



Burning Issues of Banking Sector

8 BURNING ISSUES OF BANKING ⇒ LOANS & NPA

RBI's 6-member statutory MPC decides policy rate (=repo rate) to keep inflation within 2-6% CPI (All India) but who decides lending rates of individual banks, & how? Ans.⇒

8.1 BANKS' LENDING RATES

1969	Government began nationalization of private banks, and 'administered interest rates' on them.
1991	M.Narsimham suggested deregulation: Govt should not dictate / administer individual banks' interest rates & RBI should only give methodology to banks.
2003	RBI introduced _____ (BPLR).
2010	RBI introduced BASE Rate + Spread system; update frequency on individual banks' discretion .
2016	<ul style="list-style-type: none"> - RBI introduced _____ (MCLR) + Spread system. Banks to calculate on monthly basis. It consists of CRR Cost, Operating Cost, Marginal cost of funds (Repo Rate, Deposit Interest) etc. - Benefits? Better transmission of Monetary Policy; transparency & accountability to borrowers. Although RBI's Janak Raj internal study group (2017) showed MCLR did not yield all benefits so new method...⇒
2019, 1st April	<ul style="list-style-type: none"> - NEW loans (not existing loans) to be linked with "_____ Benchmark + Spread" system. 1 Category of Loans = 1 External Benchmark. - Individual bank free to pick any one External Benchmark such as RBI repo rate (6.50%) or 91-day T-bill yield (6.56%) or 182-day T-bill yield (6.73%) or any other benchmarks by Financial Benchmarks India Pvt. Ltd. - Benefits? Same benefits which MCLR couldn't fully deliver.

Table 1: Type of Loans based on Lending Rates

Fixed Interest Loan (निश्चित ब्याज ऋण)	_____ Interest Loan (चलायमान)
e.g. Short-term crop loans upto Rs.3 lakh rupees for farmers at fixed Interest 7%. This interest rate will not be changed throughout the loan tenure.	e.g. (External Benchmark) + Spread = 12% But benchmark is regularly updated. So resultant interest rate may increase or decrease throughout the tenure of loan.
	Teaser Loan: A sub-type of _____ interest rate loan, wherein initial years have low interest, but afterwards- higher interest rate. While RBI has not banned Teaser loans but has put stricter regulations on it from 2011.



Table 2: Type of Borrowers

Prime Borrower	has capacity to repay loans.
Subprime Borrower	doesn't have the capacity to repay loan. Giving teaser rate home loans to sub-prime borrowers was among the reasons for Sub-prime Crisis in USA (2007-08), which ultimately led to Global Financial Crisis (GFC).
Overleveraged Borrower	has borrowed too much money than his ability to pay it back. An Overleveraged company has high ratio of Debt (Bonds/loans) to Equity (Shares).
Zombie Lending	When a weak bank keeps giving new loans to a subprime / overleveraged borrower.

MCQ. Why is the offering of "teaser loans" by commercial banks a cause of economic concern? (Asked in UPSC-Pre-2011)

1. The teaser loans are considered to be an aspect of sub-prime lending and banks may be exposed to the risk of defaulters in future.
2. In India, the teaser loans are mostly given to inexperienced entrepreneurs to set up manufacturing or export units.

Answer Codes: (a) 1 only (b) 2 only (c) Both 1 and 2 (d) Neither 1 or 2

MCQ. What is/are the purpose/purposes of the 'Marginal Cost of Funds based Lending Rate (MCLR)' announced by RBI? (Asked in UPSC-Pre-2016)

1. These guidelines help improve the transparency in the methodology followed by banks for determining the interest rates on advances.
2. These guidelines help ensure availability of bank credit at interest rates which are fair to the borrowers as well as the banks.

Answer Codes: (a) 1 only (b) 2 only (c) Both 1 and 2 (d) Neither 1 nor 2

8.2 NPA: अनर्जक परिसंपत्तियां

8.2.1 NPA / TBS Problem: Three Stages of

1. **Till mid-2000s:** Boom period in global economy. Indian Corporates were taking large amount of loans & became overleveraged.
2. **From 2007-08:** Subprime & Global Financial Crisis (GFC): Indian goods-services exports declined. UPA government's policy paralysis & judicial activism, environment activism ⇒ projects got delayed. Companies began facing difficulties finishing projects & repaying loans.
3. **By 2013:** ~1/3rd of the bank loans were owned by "___ companies" i.e. companies with interest coverage ratio less than 1 = not generating enough revenue even to repay the loan interest.

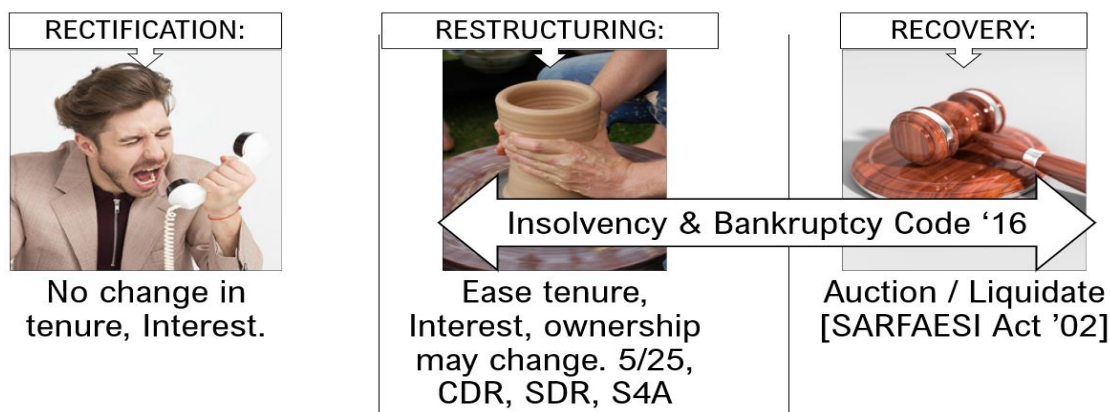
Thus, balance-sheets of (1) some _____ & (2) Public Sector Banks (PSB) became weak. It is called "Twin balance sheet syndrome (TBS)" [दोहरे तुलनपत्र की समस्या] by Economic Survey 2015-16.



8.2.2 NPA related definitions in Banking Sector

Std. Assets	Loan account where borrower is repaying the principal and interest in timely fashion.
SMA-0	If loan principal / interest unpaid for 1-30 days from its due date, then such loan account is classified as Special Mention Account-0.
SMA-1	31-60 days
SMA-2	61-90 days
NPA	<p>⇒ If loan principal or interest is not paid for more than _ _ _ _ _ from its due date, then such loan account is classified as Non-Performing Asset (NPA). For the farm loans, NPA is not counted on number of days but on number of cropping seasons.</p> <p>⇒ Indian Commercial Banks' NPA is over ₹10 lakh crores (absolute figures); and over 10% of total lending. [As of 31/3/2018].</p> <p>⇒ NPA Size: PSB > PvB > Foreign Banks.</p> <p>⇒ Provisioning: As per RBI norms, banks must set aside funds to cover losses against their NPA. Such 'provisioning of funds' decreases the profitability of the Bank. Gross NPA MINUS Provisioning = NET NPA.</p>
Substandard asset	When loan account remains in the NPA classification for 12 months/>
Doubtful asset	When loan account remains in substandard classification for 12 months/>
Loss Asset	When a bank, its auditor or RBI declares that given doubtful asset has little / no salvageable value.
Loan write-off	When loan is written off from the 'asset-side' of the bank balance sheet, to save corporation tax. Loan write-off doesn't waive bank's right to recover that bad loan, it's merely an accounting exercise for tax-benefits.
Restructured loan	When principal / interest rate / tenure of the loan is modified. Banks may do it when borrower facing difficulty in repaying loans.
Stressed Asset	NPA + Loans Written-Off + Restructured Loans = Stressed Assets
OTS with Haircut	If bank allows the client to pay 60% of dues and forgoes 40% as loss, then we say bank has offered "Onetime Settlement (OTS) with 40% haircut"
Evergreening	<ul style="list-style-type: none"> - Banking: When a borrower taking a new loan to pay off his old loan. - Patents: When drug patent expires after 20 years, pharma-company makes minor modifications in the old drug's molecule to register new patent, thus keeping its monopoly rights on the production.

8.3 RBI "3R" FRAMEWORK FOR REVITALIZING STRESSED ASSETS





8.3.1 Rectification (सुधार)

- 2015: RBI ordered the Banks to conduct Asset Quality Review (AQR) and begin rectification of bad loans i.e. Bank doesn't change in loan interest, tenure or terms, but asks client to rectify his irregularity in loan-repayment.
- In genuine case, additional loan may be given. Bank may also try to find a new partner / investor for reviving the project.

8.3.2 Restructuring (पुनर्गठन)

- ⇒ **Restructuring** = Changing the Loan interest (%) or tenure or ownership.
- ⇒ **for Infrastructure loans**: RBI allowed banks to extend infra-loan tenure upto 25 years, and even reduce loan interest rate. But such Interest rate will be reviewed each 5 years.
- ⇒ **CDR: Corporate Debt Restructuring**: loan can be restructured if 75% of the lenders approve.
- ⇒ **Strategic Debt Restructuring (रणनीतिक ऋण पुनर्गठन)**: Bank's Debt (Loan) is converted to Equity (Shares with Voting Rights) & bank sells it to highest bidder ⇒ company's ownership may change. Scheme unsuccessful as it required the approval of existing shareholders.
- ⇒ **Scheme for Sustainable Structuring of Stressed Assets (तंगहाली आस्तियों की संधारणीय संरचना)**: Only unsustainable portion of Debt (Loan) converted to equity (Preferential Shares without voting rights) & sold off to investors, in such manner that company's ownership is not changed.
- ⇒ **JLF- Joint lenders forum (ऋणदाताओं का संयुक्त मंच)**: Consortium of the lenders, who will work out aforementioned restructuring methods. But, proved unsuccessful because PSB Officials would not vote positively due to the fear of Media & 4C [Courts, CBI, CAG and CVC]. RBI stopped above schemes from 31 March 2018. Now banks can restructure loans only under the provisions of Insolvency and Bankruptcy Code (IBC) 2016.

8.3.3 Recovery (वसूली)

Bank liquidates loan-defaulter's assets under either of the following acts:

- ⇒ SARFAESI Act 2002 (सरफेसी अधिनियम) OR
- ⇒ Insolvency and Bankruptcy Code 2016 (शोधन-अक्षमता एवं दिवालियापन संहिता 2016): If 75% of the lenders don't agree for restructuring / resolution plan, then assets will be liquidated.

(UPSC-Prelim-2017) 'Scheme for Sustainable Structuring of Stressed Assets (S4A)' is related to:

- a) procedure for ecological costs of developmental schemes.
- b) scheme of RBI for reworking the financial structure of big corporates with genuine difficulties.
- c) disinvestment plan for Central Public Sector Undertakings.
- d) Provision in 'The Insolvency and Bankruptcy Code'.

8.4 SARFAESI ACT 2002: ORIGIN, OBJECTIVE & LIMITATIONS

- ⇒ **1991: Narsimhan-I** Committee on banking sector reforms observed that borrowers obtain stay orders from ordinary courts = banks have difficulty recovering NPA. So, _ _ _



----- (DRT: ऋण वसूली न्यायाधिकरण) were set up (1993)- ordinary courts can't interfere in the loan recovery process.

- ⇒ **1998: Narsimhan-II** Committee observed that DRTs need to be strengthened with a law, so, Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act enacted (2002). [प्रतिभूतीकरण और वित्तीय आस्तियों का पुनर्गठन और प्रतिभूति हित को प्रभावी करने का अधिनियम 2002]
- ⇒ Under SARFAESI act, Banks and Housing Finance Companies (NBFCs) can attach the mortgaged assets when loan is not repaid. They can change board of directors in such companies, can auction such assets, can also sell such assets to **Asset Reconstruction Companies (ARC, NBFC)**. SARFAESI not applicable on farm loans.
- ⇒ If loan-defaulter wants to obtain a stay order, he cannot go to ordinary courts. He will have to approach for DRT. If DRT doesn't help then ⇒ higher appeal to Debt Recovery Appellate Tribunal (DRAT), but DRAT will require him to deposit minimum 50% of the loan dues (to discourage frivolous appeals). ⇒ higher appeal to high court.

Limitations of SARFAESI Act

- ⇒ The DRTs & DRATs are **understaffed**. 1 lakh+ **cases pending** (2016), so, case will go on for years and the debtor will remain in possession of asset. This leads to erosion of asset-value (machinery, vehicles) even when DRT allows auction.
- ⇒ In some businesses, auction or liquidation may not yield the best return for the banks (e.g. hotel resort in remote area, where no other hoteliers are keen to invest). In such cases, if the loans were restructured, banks could salvage more value. But, SARFAESI act **doesn't facilitate arbitration** (मध्यस्थता) So, Govt. came up with a new law IBC ⇒

8.5 INSOLVENCY AND BANKRUPTCY (I&B) CODE 2016: शोधन-अक्षमता एवं दिवालियापन संहिता 2016



- ⇒ Individual, Partnership firm or Company defaults on a **business loan** of ₹ 1 lakh or more, then, lenders approach National Company Law Tribunal (NCLT: राष्ट्रीय कंपनी कानून अधिकरण), to initiate proceedings under the I&B Code.



- ⇒ NCLT will grant moratorium (पाबंदी) of 180-270 days so no other lender can unilaterally attach assets under SARFAESI Act.
- ⇒ Within that period, an _____ (IP: शोधन-अक्षमता संबंधी पेशेवर) will make a resolution plan e.g. reduce loan interest, extend loan tenure, or IP could even find another investor to finance the pending project etc.
- ⇒ If 75% of the Lenders (ऋणदाता) agree with such _____ plan, then it will be set in motion, otherwise, IP will _____ (परिसमापन) the assets to recover the dues.
- ⇒ **Appeal Structure?**
 - A. If borrower is individual / partnership firm: Appeal @DRT of SARFAESI Act. OR
 - B. If Borrower is a Company: Appeal @NCLT of the Companies Act.
- ⇒ **I&B Code is not applicable to following defaulters:**
 - A. _____ **Defaulter** (जान-बूझकर बकाएदार): A borrower who has the capacity to repay, but he's not repaying the loan. E.g. Vijay Mallya was declared willful defaulter by SBI (2017). OR
 - B. _____ **Defaulter** (असमर्थ बकाएदार): A borrower whose loan account is in NPA for more than a year, and he has no capacity to repay even partial loan amount.

Above two categories of borrowers are not eligible for I&B resolution process. Their assets will be directly liquidated under SARFAESI Act.

8.5.1 Insolvency and Bankruptcy Board of India (IBBI)

- ⇒ भारतीय शोधन-अक्षमता एवं दिवालियापन बोर्ड is the _____ body that monitors and implements I&B Code 2016.
- ⇒ IBBI composition: One Chairman (M.S.Sahoo), 1 nominated member from RBI, other members from Government's side. Total 1 chairman + 9 member = 10 people.
- ⇒ IBBI's administrative control rests with the Ministry of Corporate Affairs (MCA).
- ⇒ Chairman has **5 years / 65 age tenure**, whichever earlier. Also **eligible for reappointment**.
- ⇒ IBBI selects Insolvency Professionals Agencies (IPAs). These IPAs enroll and supervise the members practicing as Insolvency Professionals (IPs). Presently, 3 organizations given "IPA" status viz. 1) ICAI (Chartered Accounts) 2) ICSI (Company Secretaries) and 3) Institute of Cost Accountants.
- ⇒ IBBI also selects **Information Utility (IU)** organization to maintain **database of borrowers**. In 2017, **NeSL**: National E-Governance Services Ltd (owned by consortium of SBI, LIC etc.) was the first to get the IU status. It is compulsory for the lenders to share data with IU. IU helps lenders in two ways:
 - 1) by looking @borrowers' credit history, lenders can make informed decisions about whether to give loan or not, and how much interest to charge?
 - 2) This database helps establishing documentary proofs during NCLT / DRT / judicial / liquidation proceedings.

8.5.2 Banking Regulation (Amendment) Act 2017: बैंकिंग विनियमन (संशोधन) अधिनियम

- ⇒ I&B Code resolution process can start only AFTER a bank / NBFC files a motion at NCLT. But, Public Sector Bank (PSB) officials fear Media, CBI, CVC, CAG & Courts - hence were reluctant to even file motion @NCLT.



⇒ I&B Resolution plan can work only if 75% of lenders approved. But even in such voting, PSB-executives will shy away from voting positively. To solve these problems, Government first issued an ordinance and then passed a bill for amending Banking Regulation Act. This amendment increased RBI's powers to force the banks to begin process under I&B Act.

8.6 BORROWERS' DATABASE & TRACKING

8.6.1 Public Credit Registry (ऋण की सार्वजनिक रजिस्ट्री)

Presently, multiple organizations keep borrowers' database / credit history viz.

- 1) Under the I&B code, Insolvency and bankruptcy board of India (IBBI) has authorized the National e-governance services Ltd (NeSL) to act as an Information Utility (IU).
- 2) Under the Credit Information Companies Regulation Act (CICRA 2005), RBI has given license to CRISIL (oldest CIC-1987), CARE, FITCH India, ICRA, Brickwork Ratings, SMERA etc. as Credit Rating Agencies [ऋण पात्रता-मूल्यांकन एजेंसी].
- 3) RBI has its own "Central Repository of Information on Large Credits (CRILC)" for Loans above Rs 5 cr. Banks & NBFCs have to submit weekly updates in this portal.

But, not all of these databases are under the direct control of RBI. Each has their own methodology for data collection & tabulation. Not all of these databases are covering all individual and corporate borrowers of India. So, **RBI's** _____

Committee (2017-18) recommended setting up a Digital Public credit registry (PCR) with following features:

- 1) PCR will be setup under RBI, using data from SEBI, Corporate Affairs Ministry, GST authorities, IBBI, Banks, NBFCs etc.
- 2) PCR will help lenders to get complete 360-degree profile of borrower on real time basis.
- 3) PCR will help RBI in early detection of systematic stress, checking the efficacy of monetary policy & other big data analytics.

2018: RBI issued tender to select a company for developing PCR portal. _____
Company won the tender/contract. [Update when IT-Company is finalized]

[Asked in UPSC-CDS-2016-II]	[Asked in UPSC-CDS-2018-1]
Which one of the following is/are credit rating agency/ agencies in India? (a) CRISIL (b) CARE (c) ICRA (d) All of the above	The Reserve Bank of India has recently constituted a highlevel task force on Public Credit Registry (PCR), headed by (a) Sekar Karnam (b) Vishakha Mulye (c) Sriram Kalyanaraman (d) Y. M. Deosthalee

8.6.2 Legal Entity Identifier (LEI) Number: (कानूनी इकाई पहचान नंबर)

⇒ Even if a company is blacklisted by Indian banks, it could apply for loans overseas, and those overseas bankers may not be aware of company's history. So, there should be a global "Aadhar card" number for companies, and they must be forced to quote that number during every financial transaction.



- ⇒ After Sub-Prime Crisis and Global Financial Crisis (GFC), **the _____ and its Financial Stability Board (FSB)** came up this LEI concept- a 20-digit alphanumeric code.
- ⇒ LEI's Global Boss: Global Legal Entity Identifier Foundation (GLEIF), Frankfurt, Germany. LEI's Indian agent: Clearing Corporation of India.
- ⇒ **RBI had ordered** the large borrowers (who have taken loans above Rs.1,000 crore from Indian banks) to obtain LEI number by 31/8/2018, then gradually smaller companies must **obtain LEI-number in a phased manner.**
- ⇒ Companies must quote this LEI-number in their financial transaction. RBI has power to issue such directives under: Payment and Settlement Systems Act, 2007 & Banking Regulation Act 1949.

Even if a borrower has obtained LEI, his name is in PCR, yet one day he runs away from India, then what to do? Ans. ⇒

8.7 FUGITIVE ECONOMIC OFFENDERS ACT, 2018 (भगोड़ा आर्थिक अपराधी अधिनियम)

- ⇒ This act targets economic offenders accused of cheque dishonor, loan / investment / chit-fund scam, money laundering etc. worth **₹ _____ crores />** & left India to avoid facing prosecution / arrest.
- ⇒ Special courts under the PMLA (Prevention of Money-laundering Act, 2002) will order the villain to appear within 6 weeks, if not then he's declared "Fugitive Economic Offender" ⇒ his Indian & _____ & Benami properties will be attached (जब्त की).
- ⇒ Once property attached- the _____ will oversee its administration / liquidation (परिसमापन).
- ⇒ No ordinary civil court / tribunal can give stay order. Villain can make appeal only in High Court and Supreme Court. (उच्च न्यायालय और सर्वोच्च न्यायालय).

If Borrowers don't repay, SARFAESI auctions give little recovery, CRR-SLR insufficient to repay deposits then bank collapse imminent. Then, how to protect the depositors? Ans. ⇒

8.8 DICGCI ACT: OBJECTIVE & LIMITATIONS

- 1961: Deposit Insurance and Credit Guarantee Corporation Act (निक्षेप बीमा और प्रत्यय गारंटी निगम)- mandates that **all types of banks** must buy insurance on their deposit accounts from DICGCI- **100% owned by _____**. One of RBI Dy. Governor acts as chairman of DICGCI. HQ: **Mumbai**.
- When a bank shuts down, DICGCI will pay **upto ₹ _____ insurance** to every deposit holder for his principal and interest.
- Further, DICGCI also provides guarantee cover to bank loans granted to Priority Sector Borrowers, except home loans. With setting up of SIDBI (1990) & National Credit Guarantee Trustee Company Ltd. [NCGTC, 2016] this credit guarantee work is fragmented among many institutes, but we need not PHD over it.

Limitation of DICGCI

- ⇒ If a customer had deposited more than ₹1 lakh rupees in a single commercial / cooperative bank, then he gets only ₹1 lakh from DICGCI. And for remaining amount he must wait till RBI / Cooperative Registrar liquidates the bank.



- ⇒ DICGCI doesn't cover NBFCs. 2002: UTI (a Government owned mutual fund company) made big losses. DICGCI not liable to protect UTI-clients. So, Government had to pay ₹14,561 crores bailout package.
- ⇒ Therefore, Financial Sector Legislative Reform Commission (FSLRC) under Justice B.N. **Srikrishna** (2011-13) recommended a new organization called **Resolution Corporation** (RC) via FRDI Bill.

8.9 FRDI BILL 2017: OBJECTIVE & WITHDRAWAL

- ⇒ Financial Resolution and Deposit Insurance (FRDI) Bill (वित्तीय समाधान और निक्षेप बीमा) aimed to transform the DICGCI into a Resolution Corporation (RC). All financial intermediaries (Banks and NBFCs) will have to buy insurance from RC, to protect their depositors.
- ⇒ RC will monitor these Banks and NBFCs, if they come in 'imminent financial risk', RC will draft a resolution plan e.g. merging it with another entity, or finding new investors for infusing additional capital etc.
- ⇒ However, incase of weak bank, if such investor couldn't be found & merger with another bank was not possible, then RC could even use the weak-bank's depositors' money to infuse equity (share) capital into the Weak-Bank. This was called "**Bail-In**" provision - highly criticized by media and Opposition parties. 2018-Aug: Government withdrew the bill. So, we need not do further PHD over FRDI or its Bail-in provisions.

8.10 A BAD BANK CALLED "PARA"

- ⇒ Former Chief Economic Advisor (CEA) Arvind Surbamanian's Economic Survey 2016-17 had proposed a bad bank named "**Public Sector Asset Rehabilitation Agency**" (**PARA**: सार्वजनिक क्षेत्रीय परिसंपदा पुनःप्रतिष्ठापन एजेंसी).
- ⇒ PARA will buy bad loans from PSBs, try to salvage the maximum value from loan-restructuring / liquidation-auction and absorb the losses.
- ⇒ Arvind S. also suggested RBI to give additional dividend to Govt. to start this bad bank & finance its losses. Ofcourse, this idea was not implemented. But, media attention landed on Urjit Patel- *why he's unable to solve NPA problem & could Bad Bank solve this problem!!!*? So, Urjit responded by tightening Prompt Corrective Action (PCA) framework.

8.11 PROMPT CORRECTIVE ACTION (PCA) FRAMEWORK

- ⇒ 2002: RBI Governor Bimal Jalan designed it. (त्वरित सुधारात्मक कार्रवाई रूपरेखा)
- ⇒ 2017: Urjit Patel toughened PCA norms further.
- ⇒ 2018: _____ announced separate 'Prompt Corrective Action (PCA) Framework' framework for Regional Rural Banks (RRBs).
- ⇒ In PCA framework, **all Commercial Banks** are monitored for Asset Quality (NPA), Capital Sufficiency (BASEL-III), Profitability (Return on Assets: RoA)- and are classified into **Risk threshold** #1, #2, #3. Higher the number, higher the risk. Then, accordingly, RBI will take corrective actions such as:
 1. RBI giving strict warning, conducting deeper audit & supervision.
 2. Restricting bank's directors' salaries and dividend distribution to its investors.
 3. Restricting bank's branch expansion & lending operations.
 4. Forcing merger / shutdown of a weak bank (under Banking regulation Act 1949).



- ⇒ If a PCA-listed bank wants to get 'whitelisted', it'll have to reduce its ____, obtain additional ____, improve its ____.
- ⇒ As of Dec-2018: 11 out of 21 Public Sector Banks in PCA list. So, Govt. wanted RBI to lift/ease PCA-restrictions. But Urjit did not oblige.

8.12 BASEL-III NORMS (बेसेल-3 मानदंड)

- ⇒ Bank for International Settlements (BIS) is an international institution made up of 60 countries' Central Banks. HQ @ BASEL, Switzerland. Its committee on banking supervision set norms in 1988 (I), 2004 (II), 2011(III) to ensure global financial stability.

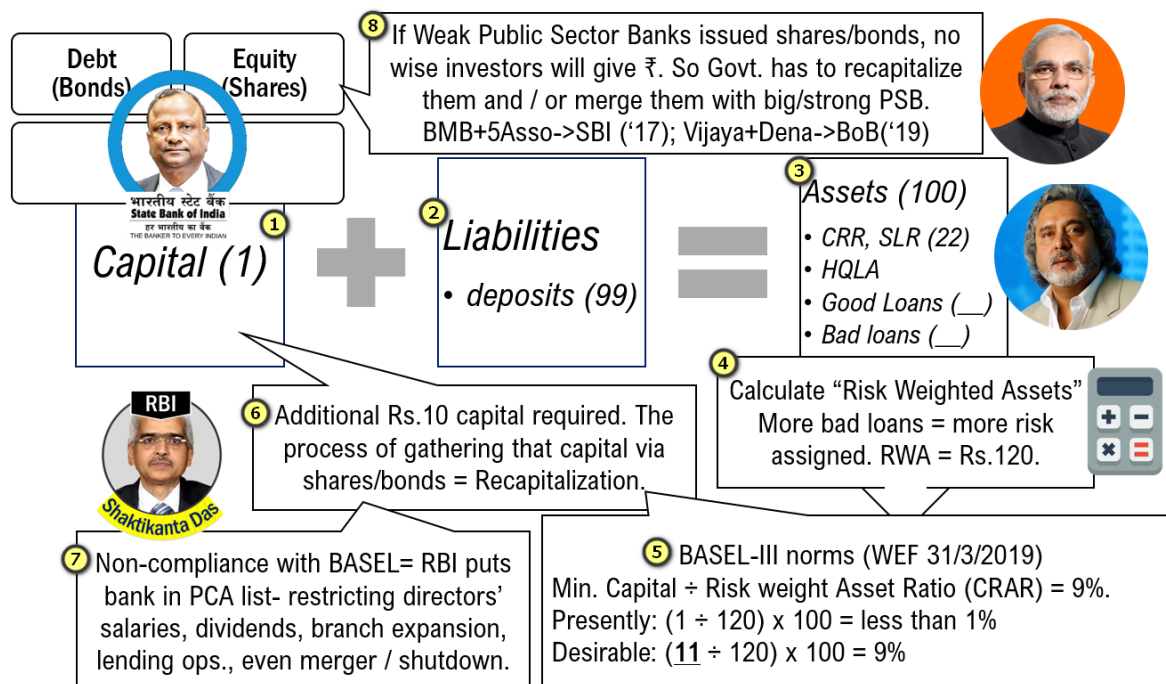


Figure 1: we need not bother with Tier-1 Tier-2 Capital etc.

- ⇒ From 1/4/2013, RBI began phased implementation of BASEL-III norms in India:
- ⇒ First, a bank needs to calculate its _____ (RWA: जोखिमपूर्ण संपत्ति).
- ⇒ Against these RWA, (Universal) Scheduled Commercial Banks (SCB) must keep:
 - **"Minimum Capital to Risk Weighted Assets Ratio" (____) at 9% or higher from 31/3/2019.**
 - Capital Conversation Buffer (CCB) from 31/3/2020.
 - Counter Cyclic Capital Buffer (CCCB): whenever RBI notifies.
- ⇒ Each member country's Central Bank can prescribe different ratios depending on their country's situation.
- ⇒ As NPA ↑ = bank's asset quality degrades = its Risk-weighted assets (RWA) will ↑; then bank must arrange more capital to comply with these ratios, norms and buffers.
- ⇒ If a bank can't comply with BASEL norms, then RBI puts it in ____ list. In worst case, bank will have to merge/ sell off its business to another bank or shut down.
- ⇒ BASEL Norms also apply on Differential Commercial Banks (____), Cooperative Banks, AIFI (____) and certain category of NBFCs, but RBI can prescribe separate norms / limits / deadlines for them.



MCQ. (UPSC-Prelim-2016) Objective of BASEL-III norms?

- a) Develop national strategies for biological diversity.
- b) reduce the GHG emissions but places a heavier burden on developed countries.
- c) transfer technology from developed Countries to poor countries to replace chlorofluorocarbons in refrigeration.
- d) improve banking sector's ability to deal with financial and economic stress and improve risk management.

8.12.1 Recapitalization of PSBs [सार्वजनिक क्षेत्र के बैंको का पुनःपूंजीकरण]

- If a bank doesn't have enough capital to comply with BASEL-III norms it can issue debt (bonds) and equities (shares) to gather new capital.
- **2015:** Projected that Public Sector Banks (PSBs) will require ₹ 1.8 lakh crore additional capital by 31/3/19 to comply with BASEL-III norms.
- So, Finance Ministry's _____ came up with _____ **PLAN** for phased-recapitalization of PSBs with ₹ 70,000 crores from 2015 to 2018. Individual PSB will get funding based on outcomes / performance.
- **2017:** It became clear ₹70,000 crores was insufficient for BASEL-III compliance. So, Modi Govt. announced ₹ 2.11 lakh crore recapitalization package.

Component	Amt in ₹ Cr.
PSBs to mobilize equity (share) capital from private investors. However, investors shy away from smaller banks with weak balancesheets, so BMB & 5 Associated Banks merged with SBI (2017). Vijaya & Dena to be merged with BoB (2019, 1 st April)	58,000
Government's budget support to PSBs	18,000
Government to issuing Bank Recapitalization Bonds (RCB) in the market with following features: <ul style="list-style-type: none"> - These bonds will have interest rate of ~7%, mature @ 2028-2033. - Non-transferable to third party, Non-convertible into shares. 	1,35,000**
Total	2,11,000*

2018-Dec: Even this ₹2.11 lakh crore package was found insufficient, so, Govt. sought supplementary grants from Parliament to infuse additional ₹41,000 crores in PSBs. Thus, **total ~₹ _____ lakh crores mobilized** help PSBs in BASEL-III compliance.

****Critiques** argue that PSBs themselves are forced to buy these Bonds using public deposits, and thus Bank Recapitalization Bonds are merely a 'creative-accounting' practice to comply with BASEL-III norms, but we need not bother with such "B.Com / Controversy in News" for UPSC.

MCQ. With reference to the governance of public sector banking in India, Find Correct Statement(s):(Asked in UPSC-Pre-2018)

1. Capital infusion into public sector banks by the Government of India has steadily increased in the last decade.
2. To put the public sector banks in order, the merger of associate banks with the parent State Bank of India has been affected.

Answer Codes: (a) 1 only (b) 2 only (c) Both 1 and 2 (d) Neither 1 nor 2.

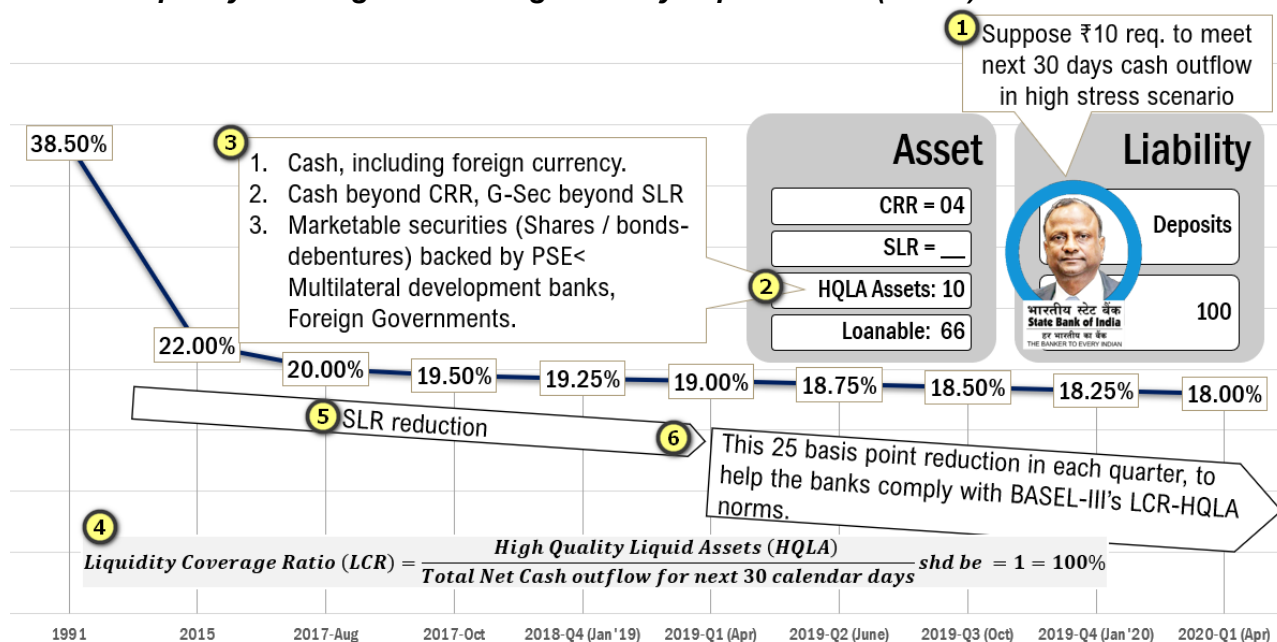


8.12.2 BASEL-III related Misc. Terms

8.12.2.1 Counter-cyclical Capital Buffer Norms (CCCB)

- ⇒ Part of BASEL-III norms. It requires banks to **create capital buffer during the boom** period in economy, so that such buffer can be used during the bust/slowdown.
- ⇒ RBI must announce this norm 4 quarters (=1 year) in advance. So far RBI has not required Indian Banks to keep CCCB.

8.12.2.2 Liquidity Coverage Ratio & High-Quality Liquid Assets (HQLA)



- ⇒ BASEL-III norms require the banks to keep enough in High Quality Liquid Assets (HQLA) so that bank can survive a 30 days high stress scenario of cash outflow / bank run. If a Bank has enough HQLA assets to survive this test, we say this Bank has Liquidity Coverage Ratio (LCR) of 1 (or 100%).
- ⇒ RBI implemented deadline came gradually Jan 2015: 60%, ..+ 10% each year.... Jan'19: 100% or more.

8.12.2.3 D-SIB: Domestic Systemic Important Banks

- ⇒ In 2010, **G-20's brainchild Financial Stability board (HQ: BASEL)** asked countries to identify Systematically Important Financial institutions and put framework to reduce risk in them. [Side note: Same parents responsible for birth of _____]
- ⇒ Each year in August, RBI identifies banks that 'too big to fail' (=if they fail, it'll severely hurt the economy)' and labels them as **Domestic Systemic Important Banks (D-SIB)**. & orders them keep additional equity capital against their Risk Weight Assets (RWA).
- ⇒ Presently, 3 D-SIBs in India: _____ **(Latest Entry)**.

8.13 BANKING SECTOR: GOVERNANCE / ADMINISTRATIVE REFORMS

8.13.1 Gyan-Sangam-I, 2015, Pune

FinMin's Dept of _____ (वित्तीय सेवा विभाग) organized a workshop of financial regulators, Public Sector Bank, Insurance Companies etc. It resulted in 3 outcomes:

- 1) PSBs' CMD post bifurcated into 1) separate chairman and 2) separate MD&CEO so that banks can function in more professional and accountable manner.



- 2) **Indradhanush** plan for bank recapitalization (Rs.70,000 crores) tied with governance reforms in PSBs.
- 3) Finance Ministry setting up an autonomous body- Bank Board Bureau (BBB).

8.13.2 Bank Board Bureau (BBB), 2016

- BBB selects top officials (MD, CEO, Chairman and full-time Directors) for PSBs, LIC and other public sector financial institutions. Actual appointment done by FinMin's Department of Financial Services. *(Just like UPSC selects candidates suitable for IAS but DoPT notifies appointment.)*
- BBB also helps the banks in governance reforms, raising capital for BASEL-III etc.
- BBB has 1 Part-Time Chairman, 3 Part-Time Members and 3 Ex-officio Members (from Govt & RBI side)
- 2018, April: **Bhanu Pratap Sharma** (retd.IAS) replaced Vinod Rai (retd.IAS, CAG) as the new chairman of BBB.

8.13.3 Enhanced Access and Service Excellence (EASE: बढ़ी पहुंच और सेवा उत्कृष्टता)

Agenda 2018

- **2017, October:** Government announced ₹2.11 lakh crore package for recapitalization of PSB. But critiques argued such relief measures will just make the PSBs lazy & undisciplined (moral hazard). So,
- **2017, November:** First Public Sector Bank (PSB)-Manthan organized by Dept of Financial Services (DFS) at Gurugram. Based on the participants' inputs...
- **2018, January:** FinMin's Dept of _____ released EASE framework with 6 pillars to make PSBs Responsive and Responsible viz.
 1. Customer Responsiveness.
 2. Responsible Banking: Reduce NPA, prevent frauds.
 3. Credit Off Take: Try to reach out to potential borrowers for home, auto, education, loans.
 4. Help MSME entrepreneurs via SIDBI's Udyamimitra.com portal. Approve/reject loans in not more than 15 days.
 5. Deepening Financial Inclusion & Digitalization.
 6. Employees' Human Resource Management (HRM): improve with training, performance linked promotion-salaries-posting-transfers etc.

Implementation? Each whole-time director of a PSB will be entrusted with one pillar of the framework. Their performance will be checked by the PSB's board of directors. An independent agency will be tasked to check public perception.



Table 3: Points for assembling Mains Answers Rapidly

Eco.Survey-2015: “4R” framework	Eco.Survey-2014: “4D” framework
Recognition: of bad loans via asset quality review (AQR)	Disinter "Digup graves, recover money": using
Resolution: via ALPHABETICAL soup: ----- ... [although scrapped post-I&B code]	Differentiate among PSB: Profit Maker PSB: Capitalize for BASEL-III whereas Loss Maker PSB: Merge or Privatize ⇒
Recapitalization: for BASEL-III norms ⇒ Indradhanush, Bank Recap Bonds & other measures: Total ₹_____ lakh crore mobilized.	Diversify: Allow more number and variety of Banks.⇒ _____ allowed. Wholesale Bank proposed.
Reforms: Governance & Administration of PSB⇒ _____	Deregulate: Lower SLR, Promote Corporate Bond market so they borrow less from Banks e.g. Tri-Party Repo mechanism.

8.14 MISC. BANK CONTROVERSIES / ISSUES

8.14.1 PNB, LoU, SWIFT, Nostro & Nirav Modi

PNB (Mumbai Branch): Give foreign currency loan to our client for purchase of goods (diamonds, airplanes, whatever), if he doesn't pay, we'll pay.

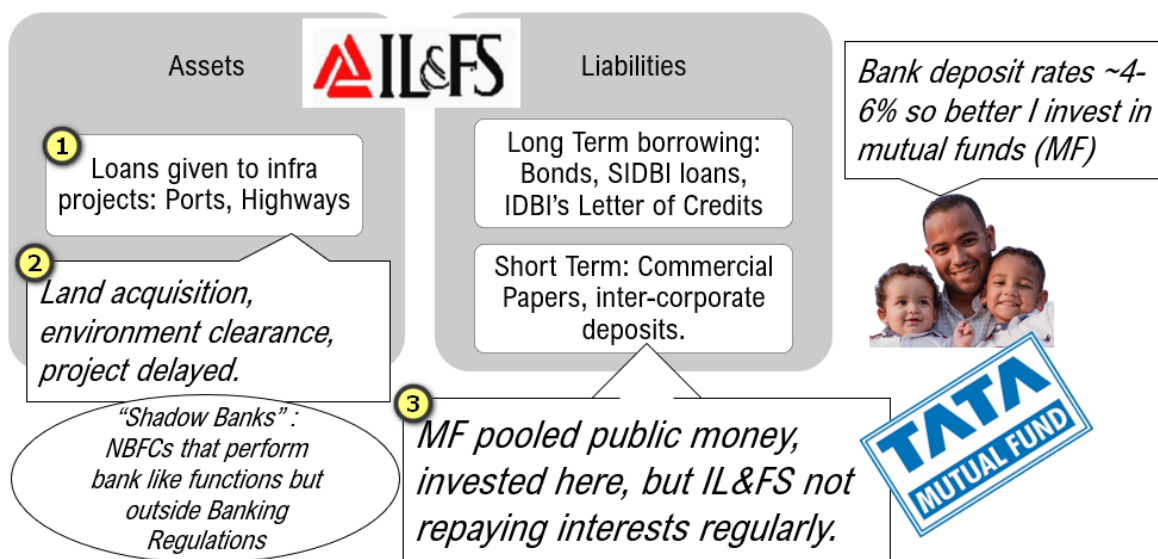
- If such bank guarantee given to another bank in a foreign country, it's called **Letter of Undertaking/ Letter of Credit**: internal-difference not important.
- if such bank guarantee given to same bank (PNB)'s overseas branch, it's called **Letter of Comfort**.
- Bank earns commission / fees from client for issuing such letters / guarantees.
- The foreign currency thus loaned, goes into PNB's Nostro (Latin:Ours) account, & Nirav uses the dollars to buy diamonds in HongKong.
- **PNB Scam:** PNB-Mumbai's corrupt manager kept issuing LoUs to diamond merchants Nirav Modi & Mehul Chowkasi without due-diligence or collaterals for 7 years, worth ~₹12,000 crores. And 2018-January duo left India.
- PNB officials couldn't detect scam because LoUs were generated through **SWIFT** platform, which was not integrated with their Core Banking Solution (CBS) server.

8.14.2 Financial Messaging Systems

Within India	Globally
Structured Financial Messaging System (SFMS)	Society for Worldwide Interbank financial telecommunication (SWIFT)
designed by Tata Consultancy Services (TCS) for IDRBT (=Research arm of RBI)	By a Cooperative organization in _____ La Hulpe city (1973).
to serve the messaging function in NEFT, RTGS, and other inter-bank, intra-bank e-transactions platforms <u>within India</u> .	To serve the messaging function for Banks, NBFCs & brokers who may / may not have direct bank relations / settlement systems with each other due to international borders.



8.14.3 IL&FS, Shadow Banking, NBFC Liquidity Crisis



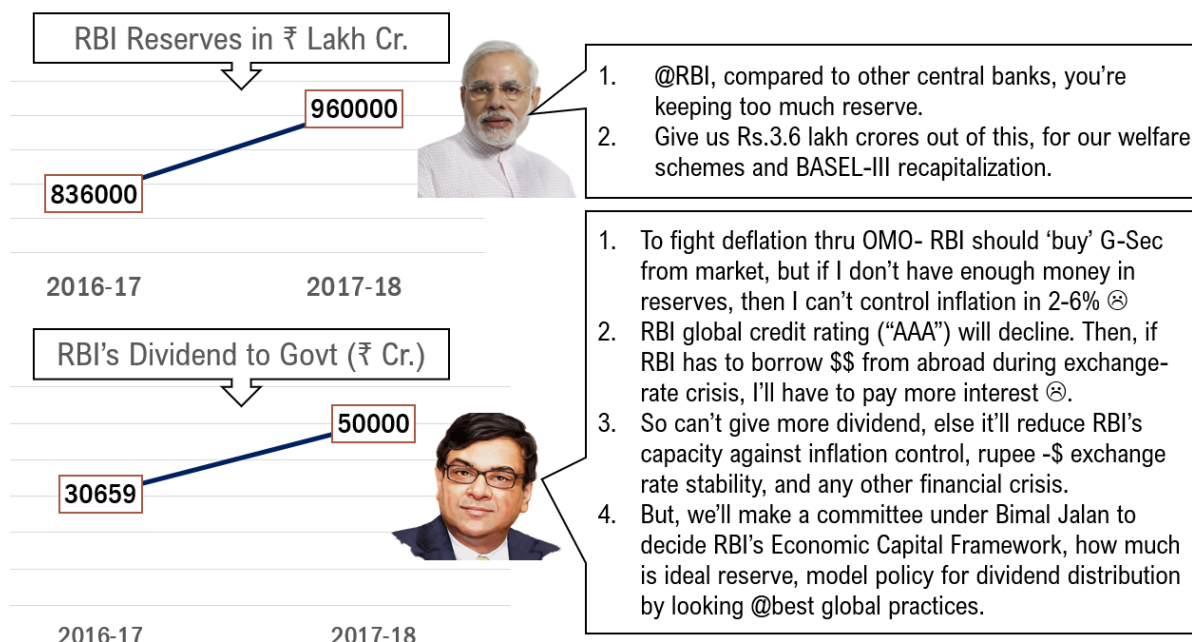
- Infrastructure Leasing & Financial Services (IL&FS) is a Systemically Important Non Deposit Taking Non - Banking Finance Company (**NBFC - ND - SI**) Setup in 1987 HQ@Mumbai.
- **Shareholders:** LIC > Japan's Orix group > Abu Dhabi's group > Central Bank of India > SBI.
- **Challenge?** 1-2-3 of above diagram.

Remedies undertaken?

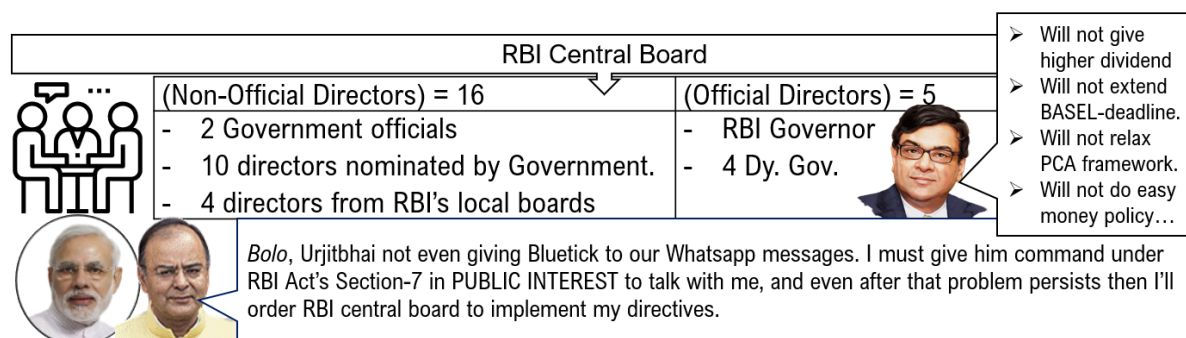
- Under Companies Act: Ministry of Corporate Affairs replaced the IL&FS's Board members. Uday Kotak made new Chairman.
- PSBs unable to lend more to IL&FS due to PCA framework. But, RBI relaxed securitization norms for NBFCs so they can use existing loan papers to issue new securities to borrow money from market, thus increasing liquidity /money supply for NBFCs' biz operations.
- LIC says we'll not allow IL&FS to collapse (=we may use Policy holders' money to rescue it just like IDFC) = "Financial Repression of households".

8.14.4 RBI Dividend, Reserves, Economic Capital Framework

RBI's income sources include:↓	From its income, RBI allocates funds for↓
1. Interest on G-Sec that are not sold in Open Market Ops.	1. Staff retirement fund, provisions for bad loans, depreciation in assets...
2. Interest on Foreign G-Sec / Sovereign Bonds.	2. Reserves for contingency (emergency): ~₹ 2.5 Lcr.
3. Interest on Loans given to its other Banks / NBFCs.	3. Reserves for Exchange Rate Stability (Technically called "Currency & Gold Revaluation Reserve: ~₹7 lakh cr)
4. Revaluation of foreign currency and gold in RBI reserves.	After making these allocations, profit is shared with Union Govt. in form of 'Dividend' (RBI Act Section 47).
5. Seigniorage: profits from printing money- because face value < intrinsic value.	
6. Penalties imposed on errant Banks.	



8.14.5 Section-7 Directive & Urjit Patel's Resignation



This topic is not very important because UPSC usually avoids "Controversy in News". Urjit Patel was unhappy with Government interfering / criticizing his work. Such as:

- ⇒ **Higher Dividend:** Govt. demanded higher dividend from RBI to finance the recapitalization of PSBs for BASEL-III, and to finance its own fiscal deficit & populist welfare programs. Urjit Patel felt RBI's higher reserves are necessary to check any financial crisis. Excessive dividend could increase inflation. He did not oblige.
- ⇒ **BASEL-III-relaxation:** These norms will become fully effective on 31/3/2019 but PSBs don't have enough capital to comply so they requested Finance Minister (FM) to tell Urjit Patel to extend the deadline, Urjit Patel did not oblige.
- ⇒ **PCA-relaxation:** Urjit Patel vigorously implemented Prompt Corrective Action framework, so Public Sector Banks' branch expansion, lending operations were restricted, they came running to FM. FM asked Urjit to relax PCA. He did not oblige.
- ⇒ **Tight Money Policy:** CEA Arvind Subramanian & BJP-Ministers were criticizing RBI's "Tight" Monetary Policy depriving MSMEs of cheap loans and thus harming India's growth rate. Whereas Urjit Patel deemed tight policy necessary to keep inflation @2-6%CPI (All India) on durable basis so he did not oblige.
- ⇒ **PNB Scam:** Jaitley expressed displeasure that RBI couldn't detect PNB-Nirav Modi fraud, whereas Urjit Patel defended that he lacks effective powers under Banking Regulation Act to take punitive actions against Public Sector Banks.

All these forced Govt. to issue Section -7 Directive to RBI.



8.14.5.1 Section-7 of RBI

- ⇒ Section 7(1) of the RBI Act empowers the Government to consult with RBI Governor in _____.
- ⇒ In, 2018-October, for the first time in the history of Independent India, Govt began a Section-7(1) consultation with RBI Governor Urjit Patel, for issues of PCA norms, BASEL-III deadline, higher dividend to Govt., Cheap Monetary Policy etc.
- ⇒ If RBI Governor doesn't positively respond in such Section-7(1) consultation, then Section 7(2): Government can issue binding direction / orders to RBI _____ to implement its wishes.
- ⇒ Although, fearing backlash from Media & Opposition Parties, Govt did not issue any specific directions to the RBI Board. But, 2018-Dec: Urjit Patel resigned before completing 3-year term. He is not the first RBI governor to resign & we need not prepare KBC-GK-names of all the RBI governors who resigned before their term.

8.15 MOCK QUESTION FOR MAINS GSM3 (250 WORDS EACH)

1. "While Insolvency & Bankruptcy Code doesn't fully cure the Twin Balance sheet Syndrome, it certainly helps alleviating the pain." Elaborate. "हालांकि शोधन-अक्षमता एवं दिवालियापन संहिता भारत के दोहरे तुलनपत्र की समस्या को पूरी तरह से ठीक नहीं करता है, लेकिन यह निश्चित रूप से दर्द को कम करने में मदद करता है." विस्तृत कीजिए.
2. Explain the significance of governance reforms in Public Sector Banks (PSBs) for India's economic growth. भारत के आर्थिक विकास के संबंध में सार्वजनिक क्षेत्र के बैंकों में शासन सुधारों के महत्व को समझाइए.
3. What is "Twin Balancesheet Syndrome"? Enumerate the steps taken by RBI to resolve it. "दोहरे तुलनपत्र की समस्या" क्या है? इसे हल करने के लिए भारतीय रिज़र्व बैंक द्वारा उठाए गए कदमों की सूची दीजिए.
4. With respect to India's financial stability, explain the significance of (i) PCR framework (ii) BASEL-III Norms (iii) Public Credit Registry (iv) Shadow Banks. भारत की वित्तीय स्थिरता के संबंध में इन्हें समझाइए: (i) पीसीआर ढांचा (ii) बेसल-III मानदंड (iii) ऋण की सार्वजनिक रजिस्ट्री (iv) प्रतिछाया बैंक्स.