Economics Class 37

ISSUES FACED BY BANKING SYSTEM IN INDIA (1:05 PM)

- **I.** Interest margin is getting reduced.
- This is the gap between the interest rates charged on deposits and on loans.
- This is mainly due to external benchmarking of rates.
- **II. Asset-liability challenges,** especially with respect to infrastructure loans.
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    - The government is pushing **Security Bonds.**
    - They are a kind of insurance for infrastructure financing.
    - They might reduce the pressure on banks for infrastructure financing.
    - They are less likely to be popular because they charge higher premiums for insurance.

financial repression on asset side and liability side

- **III.** Challenges of double financial repression.
- Double Financial Repression refers to the problems faced by the banks both on their assets and liabilities sides.
- The deposits held in the banks are other liabilities as banks need to pay interest on them.
- The loans extended by the banks are their assets because banks get interest on the loans.
- **IV.** Twin balance Sheet syndrome
- **V.** Non-Performing Assets(NPA):
- The biggest stress Indian banks faced from 2011-2016 was the issue of NPA.

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    - **Loan Waiver-** banks do not expect payback of loans extended, and instead the government promises to pay the banks on behalf of the borrowers.
    - Banks must also return the collateral to the borrowers
    - This government payment involves giving securities to the banks, instead of cash which would have been received through loan repayment.
    - **Loan Write Off:**
    - Lenders write off loans to clean up the balance sheet.
    - But, the loan account stays in their books as they hope to recover it at a later date.
    - Collateral can be auctioned off and banks can pursue other means to get back the loan + interest.
- NPA is a loan lent by banks and financial institutions whose principal and interest are delayed beyond 90 days.
- RBI has come up with the categorization of loans before they turn out to become NPAs- Special Mention Account.

Stressed Assets Classification:

Special Mention Accounts (SMA) -0	Special Mention Accounts (SMA) -1	Special Mention Accounts (SMA) -2
Principal and interest not paid for 1-30 days	Principal and interest not paid for 31-60 days	Principal and interest not paid for 61-90 days(loan becomes **NPA)**

- Any asset that ceases to provide a return to its investors for an extended period is termed NPA.

Classification of NPA:

Classification	Condition/Duration
Substandard Assets	NPA for less than or equal to 12 months
Doubtful Assets- NPA > 12 months.	NPA for more than 12 months
Loss-making Asset	Banks or their auditors have identified the loss, but the loss has not been written off.

Provisioning:

- Banks set aside a portion of their capital to safeguard in case the loans they extend do not get recovered timely.
- This action and the portion set aside is called provisioning.
- Provisioning for any loan happens as per the probability of timely recovery.
- A loan is declared as NPA when the principal and interest are not paid for a continuous period of 90 days.
- **Net NPA** is the Actual amount of loans classified as NPA.
- **Gross NPA=** Net NPA + provisioning against NPA.
- Gross NPA- Provisioning= Net NPA.
- **Provisioning** here refers to the funds set aside by the banks to cover a part of their losses due to some of their loans turning NPA.
- Gross NPA is focussed upon more for policy-making.
- These methods are based on the loss incurred by the banks.
- RBI wants banks to go for the **Expected Credit Loss** method.
- Under ECL, banks will go for provisioning before the loss has actually been incurred as per the estimation of the loss.
- Banks are postponing this because provisioning reduces the amount available for banks to be given as loans.

IMPACT OF NPA'S (1:35 PM):

- Negative impact on economic growth.
- NPAs can increase interest rates, thereby leading to cost-push inflation.
- Credit lending to small-scale sectors will be affected.
- Indirect impact on inclusiveness.

Basel Norms:

- The Basel Committee on Banking Supervision (BCBS) issues Basel norms for international banking regulations.
- Basel is a city in Switzerland, and it is the headquarters of the **Bureau of International Settlement (BIS).**
- BIS promotes cooperation among the central banks with the common goal of financial stability and banking regulatory standards.
- Basel Accords refer to a set of agreements by the BCBS that primarily address the risks associated with the bank and the financial system.
- The agreement's goal is to ensure that financial institutions have sufficient capital to meet obligations and absorb expected losses.
- The Basel Accord for the banking system has been accepted by India.
- In fact, RBI has imposed more stringent standards on a few parameters than the BCBS.

BASEL I (2:00 PM):

- BCBS introduced a capital management system called the Basel Capital Accord in 1988.
- It was also known as Basel I, and it was entirely concerned with credit risk (and not market & operational risks).
- it established the capital and the risk-weighted structure for the bank in the form of a **Capital Adequacy Ratio (CAR).**
- **CAR= Total Capital/Risk Weighted Assets (RWA).**

Risk-Weighted Assets:

- Risk-weighted assets, or RWA, are used to determine the minimum amount of capital that banks must have, with the risk profile of the bank's lending activities (and other assets).
- The more risk a bank is taking, the more capital is needed to protect depositors.
- This is necessary because different types of loans have different probabilities of timely repayment.
- Assume the following lending profile of the bank:
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Loan Amount (in crores)	**Type of loan**	**Risk Ratio**
100	Credit Card loan	100 %
100	Personal Loan	90%
50	Secured Loan	0%
100	Home Loan	50%

50	Secured Loan	0%
100	Home Loan	50%

- In the above case, the RWA of the bank will be calculated by considering both the loan amount and the probability of repayment.
- The RWA here will be 100 (1) + 100 (0.9) + 50(0) + 100 (0.5)= 240 crores.
- Credit card loans are the most risky because they are not secured by anything other than a person's promise to pay.
- Secured loans are those loans in return of which banks have taken collateral which can be used to get back the loan amount, even if the borrower does not pay back.

- The required minimum capital was set at 8% of RWA.
- As per RBI, it must be 9% of RWA.
- RWA refers to the assets with varying risk-weighted profiles.
- **For example-** an asset backed by a collateral would be less risky than a personal loan with no collateral security.
- Capital is divided into two categories- Tier I & Tier II.

Tier I capital:

- It is the bank's core capital because it is the primary measure of the bank's financial strength.
- This is very liquid and banks can use it without shutting down their operations.
- It also includes retained earnings(audited earnings visible on the balance sheets
- The majority of the core capital is made up of disclosed reserves and equity.
- Most of the equity portion will be **Common Equity** which will have no conditions attached like paying dividends, etc.

Tier II capital:

- It is used for supplemental funding since it is less reliable.
- it consists of undisclosed reserves(from bank owners), preferential shares, and subordinate debt.
- Subordinate debt is for the long term and has a lower priority than senior debt.
- Here priority means the order in which the bank will try to clear the debts in case the bank goes bankrupt.
- In ~~1991~~ 1999, India adopted Basel I guidelines.

Basel II:

- BCBS published the Basel II guidelines in June 2004.
- They were considered to be refined and reformed versions of the Basel I accord.

The guidelines were founded on three pillars:

- I. Capital Adequacy Requirements:
- The CAR is the same at 8% of RWAs, but it will consider all three risks- credit, market, and operational risks.
- II. Supervisory Review:
- Banks were required to develop and implement better risk management techniques for monitoring and managing all three types of risks.
- III. Market Discipline:
- It requires strict disclosure requirements under which banks must report their CAR, risk exposure, and other information to the central bank on a regular basis.
- After the 2008 financial crisis and the collapse of the Lehmann Brothers bank, the need for better guidelines was seen.

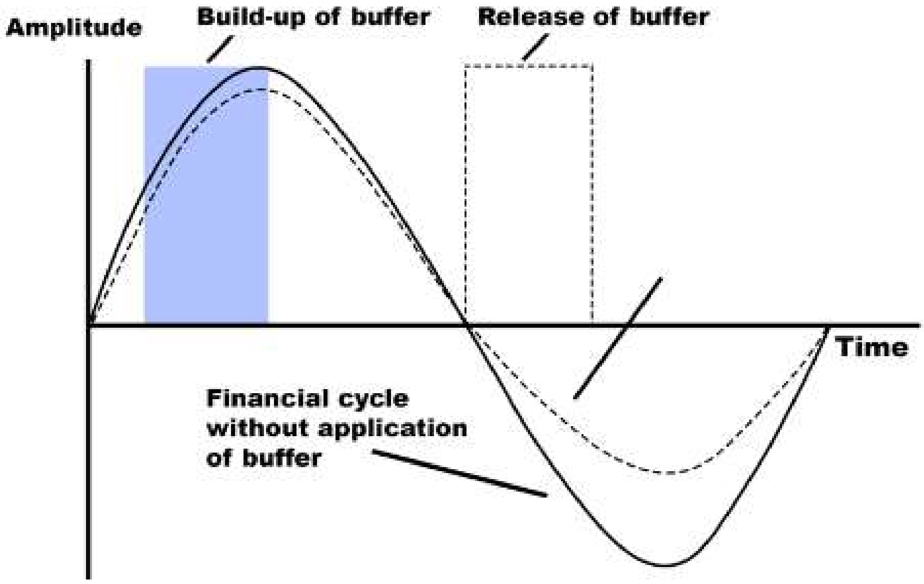
BASEL III GUIDELINES (2:30 PM):

- In the wake of the Lehmann Brothers' collapse and the financial crisis, BCBS decided to strengthen the norms.
- The guidelines were intended to promote a more resilient banking system by focussing on four critical banking parameters.
- They were capital, leverage, funding, and liquidity.
- Basel III was focussing on a better capital quality which came from a higher loss absorbing capacity.
- It also suggested additional capital conservation buffers and counter-cyclical buffers.

Capital Conservation Buffer:

- Another key feature of Basel IIIis that banks are required to hold a capital conservation buffer of 2.5 %.
- The focus of this buffer is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress.

Countercyclical buffer:

- This buffer has been introduced with the objective of increasing capital requirements during good times and decreasing them during crises.
- The buffer will slow down the banking activities when the economy overheats, and it will encourage lending during a crisis.
- The buffer will range from 0-2.5% and will consist of common equity or other loss-absorbing capital.
- It is a buffer of capital maintained by banks in good times, which may be used to maintain the credit flow in difficult times.
- 

- This will discourage banks from giving too many loans during good economic conditions, some portion of which might turn into NPA when the economic conditions are weak.
- Maintaining CCB will also reduce the lending ability of the bank.
- Banks must set aside CCB so that the bank remains adequately capitalized when the loans extended by banks start turning into bad loans.

LEVERAGE RATIO (3:00 PM)

- This is the ratio between the tier I capital and the total consolidated assets by the bank.
- This must be kept at least 3%.

Funding & Liquidity:

- **Basel III established two ratios:**

I. Liquidity Coverage Ratio (LCR):

- It will require banks to maintain a buffer of high-quality liquid assets sufficient to deal with the cash outflows encountered in an acute short-term scenario.
- The goal is to ensure that the banks have enough liquidity to handle a thirty-day stress scenario if it occurs.
- LCR assesses short-term resilience.

II. Net Stable Funding Ratio (NSFR):

- It requires banks to fund their operations with stable sources of funding for a period of one year and above.
- It will check if the banks have a stable source of funds for 1 year to give out long-term loans.
- It is the ratio between the available funds and the required funds for long-term loans.
- This must ideally be 100% or more.
- NSFR will assess medium to long-term resilience.

The Liquidity Coverage Ratio (LCR) is a regulatory standard designed to ensure that financial institutions, particularly banks, maintain an adequate level of high-quality liquid assets (HQLA) that can be easily converted into cash to meet their short-term obligations. The LCR is part of the Basel III regulatory framework, introduced by the Basel Committee on Banking Supervision (BCBS) in response to the 2008 financial crisis.

Definition: HQLA are assets that can be easily and quickly converted into cash with little or no loss in value during periods of financial stress.
Examples: Cash, central bank reserves, government securities, and other marketable securities of high credit quality.

$$LCR = \frac{\text{HQLA}}{\text{Total net cash outflows over the next 30 days}} \times 100$$

LCR Requirement:
Regulatory Threshold: The Basel III framework mandates that banks maintain an LCR of at least 100%. This means that the value of a bank's HQLA must be at least equal to or greater than its total net cash outflows expected during a 30-day stress scenario.

Restructured Loans:

- When a loan becomes NPA, provisioning against it rises, sometimes to even 100% of the loan value in case the loan is unsecured.
- Due to such high provisioning, the available capital with the bank is reduced.
- Therefore it may not remain adequately capitalized, that is it may not possess the required CRAR or may not have sufficient capital to give out new loans despite having lendable deposits to do so.
- As such it becomes difficult for banks to do business.
- In such a situation, before classifying a loan as NPA, the bank may renegotiate some terms and conditions of repayment with the borrower.
- **For example-** the banks may change the schedule of repayments lengthen the time of repayment change the interest rate, etc.
- This is called as **restructuring of loans** and such assets are called **restructured assets.**
- **Stressed Assets= NPA + Restructured Assets.**
- **Net NPA** will be the Actual amount of loans classified as NPA.
- **Gross NPA= Net NPA + provisioning against NPA.**

STEPS TAKEN AGAINST NPA (3:00 PM):

I. Strategic Debt Recovery (SDR):

- Banks will temporarily take over the management of the company and try to convert the debt of the company to equity.
- Banks hoped to run the functions of the company and get back the loan value.
- Banks can also sell the debt as equity in the market.
- There arose problems in the valuation of these shares.
- Also, buyers were not very enthusiastic about buying shares of the company which is in trouble.

II.Asset Quality Review:

- The first step is to recognize the true extent of NPAs.
- In 2013, RBI started an **Asset Quality Review(AQR)** under which it directed the banks to recognize the true extent of NPAs- come clean on their balance sheets.

III. Scheme for Sustainable Structuring of Stressed Assets(S4 A):

- Debt was to be classified as sustainable(confidence to recover) and unsustainable debt.
- If the sustainable debt is at least 50% of the debt, this process was to be proceeded with.

Bad Bank:

- It is similar to an **Asset Reconstruction Company (ARC)** that will take up the NPA of other public and private banks.
- It will purchase the bad loans from the banks at market rate and try to obtain value out of them.
- The seller banks will see their balance sheets getting improved.

Insolvent means somebody who cannot pay loans.

Bankruptcy code is the legal procedure to recover.

Insolvency and Bankruptcy Code:

- **Insolvency** refers to the situation where any firm is not in a position to repay its debt.
- While **bankruptcy** refers to the legal process of settling insolvency.
- Finally, in 2016, the Insolvency & Bankruptcy Rules were introduced with the **following provisions:**
- There will be an **Insolvency & Bankruptcy Board of India (IBBI)** to work as a platform for faster insolvency settlements.
- With this board, there are several insolvency professionals empanelled.
- Whenever a company applies for insolvency and bankruptcy settlement, an **Insolvency Professional (IP)** is allotted to that company which provides the complete road map of the settlement.
- As per the rules, first, the dues of **financial creditors** are settled, and then after **operational creditors.**
- A financial creditor is one who has provided finance to do business to the concerned firm that applied for insolvency.
- Operational creditors are those who are part of the business activities like raw material suppliers, etc.

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Year	Changes highlighted/added in IBC
2017	Wilful Defaulters will not be entertained.
2018	In the case of real estate, home buyers will be treated as financial creditors.
2020	Various creditors can liquidate(sell out assets and get liquidity against them) their assets to each other (the matter is sub-judice).

<u>THE TOPIC FOR THE NEXT CLASS IS</u> the continuation of the Insolvency & Bankruptcy Code.