CHAPTER 12

BANKING IN INDIA

*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 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.**

In This Chapter...

** See Joseph E. Stiglitz and Carl E. Walsh,* ***Economics***, 4th Edition (New York: W.W. Norton, 2006), p. 205.

- Insolvency and Bankruptcy
- Wilful Defaulter
- Capital Adequacy Ratio
- Basel III Compliance of the PSBs & RRBs
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INTRODUCTION

The sense in which we today use the term banking has its origin in the western world. It was introduced in India 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.

NBFCs

Bank is a financial institution engaged primarily in mobilising deposits and forwarding loans The deposits and loans are highly differentiated in nature. Banks are regulated by the Central bank of the country—in case of India, the RBI (Reserve Bank of India). The another category of financial institution—the ***non-bank***— is almost similar in its functions but *main* difference (though, highly simplified) being that it does not allow its depositors to withdraw money from their accounts.

NBFCs (Non-Banking Financial Companies)[1] are fast emerging as an important segment of Indian financial system. It is an *heterogeneous group* of institutions (other than commercial and co-operative banks) performing financial intermediation in a variety of ways, like accepting deposits, making loans and advances, leasing, hire purchase, etc. They *can not* have certain activities as their principal business—agricultural, industrial and sale-purchase or construction of immovable property.

They raise funds from the public, directly or indirectly, and lend them to ultimate spenders. They advance loans to the various wholesale and retail traders, small-scale industries and self-employed persons. Thus, they have broadened and diversified the range of products and services offered by a financial sector. Gradually, they are being recognised as *complementary* to the banking sector due to their—

(i) customer-oriented services;
(ii) simplified procedures;
(iii) attractive rates of return on deposits; and
(iv) flexibility and timeliness in meeting the credit needs of specified sectors.

RBI, the regulator of the NBFCs, has gives a very wide definition of such companies (a kind of 'umbrella' definition)—"a financial institution formed as a company involved in receiving deposits or lending in any manner." Based on their liability structure, they have been classified into two broad categories:

(i) deposit-taking NBFCs (NBFC-D), and
(ii) non-deposit taking NBFCs (NBFC-ND).

It is *mandatory* for a NBFC to get itself registered with the RBI as a *deposit taking* company. For registration they need to be a *company* (incorporated under the Companies Act, 1956) and should have a minimum NOF (net owned fund)[2] Rs. 2 crore.

To *obviate dual* regulation, certain category of the NBFCs which are regulated by other financial regulators are exempted from the regulatory control of the RBI:

(i) venture capital fund, merchant bank, stock broking firms (SEBI registers and regulates them);
(ii) insurance company (registered and regulated by the IRDA);

1. **RBI** update, 11 March, 2016 and the **Business.gov.in**, Government of India, April 2016.

2. The term 'NOF' means, owned funds (*paid-up capital* and *free reserves* minus *accumulated losses, deferred revenue expenditure* and *other intangible assets*) less, (i) investments in shares of subsidiaries/companies in the same group and all other NBFCs; and (ii) the book value of debentures, bonds, outstanding loans and advances, including hire-purchase and lease finance made to, and deposits with, subsidiaries/companies in the same group, in excess of 10 per cent of the owned funds.

(iii) housing finance company (regulated by the National Housing Bank);

(iv) nidhi company (regulated by the Ministry of Corporate Affairs under the Companies Act, 1956);

(e) chit fund company (by respective state governments under Chit Funds Act, 1982).

[Detailed discussion on the *Nidhi, Chit, Chitty, Kuri* and *MNBCs* are in the following sections of this Chapter.]

Some of the ***important regulations*** relating to acceptance of deposits by the NBFCs are:

- allowed to accept and/or renew public deposits for a minimum period of 12 months and maximum period of 60 months.
- cannot accept demand deposits (i.e., the *saving* and *current* accounts).
- cannot offer interest rates higher than the ceiling rate prescribed by the RBI.
- cannot offer gifts, incentives or any other additional benefit to the depositors.
- should have minimum investment grade credit rating.
- their deposits are not insured.
- the repayment of deposits by NBFCs is not guaranteed by RBI.
- need to maintain Capital Adequacy Ratio (CAR) norm as prescribed by the RBI.

The NBFCs registered with the RBI have different **types** depending on their *main business*:-

(i) *Equipment leasing company*—leasing of equipments.

(ii) *Hire-purchase company*—hire-purchase.

(iii) *Loan company*— forwarding loans.

(iv) *Investment company*—buying and selling of securities.

These NBFCs have been reclassified into ***three*** categories:

(i) Asset Finance Company (AFC)

(ii) Investment Company (IC) and

(iii) Loan Company (LC).

Under this classification, an AFC is defined as a financial institution whose principal business is that of financing the physical assets, which support various productive and economic activities in the country. Such NBFCs are supposed to play a very vital role in financing infrastructure projects in 2016–17, as per the Government of India.

To promote financial inclusion through direct interaction between small lenders and small borrowers together with addressing consumer protection, during 2017-18, RBI introduced two new categories of the NBFC—Peer to Peer (P2P) and Account Aggregators (AAa). Today[3], NBFC sector accounts for 17 per cent of bank assets and 0.26 per cent of bank deposits with a balance sheet size of Rs. 20.7 lakh crores. The sector depends largely on public funds though the share of non-convertible debentures (NCDs) also contribute to their balance sheet. By end-September the Capital to Risk Weighted Assets Ratio (CRAR) and gross NPAs were 22.5 and 5.5 per cent respectively.

DEBENTURE REDEMPTION

The norm of the NBFCs, which raise capital through debentures, have became stricter after the new Company Act, 2013 came into effect (w.e.f. 1 April, 2014), which are given below:

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

(ii) The 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 on corporate bounds. The amount canot

3. ***Economic Survey 2017-18***, Vol. 2, Ministry of Finance, GoI, N. Delhi, p. 53.

be used for any purpose other than redeeming debentures.

The norms are aimed at minimising the risk of debenture buyers in an NBFC and check the mishaps like the 'Sahara OFCD' [for Sahara ODFC 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[4] 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 and targeting (CPI–C) 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.

4. Based on the ***RBI Nationalisation Act, 1949*** and further announcements of the, Ministry of Finance, Government of India.

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.

RBI uses many instruments/tools to put in place the required kind of credit and monetary policy such as—CRR, SLR, Bank Rate, Repo & Reverse Rates, MSF Rate, OMOs, etc. on which it has regulatory controls.

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.[5] 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 (March 2018) it is 4 per cent and a 1 per cent change in it today affects the economy with Rs. 98,000 crore[6]—an increase sucks this amount from the economy, while a decrease injects this amount into the economy.

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.[7]

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.[8]

(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.[9]

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.[10]

The ratio was cut to 25 per cent (done in October 1997 after CFS suggestions).[11] 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—by **March 2018** it was 19.5 per cent.

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 Government of India, 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[12] with the MSF (Marginal Standing Facility) by the RBI in February 2012. By **March 2018**, it was 6.25 per cent.

REPO RATE

The rate of interest the RBI charges from its clients on their ***short-term*** borrowing is the repo rate in India.[13] Basically, this is an abbreviated form of the 'rate of repurchase' and in western economies it is known as the 'rate of discount'.[14]

5. ***RBI Act, 1934,*** sub-section (1) of Section 42.
6. Reserve Bank of India, **Financial Stability Report**, Government of India, New Delhi, 2017.
7. Reserve Bank of India, ***Economic Survey, 2006–07,*** (New Delhi: Government of India, 2007).
8. ***RBI (Amendment) Act, 2006***, (Mumbai: Government of India, 2007).
9. Reserve Bank of India, ***Credit and Monetary Policy,*** (Mumbai: Government of India, 2015).
10. ***RBI Act, 1934*** and ***Banking Regulation Act, 1949*** Section 24.
11. ***Committee on Financial System*** (CFS) headed by the then RBI Deputy Governor M. Narasimhan, 1991.
12. Through an RBI announcement on 15th February. 2012.
13. **RBI Act, 1934** and **Banking Regulation Act, 1949**.
14. Stiglitz and Walsh, ***Economics***, pp. 629–30.

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. The Call Money Market of India (inter-bank market) operates at this rate and banks use this route for *overnight* borrowings. This rate has direct relation with the interest rates banks charge on the loans they offer (as it affects the operational cost of the banks). The rate was 6 per cent in **March 2018**.

In October 2013, RBI introduced ***term repos*** (of different tenors, such as, 7/14/28 days), to inject liquidity over a period that is longer than overnight. It has several purposes to serve—stronger money market, stability, and better costing and signalling of the loan products.

REVERSE REPO RATE

It is the rate of interest the RBI pays to its clients who offer short-term loan to it. At present **(March 2018)** the rate is at 5.75 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.[15] 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.

15. Ministry of Finance, ***Economic Survey 2001–02,*** (New Delhi: Government of India, 2002).

MARGINAL STANDING FACILITY (MSF)[16]

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 rate has been floated as a *penal rate* and since mid-2015 RBI has maintained it 1 per cent higher than the prevailing repo rate. By end **March 2018** it was at 6.25 per cent, fully aligned with the Bank rate (i.e., equal to the Bank rate).

OTHER TOOLS

Other than the above-given instruments, RBI uses some other important , too to activate the right kind of the credit and monetary policy—

(i) Call Money Market: The call money market is an important segment of the money market where borrowing and lending of funds take place on over night basis. Participants in the call money market in India currently include scheduled commercial banks (SCBs)—excluding regional rural banks), cooperative banks (other than land development banks), insurance. Prudential limits, in respect of both outstanding borrowing and lending transactions in the call money market for each of these entities, are specified by the RBI.

16. 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 recent times, several changes have been introduced by the RBI in this market. By ***April 2016***, banks were allowed to borrow only 1 per cent of their NDTL (net demand and time liabilities, i.e., total deposit of the banks, in layman term) under overnight facility at repo rate. For the rest of 0.75 per cent of their NDTL, they may use the *term repos* of different tenors. In a sense, since late 2013, RBI has been discouraging banks to use repo route and switch over to term repos for their requirements of the short-term funds. Promoting stability and signalling better cost of loans are the main objectives of this changed stance.

(ii) *Open Market Operations (OMOs):* OMOs are conducted by the RBI via the sale/purchase of government securities (G-Sec) to/from the market with the *primary aim* of modulating rupee liquidity conditions in the market. OMOs are an effective quantitative policy tool in the armoury of the RBI, but are constrained by the stock of government securities available with it at a point in time. Other than the institutions, now individuals will also be able to participate in this market (the decision was taken in 2017 while it is yet to be implemented).

(iii) *Liquidity Adjustment Facility (LAF):* The LAF is the key element in the monetary policy operating framework of the RBI (introduced in June 2000). On daily basis, the RBI stands ready to lend to or borrow money from the banking system, as per the need of the time, at fixed interest rates (repo and reverse repo rates). Together with moderating the fund-mismatches of the banks, LAF operations help the RBI to effectively transmit *interest rate signals* to the market. The recent changes regarding a ***cap*** on the repo borrowing and provision of the ***term repo*** have changed the very dynamics of this facility after 2013.

(iv) *Market Stabilisation Scheme (MSS):* This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. The mobilised cash is held in a separate government account with the Reserve Bank. The instrument thus has features of both, SLR and CRR.

(v) *Standing Deposit Facility Scheme (SDFS):* The new scheme has been proposed by the *Union Budget 2018-19*. Such a tool was proposed by the RBI in November 2015 itself. The scheme is aimed at helping RBI to manage liquidity in a better way, especially when the economy is flush with excess fund (as was seen after the demonetisation of the high value currency notes post- November 2016).

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[17] the existing idea of BPLR on 1 July, 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

17. ***Reserve Bank of India, Announcement,*** 5 April, 2010 (New Delhi: Government of India).

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.

After its deregulation by the RBI in 2010, banks fix their own base rates. Thus, in practice base rate shows differentiation—changing from bank to bank according to differentiation in the operational costs of the banks. Banks are not allowed to offer any loan below their base rates. By ***March 2017***, the base rate of the banks were in the range of 9.25 to 9.65 per cent[18].

By the *fiscal 2015–16*, several new initiatives were taken by the RBI in the area of credit and monetary policy management—*major ones* are being given below:

(i) Transition to a *bi-monthly* monetary policy cycle.

(ii) Recognition of the *glide path for disinflation* (recommendation of *Urjit Patel Committee* report implemented). Under it, the ***CPI (C)*** is used by the RBI as the **"*Headline Inflation*"** for monetary management.

(iii) A *Monetary Policy Framework* has been put in place – an agreement in this regard was signed between the Government of India 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' is to be between 2 to 6 per cent (of the CPI-C).

(iv) Besides the existing repo route, ***term repos*** have been introduced for three set of tenors—7, 14 and 28 days.

(v) RBI is progressively *reducing* banks' access to overnight liquidity (at the fixed repo rate), and encouraging the banks to *increase* their dependency on the term repos. By ***March 2016***, banks were allowed to borrow only up to 1 per cent of their NDTL from the Call Money Market—0.25 per cent through *repo* and the rest of 0.75 per cent through *term repo*. This aims to improve the transmission of policy impulses across the interest rate spectrum and providing stability to the loan market.

(vi) As per the ***Union Budget 2016-17***, individuals will also be allowed by the RBI to participate in the government security market (similar to the developed economies like the USA).

MCLR

From the financial year ***2016-17*** (i.e., from 1st April, 2016), banks in the country have shifted to a new methodology to compute their lending rate. The new methodology—***MCLR*** (Marginal Cost of funds based Lending Rate)— which was articulated by the RBI in December 2015. The *main features* of the MCLR are—

- it will be a tenor linked internal benchmark, to be reset on annual basis.
- actual lending rates will be fixed by adding a spread to the MCLR.
- to be reviewed *every month* on a pre-announced date.
- existing borrowers will have the option to move to it.
- banks will continue to review and publish 'Base Rate' as hitherto.

18. Reserve Bank of India **Bi-monthly Credit & Monetary Policy**, February 2017.

As per the RBI, 'for monetary transmission to occur, lending rates have to be sensitive to the policy rate'. But this was not occurring by now. During 2015-16, the RBI reduced the policy rate (repo rate) by a total of **1.25** per cent. But in comparison, banks reduced the lending rate by maximum **0.6** per cent. By now, banks have been using either of the following *three methods* to compute their Base Rate:

(a) average cost of funds,

(b) marginal cost of funds, or

(c) blended cost of funds (liabilities).

As per the RBI, the MCLR will bring in the *following* benefits:

- transmission of policy rate into the lending rates of banks to improve;
- computation of the interest rates by banks will get more transparent;
- cost of loan will be fairer to the borrowers as well as the banks.
- it will help the banks to become more competitive and enhance their long-run value.

The present MCLR of banks is 7.65–7.80 per cent (***March 2018***).

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 stages:

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 the *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.

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 9 July, 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 10 October, 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 Government of India 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.[19] 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.[20] Every delay in it will hamper their interests, as per the experts.

REGIONAL RURAL BANKS (RRBs)

The Regional Rural Banks (RRBs) were first set up on 2 October, 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 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 40 RRBs (after amalgamation) functioning in India even though the amalgamation and recapitalisation processes are going on *(India 2017)*.

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19. 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.
20. Y.V. Reddy, ***Lectures on Economic and Financial Sector Reforms in India*** (New Delhi: Oxford University Press, 2002), pp. 137–57

COPERATIVE BANKS

Banks in India can be broadly classified under two heads—commercial banks and co-operative banks. While commercial banks (nationalised banks, State Bank group, private sector banks, foreign banks and regional rural banks) account for an overwhelming share of the banking business, co-operative banks also play an important role. Initially *set up to* supplant indigenous sources of rural credit, particularly money lenders, today they mostly serve the needs of agriculture and allied activities, rural-based industries and to a lesser extent, trade and industry in urban centres. Co-operative banks have a *three tier structure*—

(i) Primary Credit Societies-PCSs (agriculture or urban),

(ii) District Central Co-Operative Banks-DCCBs, and

(iii) State Co-Operative Banks-SCBc (at the apex level).

UCBs: Primary credit societies (PCSs) in urban areas that meet certain specified criteria can apply to RBI for a banking license to operate as urban co-operative banks (UCBs). They are registered and governed under the co-operative societies acts of the respective states and are covered by the Banking Regulation Act, 1949—thus are under dual regulatory control. The *managerial aspects* of these banks—registration, management, administration, recruitment, amalgamation, liquidation, etc. are controlled by the state governments, while the matters related to *banking* are regulated by RBI.

Traditionally, the area of operation of the UCBs is confined to metropolitan, urban or semi-urban centres and caters to the needs of small borrowers including MSMEs, retail traders, small entrepreneurs, professionals and the salaried class. However, there is no formal restriction as such and today UCBs can conduct business in the entire district in which they are registered, including rural areas. Well managed primary UCBs with deposits of over Rs. 50 crore are also allowed to operate in more than one state subject to certain norms.

As they are covered by the RBI Act, 1934 (2nd Schedule) they have certain rights and obligations—*rights* of obtaining refinance and loans from the RBI and *obligations* such as maintenance of cash reserves, submission of returns to the RBI etc. Presently, there are 29 UCBs.

DCCBs & SCBs: As their names suggest, they operate at the district and state levels. One district can have no more than one DCCB with a number of DCCBs reporting to the SCB. They were under supervision of the RBI—later on this function was delegated to the NABARD.

PROBLEMS OF THESE BANKS

Co-operative banks play a very vital role in India's financial system they have been faced with certain long-drawn problems also—we may have brief look them:

- Regulation remains the biggest issue as they are under dual regulatory control—the UCBs come under the RBI and the Registrar of Co-operative Societies (RCS) of the respective states while the DCCBs and SCBs come under the NABARD, the RBI and the RCSs. Given the close links between politicians and co-operatives and the fact that the RCS functions under the state government, in practice this dual (or triple) custody of the co-operative banks has, in practice, led to poor supervision and control. Besides, most co-operative banks are lacking in skill and expertise.
- Recruitments are politicised as are appointments at most levels.
- Income recognition and prudential norms that were introduced for commercial banks in the early 1990s (under the

process of banking reforms) are still to be this sector.

Co-operative banks have been in news mostly for fraudulent deals. Due to multiplicity of regulatory control of the federal nature it becomes really difficult to comply these banks to the prudential norms. Meanwhile, the Government of India decided (in the ***Union Budget 2017-18***) to bring the co-operative banks into the ambit of the 'core banking' structure. Under the core banking solution (CBS), customers are able to avail banks' services across all of the branches rather the branch where the account is—making them customers of the bank rather than of a branch.

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.[21] 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.[22] Accordingly, a ***high level*** committee on Financial System (CFS) was set up on 14 August, 1991 to examine all aspects 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.[23]

The CFS based its recommendations on certain ***assumptions***[24] 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;***

21. Repeated by the Government of India many times, i.e., the ***New Industrial Policy 1991; the Union Budget 1992–93; Eighth Five Year Plan (1992–97) Draft Approach;*** etc.

22. Announced by the government while setting up the M. Narasimham ***Committee on Finacial System*** on 14 August, 1991. See also Publication Division, India 2011 (New Delhi: Government of India, 2002).

23. The Narasimham Committee handed over its report in record time within 3 months after it was set up.

24. Reserve Bank of India, ***Committee on Financial Systems,*** 1991.

(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 recommendation[25] 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 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.

25. Ibid.

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 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[26] 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.[27] 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

26. Based on Y.V. Reddy, ***Lectures on Economic and Financial Sector Reforms in India, 2002***.
27. Ministry of Finance, ***Economic Survey 1998–99,*** (New Delhi: Government of India, 1999).

its reports in April 1998, which included the following major suggestions:[28]

(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.

(x) Board for financial Regulation and Supervisions (BFRS) should be set up for the whole banking, financial and the NBFCs in India.[29]

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.

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.[30] 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.[31] The PSL target must be met by the banks operating in India in the following way:

28. Based on the Report of the ***Committee on Banking Sector Reforms,*** April 1998 (Chairman: M. Narasimham).

29. 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, in ***Lecturers on Economic and Financial Sector Reforms in India,*** 38.

30. See Publication Division, ***India 2007*** (New Delhi: Government of India, 2008) and **Economic Survery, 2006-07**.

31. RBI, **New Guidelines on the PSL,** 2 March, 2015.

(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 (remaining same for those which have less than 20 branches). Meanwhile, some new areas have been added to the PSL.

NPAs AND STRESSED 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.[32]

NPAs were classified into three types:

(a) **Sub-standard:** remaining NPAs for less than or equal to 12 months;

(b) **Doubtful:** remaining NPAs for more than 12 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.

RECENT UPSURGE

During 2017-18, the performance of the banking sector, Public Sector Banks (PSBs) in particular, continued to be subdued. The Gross Non-Performing Assets (GNPAs) of Scheduled Commercial Banks (SCBs) increased from 9.6 per cent to **10.2** per cent between March 2017 and September 2017, whereas, their Restructured Standard Assets (RSAs) declined from 2.5 per cent to 2.0 per cent. The Stressed Assets (SAs) rose marginally from 12.1 per cent to **12.2** per cent during the same period. GNPAs of PSBs increased from 12.5 per cent to **13.5** per cent between March and September 2017. Stressed advances ratio of PSBs rose from 15.6 per cent to **16.2** per cent during the period. Though, various reasons (as reported by the Government documents since 2013-14) have been cited for the recent upsurge in the NPAs of the PSBs, by now the major ones are being considered as given below:[33]

(i) Global and domestic macro-economic instabilities due to which a slowdown

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

33. As the then RBI Governor Raghuram Rajan said deposing to the ***Parliamentary Accounts Committee*** in September 2016.

was seen in the economy diluting the capability of the borrowers to service the loans.

(ii) Delays in project approvals resulting into high cost over-runs. This dented the loan servicing capability of the borrowers in a big way.

(iii) Aggressive lending by the banks to high corporate leverage.

(iv) High incidences of 'wilful defaults'.

(v) Cases of loan frauds.

(vi) Instances of corruption in the banking institutions.

Now, the Government has commenced a multi-pronged policy framework to resolve the NPA crisis faced by the public sector banks.

RESOLUTION OF THE NPAs

At one hand, while the RBI tried to check the NPAs from rising by announcing new guidelines for the banks, on the other hand, it has also taken several steps to 'resolve' the problem. By *February 2017* (since 2014-15), the RBI has implemented a number of schemes to facilitate resolution of the NPAs problem of the banks—briefly discussed below:

5/25 Refinancing: This scheme offered a larger window for revival of stressed assets in the infrastructure sectors and 8 core industries. Under this scheme lenders were allowed to extend the tenure of loans to 25 years with interest rates adjusted every 5 years, so tenure of the loans matches the long gestation period in the sectors. The scheme thus aimed to improve the credit profile and liquidity position of borrowers, while allowing banks to treat these loans as standard in their balance sheets, reducing provisioning costs against NPAs. However, with amortisation spread out over a longer period, this arrangement also meant that the companies faced a higher interest burden, which they found difficult to repay, forcing banks to extend additional loans (called 'evergreening'). This in turn has aggravated the initial problem.

ARCs (Asset Reconstruction Companies): ARCs were introduced to India under the SARFAESI Act (2002), as specialists to resolve the burden of NPAs. But the ARCs (most are privately-owned) finding it difficult to resolve the NPAs they purchased, are today only willing to purchase such loans at low prices. As a result, banks have been unwilling to sell them loans on a large scale. Since (2014) the fee structure of the ARCs was modified (requiring ARCs to pay a greater proportion of the purchase price *up-front* in cash to the banks) purchases of NPAs by them have slowed down further—only about 5 per cent of total NPAs were sold during 2014-15 and 2015-16.

SDR (Strategic Debt Restructuring): In June 2015, RBI came up with the SDR scheme provide an opportunity to banks to convert debt of companies (whose stressed assets were restructured but which could not finally fulfil the conditions attached to such restructuring) to 51 per cent equity and sell them to the highest bidders—ownership change takes place in it. By end-December 2016, only 2 such sales had materialized, in part because many firms remained financially unviable, since only a small portion of their debt had been converted to equity.

AQR (Asset Quality Review): Resolution of the problem of bad assets requires sound recognition of such assets. Therefore, the RBI emphasized AQR, to verify that banks were assessing loans in line with RBI loan classification rules. Any deviations from such rules were to be rectified by March 2016.

S4A (Scheme for Sustainable Structuring of Stressed Assets): Introduced in June 2016, in it, an independent agency is hired by the banks which decides as how much of the stressed debt of a company is 'sustainable'. The rest ('unsustainable') is converted into equity and preference shares.

Unlike the SDR arrangement, this involves no change in the ownership of the company.

PUBLIC SECTOR ASSET REHABILITATION AGENCY (PARA)

To resolve the twin problems of 'balance sheet syndrome' (of the banks as well as the corporate sector), the ***Economic Survey 2016-17*** has suggested the Government to set up a *public sector asset rehabilitation agency* (PARA)—charged with the largest and most complex cases of the 'syndrome'. Such initiatives were successfully able to handle the 'twin balance sheet' (TBS) problems in the countries hit by the South East Currency Crises of mid-1990s. As per the Survey, the Agency charged with working out the largest and most complex cases. Such an approach could eliminate most of the obstacles currently plaguing loan resolution.

- coordination problem as in this case, the debts would be centralised in one agency;
- it could be set up with proper incentives by giving it an explicit mandate to maximize recoveries within a defined time period; and
- it would separate the loan resolution process from concerns about bank capital.

The ***Survey*** has outlined seven reasons in support of its suggestion for setting up the PARA—which are as given below[34]:

(i) *It's not just about banks, it's a lot about companies.* So far, the NPAs issues revolved around the capital of the bank and how to fund them so that they start giving loans again. But more important issue is to find out a way to resolve the NPAs created by the corporate houses (as why they are stressed).

(ii) *It is an economic problem, not a morality play.* Diversion of funds (wilful defaults) have undoubtedly been one reason behind non-payment of the debts. But a large number of loan defaults have been caused by unexpected changes in the economic environment—timetables, exchange rates, and growth rate assumptions going wrong.

(iii) *The stressed debt is heavily concentrated in large companies.* This is an opportunity, because TBS could be overcome by solving a relatively small number of cases. But it presents an even bigger challenge, because large cases are inherently difficult to resolve.

(iv) *Many of these companies are unviable at current levels of debt requiring debt write-downs in many case.* Cash flows in the large stressed companies have been deteriorating over the past few years, to the point where debt reductions of more than 50 per cent will often be needed to restore viability. The only alternative would be to convert *debt to equity*, take over the companies, and then sell them at a loss.

(v) *Banks are finding it difficult to resolve these cases, despite a proliferation of schemes to help them.* Among other issues, they face severe coordination problems, since large debtors have many creditors, with different interests. If PSBs grant large debt reductions, this could attract the attention of the investigative agencies. But taking over large companies will be politically difficult, as well.

(vi) *Delay is costly.* Since banks can't resolve the big cases, they have simply refinanced the debtors—deteriorating the situation. But this is costly for the government, because it means the bad debts keep rising,

34. **Economic Survey 2016-17**, Government of India, Ministry of Finance, N. Delhi, Vol. 1, p. 85.

increasing the ultimate recapitalization bill for the government and the associated political difficulties. Delay is also costly for the economy, because impaired banks are scaling back their credit, while stressed companies are cutting their investments.

(vii) *Progress may require a PARA.* The ARCs (Asset Reconstruction Companies) haven't proved any more successful than banks in resolving bad debts. But international experience shows that a professionally run central agency with government backing (not without its own difficulties) can provide the solution in this regard.

By late ***February 2017***, Government hinted towards its interest to the idea of PARA. But before the idea takes shape several related issues are to be settled by the government, such as—its funding mechanism; selection of the companies for their balance sheet resolution; recovery mechanism of the banks' NPAs; etc. among others.

INSOLVENCY AND BANKRUPTCY

By now several measures were put in place by the Government/RBI to resolve the 'twin balance sheet' (TBS) crisis faced by the economy but they could not bring out effective results. Finally, we see the Government moving to make the insolvency procedure effective to address the issue. The lenders (banks) and borrowers (private corporate sector) both have been paying a high financial cost of country's complex and time-taking process of insolvency and bankruptcy process. The new Insolvency and Bankruptcy Code, 2016 (IBC) was amended and enforced by the Government in November 2017. There has been a significant amount of progress in this regard—the entire mechanism for the Corporate Insolvency Resolution Process (CIRP) has been put in place. A number of rules and regulations have been notified to create the institutions and professionals necessary for the process to work. A large number of cases have entered the insolvency process. By January 2018, over 525 cases of corporate insolvency have been admitted across all the National Company Law Tribunal (NCLT), as per the ***Economic Survey 2017-18***.

A major factor behind the effectiveness of the new Code has been the *adjudication* by the Judiciary—it prescribes *strict time limits* for various procedures under it. In spite of the large inflow of cases to NCLT benches across India, these benches have been able to admit or reject applications for CIRP admissions with few delays. In addition, appellate courts, including the NCLAT, High Courts and the Supreme Court have also disposed appeals quickly and decisively. In this process, a rich case-law has evolved, reducing future legal uncertainty. In the CIRP, the Committee of Creditors (CoC) invites resolution plans from resolution applicants, and may select one of these plans. The Code originally *does not specify* any restrictions on who these resolution applicants might be though it declares some persons are ineligible to submit resolution plans—

(*i*) an undischarged insolvent;

(*ii*) a wilful defaulter;

(*iii*) a borrower whose account has been identified as a non-performing asset for over a year and who has not repaid the amount before submitting a plan;

(*iv*) a person convicted of an offence punishable with two or more years of imprisonment;

(*v*) a person disqualified as a director under the Companies Act, 2013;

(*vi*) a person prohibited from trading in securities;

(*vii*) a person who is the promoter or in the management of a company which has indulged in undervalued, preferential, or fraudulent transactions;

(*viii*) a person who has given guarantee on a liability of the defaulting company undergoing resolution or liquidation, and has not honoured the guarantee;

(*ix*) a person who is subject to any of the above disabilities in any jurisdiction outside India; or

(*x*) a person who has a connected person disqualified in any manner above.

The ***thrust*** of the Bill is to prevent a range of undesirable persons from bidding for the debtor. It may prevent promoters from bidding for their own firms. A resolution plan would typically involve significant *haircuts* (price cuts in the market value of the assets) on the parts of the financial and operational creditors. Thus, allowing a promoter to bid without restriction would mean countenancing a situation where an owner, having driven a firm into insolvency, is now able to purchase it back at a discount. This can lead to a situation of *moral hazard*, where incompetent or fraudulent promoters are effectively rewarded with the control of their company, leaving the creditors to write off their debts

The new code seeks to achieve a balanced approach, enabling the CoC to avoid imprudent transactions, while preserving its freedom to choose the best resolution plan from amongst all the applicants. The steps of the Government towards insolvency and bankruptcy process have been welcomed by the experts and entrepreneurs alike.

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:
   - (i) Issue notice of default to borrowers asking to clear dues within 60 days.
   - (ii) On the borrower's failure to repay:
     - (a) Take possession of security and/or
     - (b) take over the management of the borrowing concern and/or
     - (c) appoint a person to manage the concern.
   - (iii) 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.]

WILFUL 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—

(i) Barred from participating in the capital market.
(ii) Barred from availing any further banking facilities and to access financial institutions for five years for the purpose of starting a new venture.
(iii) The lenders can initiate the process of recovery with full vigour and can even initiate criminal proceedings, if required.
(iv) 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., ***"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:[35]

(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.**[36] The accord was agreed upon at Basel, Switzerland at a meeting of the Bank for International Settlements (BIS).[37] 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***[38] (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***[39] of Rs. 8 at that particular time. ***The capital adequacy ratio is the percentage of total capital to the total risk—weighted assets*** (see footnote 40).

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: *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.[40] In the coming years the Basel norms were extended to term-lending

35. Through various legislations, since the ***RBI Nationalisation Act, 1949*** and the ***Banking Regulation Act, 1949*** were enacted – and further ***Amendments*** to the Acts, Ministry of Finance, Government of India, New Delhi.

36. Simon Cox (ed.), 'Economics', ***The Economist***, 2007, p. 75.

37. 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.

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

39. 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.

40. 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).

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*).[41]

(iii) Foreign banks as well as Indian banks with foreign presence to follow ***Basel-II norms,*** w.e.f. 31 March, 2008 while other scheduled commercial banks to follow it not later than 31 March, 2009. The Basel-II norm for the CAR is 12 per cent.[42]

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**[43] 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[44] as:

(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.[45]

41. Ministry of Finance, ***Committee on Banking Sector Reforms*** (M Narasimhan Committee-II), (New Delhi: Government of India, April 1998).
42. Ministry of Finnace, ***Economic Survey 2006–07***.
43. D. M. Nachane, Partha Ray and Saibal Ghosh, ***India Development Report 2004–05*** (New Delhi: Oxford University Press, 2005), p. 171.
44. Ibid, p. 172.
45. G-10 comprises Belgium, Canada, France, Germany, Italy, Japan, The Netherlands, Sweden, UK and USA; later the group incorporated Luxembourg, Switzerland and recently Spain into its fold.

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 to[46]:

(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 *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[47] 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

46. ***Bank of International Settlemets,*** Basel, Switzerland, 15 May, 2012.

47. 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.

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[48]

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 per 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.

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

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 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,[49] 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).

49. **Basel III** norms prescribe a minimum regulatory capital of 10.5 per cent for banks by 1 January, 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.

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 2012–13 in seven PSBs.

(ii) Rs. 12,517 crore infused in 2013–14 in 8 PSBs.

(iii) In 2014–15, the PSBs were recapitalised with Rs. 6,990 crore. This capital infusion was based on some new criteria— asset quality , efficiency and strength of the banks.

(iv) During 2015–16, the government released Rs. 19,950 crore to 13 PSBs *(Economic Survey 2015–16).*

(v) For the year 2016-17, the government has announced a sum of Rs. 25,000 crore for the purpose of recapitalising the PSBs *(Union Budget 2016–17).*

(vi) The *Indradhanush* scheme was launched (in 2015-16) by the Government under which the PSBs are to be infused with Rs. 70,000 crore by March 2019 to enable them meet the 'global risk norms' (i.e., Basel III norms).

(vii) The ongoing recapitalisation process of the PSBs got a big boost when the Government announced *(February 2018)* a hefty sum of Rs. 2.11 lakh crores for it. Infused into the PSBs upto October 2019, a part of it (Rs. 1.35 lakh crores) will be mobilised through *Recapitalisation Bonds* while rest of it (Rs. 76,000 crores) will be raised by the banks from market (disinvestment process) and budgetary support. This process will help the banks in meeting their capital adequacy targets also.

As per the latest ***Economic Survey 2017-18***, by September, the capital to risk-weighted asset ratio (CRAR) of the scheduled commercial banks (SCBs) was 13.9 per cent (it was 13.6 per cent by March 2017)—largely due to an improvement among the PVBs (private sector banks).

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), viz., 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).

M^4 = M^3+ total deposits of the post offices (both, Demand and Term/Time Deposits).

Now the RBI has started[50] 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

50. 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.

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'[51] 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 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

51. '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.

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 per cent in 2009–10.

HIGH POWER MONEY

The central banks of all the countries are empowered to issue the currency. The currency issued by the central bank is called 'high power money' because it is generally backed by supporting 'reserves' and its value is guaranteed by the government and it is the source of all other forms of money. The currency issued by the central bank is, in fact, is a liability of the central bank and the government. In general, therefore, this liability must be backed by an equal value of assets consisting mainly, gold and foreign exchange reserves. In practice, however, most countries[#] have adopted a 'minimum reserve system'.

Under the *minimum reserve system* the central bank is required to keep a certain minimum 'reserve of gold and foreign securities and is empowered to ***issue currency to any extent***. India adopted this system in October 1956. The RBI was required to hold a reserve worth of only Rs 515 crore consisting of foreign securities worth Rs 400 crore and gold worth Rs 115 crore. In 1957, however, the minimum reserves were further reduced to only gold reserve of Rs 115 crore and the rest in the form of rupee securities, mainly due to the scarcity of foreign exchange to meet essential import bill. A gold reserve of Rs. 115 crore against the currency of Rs. 17,00,000 crore in circulation today, makes only 0.7 per cent reserve which is of no consequence. This makes the Indian currency system a 'managed paper currency system'. In India, there are two sources of *high power money* supply:

(i) RBI; and
(ii) Government of India.

The RBI issues currency notes of rupees 2, 5, 10, 20, 50, 100, and 2000 denominations which RBI calls as the 'Reserve Money'. The RBI issues currency of one rupee notes and coins including coins of smaller denominations on behalf of the Government of India which accounts for around 2 per cent of the total high power money.

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 **31 December, 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.[52]

India's sovereign debt is usually rated by six 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 15 *January, 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.

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

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.**[53] International rating agencies such as Moody's, S & 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[54]

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:[55]

(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.

53. S. Sundararajan, ***Book of Financial Terms,*** (New Delhi: Tata McGraw Hill, 2004), p. 44.

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

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

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-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*[56] 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.

56. 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*.

(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.

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)[57]

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.

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

57. 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.

any *mutual benefit society*[58] notified by the 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 (RNBCs);

(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

58. **Mutual Benefit Society** (also known globally as 'benefit society' or 'mutual aid society') is an organisation, or voluntary association formed to provide mutual aid, benefit, or insurance for relief from common difficulties. Such organisations may be formally organised with charters and established customs, or may arise ad hoc to meet unique needs of a particular time and place. They may be organised 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 organisation; 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.

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.

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.* 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—

(i) The minimum capital requirement would be Rs 100 crore.

(ii) 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.

(iii) Foreign shareholding in these banks will be as per current FDI policy.

(iv) Voting rights to be line with the existing guideline for private banks.

(v) Entities other than promoters will not be permitted to have shareholding in excess of 10 per cent.

(vi) The bank should comply with the corporate governance guidelines, including 'fit and proper' criteria for Directors as issued by RBI.

(vii) 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:

(i) 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.

(ii) For the initial three years, prior approval will be required for branch expansion.

(iii) 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.

(iv) 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.

(v) The promoters' other financial and non-financial services activities, if any, should be distinctly ring-fenced and not co-mingled with banking business.

(vi) 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.

(vii) In view of concentration of area of operations, the Small Bank would need a diversified portfolio of loans, spread over it area of operations.

(viii) The maximum loan size and investment limit exposure to single/group borrowers/ issuers would be restricted to 15 per cent of capital funds.

(ix) Loans and advances of up to Rs 25 lakhs, primarily to micro enterprises, should constitute at least 50 per cent of the loan portfolio.

(x) 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-DHAN YOJANA

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 23 August, 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 issues 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 from 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.

GOLD INVESTMENT SCHEMES

Two new gold investment schemes were launched by the Government of India by November 2015—the Sovereign Gold Bonds and Gold Monetisation Schemes. The schemes are aimed at twin objectives:

(i) Reducing the demand for physical gold; and

(ii) Shifting a part of the gold imported every year for investment purposes into financial savings.

Brief feature of the schemes are as given below:

SOVEREIGN GOLD BONDS

These are issued by RBI on behalf of the GoI in rupees and denominated in grams of gold and restricted for sale to the resident Indian entities only, both in demat and paper form. The minimum and maximum investment limits are two grams and 500 grams of gold per person per fiscal year, respectively. The rate of interest for the year 2015–16 was 2.75 per cent per annum, payable on a half yearly basis. The tenor of the Bond is for a period of 8 years with exit option from 5th year onwards. KYC norms are the same as that for gold. Exemption from capital gains tax is also available. Redemption is made in the rupee value equivalent to the price of gold at the time of maturity.

GOLD MONETISATION SCHEME

In this scheme, BIS (Bureau of Indian Standards) certified CPTCs (Collection, Purity Testing Centres) collect the gold from the customer on behalf of the banks. The minimum quantity of gold (bullion or jewellery) which can be deposited is 30 grams and there is no limit for maximum deposit.

Gold Saving Account can be opened with any of the designated bank and denomination in grams of gold for short-term period of 1–3 years, a medium-term period of 5–7 years and a long-term period of 12–15 years. The CPTCs transfer the gold to the refiners. The banks will have a tripartite/bipartite legal agreement with refiners and CPTCs.

For the year 2015–16 interest rates was fixed as 2.25 per cent and 2.5 per cent for the medium- and long- term, respectively. Redemption is made in cash/gold for short term and in cash for medium and long term deposits.

The difference between the current borrowing cost for the government and the interest rate paid by the government under the medium/long term deposit will be credited to the Gold Reserve Fund.

MUDRA BANK

As per the Government of India, large industries provide employment to only 1.25 crore people in the country while the *micro units* employ around 12 crore people. There is a need to focus on these 5.75 crore self-employed people (owners of the micro units) who use funds of Rs. 11 lakh crore, with an average per unit debt of merely Rs. 17,000. Capital is the key to the small entrepreneurs. These entrepreneurs depend heavily on the local money lenders for their fund requirements.

Looking at the importance of these enterprises, the Government of India launched (April 2015) the *Micro Units Development and Refinance Agency Bank (MUDRA Bank)* with the aim of *funding* these *unfunded* non-corporate enterprises. This was launched as the PMMY (Prime Minister Mudra Yojana). Important features of the MUDRA Bank are as given below:

- Under this banking model, the micro units can avail up to Rs. 10 lakh loan through refinance route (through the Public and private sector banks, NBFCs, MFIs, RRBs, District Banks, etc).

- The products designed under it are categorized into three buckets of finance named *Shishu* (loan up to Rs. 50,000), *Kishor* (Rs. 50,000 to Rs 5 lakh) and *Tarun* (Rs. 5 lakh to Rs. 10 lakh).
- Though the scheme covers the traders of fruits and vegetables, in general, it does not refinance the agriculture sector.
- There is no fixed interest rate in this scheme. As per the Government of India, presently, banks are charging the interest rates between Base Rate plus one per cent to 7 per cent per annum. Interest rates on the loans are supposed to vary according the risk involved in the enterprises seeking loans. There is no general subsidy offered on interest rates except if the loan is linked to some other government scheme.