# GS FOUNDATION FOR CSE 2024
# ECONOMY-8
# BANKING SECTOR – CAPITAL ADEQUACY; D-SIBS, DEPOSIT INSURANCE, NPAS

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# 2. BASEL NORMS

- **What?**
  - Basel norms/standards are **global, voluntary, regulatory framework on bank Capital Adequacy, Stress Testing and Market Liquidity risks**. It is formulated by the Basel Committee on Banking Supervision (BCBS).

    - BCBS aims to enhance the understanding of key supervisory issues and improve the quality of banking supervision worldwide. The committee's **secretariat** is located at the **Bank of International Settlement (BIS) in Basel, Switzerland**.

  - **About Bank of International Settlement (BIS), Basel**
    - BIS, situated at Basel, Switzerland, is a promoter of Central Banks' cooperation in an effort to ensure global monetary and financial stability. It was established in 1930 and is the oldest global financial institution and operates under international law. It is owned by 60 central banks.

  - **Need?**
    - **Ensuring Risk preparedness**
    - **Uniform standards** ensure better understandability of banking system's stability. This helps investors and agencies to better decide their investment opportunities across the world.
    - **Global Village** -> vulnerability in one country affects other countries (e.g. the 2007-08 crisis). Therefore the banking system should be stable throughout the world.

- **Basic Terms**
  - **Risk Weighted Assets:**
    - **Risk weighted assets** of a bank are its assets weighted by their degree of credit risk.
      - For e.g.in India, according to RBI Regulations loans issued to government are weighted at 0.0%, while those given for housing purposes is given a weight of 50%.
    - Risk weighted assets are **used to determine the minimum amount of capital** that must be held by banks and other institutions to reduce the risk of insolvency.
    - **The financial crisis of 2007-08** was driven by financial institutions investing in subprime home mortgage loans that had a far higher risk of default.
    - **To avoid the problem** moving forward, regulators now insist that each bank must group its assets together by risk category so that the amount of required capital is matched with the risk of each asset.

  - **Capital to Risk Weighted Asset Ratio (CRAR) / Capital Adequacy Ratio (CAR)**
    - CAR is a measurement of a bank's available capital expressed as a percentage of a bank's risk-weighted credit exposure. It is used to protect depositors and promote the stability and efficiency of financial systems around the world.
    - It is calculated by adding a bank's Tier 1 Capital and Tier 2 Capital and dividing the total by its total risk-weighted assets.

## The Formula for CAR:

$$CAR = \frac{Tier\ 1\ Capital + Tier\ 2\ Capital}{Risk\ Weighted\ Assets}$$

- CAR = (Tier 1 Capital + Tier 2 Capital) / Risk Weighted Assets

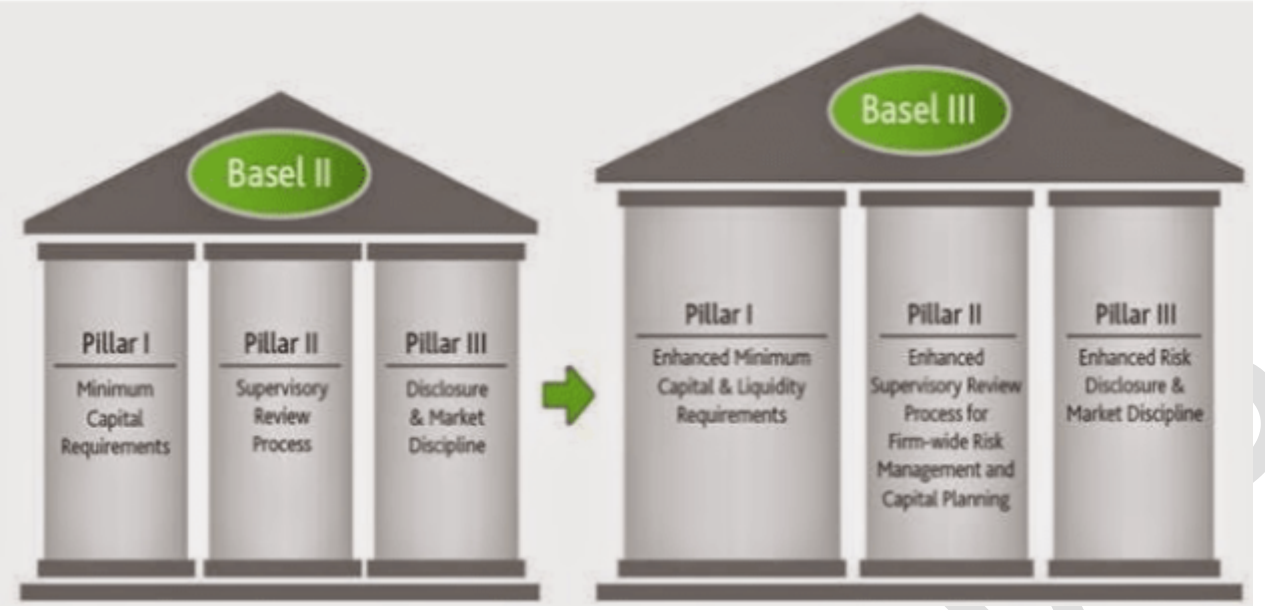
- **Tier 1 Capital**
  - It is bank's **core capital**, which is used when it needs to absorb losses without ceasing its operation.
  - It consists of Paid up Capital, capital reserves out of sale of assets, Balance in P&L account.
  - **Additional Tier-1 capital** are perpetual bonds which carry a fixed coupon payable annually from past or present profits of the bank.

- **Tier 2 Capital**
  - It is bank's **supplementary capital** used to absorb losses if a bank is winding up its assets. This provides a lesser degree of protection to depositors.
  - They include revaluation reserves, general provisions, subordinated term debt, and hybrid capital instruments.

- **Significance of CAR**
  - Minimum CAR are critical to make sure that banks have enough cushion to absorb a reasonable amount of losses before they become insolvent and consequently loss depositor's funds.

- **Basel 1 and Basel 2**
  - In **1988**, BCBS introduced capital measurement system called Basel Capital Accord, also called **Basel 1**. It **focused entirely on credit risk**. Here minimum CAR was kept at 8%.
  - **BASEL II**
    - These were introduced in 2004 by BCBS and were considered a refined and reformed version of Basel-I accord.
      - It expanded the scope of regulation to include operational risk and introduced more sophisticated risk assessment methods.
    - **In India** Basel-II was implemented from 2009.
  - **Basel 3**
    - They were released in Dec 2010. These guidelines were a response to the 2007-08 financial crisis where the banking system realized that the BASEL-II guidelines were not enough to protect bank depositors. It was realized that banks were under-capitalized, over-leveraged, and had a greater reliance on short-term funding.

- **Basel II -> Basel III**




- **Pillar -1: Enhanced Minimum Capital & Liquidity Requirements**: It sets out minimum amount of capital that banks must hold to cover their **credit, market and operational risks**. They are also required to hold a capital conservation buffer to absorb losses during period of stress.
- **Pillar -2: Supervisory Review Process**: Regulators are required to conduct a regular supervisory review of a bank's risk management practices and capital adequacy.
- **Pillar-3**: **Market Discipline**: It requires banks to disclose information about their risk profile, capital adequacy, and risk management practices.

- **Objectives**
  - Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
  - Improve risk management and governance
  - Strengthen bank's transparency and disclosure

- **Major Changes in the Basel Norm for Banking**
  - **Better Capital Quality: Minimum Common Equity and Tier 1 Capital Requirements:**
    - The **minimum requirement of common equity**, the highest form of loss-absorbing capital, has been raised under Basel-III from **2% to 4.5%** of total risk-weighted assets.
    - **The Overall Tier 1 Capital Requirement,** consisting of not only common equity but also other qualifying financial instruments, will also increase from the current minimum **4% to 6%**.
    - Although **the minimum total capital requirement will remain at the current 8%**, yet the required total capital will increase to **10.5%** when combined with **conservation buffer**.
  - **Capital Conservation Buffer**
    - Now banks are required to hold a capital conservation buffer of **2.5%**. The **aim** of asking to build capital conservation buffer is to ensure that banks maintain a **cushion** of capital that can be used to **absorb losses during period of financial and economic stress.**

  - **Counter cyclical Capital Buffer (CCCB)** is another key element of Basel-III norms

- Objective is to increase capital requirements in good times and decrease them in bad times.
- It will slow banking activities when it overheats and will encourage lending when times are tough.
- The buffer will range from **0% - 2.5%** consisting of common equity or other full loss-absorbing capital and will be stored with Central Bank.

» **Leverage Ratio**
- A leverage ratio is a **relative amount of capital to total assets** (not risk-weighted). The aim is to put a cap on swelling of leverage in the banking sector on a global basis.
  - LR = (Tier1 Capital)/ (Total Assets)
- Banks are expected to maintain a **leverage ratio of 3%** under BASEL-III norms.

» **Liquidity Ratio**
- A new **Liquidity Coverage Ratio** (LCR) and **Net Stable Funding Ratio** (NSFR) got introduced in 2015 and 2018 respectively.
- **Liquidity Coverage Ratio** refers to proportion of highly liquid assets held by financial institutions, to ensure their ongoing ability to meet short-term obligations**. Banks are required to hold an amount of high-quality liquid assets that's enough to fund cash outflow for 30 days**. This is aimed to ensure that financial institutions possess suitable capital preservation, to ride out any short-term liquidity disruptions, that may plague the market.
  - LCR is calculated by dividing a bank's high quality liquid assets by its total net cash flows, over a 30-day stress period.
  - **Note: Urjit Patel Committee** has recommended that India should move onto LCR and do away with Statutory Liquidity Ratio (SLR) mechanism. This will make our system aligned with international mechanism. India is still using SLR.

» **Net Stable Funding Requirement (NSFR)**
- Introduced by BASEL-III it is a liquidity standard requiring banks to **hold enough stable funding to cover the duration of their long term assets**. Banks must maintain **a ratio of 100% to satisfy the requirement**.
  - It is defined as the amount of available stable funding (ASF) in relation to the amount of required stable funding.
- The ratio **ensures** that banks do not undertake excessive maturity transformation, which is the practice of using short-term funding to meet the long-term liability.

» **Systematically Important Financial Institutions (SIFI):** As part of the macro-prudential framework, systematically important banks will be expected to have a **loss absorbing capability beyond the Basel-III requirements**.
- Also called G-SIBs (Globally Systematically important banks)
- **No Indian bank** has been listed in this.

## 1) CAR NORMS IN INDIA BY RBI

- Norms/guidelines regarding the capital required to be maintained by banks in India including the Basel III capital regulations, are **issued by RBI**.

- RBI had envisaged implementation of BASEL-III in March 2019. But it was pushed to March 2020. Due to COVID-19 pandemic it was again shifted by 6 months.

- **Capital Adequacy Ratio**: 11.5% (stricter than Basel-III norm of 10.5%)
  - Indian banks need to maintain a minimum capital adequacy ratio (CAR) of **9%**, in addition to a **capital conservation buffer**, which would be in the form of common equity at 2.5% of the risk weighted assets.
    - Indian banks as per RBI directions are required to maintain **5.5% of Common Equity Tier 1** (CET1) as against 4.5% required under the BASEL-III framework.
    - **Note: CAR requirements applied by RBI is stricter than the BASEL-III** norms.
    - **Note2:** In case of SFB and PB, the CAR requirement is that of **15%** from 1st March 2019.

- **Countercyclical Buffer**:
  - The RBI introduced a countercyclical buffer (CCB) for Indian banks, which ranges from 0% - 2.5% of risk weighted assets depending on macro-economic conditions.

- **Leverage Ratio**:
  - The RBI introduced a leverage ratio requirement for Indian banks, which measures leverage ratio (LR) = (Tier1 Capital)/ (Total Assets).
    - The minimum requirement was set at 4.5%, with a bugger of 2.5%.
- **LCR** requires banks to hold a minimum amount high-quality liquid assets (HQLA) to meet the short term liquidity needs.
  - In India LCR was introduced in a phased manner with a minimum requirement of 60% in 2015, increasing to 100% by Jan 2019.

- **NSFR** of **at least 100%** has been mandated by RBI
  - Individual banks may have to adopt stricter standards to reflect funding risks and compliance.
  - Date of applicability will be announced later.
- **Disclosure requirements** (under Pillar-3) have also been introduced.

- **RBI has also revised regulation on the implementation of leverage ratio for banks in India** under the BASEL-III capital regulation. (July 2019)
  - RBI has decided that the minimum leverage ratio shall be **4% for D-SIBS** and **3.5%** for other banks.
  - These guidelines shall be effective from the quarter commencing Oct 01, 2019.

- **RBI extends Basel-III capital framework to AIFIs (All India Financial Institutions)** (Oct 2021)
  - **All India Financial Institutions** include EXIM Bank, NABARD, NHB, SIDBI.
    - The AIFIs are increasingly being seen as key institutions to promote the flow of direct or indirect credit to the economic sectors they cater to.
  - **As per the draft Master Direction on Prudential Regulation or AIFIs**, AIFIs will implement all the three pillars of BASEL-III capital regulations - Pillar 1 covering capital, risk coverage, and

containing leverage, pillar 2 covering risk management and supervision and pillar 3 covering market discipline.

- The RBI wants AIFIs to achieve **minimum total capital of 9% and capital conservation buffer** of 2.5%, with the minimum total capital and CCB adding to 11.5% by 1st April 2022.
  - For NHB, since the financial year is July-June, the implementation shall commence on 1st July 2022.

– **Current Situation in India**: ESI 2022-23:
  - The **Provisioning Coverage Ratio (PCR)** has been increasing steadily since March 2021 and reached 71.6% in Sep 2022.
  - The **CRAR** of SCBs has been rising sequentially in the post-asset quality review period.
    - It remains well-above the minimum capital requirement, including Capital Conservation Buffer (CCB) requirements of 11.5%.

## 3. DOMESTIC SYSTEMICALLY IMPORTANT BANKS

– **Introduction**
  » D-SIBs means the bank is **too big to fail** i.e. their failure would be significant disruption to the essential services they provide to the banking system and the overall economy.
  » According to RBI, these banks have become systematically important due to their size, cross jurisdictional activities, complexity and lack of substitution and inter-connection. Banks whose assets exceed **2% of the GDP** are considered part of this group.
  » Too big to fail indicates that in case of distress **government is expected to support these banks**. Due to this perception, they enjoy certain advantages in funding/investment.

– **D-SIB framework**
  » As per the framework, from 2015, every August, the central bank has to disclose the names of banks designated as D-SIB.
  » It classifies banks under five buckets depending on order of importance.
    - ICICI and HDFC are in bucket-1 and SBI is in bucket-3. (Bucket 1 is lowest and Bucket 5 is highest)

| Bucket | Banks | Additional Common Equity Tier 1 requirement as a percentage of Risk Weighted Assets (RWAs) for FY 2018-19 | Additional Common Equity Tier 1 requirement applicable from April 1, 2019 (as per phase-in arrangement) |
|---|---|---|---|
| 5 | - | 0.75% | 1% |
| 4 | - | 0.60% | 0.80% |
| 3 | State Bank of India | 0.45% | 0.60% |
| 2 | - | 0.30% | 0.40% |
| 1 | ICICI Bank, HDFC Bank | 0.15% | 0.20% |

– Banks classified as D-SIBs are **subjected to additional stability requirements**:
  » They are subjected to additional common equity tier 1 (CET1) capital requirements in addition to capital conservation buffer.
    - The additional CET 1 requirement as a percentage of Risk Weighted Assets for SBI stands at **0.6%, and 0.2% each for ICICI and HDFC Bank**.
  » **Higher Minimum leverage ratio** for D-SIBS: It shall be 4% for D-SIBs and 3.5% for other banks.

– **Note: Global SIBS**:

» **The Basel - Switzerland based** Financial Stability Board (FSB), an initiative of G20 nations, has identified, in consultation with the Basel Committee on Banking Supervision (BCBS), a list of G-SIBS.

- There are 30 G-SIBs currently (no Indian Bank), including JP Morgan, Citibank, HSBC, Bank of America, Bank of China, Barclays, BNP Paribas, Deutsche Bank, and Goldman Sachs.

## 4. DEPOSIT INSURANCE

– **Introduction: Deposit Insurance Situation in India**

» The deposit insurance provisions in India were introduced through the Deposit Insurance Corporation Act, 1962.

- This insurance cover is provided by **Deposit Insurance and Credit Guarantee Corporation (DICGC)**, a fully owned **subsidiary of RBI**. The banks pay deposit insurance premium (0.1% per annum i.e. 10 paisa for Rs 100 insured), which is held by the DICGC and in turn is used to pay deposits if needed.
- Under the act, the Corporation is liable to pay the insured deposit to depositors of an insured bank. Such liability may arise **when an insured bank undergoes**:
  - i. **Liquidation** (sale of assets or closing down of the bank)
  - ii. **Reconstruction or any other arrangement under the scheme**
  - iii. **Merger or acquisition by another bank**
- **Note:**
  - Deposit Insurance and Credit Guarantee Corporation (DICGC) came into existence in 1978 with the merger of Deposit Insurance Corporation (DIC) and Credit Guarantee Corporation of India Ltd. (CGCI).
  - It is a fully owned subsidiary of RBI.

– This insurance cover is available to:

- **Commercial banks**, including small financial banks, Payment Banks, and Indian branches of foreign banks.
- Regional rural banks, Local Area Banks (LABs), and Cooperative Banks
- **All bank deposits** - savings, fixed, current and recurring - payable in India are covered. However, deposits of central/state/foreign governments, inter-bank deposits, deposits of the state land development banks with the state cooperative banks etc. are not covered.

– **Budget 2020-21 increased the deposit insurance** to **Rs 5 lakh**.

- This is the first time since 1993 that the deposit insurance cover has been raised. In 1993 the insurance cover was revised from Rs 30,000 to Rs 1,00,000.
- The **raised cover** will address 98.3% of all deposit accounts by number, and 50.9% of deposits by value.
  - Globally, deposit insurance coverage is only 80 per cent globally and it covers only 20-30 per cent of deposit value.

- **Note-1**: If the funds are in different types of ownership or are deposited into separate banks, they would then be separately insured.
- **Note-2**: Banks have the right to set off their dues from the number of deposits as on cut-off date. The deposit insurance is available after netting of such dues.

- **Problems that remained even after this increased in insured deposit to 5 Lakh**:
  - **When various restrictions**, such as moratorium, etc are imposed on a bank by RBI, genuine depositors continued to face serious difficulties and were unable to access their own money even to the extent of the insured value, despite insurance being in place. Therefore, the **Deposit Insurance and Credit Guarantee Corporation (Amendment) Act, 2021** was enacted.

- **Key Features of the 2021 amendment**
  - ***Introduced interim payments:*** Interim payment will now be made by DICGC to depositors of those banks for whom any restrictions/ moratorium have been imposed by RBI under the Banking Regulation Act resulting in restrictions on depositors from accessing their own savings.
  - ***Timeline for interim payments*****:** Clear-cut timeline of maximum of 90 days has been fixed for providing interim payment to depositors.
    - Within the first 45 days, the insured bank must furnish the details of all outstanding deposits to the Corporation.
    - Within 30 days of the receipt of details, the Corporation will verify the authenticity of the claims and
    - Within 15 days of the verification, the Corporation must make the payment to such depositors.
  - ***Repayment by banks to DICGC:*** *Deferment of repayments*: DICGC may defer repayments due to it from an insured bank after insurance pay out, on terms decided by DICGC's Board. It is in spirit with the rationale of interim payments, i.e., to help depositors while also enabling rescue efforts for the bank
  - ***Timely repayment by the bank to DICGC*****:** To establish the priority of repayment to DICGC (both interest and principal amount), a **provision for penal interest** in case of delay has been put in the act.
  - **No ceiling on premium**: The earlier act earlier had a ceiling of 15 paise on premium, which has been removed. Now, the ceiling on premium will be notified by DICGC, with the prior approval of RBI.

- **Key concerns in deposit insurance mechanism in India and the way forward**
  - No **option for extending** the protection.
  - **Depositors are left in lurch in case of crisis** - for e.g., the recent restrictions on the amount of money that can be withdrawn from PMC. (2021 amendment would reduce this problem)
  - **Uniform insurance premium is unfair for well-functioning banks.**

      - **Jasbir Singh** committee in 2015 also recommended the introduction of risk-based premium for banks.
  - **Only one insurance company** -> limits accurate risk-based pricing of insurance.
      - For e.g., in FY19, DICGC collected Rs 12,043 crore as premium and settled only Rs 37 crore worth claims.
- **Conclusion**
  - The financial system runs on the trust of depositors and denying people the right over their hard-earned money is a colossal hazard for the financial system.
  - Other than the steps for increasing the insured amounts and ensuring immediate availability of deposits for depositors, steps should be taken to bring in more competition in the deposit insurance sector by promoting private players etc., so that banks would be able to choose the best services.

## 5. NPA ISSUE

- **Non-Performing Assets - Basics**
  - » Assets in a banking system comprises of loans given and investments (in bonds etc.) made by banks as these earn interest/profit for banks.
  - » If the interest/ principal instalment of a loan is not paid until due date, it is called **bad loan**.
  - » An asset including a leased asset, becomes non-performing when it ceases to generate income for the bank.
  - » According to RBI **A Non-Performing Asset** is a loan or advance where instalment/interest is due for more than **90 days** in case of a term loan or overdraft account/ credit account. Similarly in case of **agriculture loans** an account becomes an NPA if the instalment/interest remains overdue for two crop season for a short duration crop, or one crop season for a long duration crop.

- **Stressed Assets** refers to all NPAs plus restructured assets plus written off assets.

- **NPAs of Indian Banking System had reached 11.18% in 2018**.

- **Why had NPAs increased so much in the last decade?**
  - I. **Credit Boom in mid 2000s and then the global financial crisis**: In Mid 2000s large corporates were granted loans based on extrapolation of their recent growth and performance. But with stagnating economic growth due to Global financial crisis, their loan returning capabilities decreased.
  - II. **Indian creditors used the strategy of "Giving time to time" and hoped that economic revival will reduce NPAs -> this only led to evergreening of NPAs.**
  - III. **Poor Recognition:** Banks were initially reluctant to recognize NPAs. The true extent of NPA problem only started becoming clear once the RBI initiated the Asset Quality Review in 2015.
  - IV. **Poor Governance and Regulation of Banks - Crony Capitalism - Poor Recovery**
  - V. **Lack of specialization of banks in recovering bad loans / NPAs**
  - VI. **Other Factors which negatively impacted businesses**

- **Key Judicial Decisions**
    - Judicial decisions like abrupt cancellation of coal mines and spectrum allocation led to reallocation through expensive auctioning procedure and thus proved to be a fatal burden on respective business models of power, steel and telecom.
- **Land Acquisition and environmental clearance issues** also blocked a number of projects and contributed towards increasing NPAs.

VII. **Insolvency and Bankruptcy Procedure** has not proved very effective yet.

VIII. **Absence of strict action against bank frauds of high magnitude**

- This is because of absence of a strong law against wilful defaulters and fraudsters

– **IMPACT Of High NPAs**

» **On Banking Sector**

- Decreasing income/Increasing losses for the banks
- Reduces effective internal source of increasing capital which is even under a lot of pressure on account of impeding BASEL-3 guidelines.
- Downgrading of ratings as asset quality deteriorates, this would make international operation and funding difficult.

» **Hinders Economic Growth**

- Accumulation of NPAs in the banking system, specifically in the PSBs, had adverse effects on credit disbursement. Reduction in credit available for market and individual customers led to slowing down of economy.
- The Rise in NPAs occurred with the deterioration of the balance sheet of non-financial firms, and this **twin balance sheet problem** contributed significantly to the deceleration of growth in late 2000s.

» **On Government**

- Increasing **fiscal burden** on government as it has to recapitalize these banks to ensure their proper functioning.

» **On Individuals/ Society**

- **Relatively expensive loans** and decreased interest on deposits.
    - This means that performing borrowers and depositors were effectively being taxed in order to subsidize the non-performing borrowers.
    - Only after demonetization, the interest rates went down because of the flux of cash with the banks
- Less budget/credit available for social welfare programs.
- Eventually its common man's money in the form of deposits which have been lend by banks and is put at risk in case the bank fails.

– **Balance Sheet Syndrome with Indian Characteristics:** High NPAs (TBS problem) have derailed growth in other countries. But huge NPAs have not had as huge an impact as in case of other countries. This is being considered 'Balance Sheet Syndrome with Indian Characteristics.'

- This is because the NPA's are concentrated in **public sector banks** which not only hold their own capital but are ultimately backed by the government who would eventually come to save these banks in case situation gets out of hand. Therefore, creditors have retained confidence in the banking system and there has been no bank runs, no stress in the inter-bank market etc.

- Mid 2000s boom had created **enough infrastructure** (in India's severe supply constraint economy), that there was ample room for the economy to grow after the GFC.

– **4 Key steps in solving the NPA problem** (As suggested by Economic Survey of India 2015-16)
  - **4Rs, Recognition, Recapitalization, Resolution, Reform**
    - **Recognition**: Banks must value their assets as far as possible close to true value (recognition) as the RBI has been emphasizing
      - Asset Quality Review by RBI has done this and brought the real numbers forward.
    - **Recapitalization**: Once the true value of the assets is recognized, the capital position must be safeguarded via infusion of equity (recapitalization).
      - Bank recapitalization has been a regular feature of the Union Budget since 2016-17. Between FY17 and FY21, the centre has infused **about 3.31 lakh crore into banks**.
    - **Resolution**: The underlying stressed assets in the corporate sector must be sold or rehabilitated (resolution) as the government has been desiring.
      - **IBC** has played an important role in increasing recovery.
    - **Reform**: Future incentives for private sector and corporates must be set-right to avoid repetition of the problem.
      - Reform is one area where least progress has been made.
      - Governance structure of the banks have almost remained the same

– **Steps Taken:**
1. **Know your customer (KYC)** norms have been strengthened
2. **Early identification and reporting of stress** - Special Mention Account (As per revised framework for resolution of stressed assets - Feb 2018)
   - Lenders are required to identify incipient stress in loan accounts, immediately on default, by classifying assets as Special Mention Account (SMA) as per the following categories

| **SMA Subcategory** | **Basis for classification -** principal or interest payment or any other amount wholly or partly overdue |
|---|---|
| **SMA-0** | 1-30 days |
| **SMA-1** | 31-60 days |
| **SMA-2** | 61-90 days |

   - This has to be reported to Central Repository of Information on Large Credit (CRILC) on all borrowers' entities having aggregate exposure of Rs 5 crore and above with them.
3. **Asset Quality Review by RBI**
   - To deal with the cases of divergences in identification of NPAs or addition provisioning across banks at the central office level

4. **Indradhanush Scheme**
   - Improving 7 different areas of banks (including capitalization)

5. **Insolvency and Bankruptcy Code (IBC-2016)**
    - To fast track insolvency resolution process and increase the % recovery. This was a more direct path to handle bad loan.
    - It allowed lenders to take defaulting borrowers to NCLT and trigger off bankruptcy proceedings against them.

6. **Fugitive Economic Offenders Act, 2018,** is also acting as a deterrent and may prevent future offenders from running to other countries.

7. **Project Sashakt** (July 2018)
    - **About Project Sashakt**
        - It is a five pronged strategy to resolve bad loans outline - SME resolution approach, bank led resolution approach, AMC/AIF led resolution approach, NCLT/IBC approach and asset trading platform
            1. **SME Resolution Approach (SRA):** Bad loans of upto 50 crore will be resolved at the bank level, with a deadline of **90 days**. For this approach, the committee has also suggested setting up of a steering committee by banks for formulating and validating the schemes, with a provisional for additional funds.
            2. **Bank led resolution approach:** For loans between 50-500 crore, banks will enter an **inter-creditor agreement**, authorizing the lead bank to implement a resolution plan in **180 days**, or refer the asset to NCLT. Here, an independent steering committee appointed by the Indian Banks Association (IBA) will validate the process. The resolution plan has to be approved by lenders holding at least 66% of the debt.
            3. **AMC/AIF led resolution approach:** For loans above 500 crore, the panel envisages one or more Independent Asset Management Company (AMC), supported by institutional funding through the Alternate Investment Fund (AIF).
                - The committee suggested that the bidding process should follow a market-led approach, inviting bids from AMCs, ARCs, and AIF.
                - Existing players, such as ARCIL and the national AMC, will be allowed to set the floor price for the bad assets while other players will be asked to either match the price or better it.
                - The AMC has to redeem security issued to banks by ARCs within 60 day
            4. **Asset trading platform** for performing and non-performing loans
            5. **NCLT/IBC approach**
                - If none of the above approaches work, NCLT will take over under the IBC provisions.

8. **Prompt Corrective Action (PCA) Framework**
    - **What is PCA?**
        - It is a framework under which banks with weak financial matrices are put under watch by RBI.

- The framework uses **three parameters** to measure the weakness of a bank:
  - **Capital Ratio**
  - **Asset Quality**
  - **Profitability**

- **RBI's revised PCA framework for banks applicable from 1st Jan 2022.**
  - The framework would apply on all banks operating in India, including foreign banks operating through branches or subsidiaries based on breach of risk thresholds of identified indicators.
  - **Three parameters** to measure the weakness of the bank: Capital, Asset Quality and Leverage Ratio.
  - **Indicators to be tracked** for capital, asset quality and leverage would be CRAR/Common Equity Tier-1 Ratio, Net NPA Ratio, and Tier 1 Leverage Ratio.
  - **Breach** of any risk threshold may result in invocation the PCA.
  - **Entry:** A bank will generally be placed under PCA framework based on the Audited Annual Financial Results and the ongoing Supervisory Assessment made by RBI.

**PCA matrix – Parameters, indicators and risk thresholds**

| Parameter | Indicator | Risk Threshold 1 | Risk Threshold 2 | Risk Threshold 3 |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5) |
| **Capital (Breach of either CRAR or CET 1 ratio)** | CRAR - Minimum regulatory prescription for Capital to Risk Assets Ratio + applicable Capital Conservation Buffer (CCB)<br><br>**and/or**<br><br>Regulatory Pre-Specified Trigger of Common Equity Tier 1 Ratio (CET 1 PST) + applicable Capital Conservation Buffer (CCB) | Upto 250 bps below the Indicator prescribed at column (2)<br><br>Upto 162.50 bps below the Indicator prescribed at column (2) | More than 250 bps but not exceeding 400 bps below the Indicator prescribed at column (2)<br><br>More than 162.50 bps below but not exceeding 312.50 bps below the Indicator prescribed at column (2) | In excess of 400 bps below the Indicator prescribed at column (2)<br><br>In excess of 312.50 bps below the Indicator prescribed at column (2) |
| | **Breach of either CRAR or CET 1 ratio to trigger PCA** | | | |
| **Asset Quality** | Net Non-Performing Advances (NNPA) ratio | >=6.0% but <9.0% | >=9.0% but < 12.0% | >=12.0% |
| **Leverage** | Regulatory minimum Tier 1 Leverage Ratio | Upto 50 bps below the regulatory minimum | More than 50 bps but not exceeding 100 bps below the regulatory minimum | More than 100 bps below the regulatory minimum |

- **RBI's corrective action plan based on risk threshold**
  - RBI can put **mandatory restrictions** on dividend distribution, branch expansion, and management compensation based on the risk threshold.
    - In an extreme situation, breach of third threshold, would identify bank as likely candidate for resolution through amalgamation, reconstruction or winding up.
  - Further there can be **discretional restrictions** on bank's lending limit, special audit etc.
  - RBI can supersede the bank's board, under the PCA.

- **Idea behind PCA:**
  - Handle problems before they attain crisis situation.
  - Essentially PCA helps RBI monitor key performance indicators of banks, and taking corrective measures, to restore financial health of a bank.

9. **UDAY Scheme** (for state power discoms)
    - As they were one of the largest NPA holders.

10. **Governance Reform in banks**
    - E.g., Separation of the post of CMD and Chairman

- **Impact: Current Situation:**
  - Since 2015-16, RBI and the government have made dedicated efforts in terms of calibrated measures like strengthening the regulatory and supervisory framework, implementation of **4R's** approach of **Recognition, Resolution, Recapitalization,** and **Reforms** to clean and strengthen the balance sheet of the banking system. These continuous efforts have culminated in the enhancement of risk absorption capacity and a healthier banking system balance sheet in terms of asset quantity and quality over the years.
  - **Indian Banks' NPA** has fallen to a **10-year low and is expected to improve further: RBI**
    - **Gross NPAs** of Indian Banks is **3.9%** as of March 2023.
    - **Net NPAs** had dropped to a ten year low of **1.3%** in Sep 2022.
  - **Why decrease:**
    - Lower slippages and reduction in outstanding GNPAs through recoveries, upgrades, and write offs led to this decrease.

- **What more can be done:**
  - **Governance Reform in Banks** and **exit of poorly performing banks.**
    - Financial sector is undergoing structural changes (fintech and other NBFCs) are challenging existing business models.
    - Governance reforms and cost reduction through innovation should be the key to survive in this environment and therefore it is important that inefficient banks should be wind up.
    - Banks have to come up with robust credit worthiness evaluation mechanism.
    - Process of consolidation of banking sector should continue.
  - **Strengthening Insolvency and Bankruptcy Code** as and when loopholes emerge
    - Currently NCLT faces huge work load and hence its resources needs improvement.
  - **Bring back developmental financial institutions.**
  - **Robust and Transparent Secondary market** should be promoted to deal with bad loans.
    - For e.g., in USA, almost a trillion dollar of bad debt is handled every year through an active secondary market which includes ARCs.
    - A robust and transparent secondary market, unhindered by excessive regulation, is an essential element in the vital process of transferring risk from the banks to the capital markets.
  - **Strengthening legal system** to deal with willful defaulters.
    - Currently, willful defaulters are mostly able to go scot free. This will inculcate discipline among the borrowers.

- **Conclusion**
  - Though NPA issue has been resolved, but if the core issues of the banking sector like poor governance, political interference, etc are not resolved, the problem may re-emerge in future.

## 6. TOPICS FOR NEXT BOOKLET

**2) NATIONAL ASSET RECONSTRUCTION COMPANY (BAD BANK)**

**3) VARIOUS TYPES OF BANKS AND FINANCIAL INSTITUTIONS**

**4) INSURANCE SECTOR**

**5) PENSION SECTOR**