Banking System in India

A commercial bank is a type of financial intermediary. It is a financial intermediary because it mediates between the savers and borrowers. It does so by accepting deposits from the public and lending money to businesses and consumers. Its primary liabilities are deposits and primary assets are loans and bonds.

"Commercial bank" has to be distinguished from another type called "investment bank". Investment banks assist companies in raising funds in the capital markets (both equity and debt), as well as in providing strategic advisory services for mergers, acquisitions and other types of financial transactions. It is also called merchant bank.

The commercial banking system in India consists of public sector banks; private sector banks and cooperative banks.

Currently, India has 88 scheduled commercial banks (SCBs) - 25 public sector banks (that is with the Government of India holding majority stake), 31 private banks and 38 foreign banks. Public sector banks hold over 75 percent of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively

Public Sector Banks

They are owned by the Government- either totally or as a majority stake holder.

- State Bank of India and its five associate banks called the State Bank group
- 19 nationalized banks
- Regional Rural Banks mainly sponsored by Public Sector Banks

SBI has five associate banks: State Bank of Bikaner & Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala and State Bank of Travancore. Earlier SBI had seven associate banks, State Bank of Saurashtra and Indore merged with SBI.

Private Sector Banks include domestic and foreign banks

Co-operative Banks are another class of banks and are not considered as commercial banks as they have social objective and profit is the motive.

Reserve Bank of India lays down the norms for banking operations and has the final supervising power.

Development Banks

Development Banks are those financial institutions which provide long term capital for industries and agriculture : Industrial Finance Corporation of India (IFCI) ;Industrial Development Bank of India (IDBI) ;Industrial Credit and Investment Corporation of India (ICICI) that was merged with the ICICI Bank in 2000 ;Industrial Investment Bank of India (IIBI) ;Small Industries Development Bank of India (SIDBI) ;National Bank for Agriculture and Rural Development (NABARD) ;Export Import Bank of India ; National Housing Bank(NHB).

The commercial banking network essentially catered to the needs of general banking and for meeting the short-term working capital requirements of industry and agriculture. Specialized development financial institutions (DFIs) such as the IDBI, NABARD, NHB and SIDBI, etc., with majority ownership of the Reserve Bank were set up to meet the long-term financing requirements of industry and agriculture. To facilitate the growth of these institutions,, a mechanism to provide concessional finance to these institutions was also put in place by the Reserve Bank.

The first development bank in India- IFCI- was incorporated "immediately after Independence in 1948 under the Industrial Finance Corporation Act as a statutory corporation to pioneer institutional credit to medium and large-scale. Then after in regular intervals the government started new and different development financial institutions to attain the different objectives and helpful to five-year plans.

Government utilized these institutions for the achievements in planning and development of the nation as a whole. The all India financial institutions can be classified under four heads according to their economic importance that are:

- All-India Development Banks
- Specialized Financial Institutions(SIDBI)
- Investment Institutions (The Industrial Reconstruction Corporation of India Ltd., set up in 1971 for rehabilitation of sick industrial companies)
- State-level institutions(SFC)

S.H.Khan committee appointed by RBI(1997) recommended to transform the DFI (development finance institution) into universal banks that can provide a menu of financial services and leverage on their assets and talent.

Bank Nationalization

In 1969 and again in 1980, Government nationalized private commercial banking units for channelizing banking capital into rural sectors; checking misuse of banking capital for speculative purposes; to shift from 'class banking' to 'mass banking'(social banking); and to make banking into an integral part of the planning „ process of socio-economic development in the country. Today, no other developing country can boast of a banking system comparable to India's in terms of geographic coverage, operational capabilities, range of services and technological prowess.

Commercial Banks

Today banks are broadly classified into two types - Scheduled Banks and Non-scheduled Banks

Scheduled banks are those banks which are included in the Second Schedule of the Reserve Bank Act, 1934. They satisfy two conditions under the Reserve Bank of India Act

- paid-up capital and reserves of an aggregate value of not less than Rs 5 lakh
- it must satisfy RBI that its affairs are not conducted in a manner detrimental to the depositors.

The scheduled banks enjoy certain privileges like approaching RBI for financial assistance, refinance etc and correspondingly, they have certain obligations like maintaining certain cash reserves as prescribed the RBI etc. The scheduled banks in India comprise of State Bank of India and its associates (5), the other nationalised banks (19), foreign banks, private sector banks, co-operative banks and regional rural banks. Today, there are about 300 scheduled banks in India having a total network of 79,000 branches among them.

Non-scheduled banks are those banks which are not included in the second schedule of the RBI Act as they do not comply with the above criteria and so they do not enjoy the benefits either.

There are only 3 non-scheduled commercial banks operating in the country with a total of 9 branches

Cooperative Banks

Co-operative Banks are organized and managed on the principle of co-operation, self-help, and mutual help. They function with the rule of "one member, one vote" and on "no profit, no loss" basis. Co-operative banks, as a principle, do not pursue the goal of profit maximization.

Co-operative bank performs all the main banking functions of deposit mobilization, supply of credit and provision of remittance facilities.

Co-operative Banks provide limited banking products and are functionally specialists in agriculture related products. However, co-operative banks now provide housing loans also.

Urban Co-operative Banks (UCBs) are located in urban and semi-urban areas. These banks, till 1996, were allowed to lend money only for non-agricultural purposes. This distinction does not hold today. Earlier, they essentially lent to small borrowers and businesses. Today, their scope of operations has widened considerably. Urban CBs provide working capital, loans and term loan as well.

Co-operative banks are the first government sponsored, government-supported, and government-subsidized financial agency in India. They get financial and other help from the Reserve Bank of India, NAB ARE), central government and state governments. RBI provides financial resources in the form of contribution to the initial capital (through state government),working capital, refinance.

Co-operative Banks belong to the money market as well as to the capital market-they offer short term and long term loans.

Primary agricultural credit societies provide short term and medium term loans. State Cooperative Banks (SCBs) and CCBs(Central Cooperative Banks at the district level) provide both short term and term loans. Land Development Banks (LDBs) provide long-term loans.

Long term cooperative credit structure comprises of state cooperative agriculture and rural development bank (SCARDB) at the state level and primary PCARDBs or branches of SCARDB at the decentralized district or block level providing typically medium and long term loans for making investments in agriculture, rural industries, and lately housing. The sources of their funds (resources) are

- ownership funds
- deposits or debenture issues.
- central and state government
- Reserve Bank of India
- NABARD
- other co-operative institutions

- Some co-operative bank are scheduled banks, while others are non-scheduled banks. For instance, SCBs and some UCBs are scheduled banks(included in the Second Schedule of the Reserve Bank of India Act)

Co-operative Banks are subject to CRR and SLR requirements as other banks. However, their requirements are less than commercial banks.

Although the main aim of the co-operative bank is to provide cheaper credit to their members and not to maximize profits, they may access the money market to improve their income so as to remain viable.

Commercial banks and their weaknesses by 1991

The major factors that contributed to deteriorating bank performance upto the end of eighties were

- high SLR and CRR locking up funds
- low interest rates charged on government bonds
- directed and concessional lending for populist reasons
- administered interest rates and
- lack of competition.

The reforms to set the above problems right were

Floor and cap on CRR and floor on SLR removed in 2006

- interest rates were deregulated to make banks respond dynamically to the market conditions
- near level playing field for public, private and foreign banks in entry
- adoption of prudential norms- Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning to make banks safer
- Basel II norms adopted for safe banking
- VRS for better work culture and productivity
- FDI upto 74% is permitted in private banks

One of the sectors that has been subjected to reforms as a part of the new economic policy since 1991 consistently is the banking sector. The objectives of banking sector reforms have been:

- to make them competitive and profitable
- to strengthen the sector to face global challenges
- sound and safe banking
- to help them technologically modernize for customer benefit
- make available global expertise and capital by relaxing FDI norms.

Narasimham Committee

Banking sector reforms in India were conducted on the basis of Narasimham Committee reports I and II (1991 and 1998 respectively). The recommendations of Narasimham committee 1991 .are

No more nationalization

- create a level playing field between the public sector, private sector and foreign sector banks
  select few banks like SBI for global Operations
- reduce Statutory Liquidity Ratio(SLR) as that will leave more resources with banks for lending
- reduce Cash Reserve Ratio(CRR) to increase lendable resources of banks
- rationalize and better target priority sector lending as a sizeable portion of it is wasted and also much of it turning into non-performing asset
- introduce prudential norms for better risk management and transparency in operations
- deregulate interest rates
- Set up Asset Reconstruction Company(ARC) that can take over some of the bad debts of the banks and financial institutions and collect them for a commission.

Divestment in public sector banks led to their listing on the stock exchanges and their performance has improved.

NPAs

Non-performing assets are those accounts of borrowers who have defaulted in payment of interest or installment of the principal or both for more than 90 days.

- RBI rules require that banks should set aside certain amount of money (provisioning) for the NPAs. Gross NPAs include the amount due along with the amount provisioned. Net NPAs include only the amount due.

NPAs are largely a fallout of banks' credit appraisal system, monitoring of end-usage of funds and recovery procedures. It also depends on the overall economic environment, the business cycle and the legal environment for recovery of defaulted loans. Willful default; priority sector problems among the poor etc are also responsible.

High levels of NPAs means: banks' profitability diminishes; precious capital is locked up; cost of borrowing will rise as lendable assets shrink; stock prices of banks will go down and investors will lose; investment suffers etc.

NPAs are classified as sub-standard; doubtful and loss making assets for provisioning requirements.

The following are the RBI guidelines for NPAs classification and provisioning: Sub Standard Assets - These are those accounts which have been classified as NPAs for a period less than, or equal to 18 months.

Doubtful Assets -These are those accounts which have remained as NPAs for a period exceeding 18 months.

Loss Assets - In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value. But a loss asset has not been written off, wholly or partly.

What is being done

- provisioning
- CAR norms
- securitization law
- foreclosure norms
- one time settlement
- interest waiver
- write offs
- debt recovery tribunals

Foreclosure means taking over by the lender of the mortgaged property if the borrower does not conform to the terms of mortgage.

Securitization is the process of pooling a group of assets, such as loans or mortgages, and selling securities backed by these assets.

SARFAESI Act 2002

To expedite recovery of loans and bring down the non-performing asset level of the Indian banking and financial sector, the government in 2002 made a new law that promises to make it much easier to recover bad loans from willful defaulters. Called the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002(SARFAESI), the law has given unprecedented powers to banks, financial institutions and asset reconstruction/securitization companies to take over management control of a loan defaulter or even capture its assets.

Asset Reconstruction Company

Normally banks and FIs themselves recover the loans. But in the case of bad debts(sticky loans), it is outsourced to the ARCs who have built-in professional expertise in this task and who handle recovery as their core business. ARCs buy bad loans from banks and try to restructure them and collect them. ARCs were recommended by Narasimham committee II. ARCIL- the first asset reconstruction company was set up recently.

Prudential Norms

Prudential norms relate to

- income recognition
- asset classification
- provisioning for NPAs
- capital adequacy norms(capital to risk-weighted asset ratio, CRAR).

A proper definition of income is essential in order to ensure that banks take into account income that is actually realized(received) . It helps in classifying an asset as NPA in certain cases. Once classified as NPA, funds must be set apart to balance the bank's operations so as to maintain safety of operations in case of non-recovery of NPAs. Thus, income recognition, asset classification and provisioning norms are inter-related.

Prudential norms make the operations transparent, accountable and safe.

Prudential norms serve two primary purposes: bring out the true position of a bank's loan portfolio and help in prevention of its deterioration.

Basel Norms

Banks lend to different types of borrowers and each carries its own risk. They lend the deposits of public as well as money raised from the market- equity and debt. The intermediation activity exposes the bank to a variety of risks. Cases of big banks collapsing due to their inability to sustain the risk exposures are readily available. Therefore, banks have to keep aside a certain percentage of capital as security against the risk of non-recovery. Basel committee provided the norms called Basel norms to tackle the risk.

Capital to Risk Weighted Assets Ratio (CRAR) as given by the Basel Committee mandates CRAR at 9 percent of the risk weighted assets.. It is the capital that is required to be set aside for absoRBIng risks. It is not to be provisioned from deposits raised but has to be additionally provided from debt, equity, reserves etc.

For the public sector banks, when they could not set aside finances in compliance of prudential norms, Government recapitalized them.

In 1988 Basel committee gave the first set of norms (Basel I) and presently the Basel II norms are being complied with by Indian banks as follows:

- by 2008- foreign banks and Indian banks with overseas operation and
- by 2009 other Indian banks except local area banks and RRBs.

Basel 2 norms are 8% of CRAR.RBI made it 9% for greater security.

India adopted Basel I norms in 1992 as a part of launch of economic reforms.

One of the problems perceived in Basel I norms was that all sovereign debt, in general, was given a risk weight of zero, while all corporate debt was given similarly an equal weight irrespective of the difference in risk of the corporate concerned.

The risk weights led to some curious behavior in lending. Banks started preferring to lend to governments, which required no capital addition, while even risk-free corporates, which had good rating, demanded additional capital provisioning under adequacy norms. Thus, one size fits all approach brought in distortions in lending.

Basel Committee revised Basel 1 norms and announced Basel 2 norms in 2004.

Basel II

Basel-II aims to strengthen bank safety.

Credit Risk

Not only credit risk but also market risk and operational risk are covered. Credit risk

A bank always faces the risk that some of its borrowers may not repay loan, interest or both. This risk is called credit risk, which varies from borrower to borrower depending on their credit quality. Basel II requires banks to accurately measure credit risk to hold sufficient capital to cover it.

Market risk

As part of the statutory requirement, in the form of SLR (statutory liquidity ratio), banks are required to invest in liquid assets such as cash, gold, government and other approved securities. For instance, Indian banks are required to invest 24 per cent of their net demand and term liabilities in cash, gold, government securities and other eligible securities to comply with SLR requirements(2008-09).

Such investments are risky because of the change in their prices. This volatility in the value of a bank's investment portfolio in known as the market risk, as it is driven by the market.

Operational risk

Several events that are neither due to default by third party nor because of the vagaries of the market. These events are called operational risks and can be attributed to internal systems, processes, people and external factors.

Basel II uses a "three pillars" concept:

Pillar 1: Specifies includes more types of risk- credit risk ,market risk and operational risk.

Pillar 2 :Enlarges the role of banking supervisors.

Pillar 3 :Defines the standards and requirements for higher disclosure by banks on capital adequacy, asset quality and other risk management processes.

Capital –Tier l and Tier 2

Capital adequacy norms divide the capital into two categories. Tier one capital is used to absorb losses while the Tier 2 capital is meant to be used at the time of winding up.

Tier I Capital: Actual contributed equity plus retained earnings.

Tier II Capital: Preferred shares plus 50% of subordinated debt (junior debt)

Subordinated debt figures between debt and equity - coming after the first in terms of eligibility for benefits like compensation.

Recapitalization is lending to the bank the resources needed to conform to the capital adequacy norms which stand at 8% today - minimum level.

BIS

The Bank for International Settlements (BIS) is an international organization of central banks which fosters international monetary and Financial cooperation and serves as a bank for central banks." It also provides banking services, but only to central banks, or to international organizations. Based in Basel, Switzerland, the BIS was established by the Hague agreements of 1930.

As an organization of central banks, the BIS seeks to make monetary policy more predictable and transparent among its 55 member central banks. The BIS' main role is in setting capital adequacy requirements to safeguard bank's operations.

Basel 3 Norms

The Bank for International Settlements (BIS) will soon unveil proposals for bank capital as part of what is being called Basel-3 norms. (Global rules for bank capital known as Basel 1 were instituted in 1988. Basel 2 was introduced in 2007). The recent G20 meets endorsed the need for a new set of Basel norms in the light of the global financial and economic crisis since 2008.

Q and A on Basel 3

What are these new Basel rules about?

The Basel committee is a group of bank regulators that meets regularly to decide on risk management rules for banks

The latest rules(Basel 3) are much stricter, and have been agreed in response to the 2008 global financial crisis.The most important rule by far is the "capital adequacy ratio", which sets the minimum cushion of capital a bank must keep to absorb losses on their loans. Banks may need to cut back on their lending in order to comply with the new rules. And in the long run, the rules should prevent a repeat of the credit-fuelled boom seen in the last decade.

What is bank capital?

It is the value of the bank's assets minus its liabilities. When a bank's assets are worth less than its liabilities, it is insolvent - it cannot pay its debts - and should be shut down. So the more capital a bank has, the more losses it can take on its loans before it goes bust.

How do they calculate this capital adequacy ratio?

It is the value of the bank's capital as a percentage of its assets.

Regulators "risk-weight", the assets to calculate the ratio. This means they ignore ultra-safe investments like cash, but heavily weight risky investments, like a loan to a struggling company. Under the new rules, the risk-weightings are being made more cautious, especially for the complex financial transactions that were at the heart of the crisis.

What is the new ratio?

The most important - and the strictest - is the "core capital" ratio. lt will rise more than threefold, from ***2%*** currently, to 7% - although there are "buffers" that allow for flexibility in this number in simple terms, if a bank has Rs.2 of capital, it can currently make a maximum Rs.100 of loans. In future, it must either increase its capital to Rs.7, or else cut its lending to R.28 (because Rs.2 is 7% of Rs.28).

What about these "buffers"?

The 7% ratio includes a 2.5% "capital conservation buffer". This means that in a crisis, a bank will be allowed to let its capital ratio drop temporarily to as low as 4.5%.

But then the bank will be limited from paying bonuses and dividends until it has rebuilt its ratio back to 7%.

There is also an extra 2***5%*** "countercyclical" buffer that will allow regulators to raise the capital requirement to 9.5% during boom times in order to slow down lending.

Then how will banks meet the new capital rules?

A bank has three choices:

It can issue new shares. This gives the bank more money without adding to its liabilities, adding to its capital

It can choose not to pay dividends. Profits not paid out to shareholders are included in its capital

Or it can cut back on lending and make less risky investments. This will reduce its risk-weighted assets, improving its capital adequacy ratio.

How soon do the banks have to do all this?

The new capital rules will be phased in over several years, and will only be fully operational by 20 %..Controversially, the capital conservation buffer will only apply after 2016.That implies there will be no restrictions on banks' ability to pay dividends and bonuses for over three years, even though many banks have far too little capital.

Special allowance has been made for banks rescued during the financial crisis - they will have 10 years to fully comply.

Governments have given their banks so much time because they are afraid that if the change is rushed, then the banks are more likely to cut their lending, pushing the world back into recession.

So is it the same rules for everyone?

The rules set a minimum standard, but some countries may choose to set stricter standards. And it will also be up to individual countries when to apply the counter-cyclical buffer. There are also higher requirements still to come for the biggest banks, whose failure could bring down the entire financial system.

Basel 3 and India

Reserve Bank of India (RBI) does not see higher capital requirements under the proposed Basel III norms hitting Indian banks significantly.

Indian banks are not likely to be significantly impacted by the proposed new capital rules. As on June 30,2010, the aggregate capital to risk weighted assets ratio of the Indian banking system stood at 13.4%, of which Tier I capital constituted 9.3%.

The Basel Committee on Banking Supervision, under the Basel III rules, proposes that banks hold more and better quality capital, besides having more liquid assets.

The norms will also limit banks' leverage and make it mandatory for them to build up capital buffers in good times that can be utilised in periods of stress.

Equity capital and some portion of reserves are together called core capital and it is a part of Tier 1.

Bank Stress Test

What if inflation sky rocketed asset bubbles formed and economic growth ground to a halt? How would banks fare?Banks and government officials charged with overseeing banking systems try to answer these types of questions by performing stress tests—subjecting banks to "unlikely but plausible" scenarios designed to determine whether an institution has enough net wealth—capital—to weather the impact of such adverse developments.

Stress tests of banking systems in Europe in 2010 and the United States in 2009 have generated considerable interest given the impact of the global crisis on the health of the financial system as a whole.

Stress tests are meant to find weak spots in the banking system at an early stage, and to guide preventive actions by banks and those charged with their oversight.

Stress test results depend on how pessimistic the scenarios' assumptions are, and should be interpreted in light of the assumptions made.

In the wake of the 2008 failure of investment bank Lehman Brothers, and of the worst global financial and economic crisis in 80 years, those who design stress tests are taking a long, hard look at what constitutes "unlikely but plausible" scenarios.

There are many different types of stress tests, with different uses. Some are carried out by banks themselves to help manage their own risks. Some are done by supervisors as part of their ongoing oversight of individual banks and banking systems. Many of these tests are never published.

There is one thing that almost all stress tests have in common. They are typically carried out to shed more light on a few key types of-threats to banks' financial health: credit and market risk

Credit and market risks

Credit and market risks are key because they affect banks' profits and solvency. Credit risks reflect potential losses from defaults on the loans a bank makes, including consumer loans, such as mortgages, and corporate loans. Stress tests for credit risk examine the impact of rising loan defaults, or non-performing loans, on bank profit and capital.

Market risk stress tests gauge how changes in exchange rates, interest rates, and the prices of various financial assets, such as equities and bonds, affect the value of the assets in a bank's portfolio, as well as its profits and capital. Typically, the test would assume a drop in the value of the various assets in the bank's portfolio. The changes in asset prices and default rates are often linked to a negative economic scenario in which, among other things, unemployment climbs and economic growth plummets.

Shadow banks

NBFCs are largely referred to as shadow banking system or the shadow financial system. They have become the major financial intermediaries. As seen in the note on NBFCs elsewhere, shadow institutions do not accept demand deposits and therefore are not subject to the same regulations. Familiar examples of shadow institutions included Bear Stearns and Lehman Brothers. Hedge funds, pension funds, mutual funds and investment banks are some examples.

Shadow institutions are not as effectively regulated as banks and so carry higher risk of failure.

FDI in Banks

A **foreign bank or its wholly owned subsidiary regulated by a financial sector regulator in the host country can now invest up to 100% in an Indian private sector bank** This option of 100% FDI will be only available to a regulated wholly owned subsidiary of a foreign bank and not any investment companies. Other foreign investors can invest up to 74% in an Indian private sector bank, through direct or portfolio investment.

The Government has also permitted foreign banks to set up wholly owned subsidiaries in India.The government, however, restricted voting rights to 10% cap to the extent of shareholding.

The new FDI norms will not apply to PSU banks, where the FDI ceiling is still capped at 20%.

Universal Banking in India

Universal banking in India was recommended by the second Narasimham Committee (1998) and the Khan Committee (1998) reports. It aims at widening and integration of financial activities.

Universal Banking is a multi-purpose and multi-functional financial supermarket. 'Universal banking' refers to those banks that offer a wide range of financial services, beyond the commercial banking functions like Mutual Funds, Merchant Banking, Factoring, Credit Cards, Retail loans, Housing Finance, Auto loans, Investment banking, Insurance etc. This is most common in European countries.

Benefits to banks from universal banking are that, since they have competence in the related areas, they can reduce average costs and thereby improve spreads(difference between cost of borrowing and the return on lending) by diversification. Many financial services are inter-linked activities, e.g. insurance, stock broking and lending. A bank can use its instruments in one activity to exploit the other, e.g., in the case of project lending to the same firm which has purchased insurance from the bank. To the customers, 'one-stop-shopping' saves transaction costs.

However, one drawback is that universal banking leads to a loss in specialization. There is also the problem of the bank indulging in too many risky activities. ICICI(Industrial Credit and Investment Corporation of India) merged with its subsidiary-ICICI Bank in a reverse merger(parent merging with the subsidiary, the ICICI Bank). Other banks are also emerging as universal banks which are popular in Europe.

The compulsions for the DFIs like ICICI, IDBI, IFCI etc to become UBs is the following:

Earlier in the sixties and seventies, the DFIs specialized in project finance for the industries with long term capital needs. But the industries of late are mobilizing the finances from external sources or from the stock market and so the DFI business suffered. The cheap Government funds that were available in the earlier pre-liberalization era also are not available today. Banks and DFIs are having to compete for the same clients. Banks have an advantage in that they have a deposit **base but the DFIs** do not have same.

Financial inclusion

Many people, particularly those living on low incomes, cannot access mainstream financial products such as bank accounts and low cost loans. This financial exclusion forces them to borrow from the moneylenders at high cost. Therefore, financial inclusion has been the goal of government's policy since late sixties.

Financial inclusion or taking banking services to the common man was the main driver of bank nationalization in 1969 and 1980 powered by three priority areas

- access to banking
- access to affordable credit, and
- access to free face-to face money advice.

Thus, financial inclusion is the delivery of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups. The Government of India's rationale for creating Regional Rural Banks (RRBs) in the years in 1975 following the nationalization of the country's banks was to ensure that banking services reached poor people.

The branches of commercial banks and the RRBs grew from 8,321 in 1969 to about 70,000.

Priority sector credit under which 40% of all bank advances should go to certain specified areas like agriculture is a form of directed credit that is aimed at financial inclusion.

Micro-finance(savings, insurance and lending in small quantities) and self help groups are another innovation in financial inclusion.

Differential rate of interest; kisan credit cards; no-frills account (allowing opening of account with very little or no minimum balances)etc are examples of financial inclusion.

Scaling-up access to finance for India's rural poor, to meet their diverse financial needs (savings, credit, insurance, etc.) through flexible products at competitive prices is the goal of financial inclusion.

The total number of no-frill accounts opened over a two-year period (April 1, 2007 to May 30,2009) stands at 25.1 million.

While it is beyond doubt that financial access of the people has significantly improved in the last three-and-a-half decades, and even more so in the last two years, the focus now should be on how to accelerate it as financial inclusion is important for economic growth, equity and poverty alleviation.

Unique identification number has some advantages for financial inclusion

KYC (know your customer) bottlenecks will be dramatically reduced. Millions of new customers will become bankable. Growth will get a boost. Risk management will undergo a paradigm shift. Credit histories will be available on tap. Profitability will improve and so will customer service. We could finally have a technology initiative to extend financial inclusion .

Bank consolidation .

Merging public sector banks to form big and globally aspiring banks is bank consolidation. It is expected to bring about financial stability and was recommended by the Narasimham Committee-II (1997) on financial sector reform.

State Bank of Saurashtra's merger with SBI has been achieved and the remaining six are to be merged. Government says that bigger banks can take on competition; can raise more than smaller banks;

Rationalising the manpower and branch network after bank mergers is a challenge and the criticism also includes that the bigger banks will be so much more bureaucratized. Bigness also does not reduce chances of failure as seen in the west in the current meltdown.

India has more than 175 commercial banks, out of which 28 state-run banks account for the majority of the banking sector's assets followed by private sector banks and foreign banks, which have a tiny share.

Financial stability

Financial stability is a situation where the financial system operates with no serious failures or undesirable impacts on development of the economy as a whole, while showing a high degree of resilience to shocks.

Financial stability may be disturbed both by processes inside the financial sector leading to the emergence of weak spots like excessive of leverage; dealing in doubtful products like collateralized debt options(CDS) etc. It can also be undermined through regulatory lapses and inadequate safeguards prescribed by law.

In India, the banking system was not impacted badly by the world financial crisis as Indian banks are well-regulated through proper supervision. They are also well capitalized through capital adequacy ratio according to the Bank of International Settlements(Basel, Switzerland).

Calibrated globalization also meant that we would open upon only on achieving the strength to compete successfully.

Core banking

Core Banking is normally defined as the business conducted by a banking institution with its retail and small business customers. Many banks treat the retail customers as their core banking customers, and have a separate line of business to manage small businesses. Larger businesses are managed via the Corporate Banking division of the institution. Core banking basically is depositing and lending of money.

World bank recapitalization

Government of India has made an assessment that the public sector banking system would need as much as Rs.3 5(000 crore worth of Tier-1 capital by 2012, given projections of how much their business needs to expand. Past divestment of equity has significantly reduced the government's shareholding in many public sector banks. Hence, it is argued, if 51 per cent government ownership has to be maintained to secure the public sector character of these banks, this recapitalization has to be in the form of new government equity capital. Since the government is strapped for funds for this purpose, it has decided to use this requirement as the basis for opting for a sector-specific$2billionWorldBankloan.

Banks stress tests

A stress test is an assessment or evaluation of a bank's balance sheet to determine if it is viable as a business or likely to go bankrupt when faced with certain recessionary and other stress situations- whether it has sufficient capital buffers to withstand the recession and financial crisis. European banks were recently subjected to such stress tests.

Financial sector reforms

Reforming the financial sector - banking, insurance, pension reforms- is crucial to make them generate resources; gain efficiencies; innovate new products and serve the economy and people well. It involves adoption of best practices in regulation and other areas like micro finance etc. The need is particularly felt in the wake of the global financial crisis brought about essentially by the financial sector that ruined the real economy related to production.

Some recent initiatives in this sector relate to introduction of base rate for banks; setting up of Financial Stability and Development Council; business correspondent model for financial inclusion.

There is a need however to improve the regulation of the NBFCs as they borrow from banks and lend which means if they are not properly regulated, the whole financial system is vulnerable.

CRR and SLR have been freed from floor and cap to make banking more flexible.

Consolidation of banks is taking place so that benefits of scale can push Indian banks to global heights. State Bank of Saurashtra is merged with SBI and State Bank of Indore is also being merged. Bank of Rajasthan has been acquired by ICICI Bank and merged with the latter.

However, in the insurance sector, reforms are still due. The Insurance Laws (Amendment) Bill, 2008, which was introduced by the government in the Rajya Sabha in 2008, provides for enhancement of share holdings by a foreign company from 26% to 49%. The Bill is pending parliamentary approval.

Pension reforms are taking place. NPS has been introduced. Private sector entities have been invited to manage pension funds of Central government employees. Thus, there is dynamism imparted to mobilization of pension funds and their deployment to reduce government's fiscal burden and generate higher savings for the pensioners.

Debt market: The bond market in India remains limited in terms of nature of instruments, their maturity, investor participation and liquidity .Recent reforms include raising of the cap on investment by foreign institutional investors, or FIIs, from $6 billion to $15 billion.

Regulatory reforms- setting up of the FSDC is crucial for better supervision and clear demarcation of the jurisdiction.

The roadmap for financial sector reforms has been defined by the RH Patil, Percy Mistry & Raghuram Rajan reports.

RBI and financial stability

Recent global financial crisis is largely attributed to the financial sector recklessness due to lack of quality regulation. The lesson to draw from the crisis is to provide for good regulation- need not be more regulation- by the Central bank so that there is financial stability. Traditionally, central bank is the institution that is given the function to regulate the financial system of which banks are the lifeline.

In India, RBI has performed the role by the following instruments Licensing of banks

Deciding on who can set up a bank, expand etc SLR, CRR norms CAR rules Lender of last resort Laying down prudential norms Supervisory functions

RBI Governor heads the HLCC- High Level Coordination Committee of financial regulators of SEBI, PFRDA and IRDA.

RBI defines from time to time NPA norms; allows or limits or banks credit to certain sectors like real estate in order to make banking operations safe and stable.

Interest rates are also changed through repo and reverse repo rates to caution the borrowers and consumers.

How Indian banks survived the global crisis

Even though many banks failed and some survived on huge bailouts in the west due to the global financial crisis, Indian banking is almost unscathed for the following reasons

- Public sector banks- 27- dominate
- FDI is 74% in private banks but voting rights are only 10%
- We adopted capital account convertibility in a measured manner
- RBI has been conservative and regulated the banks well. Banks were not allowed to invest in risky instruments like credit default swaps(CDS)
- Basel norms, SLR and CRR levels were well maintained
- Prudential norms also saved the Indian banks from recklessness.

Financial Inclusion and the recommendations of the Ragarajan Panel

Access to finance by the poor and vulnerable groups is a prerequisite for poverty reduction and social cohesion. This has to become an integral part of our efforts to promote inclusive growth. Financial inclusion means delivery of financial services at an affordable cost to the vast sections of the disadvantaged and low-income groups. The various financial services include credit, savings, insurance and payments and remittance facilities. The objective of financial inclusion is to extend the scope of activities of the organized financial system to include within its ambit people with low incomes.

NSSO data reveal that 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households do not access credit, either from institutional or non-institutional sources. Further, despite the vast network of bank branches, only 27% of total farm households are indebted to formal sources (of which one-third also borrow from informal sources). The poorer the group, the greater is the exclusion.

While financial inclusion can be substantially enhanced by improving the supply side or the delivery systems, it is also important to note that many regions, segments of the population and sub-sectors of the economy have a limited or weak demand for financial services. In order to improve their level of inclusion, demand side efforts need to be undertaken including improving human and physical resource endowments, enhancing productivity, mitigating risk and strengthening market linkages.

The Committee on Financial Inclusion headed by Shri C. Rangarajan, submitted its report in 2008 and recommended that the semi-urban and rural branches of commercial banks and Regional Rural Banks may set for themselves a minimum target of covering 250 new cultivator and non-cultivator households per branch per annum, with an emphasis on financing marginal farmers and poor non-cultivator households for achieving financial inclusion.

The Committee feels that the task of financial inclusion must be taken up in a mission mode as a financial inclusion plan at the national level. A National Mission on Financial Inclusion (NaMFI) comprising representatives from all stakeholders may be constituted to aim at achieving universal financial inclusion within a specific time frame. The Mission should be responsible for suggesting the overall policy

changes required for achieving the desired level of financial inclusion, and for supporting a range of stakeholders - in the domain of public, private and NGO sectors - in undertaking promotional initiatives.

A National Rural Financial Inclusion Plan (NRFIP) may be launched with a clear target to provide access to comprehensive financial services, including credit, to atleast 50% of financially excluded households, by 2012 through rural/semi-urban branches of Commercial Banks and Regional Rural Banks. The remaining households, with such shifts as may occur in the rural/urban population, have to be covered by 2015.

There is a cost involved in this massive exercise of extending financial services to hitherto excluded segments of population. The Committee proposed* the constitution of two funds with NABARD - the Financial Inclusion Promotion & Development Fund and the Financial Inclusion Technology Fund with an initial corpus of Rs. 500 crore each to be contributed in equal proportion by GOI / RBI / NABARD. In 2007-08 the Government had set up a Financial Inclusion Fund and a Financial Inclusion Technology Fund in NABARD, to reach banking services to the unbanked areas. To give momentum to the pace of financial inclusion, Union Budget 2010-2011 proposed an augmentation of Rs.100 crore for each of these funds, which shall be contributed by Government of India, RBI and NABARD.

Extending outreach on a scale envisaged under NRFIP would be possible only by leveraging technology to open up channels beyond branch network. Adoption of appropriate technology would enable the branches to go where the customer is present instead of the other way round. This, however, is in addition to extending traditional mode of banking by targeted branch expansion in identified districts. The Business Facilitator/Business Correspondent (BF/BC) models riding on appropriate technology can deliver this outreach and should form the core of the strategy for extending financial inclusion. The Committee has made some recommendations for relaxation of norms for expanding the coverage of BF/BC. Ultimately, banks should endeavour to have a BC touch point in each of the 6,00,000 villages in the country.

RRBs, post-merger, represent a powerful instrument for financial inclusion. Their Outreach vis-a-vis other scheduled commercial banks particularly in regions and across population groups facing the brunt of financial exclusion is impressive. RRBs account for 37% of total rural offices of all scheduled commercial banks and 91% of their workforce is posted in rural and semi-urban areas. They account for 31% of deposit accounts and 37% of loan accounts in rural areas. RRB's have a large presence in regions marked by financial exclusion of a high order. RRBs are, thus, the best suited vehicles to widen and deepen the process of financial inclusion. However, there has to be a firm reinforcement of the rural orientation of these institutions with a specific mandate on financial inclusion. The Committee has recommended the recapitalisation of RRBs with negative Net Worth and widening of their network to cover all unbanked villages in the districts where they are operating, either by opening a branch or through the BF/BC model in a time bound manner. Their area of operation may also be extended to cover the 87 districts, presently not covered by them.

The SHG - Bank Linkage Programme can be regarded as the most potent initiative since Independence for delivering financial services to the poor in a sustainable manner. It needs to be extended to urban areas more. The Committee has recommended amendment to NABARD Act to enable it to provide micro finance services to the urban poor.

JLBs are proposed by the committee. It is like the SHG but is confined to farming operations mainly .A Joint Liability Group (JLG) is an informal group comprising preferably of 4 to 10 individuals coming together for the purposes of availing bank loan either singly or through the group mechanism against mutual guarantee. The JLG members are expected to engage in similar type of economic activities like crop production.

Micro Finance Institutions (MFIs) could play **a** significant role in facilitating inclusion, as they are uniquely positioned in reaching out to the rural poor. The committee feels that legislation to regulate the microfinance sector is essentiaLFor example, The Micro Financial Sector (Development and Regulation) Bill, 2007

Basics of Base Rate

What is the base rate (BR)?

It is the minimum rate of interest that a bank is allowed to charge from its customers. Unless mandated by the government, RBI rule stipulates that no bank can offer loans at a rate lower than BR to any of its customers.

How is the base rate calculated?
A host of factors, like the cost of deposits, administrative costs, a bank's profitability in the previous financial year and a few other parameters, with stipulated weights, are considered While calculating a lender's BR. The cost of deposits has the highest weight in calculating the new benchmark. Banks, however, have the leeway to take into account the cost of deposits of any tenure while calculating their BR. For example, SBI took costs of its 6-month deposits into account while calculating its BR, which it has fixed at 7.5%.

When did the base rate come into force?
It is effective from Thursday, July 1. However, all existing loans, including home loans and car loans, continue to be at the current rate. Only the new loans taken on or after July 1 and old loans being renewed after this date are be linked to BR.

How is it different from bank prime lending rate?
BR is a more objective reference number than the bank prime lending rate (BPLR) — the current benchmark. BPLR is the rate at which a bank lends to lend to its most trustworthy, low-risk customer. However, often banks lend at rates below BPLR. For example, most home loan rates are at sub-BPLR levels. Some large corporates also get loans at rates substantially lower than BPLR. For all banks, BR will be much lower than their BPLR.

How often can a bank change its Bank Rate?

A bank can change its Bank Rate every quarter, and also during the quarter. What does it mean for corporate borrowers?

Under the BPLR system, large corporates who enjoyed rates as low as 4-6% will be hit. What are its benefits?

Makes the lending rates transparent. Monetary policy changes will find genuine transmission. Cross subsidation of the corporate at the expense of MSMEs will stop and MSMEs will get credit more affordably.

What are the exceptions?
Educational loans, export credit, credit to weaker sections can be given at sub-base rate.

Securities and Insurance Laws (Amendment) and Validation Bill, 2010

United Linked Invest Plans(Ulips) are the insurance products in which payment is made partly for premium(insurance) and rest of it invested in the capital market like a Mutual Fund investment. It led to jurisdictional disputes between SEBI and IRDA. SEBI says that a huge amount of Ulip is invested in stock market. Government promulgated an ordinance to set up a mechanism to regulate such jurisdictional disputes.

Financial sector is inter-related. Banks keep money that is invested in stock market. Insurance companies have stock market related products like Ulips. Pension funds are becoming popular in the stock market. These players can have mutual problems of jurisdiction as seen in the case of Ulips. Therefore, there is a need for a "super regulator'.

Parliament passed a Bill- Securities and Insurance Laws (Amendment) and Validation Bill, 2010 -that provides a mechanism, headed by the finance minister, to resolve disputes between financial regulators as an ad-hoc arrangement. It has representations from the four financial sector regulators and the Finance Ministry- SEBI, IRDA, RBI and PFRDA.

The Bill states that the Reserve Bank Governor will be the vice-chairman of the joint committee. The joint body can entertain only jurisdictional issues . Even here, first the involved parties should settle it between them

However, there were apprehensions expressed by RBI over its autonomy.

The government is still working on a permanent body to settle the inter-regulator disputes such as the SEBI-IRDA turf war.
The criticism is that there is already a High level Coordination Committee with RBI Governor heading it and there is no need for the current mechanism. It has lead to politicization.

CDS: Q and A

What is a credit default swap?
A credit default swap is a bilateral contract where one party buys and another party sells protection on a credit instrument, which could either be a bond or a loan, in case of occurrence of a 'credit event'. If the reference bond performs without default, the buyer of the swap makes interim payments to the seller till maturity. If the bond or the credit instrument defaults, then the seller pays par value of the bond to the buyer.

A default is referred to as a "credit event" and includes such events as failure to pay, restructuring or bankruptcy.

What is the difference between a CDS and credit insurance?

The buyer of a CDS does not need to own the underlying security or other forms of credit exposure; in fact the buyer does not even have to suffer a loss from the default event.

Teaser rates: Q and A

What are teaser rates?
Teaser loan rates are special home loan rates that are called so, as the banks attract customers by offering them lower rates of interest in the initial years and then, in the longer run, the rates are shifted from fixed to floating rates or the market-adjusted rates.

In the months that followed the collapse of Lehman Brothers, the Indian Banks' Association, nudged by the government, formulated a scheme where interest rates for loans up to 5 lakh and loans up to 20 lakh were available at discounted rates of 8.5% and 9.25%, respectively, for the first five years. This was a limited period scheme, which was part of the stimulus measures announced by the government.

Why have teaser loans received a bad name?
Teaser home loans have received a bad name because of the sup-prime crisis in the US. In America, many lenders encouraged borrowers to take on home loans they could not afford by offering them teaser rates for the initial years. As long as home prices rose, many borrowers were able to take second loans on their property and meet their obligations. But when home prices stabilized, many borrowers were not in a position to repay and banks found it difficult to realize their loans.

What are the banks' arguments?
India faces a housing shortage of 19 million homes, which means that the demand is unlikely to fall. Also, the systemic risk is lower because in India, the average loan-to-value ratio is below 80%, which means that lenders have a good chance of recovering , their loans in a.default.

Why is it a cause of concern for RBI?

RBI's concern over teaser rates has to be seen in conjunction with its concern over the sudden rise in real estate prices, which have jumped 60% in less than two years in some centres. RBI fears that teaser rates might facilitate individuals to make expensive bets on property. If interest rates rise sharply after two years, many borrowers might find it difficult to afford to pay their instalments and if there is a simultaneous correction in real estate prices, it could also lead to a rise in defaults. To reduce these risks, RBI raised the standard provision on teaser loans from 0.40% to 2% .

Inflation-indexed bonds:
Q and A
The Reserve Bank of India released a technical paper on inflation-indexed bonds in December 2010.

What are bonds?

Bonds are fixed income securities or financial instrument through which an investor loans money to an entity in return for a periodic interest payments (coupon) and repayment of the amount loan at the end of the agreed maturity.

The rate of interest demanded by investors is based on risk profile of the borrower, inflation expectation over the maturity period and the real yield demanded. That is an investor expects a real rate of return after adjusting for inflation.

What is the inflation risk in investing in regular bonds?

The fixed rate of return demanded by investors is based on inflation expectation. There is a chance that the actual inflation over the maturity period of bond turns out to be higher than his inflation expectation.

In such a case, the investor could end up with a negative rate of return. How do inflation-indexed bonds reduce risk for

investors?

Inflation-indexed bonds assures investors a fixed real rate of return. That is the return that an investor gets will be a fixed premium over some measure of inflation such as the wholesale price index.

This means that the interest payment that investors would receive would tend to vary from year to year, depending on the rate of inflation. But investor will be protected because he would get a real rate of return on investment. These are particularly beneficial to investors such as pension and retirement funds that want to invest funds for long periods.

The structure proposed by the RBI has suggested that while coupon, or the rate or interest, will remain fixed the principal will be indexed to inflation. For example, if an investor invests in a bond of face value of Rs 100 for a ***5%*** interest rate after one year in which average inflation is 5% the principal will be increased to Rs 105 after one year and the 5% return will be calculated on this higher amount.

One variant of the inflation-indexed bond, capital index bond, was issued in India in 1997 wherein only principal repayment at the time of redemption was indexed to inflation. The response to the issuance was muted, as interest payments were not protected against inflation.

RBI Discussion Paper on entry of new banks in the private sector

The Reserve Bank of India released in August 2010 the Discussion Paper on "Entry of New Banks in the Private Sector". The paper seeks views/comments of banks, non-banking financial institutions, industrial houses, other institutions and the public at large. Suggestions and comments are invited on the following aspects delineated in the Discussion Paper:

- Minimum capital requirements for new banks and promoters contribution
- Minimum and maximum caps on promoter shareholding and other shareholders
- Foreign shareholding in the new banks
- Whether industrial and business houses could be allowed to promote banks
- Should Non-Banking Financial Companies be allowed conversion into banks or to promote a bank
- Business model for the new banks

After receiving feedback, comments and suggestions on the possible approaches discussed in this paper and detailed discussions with the stakeholders, comprehensive guidelines for licensing of new banks would be framed and applications invited for setting up new banks.

Public Sector Bank recapitalization

The Government approved to provide an additional amount of Rs. 6000 crore, in addition to the Rs. 15000 crore already provided in the Budget 2010-11, to ensure Tier I CRAR(Capital to Risk Weighted Assets) of Public Sector Banks (PSBs) and also to raise Government of India holding in all PSBs to 58%.

The proposed capital infusion would enhance the lending capacity of the PSBs to meet the credit requirement of the economy in order to maintain and accelerate the economic growth momentum.

This additional availability of capital is likely to benefit employment oriented sectors, especially agriculture, micro & small enterprises, export, entrepreneurs etc.

During the recent global financial crisis, the Public Sector Banks (PSBs) played a pivotal role in the economy by extending credit to all the productive sectors of the economy.

These banks, in this backdrop, would require capital commensurate with the increase in their Risk Weighted Assets (RWAs). Though the minimum regulatory requirement of Capital to Risk Weighted Assets (CRAR) for the banks is 9%, the Government has mandated a total CRAR of 12% with 8% Tier I Capital. Keeping, all other factors, the Finance Minister, in his Budget speech for the year 2010-11 announced that capital would be infused in the PSBs so that these are able to attain a minimum 8 percent Tier I Capital by 31st March, 2011.

There are many PSBs where the Government of India's holding is close to 51%. This implies that in case of need, these banks cannot access the capital market for •raising additional capital by dilution of Government holding. The present capitalization process of the PSBs has presented an opportunity to the Government to raise its shareholding in the PSBs, specially in those PSBs where the Government's holding is close to 51%. This will enable the PSBs to raise additional capital from the market, in future, without depending upon the Government.

Recapitalization is a process of changing a firm's capital structure by altering the mix of debt and equity financing without changing the total amount of capital.