RBIs new guidelines for PSBs

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Manifest pedagogy:

Banking and Finance is a major factor for the stress in Indian economy today. UPSC might delve into steps, programmes and initiatives with respect to prelims and ask for overall analysis of the impact and significance of stress in the banking sector. Also, one has to focus on interlinking of financial sector to Fintech and Globalisation 4.0 in an era of increasing uncertainties

In news:

- RBI has set new guidelines for making top appointments in Public Sector Banks (PSBs).

Placing it in syllabus:

Financial Sector Reforms after 1991 – Banking

Static dimensions:

- "CAMELS" Approach
- Mission Indradhanush

Current dimensions:

- New guidelines for Appointments
- Norms under BASEL 1, 2 and 3

Content:

CAMELS:

- The acronym "CAMEL" refers to the five components of a bank's condition that are assessed: **Capital adequacy, Asset quality, Management, Earnings, and Liquidity**.

- A sixth component, a bank’s **Sensitivity to market risk,** was added in 1997; hence the acronym was changed to CAMELS.
- Ratings are assigned for each component in addition to the overall rating of a bank’s financial condition.
- The ratings are assigned on a scale from 1 to 5.
- Banks with ratings of 1 or 2 are considered to present few, supervisory concerns, while banks with ratings of 3, 4, or 5 present moderate to extreme degrees of supervisory concern.

Various studies have been conducted in India as well on various banks using CAMELS framework. Different banks are ranked according to the ratings obtained by them on the six parameters. The results show that there is a statistically significant difference between the CAMELS ratios of all the PSBs in India, thus, signifying that the overall performance of PSBs is different. Also, the banks with least ranking need to improve their performance to come up to the desired standards

Mission Indradhanush:

- Mission Indradhanush is a 7 pronged plan launched by Government of India to resolve issues faced by Public Sector banks.
- It aims to revamp their functioning to enable them to compete with Private Sector banks

- Many of the measures taken were suggested by P J Nayak committee on Banking sector reforms as indicated.
- The 7 parts include **appointments, Banks board bureau(BBB)**, **capitalisation, de-stressing, empowerment, framework of accountability and governance reforms (ABCDEFG)**

Appointments – separation of the posts of CEO and MD to check excess concentration of power and smoothen the functioning of banks. Induction of talent from the private sector (recommendation of P J Nayak Committee)

Bank Boards Bureau – will replace the appointments board of PSBs.

- The Banks Board Bureau has its genesis in the recommendations of The Committee to Review Governance of Boards of Banks in India, May 2014.
- The Bureau started functioning from April 01, 2016 as an autonomous recommendatory body.
- The Bureau is engaging with various stakeholders with the objective of helping the banks in the public sector universe to take on the competition, have the ability to appropriately manage and price risk across business cycles, develop resilience to generate internal capital and have the capacity to generate external capital.
- The Bureau is also engaging with the PSBs to help build capacity to attract, retain and nurture both talent and technology.
- It will advise the banks on how to raise funds and how to go ahead with mergers and acquisitions.
- It will also hold bad assets of public sector banks.
- It will separate the functioning of the banks from the government by acting as a middle link.

Capitalisation – Capitalisation of the banks by inducing Rs 70,000 crore into the banks in the next 4 years. Banks are in need of capitalisation due to high NPAs and due to need to meet the new BASEL- III norms.

De-stressing – Solve issues in the infrastructure sector to check the problem of stressed assets in banks.

Empowerment – Greater autonomy for banks; more flexibility for hiring manpower

Framework of accountability– The banks will be assessed on the basis of new key performance indicators. These quantitative parameters such as NPA management, return on capital, growth and diversification of business and financial inclusion as well as qualitative parameters such as human resource initiatives and strategic steps to improve assets quality.

Governance Reforms – **Gyan Sangam conferences** between government officials and bankers for resolving issues in the banking sector and chalking out future policy.

New guidelines for the appointment of directors for PSBs:

- RBI has tightened the ‘fit-and-proper’ criteria for directors on the boards of state-run banks, and said the Centre’s nominee director shall not be part of the nomination and remuneration committee (NRC).
- The revised criteria for the first time, laid down an exhaustive list for the disqualification of directors.
- The terms with regard to the NRC and the manner of the appointment of directors have been aligned with the practice in private banks, the recommendations made by the Banks Board Bureau, and with the provisions in the Companies Act.
- While the **revised norms are applicable only to public sector banks (PSBs)**, separate guidelines for private banks and non-banking financial companies (NBFCs) may be our soon.
- The NRC will have a minimum of three non-executive directors from amongst the board of directors and of this, not less than one-half shall be independent directors and should include at least one member from the risk management committee of the board.
- The ‘list of entities’ in which a prospective director has an interest will be scrutinised to ascertain if such a firm is in default or has been in default in the past decade.
- The negative list says that the candidate should not be a member of the board of any bank, the RBI, financial

institution (FI), insurance company or a non-operative financial holding company (NOFHC).

- The candidate should not be connected with hire-purchase, financing, money lending, investment, leasing and other para-banking activities.
- However, investors of such entities would not be disqualified for appointment as directors if they do not enjoy any managerial control in them.
- The elected director can be appointed for three years and could be re-elected but cannot hold office for more than six years.
- The candidate should not be engaging in the business of stock broking.
- The candidate should not be a member of Parliament, state legislature, municipal corporation, municipality, or other local bodies.
- The candidate should not be a partner of a chartered accountant (CA) firm currently engaged as a statutory central auditor of any nationalised bank or State Bank of India.

Basel norms:

Basel I is a set of international banking regulations put forth by the Basel Committee on Bank Supervision (BCBS) that sets out the minimum capital requirements of financial institutions with the goal of minimizing credit risk. The BCBS regulations do not have legal force. Members are responsible for their implementation in their home countries.

Basel I was the BCBS' first accord. It was issued in 1988 and focused mainly on credit risk by creating a bank asset classification system. The bank must maintain capital (Tier 1 and Tier 2) equal to at least 8% of its risk-weighted assets. For example, if a bank has risk-weighted assets of $100 million, it is required to maintain capital of at least $8 million.

The Basel I classification system groups a bank's assets into **five risk categories**, classified as percentages: 0%, 10%, 20%, 50%, and 100%. A bank's assets are placed into a category based on the nature of the debtor. Public sector debt can be placed in the 0%, 10%, 20% or 50% category, depending on the debtor

Basel 2 norms:

Basel II improved on Basel I, first enacted in the 1980s, by offering more complex models for calculating regulatory capital. The **three essential requirements of Basel II** are:

- Mandating that capital allocations by institutional managers are more risk sensitive.
- Separating credit risks from operational risks and quantifying both.
- Reducing the scope or possibility of regulatory arbitrage by attempting to align the real or economic risk precisely with regulatory assessment.

Basel 3 norms:

Basel III is a comprehensive set of reform measures, to strengthen the regulation, supervision and risk management of the banking sector

Basel 3 measures aim to:

- Improve the banking sector's ability to absorb ups and downs arising from financial and economic instability.
- Improve risk management and governance of banking sector.
- Strengthen banks' transparency and disclosures

Major changes proposed in Basel 3 over earlier accords:

Better Capital Quality: Better quality capital means the higher loss-absorbing capacity. This in turn will mean that banks will be stronger, allowing them to better withstand periods of stress

Capital Conservation Buffer: Now banks will be required to hold a capital conservation buffer of 2.5%. The aim is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress

Countercyclical Buffer: The objective is to increase capital requirements in good times and decrease the same in bad times. The buffer will slow banking activity when it overheats and will encourage lending when times are tough

Minimum Common Equity and Tier 1 Capital Requirements: The minimum requirement for common equity, 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 of 4% to 6%

Leverage Ratio: A leverage ratio is the relative amount of capital to total assets (not risk-weighted). This aims to put a cap on swelling of leverage in the banking sector on a global basis. 3% leverage ratio of Tier 1 will be tested before a mandatory leverage ratio is introduced in January 2018

Liquidity Ratios: A new Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are to be introduced in 2015 and 2018, respectively