriable) Rupee Deposit Account* and *Non-Resident (Special) Rupee Account*—an amendment to Foreign Exchange Management (Deposit) Regulations, in 2002, discontinued the acceptance of deposits in these two accounts from April 2002 onwards.

Repatriation of funds in FCNR(B) and NRE accounts is permitted. Hence, deposits in these accounts are included in India's *external debt* outstanding. While the principal of NRO deposits is non-repatriable, current income and interest earning is repatriable. Account-holders of NRO accounts are permitted to annually remit an amount up to US$ 1 million out of the balances held in their accounts. Therefore, deposits in NRO accounts too are included in India's *external debt.*

GUIDELINES FOR LICENSING OF NEW BANKS

The RBI on *February 22, 2013* released the Guidelines for *'Licensing of New Banks in the Private Sector'*. Key features of the guidelines are:

(i) *Eligible Promoters:* A private sector/public sector/NBFCs/entity/group eligible to set up a bank through a wholly-owned "Non-

53. Ibid.

54. As per the latest update by the ***RBI,*** May 11, 2012.

Operative Financial Holding Company (NOFHC)".

(ii) *'Fit and Proper' criteria:* A past record of sound credentials, integrity and sound financial background with a successful track record of 10 years will be required.

(iii) *Corporate structure of the NOFHC:* The NOFHC to be wholly owned by the promoter/promoter group which shall hold the bank as well as all the other financial services entities of the group.

(iv) *Minimum voting equity capital requirements for banks and shareholding by NOFHC:* The initial minimum *paid-up voting equity capital*[55] for a bank shall be Rs. 5 billion. The NOFHC shall initially hold a minimum of 40 per cent of the paid-up voting equity capital of the bank which shall be locked in for a period of *five years* and which shall be brought down to 15 per cent within 12 years. Bank's shares to be listed on the stock exchanges within *three years* of the business commencement.

(v) *Regulatory framework:* The bank to be regulated by the relevant Acts/Statutes/Directives, issued by the RBI and other regulators. The NOFHC shall be *registered as* an NBFC with the RBI and will be governed by a separate set of directions issued by the RBI.

(vi) *Foreign shareholding in the bank:* Foreign shareholding upto 49 per cent for the first 5 years after which it will be as per the extant policy.

(vii) *Corporate governance of NOFHC:* At least 50 per cent of the Directors of the NOFHC should be independent directors. The corporate structure should not impede effective supervision of the bank and the NOFHC by RBI.

(viii) *Prudential norms for the NOFHC:* The *prudential norms* will be applied to NOFHC on similar lines as that of the bank.

(ix) *Exposure norms:* The Bank/NOFHC allowed no *exposure* to the Promoter Group—the bank shall not invest in the equity/debt capital instruments of any financial entities held by the NOFHC.

(x) *Business Plan for the bank:* The business plan should be realistic and viable and should address how the bank proposes to achieve *financial inclusion*.

(xi) *Additional conditions for NBFCs promoting/converting into a bank:* Existing NBFCs, if considered eligible, may be permitted to promote a new bank or convert themselves into banks.

(xii) *Other conditions for the bank:*

(a) To open at least 25 per cent of its branches in un-banked rural centres (with population of upto 9,999 as per the latest census).

(b) To comply with the *priority sector lending* targets applicable to the existing domestic banks.

(c) Banks promoted by groups having 40 per cent or more assets/income from non-financial business will require RBI's prior approval for raising paid-up voting equity capital beyond Rs. 10 billion.

(d) Any non-compliance of terms and conditions will attract penal measures including cancellation of licence of the bank.

55. The part of 'Authorised Capital' (the limit upto which a company can issue shares) which has been actually 'paid' by the shareholders is known as the 'Paid-up Capital' of a company. [for detailed analysis of different kind of 'Capitals' of a company refer the *Chapter 14: Security Market in India*].

Two new banks get licence: The RBI by early April, 2014 granted *'in-principle'* approval to two applicants, IDFC Limited and Bandhan Financial Services Private Limited, to set up banks—'in-principle' approval granted will be valid for 18 months during which the applicants have to comply with the requirements and fulfil other conditions. Both are leading non-banking finance companies, while IDFC deals in infrastructure finance, Bandhan is in microfinance business. A High Level Advisory Committee headed by former RBI Governor Bimal Jalan recommended these two applicants out of a list of 25 applications. The case of India post will be decided by the RBI in consultation with the Government of India. The RBI also announced to work on giving licences more regularly, that is virtually 'on-tap'. As per the RBI, those applicants who have been denied licences can apply for the 'differentiated licences' (once RBI invites applications for it)—some of them may be better off applying for a differentiated licence rather than for a full licence. The so-called differentiated banks will be specialised institutions such as the 'payment banks' suggested by an RBI panel (headed by **Nachiket Mor**) on financial inclusion, to widen the spread of *payment services* and *deposit products* to small businesses and low-income households.

LABELS OF ATM

The automated teller machine (ATM) enetered India by late 1980s and have evolved into three of its types by now—

(i) *Bank's own ATMs:* These are owned and operated by the concerned bank and carry the bank's 'logo'. They are the costliest way to provide such service to bank's customers.

(ii) *Brown Label ATMs (BLAs):* These are owned by third party (a non-banking firm). The concerned banks only handle part of the process that is 'cash handling' and 'back-end server' connectivity. They carry 'logo' of the bank which outsources their service.

(iii) *White Label ATMs (WLAs):* These are 'owned' and 'operated' by a third party (a non-banking firm). They do not bear 'logo' of the banks they serve (that is why such a name). In place, they carry logo of the firm which own them. They serve customers of all banks and are interconnected with the entire ATM network in the country. The role of the concerned bank is only limited to provide account information and back-end money transfers to the third parties managing these ATM machines. These entities have a mandate to deploy 67 per cent of ATMs in rural locations (Tier III-VI) and 33 per cent in urban locations (Tier I and II cities). The Tata Communications Payment Solutions became the first such firm to get permission of the RBI (by mid-2013) to set up such ATMs – its brand name is 'Indicash'.

The main objectives of the Brown/White Label ATMs are cutting operation cost of running them and financial inclusion.

NON-OPERATIVE FINANCIAL HOLDING COMPANY (NOFHC)[56]

The difference between an *operating company* and a *holding company* lies in the fundamental structures of the two, in their management and their interactions with one another. Business goals are often different, and both business types are after profits, but holding companies can still benefit from operating company losses under certain conditions.

56. Though this sub-topic originally belongs to the *Chapter 14: Security Market in India*, it has been discussed here to make the new guidelines of setting-up banks an 'easy-to-understand' thing for the readers.

The primary function of a ***holding company*** is to invest in other companies, commonly known as subsidiaries. Holding companies are usually not involved in day-to-day operations of the operating company, but lend initial or ongoing financial support via cash reserves or stock sales, and may assist in restructuring the operational model to ensure profits. Holding companies are normally structured as *corporations* (limited liability firms i.e., known as a **Ltd.** company in India) to protect assets and absorb financial losses.

Operating companies are owned by the holding company, but are responsible for all day-to-day operations of the company. When a holding company creates or purchases an operating company, they are sometimes allowed to conduct business as usual – especially, if they are profitable. Net profits after expenses are then handed over to the holding company.

Ownership of operating companies, even when purchased, revert to the holding company. Former owners who are kept on-board are often given control of the operating company in the form of executive management responsibility, but have no ownership rights. All major decisions that may affect profitability or involve large expenditures must first be approved by the holding company.

Although operating company's *profitability* should make sense for the holding company, this is not always the case. Especially for larger holding companies with heavy tax burdens, owning one or more operating companies that lose money can benefit the parent company in the form of a business loss when tax time rolls around. This does not benefit the operating company, as it is responsible for operating income to run the business. If the losses become too great, operating companies can go out of business, but the holding company can still benefit because the operating company can help to balance overall profits and stock prices.

There are *three basic types* of holding companies:

(i) A *pure holding company* that is non-operating and exists solely to invest in and hold the voting shares of its subsidiaries. This type of holding company derives its income from the dividends earned from its ownership of the shares of its subsidiaries and from any gains realised from other investments.

(ii) A *general* or *operating holding company* that earns its income from selling goods and services in addition to the income derived from its ownership of subsidiaries.

(iii) A *pyramid holding company* that owns controlling interest in its subsidiaries with less invested capital than the two other categories.

NIDHI

Nidhi in the Indian context means 'treasure'. However, in the Indian financial sector it refers to any *mutual benefit society*[57] notified by the

57. **Mutual Benefit Society** (also known globally as 'benefit society' or 'mutual aid society') is an organization, or voluntary association formed to provide mutual aid, benefit, or insurance for relief from common difficulties. Such organizations may be formally organized with charters and established customs, or may arise ad hoc to meet unique needs of a particular time and place. They may be organized around a shared ethnic background, religion, occupation, geographical region or other basis. Benefits may include money or assistance for sickness, retirement, education, birth of a baby, funeral and medical expenses, unemployment. Often benefit societies provide a social or educational framework for members and their families to support each other and contribute to the wider community.

A benefit society may have some common features – members having equivalent opportunity in the organization; members having equivalent benefits; aid goes to needy (stronger helping the weaker); payment of benefits by collection of funds from the members; educating others about a group's interest; preserving cultural traditions; and mutual defence.

Examples of benefit societies include trade unions, self-help groups, etc. It is believed that such societies predate human culture are found around the world.

Central / Union Government as a Nidhi Company. They are created mainly for cultivating the habit of *thrift* and *savings* amongst its members. The companies doing Nidhi business, viz., borrowing from members and lending to members only, are known under different names such as *Nidhi, Permanent Fund, Benefit Funds, Mutual Benefit Funds* and *Mutual Benefit Company.*

Nidhis are more popular in ***South India*** and are highly localised single office institutions. They are mutual benefit societies, because their dealings are restricted only to the members; and membership is limited to individuals. The principal source of funds is the contribution from the members. The loans are given to the members at relatively reasonable rates for purposes such as house construction or repairs and are generally secured. The deposits mobilised by Nidhis are not much when compared to the organised banking sector.

Nidhis are companies registered under the Companies Act, 1956 and are regulated by the Ministry of Corporate Affairs (MCA). Even though Nidhis are regulated by the provisions of the Companies Act, 1956, they are exempted from certain provisions of the Act, as applicable to other companies, due to limiting their operations within members.

Nidhis are also included in the definition of ***NBFCs,*** which operate mainly in the *unorganised money market*. However, since 1997, NBFCs have been brought increasingly under the regulatory ambit of the RBI. Non-banking financial entities partially or wholly regulated by the RBI include:

(i) NBFCs comprising equipment leasing (EL), hire purchase finance (HP), loan (LC), investment (IC) [including primary dealers (PDs] and residuary non-banking companies RNBC;

(ii) Mutual benefit financial company (MBFC), i.e., *nidhi company*;

(iii) Mutual benefit company (MBC), i.e., potential nidhi company; i.e., a company which is working on the lines of a Nidhi company, but has not yet been so declared by the Central Government; has minimum net owned fund (NOF) of Rs.10 lakh, has applied to the RBI for certificate of registration and also to the Department of Company Affairs (DCA) for being notified as a Nidhi company and has not contravened directions / regulations of RBI/DCA.

(iv) Miscellaneous non-banking company (MNBC), i.e., *chit fund company.*

Since Nidhis come under one class of NBFCs, RBI is empowered to issue directions to them in matters relating to their deposit acceptance activities. However, in recognition of the fact that these Nidhis deal with their shareholder-members only, RBI has exempted the notified Nidhis from the core provisions of the RBI Act and other directions applicable to NBFCs. As on date *(February 2013)* RBI does not have any specified regulatory framework for Nidhis.

The Central Government in March 2000 constituted a committee to examine the various aspects of the functioning of Nidhi Companies. There was no government notification defining the word 'Nidhi'. Taking into consideration the manner of functioning of Nidhis and the recommendations of the *P. Sabanayagam Committee* in its report and also to prevent unscrupulous persons using the word 'Nidhi' in their name without being incorporated by the Department of Company Affairs (DCA) and yet doing Nidhi business, the committee suggested the following ***definition*** for Nidhis (a part of this definition is appearing in the new *Companies Bill 2012 (Section 406):*

"Nidhi is a company formed with the exclusive object of cultivating the habit of thrift, savings and functioning for the mutual benefit of members by receiving deposits only from individuals enrolled as members and by lending only to individuals, also enrolled as members, and which functions as per Notification and Guidelines prescribed by the DCA. The word Nidhi shall not form part of the name of any company, firm or individual engaged in borrowing and lending money without incorporation by DCA and such contravention will attract penal action."

CHIT FUND

Recently, Chit Fund was in centre of news after the Kolkata-based *Saradha Chit Fund* scam came to light. Most of the media people were themselves not very clear about the 'finer' points related to the idea of 'chits' in India, but they kept on highlighting chits as they needed to report on the scam. Let us try understand what 'chits' are and some other similar concepts in India:

Chit funds (also known by their other names such as – *Chitty, Kuri, Miscellaneous Non-Banking Company*) are essentially saving institutions. They are of various forms and lack any standardised form. Chit funds have regular members who make periodical subscriptions to the fund. The periodic collection is given to some member of the chit funds selected on the basis of previously agreed criterion. The beneficiary is selected usually on the basis of bids or by draw of lots or in some cases by auction or by tender. In any case, each member of the chit fund is assured of his turn before the second round starts and any member becomes entitled to get periodic collection again. Chit funds are the Indian versions of 'Rotating Savings and Credit Associations' found across the globe.

Chit fund business is regulated under the Central *Chit Funds Act, 1982* and the rules framed under this Act by the various state governments for this purpose. The Central Government has not framed any rules of operation for them. Thus, registration and regulation of chit funds are carried out by *state governments* under the rules framed by them. Functionally, chit funds are included in the definition of NBFCs by the RBI under the sub-head *miscellaneous non-banking company*(MNBC). But RBI has not laid out any separate regulatory framework for them.

Official Definition: As per the Chit Funds Act, 1982, chit means "a transaction whether called *chit, chit fund, chitty, kuri* or by *any other name* by or under which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money (or a certain quantity of *grain* instead) by way of periodical installments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount". A transaction is not a chit, if in such transaction :

(i) Some alone, but not all, of the subscribers get the prize amount without any liability to pay future subscriptions; or

(ii) All the subscribers get the chit amount by turns with a liability to pay future subscriptions.

URJIT PATEL COMMITTEE

An expert committee headed by Urjit R. Patel, Deputy Governor of the RBI was appointed in September 2013 to *Revise and Strengthen the Monetary Policy Framework*. The **main objective** of the committee was to recommend what needs to be done to revise and strengthen the current monetary policy framework with a view to making it transparent and predictable. The panel submitted its report (January, 2014) made the following recommendations:

1. CPI (combined) should be used as the nominal anchor for a flexible inflation targeting (FIT) framework. The choice of CPI as nominal anchor was mainly on account of the fact that the CPI closely

reflects cost of living and has larger influences on inflationary expectations than other anchors.

2. Target rate of inflation should be 4 per cent with a tolerance band of 2 per cent to be achieved in a two-year time frame.
3. The transition path to the target zone should be graduated to bring down inflation from the current level of around 10 per cent to 8 per cent over a period not exceeding 12 months and to 6 per cent over a period not exceeding the next 24 months.
4. Administered prices and interest rates should be eliminated as they act as impediments to monetary policy transmission and achievement of price stability.
5. The monetary policy decision-making should be vested with a monetary policy committee (MPC)—the RBI Governor as its Chairman and Deputy Governor as the Vice-Chairman, the Executive Director in charge of monetary policy could be its member and two external members.
6. All fixed income financial products should be treated on a par with bank deposits for the purposes of taxation and TDS. With a sharp rise in the ratio of agricultural credit to agricultural GDP, the need for subventions on interest rate for lending to certain sectors would have to re-visited.
7. In view of the cross-country and Indian experience with *global spillovers* driving episodes of large and volatile capital inflows as well as outflows, the committee felt that a flexible setting of monetary policy by the RBI in the short-run was warranted. This presages readiness to use range of instruments at its command.

   With regard to inflows that are excessive in relation to external financing requirements and the need for sterilised intervention, the RBI should build a *sterilisation reserve* out of its existing and evolving portfolio of GoI securities across the range of maturities, but accentuated towards a 'strike capability' to rapidly intervene at the short-end. The central bank should introduce a remunerated standing deposit facility, which would effectively empower it with unlimited sterilisation capability. As a buffer against outflows, the RBI's strategy should be to build an adequate level of foreign exchange reserves.
8. The committee asked the Central Government to ensure that the fiscal deficit as a ratio to GDP (gross domestic product) is brought down to 3.0 per cent by 2016–17.

In view of the elevated level of current CPI inflation and hardened inflation expectations, supply constraints and weak output performance, the committee said the transition path to the target zone should be graduated to bringing down inflation from the current level of 10 per cent to 8 per cent over a period not exceeding the next 12 months and to 6 per cent over a period not exceeding the next 24 month period before formally adopting the recommended target of 4 per cent inflation with a band of +/- 2 per cent.

Since food and fuel account for more than **57** per cent of the CPI on which the direct influence of monetary policy is limited, the commitment to the nominal anchor would need to be demonstrated by timely monetary policy response to risks from second-round effects and inflation expectations in response to shocks to food and fuel, the committee pointed out.

NACHIKET MOR COMMITTEE

The RBI set up the *Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households* (CCFS) in September 2013 under the Chairmanship of Dr Nachiket Mor. The Committee's Report was released on 7 January 2014.

At its **core**, the Committee's recommendations are that in order to achieve the task of *financial inclusion* in a manner that enhances both financial inclusion and stability, there is need to move away from an exclusive focus on any one model to an approach where multiple models and partnerships are allowed to thrive, particularly between national full-service banks, regional banks of various types, NBFCs, and financial markets. The common theme of all the recommendations made by the Committee is that instead of focusing only on large generalist institutions, specialization and partnerships between specialists must be encouraged. Such an approach, in its view, would be far more effective at delivering high quality financial inclusion, without compromising financial stability or responsibility towards customers. Some of the *key recommendations* of the CCFS include:

1. *Universal Electronic Bank Account* for every resident to be made available at the time of issuing the Aadhaar number.
2. *Licensing*, with lowered entry barriers but otherwise equivalent treatment, more functionally focused banks, including payment banks, wholesale consumer banks, and wholesale investment banks.
3. *Developing risk-based supervision* processes for regional banks and strengthening existing ones before creating new regional banks.
4. *Reorienting the focus* of NABARD, SIDBI, and NHB to be market-makers and providers of risk-based credit enhancements.
5. *Consolidating NBFC definitions* into two categories: Core investment companies and other NBFCs. Restore permission of NBFCs-ND to act as business correspondents.
6. *On priority sector lending*, while the Committee acknowledged that the current focus of the policy, on small farmers, small businesses, and weaker sections, was well placed, it recommended an approach that incentivizes each provider to specialise in one or more sectors of the economy and regions of the country. Government subsidies to be channelled as direct benefit transfers (DBTs) rather than as subventions or waivers.
7. All *financial firms* regulated by the RBI be required to have an internal process to assess suitability of products prior to advising clients with regard to them.

SMALL & PAYMENT BANKS

By mid-July 2014, the RBI issued the *draft guidelines* for setting up small banks and payment banks. The guidelines said that both are 'niche' or 'differentiated' banks with the common objective of furthering *financial inclusion*. It is in pursuance of the announcement made in the *Union Budget 2014–15 (Full)*. The details regarding the provisions to set up such banks and their operational criteria are as given below:

The ***guidelines*** to set up both the banks are same—

- The minimum capital requirement would be Rs 100 crore.
- Promoter contribution would be at least 40 per cent for the first five years. Excess shareholding should be brought down to 40 per cent by the end of fifth year, to 30 per cent by the end of 10th year and to

26 per cent in 12 years from the date of commencement of business.

- Foreign shareholding in these banks will be as per current FDI policy.
- Voting rights to be line with the existing guideline for private banks.
- Entities other than promoters will not be permitted to have shareholding in excess of 10 per cent.
- The bank should comply with the corporate governance guidelines, including 'fit and proper' criteria for Directors as issued by RBI.
- Operations of the bank should be fully networked and technology driven from the beginning.

SMALL BANKS

The purpose of the small banks will be to provide a whole suite of basic banking products such as *deposits* and supply of *credit*, but in a *limited area of operation*. The **objective** of the Small Banks to increase financial inclusion by provision of savings vehicles to under-served and unserved sections of the population, supply of credit to small farmers, micro and small industries, and other unorganised sector entities through high technology low-cost operations. Other features of the small banks are as follows:

- Resident individuals with 10 years of experience in banking and finance, companies and Societies will be eligible as promoters to set up small banks. NFBCs, microfinance institutions (MFIs), and Local Area Banks (LABs) can convert their operations into those of a small bank. Local focus and ability to serve smaller customers will be a key criterion in licensing such banks.
- For the initial three years, prior approval will be required for branch expansion.
- The area of operations would normally be restricted to contiguous districts in a homogenous cluster of states or union territories so that the Small Bank has a 'local feel' and culture. However, if necessary, it would be allowed to expand its area of operations beyon contiguous districts in one or more states with reasonable geographical proximity.
- The bank shall primarily undertake *basic banking activities* of accepting deposits and lending to small farmers, small businesses, micro and small industries, and unorganised sector entities. It cannot set up subsidiaries to undertake non-banking financial services activities. After the initial stabilisation period of five years, and after a review, the RBI may liberalise the scope of activities for Small Banks.
- The promoters' other financial and non-financial services activities, if any, should be distinctly ring-fenced and not co-mingled with banking business.
- A robust risk management framework is required and the banks would be subject to all prudential norms and RBI regulations that apply to existing commercial banks, including maintenance of CRR and SLR.
- In view of concentration of area of operations, the Small Bank would need a diversified portfolio of loans, spread over it area of operations.
- The maximum loan size and investment limit exposure to single/group borrowers/ issuers would be restricted to 15 per cent of capital funds.
- Loans and advances of up to Rs 25 lakhs, primarily to micro enterprises, should constitute at least 50 per cent of the loan portfolio.

- For the first three years, 25 per cent of branches should be in unbanked rural areas.

Payments Banks

The **objective** of payments banks is to increase financial inclusion by providing small savings accounts, payment/remittance services to migrant labour, low income households, small businesses, other unorganised sector entities and other users by enabling high volume-low value transactions in deposits and payments/remittance services in a secured technology-driven environment.

- Those who can promote a payments banks can be a non-bank PPIs, NBFCs, corporate's, mobile telephone companies, super market chains, real sector cooperatives companies and public sector entities. Even banks can take equity in Payments Banks.
- Payments Banks can accept demand deposits (only current account and savings accounts). They would initially be restricted to holding a maximum balance of Rs 100,000 per customer. Based on performance, the RBI could enhance this limit.
- The banks can offer payments and remittance services, issuance of prepaid payment instruments, internet banking, functioning as business correspondent for other banks.
- Payments Banks cannot set up subsidiaries to undertake NBFC business.
- As in the case of Small Banks, other financial and non-financial services activities of the promoters should be ring-fenced.
- The Payments Banks would be required to use the word 'Payments' in its name to differentiate it from other banks.
- No credit lending is allowed for Payments Banks.
- The float funds can be parked only in less than one year G-Secs.

Meanwhile, the RBI has received 72 applications for small banks and 41 applications for payments banks. The applications are, at present, under consideration of the RBI. It is expected that soon some of them will get the nod for setting up these niche banks.

FINANCIAL INCLUSION

Financial inclusion is an important priority of the government. The objective is to ensure the excluded sections, i.e. weaker sections and low income groups, access to various financial services such as a basic savings bank account, need-based credit, remittance facility, insurance and pension. The government has recently launched an effective scheme to promote the cause of financial inclusion—the PMJDY:

Pradhan Mantri Jan-DhanYojana

To achieve the objective of financial inclusion by extending financial services to the large hitherto unserved population of the country and to unlock its growth potential, the Pradhan Mantri Jan-DhanYojana (PMJDY) was launched on 28 August 2014. The Yojana envisages—

(i) Universal access to banking facilities with at least one basic banking account for every household,

(ii) Financial literacy, access to credit and insurance.

(iii) The beneficiaries will receive a *RuPay* Debit Card having inbuilt accident insurance cover of Rs1 lakh.

(iv) In addition, there is a life insurance cover of Rs. 30,000 to those who opened their bank accounts for the first time between

15 August 2014 and 26 January 2015 and meet other eligibility conditions of the Yojana.

The Yojana has entered the *Guinness World Records* for opening most bank accounts during the week starting August 23, 2014 as part of the financial campaign. As on 28 January 2015, 12.31 crore bank accounts have been opened, of which 7.36 crore are in rural areas and 4.95 crore inurban areas. Under the PMJDY, 67.5 per cent of the accounts as on January 28, 2015 are with zero balance.

ALM OF BANKS

Banks have been faced with *Asset-Liability Management (ALM)* problems in recent times due to their existing long-term loans forwarded to certain sectors, viz., infrastructure, core sector and real estate sector. Again, raising new funds for new projects in these sectors had become quite difficult for the banks. These sectors constitute the major portion of banks' non-performing assests.

Banks have been seeking permission for longer tenor amortisation of the loan with periodic *refinancing* of balance debt. Banks have been raising resources in a significant way, issuance of long-term bonds for funding loans to infrastructure sector has not picked up at all. Infrastructure and core industries projects are characterised by long gestation periods and large capital investments. The long maturities of such project loans consist of the initial construction period and the economic life of the asset/underlying concession period (usually 25–30 years).

In pursuance of the *Union Budget 2015-16,* the RBI announced 'eased' norms in *July 2015* for the banks to take care of the Asset-Liability Management iisues of the banks, which are as follows:

(i) Banks allowed to raise fund through long-term bonds (with maturity period of not less than 7 years),

(ii) Such bonds exempted the mandatory regulatory norms such as the CRR, SLR and PSL.

(iii) Such funds to be used to finance long-term projects in infrastructure, core sector and affordable housing. Affordable housing means loans eligible under the priority sector lending (PSL), and loans up to Rs.50 lakh to individuals for houses costing up to Rs.65 lakh located in the six metropolitan centres. For other areas, it covers loans of Rs.40 lakh for houses with values up to Rs.50 lakh.

(iv) Banks can extend long term loans with flexible structuring to absorb potential adverse contingencies, known as the *5/25 structure*. Under the 5/25 structure, bank may fix longer amortisation period (25 years) with periodic refinancing (every 5 years.

India is looking at investing US $1 trillion in infrastructure development by 2017, half of which is expected to come from the private sector. The instructions announced by the RBI are in pursuance of the *Union Budget 2015–16* announcement.

NEW INITIATIVES IN THE BANKING SECTOR

In order to strengthen the banking industry , imparting greater transparency and accountability together with providing speedier and effective legal framework, the GoI took several important steps, in the recent times. Major steps, as per the *Economic Survey 2014–15,* are as follows:

(a) The RBI issued guidelines for licensing of new banks in the private sector on

22 February 2013, and in April 2014 two applicants have been granted 'in principle' approval to set up new banks in the private sector within a period of eighteen months.

(b) Pursuant to the *Union Budget 2014–2015* announcement for setting up of differentiated banks serving niche interests such as local area banks and payment banks, the RBI has formulated and released guidelines in November 2014 for licensing of payments banks and small finance banks in the private sector. Subsequently, the RBI has invited applications for setting up of small banks and payments banks.

(c) *Payment and Settlement Systems (Amendment) Bill 2014*: The Payment and Settlement Systems Act 2007 (PSS Act) was enacted with a view to providing sound legal basis for the regulation and supervision of payment systems in India by the RBI. For establishing a legal framework for regulation of trade repositories and legal entity identifier issuer, amendments have been considered necessary to make the PSS Act more effective.

The proposed amendments will provide finality to the determination of the payment obligations and settlement instructions between a central counter party (the system provider) and system participants in the event of insolvency, dissolution, or winding up of a central counter party.

(d) *Capital requirement of PSBs*: The GoI, in December 2014, approved aproposal allowing PSBs to raise capital from public markets through FPO (follow on public offer) or QIP (qualified institutional placement) by diluting Government of India holding upto 52 per cent in a phased manner based on their capital requirement, stock performance, liquidity, market appetite and subject to certain conditions.