# Weekly EBook for RBI Grade B 2023 (1-7 May)

## Evolution of Banking Structure of India

**Introduction**

India's Banking sector evolution can be divided into three phases:
Phase I: 1947-51 i.e. before initiation of planned economic development
Phase II: 1951 to 1980s i.e. period of planned economic development
Phase III: Post 1991. i.e. LPG reforms phase.

**Phase I (1947-51)**

Indian economy was traditional and characterized by low per capita output, limited industrial entrepreneurship andnarrow securities market. After independence, commercial banks were limited to urban, industrializing areas and catered to the needs of only rich, industrial class. The reason for this was nexus between banks and industrial houses, Management of banks composed mainly of industrial class. Policies were made to favour business houses. Banking for poor did not existed. The traditional banking system of Sahukar was prevalent which gave money on very high interest rate.

**Phase II (1951-1991)**

Banks initially engaged in short-term lending, but term lending started in the 1960s. Refinance Corporation of India was established to refinance banks for industrial lending since they need to be refinanced for term loans that they have sent. Innovative banking was popular from the 1960s to the 1980s. Emphasis on fair credit distribution from banks was given.

**Steps taken in this direction:**

Major steps taken by Government of India

A. Change in ownership of financial institutions:

1. **Nationalization:**
    - Nationalization of RBI w.e.f January 1, 1949 on the basis of RBI (Transfer to Public Ownership) Act, 1948.
    - Conversion of Imperial Bank to SBI in 1955 (SBI Act 1955) and its nationalization.
    - 245 insurances companies were nationalized and one LIC was created through LIC Act 1956.
    - Nationalization of 14 banks in 1969 to break the nexus between banks and industrial houses. 6 more were nationalized in 1980.
    - General Insurance Company (GIC) was setup in 1972 by nationalizing general insurance companies 6 more commercial banks were nationalized in 1980.
2. **New Institutions were established:**
    - Development Financial Institutions for financing growth and expansion of big industries by providing long term finance at low rate
    - Unit Trust of India (UTI) was created as an investment fund (now called Mutual Fund) where people could invest their money and get pre-decided or market linked returns. It was a tool of transferring household savingsfor growth of the economy.

**Development Finance Institutions:**

1948: Creation of IFCI to act as a gap-filler i.e. where banks were found incapable of providing finance for medium to long term loans.

1955: Creation of ICICI for underwriting of capital issues and channeling of foreign loans to private sector

1956:LIC was created in 1956 by amalgamating 245 life insurance companies. Purpose was to bring concentration of long-term funds in the hands of LIC and through LIC to financial markets and potential borrower

1964: IDBI was setup as a subsidiary of RBI. It coordinated activities of all financial institutions. Delinked from RBI in 1976: RRBs were established

1990: SIDBI was setup in 1990 as a subsidiary of IDBI for fostering development of small and medium enterprises.

B. New Schemes to provide loans to deficit sectors of the economy:
   Priority sector lending
   Lead Bank Scheme 1969: Based on "Area Approach" wherein a lead bank designated for the district is responsible for taking lead role in surveying credit needs of the population, development of banking and creditfacilities in the district.

C. Investor_Protection: 4 major laws/ acts were passed to empower people and the state to protect the investor from corporate frauds.
   a. Companies Act 1956
   b. Securities Contract Regulation act 1956
   c. MRTP Act 1970
   d. Foreign Exchange Regulation Act 1956

**Problems in Indian Financial System in Phase 2**

Heavy dominance of DFIs. This was in contrast to advanced economies where there existed a direct link between retail investor and borrower company

Share of equity was low and declining due to predominance of development banks which provided long term loansto industry. It was called "equityless structure".

Financing needs of small and medium enterprises were largely ignored in this phase

**Phase III (Post 1991)**

**Narasimhan Committee 1991:** Recommendations:

- Deregulation of interest rates: Administered interest rate regime should be discontinued.PSL should be done at normal interest rates. Intervention subvention should be stopped
- Debt Recovery Tribunal(DRT) should be made to recover debts fast. Creation of DRT in 1993 and SARFAESI Act in 2002
- Liberal branch expansion policy to increase autonomy of banks in opening up of branchesReduce CRR and SLR
- Phased privatization of banking industry in India. Phase 1 in 1993, phase 2 in 2001 and Phase 3 in 2013.

**Narasimhan Committee 1998:** Recommendations:

- Create a legal framework for computerization and electronic fund transfer which lead Payment and Settlement Act 2007 Before 1998, classification of financial intermediaries was of three kinds- Banks, NBFIs and Development financialinstitutions. After Narasimhan committee, the classification was reduced to just Banks and NBFIs

1. Reforms in Banking Sector: Before 1991, banks faced various issues like:
   1) High CRR and SLR requirements
   2)Lower quality of loans and lesser profitability due to PSL lending
   3) Political interference
   4) Sudden expansion of banking into rural areas
   5) Lack of flexibility in operations and lack of autonomy

   **Prudential Measures:**
   - Implementation of BASEL norms, risk management norms
   - Allowing entry of private sector in banking, permission to banks to diversify product portfolio and business activitiesMore autonomy to PSBs, reduction in public ownership in PSBs
   - Reduction in reserve requirements
   - Discontinuation of administered interest regime (except few exceptions)

   **Institutional and Legal Measures:**
   - DRT, ARC, SARFAESI
   - Setting up of Credit Information Bureau (CIBIL) for information sharing on defaulters and other borrowers etc

   Supervisory Measures:
   - Formation of Board for Financial Supervision as the apex supervisory authority for commercial banksIntroduction of CAMELS rating system
   - Strengthening corporate governance in banks

2. Reforms in Monetary Policy Framework
   - Introduction of Liquidity Adjustment Framework(LAF) and Open Market Operations (OMO)
   - Introduction of Market Stabilisation Scheme (MSS) as an additional instrument to deal with capital inflows

3. Privatization of Financial Institutions
   - Conversion of IFCI (a DFI) into a public company, allowing private investment in it
   - IRDAI was setup on recommendation on R N Malhotra Committee. It oversees both domestic as well as foreigninsurance companies
   - PFRDA was setup to oversee pension business and private pension companies were allowed to enter Indian market

**Status of DFI after 1991**

Due to emergence of capital market and development of banking sector after 1991, need for DFIs reduced and theydisappeared from the scene.

They have re-emerged in the past few years but today they do not rely on government finance to provide loans to industry. Instead, they raise money from market to finance borrowers.

# Green Finance

**Why in news?**

RBI has recently shared the framework for green deposit. It is one of the steps to promote finance towards projects which are meant to protect environment

Let's discuss what is green finance and its recent news.

**What is green finance?**

Green finance means lending to and/or investing in the activities/projects that contributes to climate risk mitigation, climate adaptation and resilience, and other climate-related or environmental objectives - including biodiversity management and nature-based solutions

**What is the need of green finance?**

Green financing is to increase level of financial flows (from banking, micro-credit, insurance and investment) from the public, private and not-for-profit sectors to sustainable development priorities. A key part of this is to better manage environmental and social risks, take up opportunities that bring both a decent rate of return and environmental benefit and deliver greater accountability.

**What are the various steps need to be taken to promote green financing?**

**What is green deposits?**

Green deposit means an interest-bearing deposit, received by the RE for a fixed period and the proceeds of which are earmarked for being allocated towards green finance;

**What is green washing?**

Greenwashing means the practice of marketing products/services as green, when in fact they do not meet requirements to be defined as green activities/projects.

**Important points of Framework for green financing:**

- To ensure effective allocation of green deposits, REs must put in place a **Board-approved Financing Framework (FF).**
- The green deposits shall be denominated in Indian Rupees only.
- The allocation of funds raised through green deposits by REs during a financial year shall be **subject to independent third-party verification/assurance,** which shall be done on an annual basis.

**Which of the projects include and excluded under green finance?**

- REs shall be required to allocate the proceeds raised through green deposits towards the following list of green activities/projects which encourage energy efficiency in resource utilisation, reduce carbon emissions and greenhouse gases, promote climate resilience and/or adaptation and value and improve natural ecosystems and biodiversity.

| Sector | Description |
|---|---|
| Renewable Energy | • Solar/wind/biomass/hydropower energy projects that integrate energy generation and storage.<br>• Incentivizing adoption of renewable energy. |
| Energy Efficiency | • Design and construction of energy-efficient and energy-saving systems and installations in buildings and properties.<br>• Supporting lighting improvements (e.g. replacement with LEDs).<br>• Supporting construction of new low-carbon buildings as well as energy-efficiency retrofits to existing buildings.<br>• Projects to reduce electricity grid losses. |
| Clean Transportation | • Projects promoting electrification of transportation.<br>• Adoption of clean fuels like electric vehicles including building charging infrastructure. |
| Climate Change Adaptation | • Projects aimed at making infrastructure more resilient to impacts of climate change. |
| Sustainable Water and Waste Management | • Promoting water efficient irrigation systems.<br>• Installation/upgradation of wastewater infrastructure including transport, treatment and disposal systems.<br>• Water resources conservation.<br>• Flood defence systems. |
| Pollution Prevention and Control | • Projects targeting reduction of air emissions, greenhouse gas control, soil remediation, waste management, waste prevention, waste recycling, waste reduction and energy/emission-efficient waste-to-energy. |
| Green Buildings | • Projects related to buildings that meet regional, national or internationally recognized standards or certifications for environmental performance. |
| Sustainable Management of Living Natural Resources and Land Use | • Environmentally sustainable management of agriculture, animal husbandry, fishery and aquaculture.<br>• Sustainable forestry management including afforestation/reforestation.<br>• Support to certified organic farming.<br>• Research on living resources and biodiversity protection. |
| Terrestrial and Aquatic Biodiversity Conservation | • Projects relating to coastal and marine environments.<br>• Projects related to biodiversity preservation, including conservation of endangered species, habitats and ecosystems. |

- Projects involving new or existing extraction, **production and distribution of fossil fuels, including improvements and upgrades,** nuclear power, direct waste incineration, alcohol, weapons, tobacco, gaming, or palm oil industries, **renewable energy projects generating energy from biomass** using feedstock originating from protected areas, landfill projects and hydropower plants larger than 25 MW have been excluded from green financing.

# What is Alternate Source of Finance?

When a business is unable to get loans from the traditional sources like banks, NBFCs etc. It can for other sources of finances. These sources are called Alternate sources of Finance. These Alternates sources are divided in two categories: Traditional and Modern form.

1. **Leasing:** Leasing is a method in which the user (lessee) rents the asset from the owner (lessor) through an agreement. In this process the ownership is always with the lessor. The lessor grants the lessee right to use the property of the lessor for a defined period.
   The agreement between the two parties that specifies the terms and conditions for the rental use of a tangible resource such as a building / equipment is called the **lease**.
   Benefits of leasing The lessee saves its money from investing in the resources. It gives him more working capital
2. **Franchising**: You must have seen there are many outlets of McDonalds/ Burger king. For these companies it will be very difficult to manage store directly across the world. They use the mechanism of Franchising. In Franchising, the parent company makes an agreement with individual or enterprise to use the former's successful business model, in stipulated areas.It is a business relationship. It can be used to give authorization to use their brand, product, management format, business format.
3. **Factoring**: A company might use factoring, a form of finance, to cover its short-term cash needs by selling its accounts receivable (invoices) to a third party. In accordance with the agreement, the factor would pay the invoices' outstanding balance less any commission or fees. It is similar to bill discounting
4. **Crowd Funding:** Instead of searching for a single investor, crowd funding platforms enable businesses to pool small investments from multiple investors.in words of RBI: ''Crowd Funding' generally refers to a method of funding a project or venture through small amounts of money raised from a large number of people, typically through a portal acting as an intermediary. There are numerous forms of crowd funding: some are charitable donations that provide intangible benefits but no financial returns; others, such as equity crowd funding would fall within the domain of financial markets."
5. **P2P lending:** P2P lending is a form of crowd-funding used to raise loans which are paid back with interest. It can be defined as the use of an online platform that matches lenders with borrowers in order to provide unsecured loans. The borrower can either be an individual or a legal person requiring a loan. The interest rate may be set by the platform or by mutual agreement between the borrower and the lender. Fees are paid to the platform by both the lender as well as the borrower. The borrowers pay an origination fee (either a flat rate fee or as a percentage of the loan amount raised) according to their risk category. The lenders, depending on the terms of the platform, have to pay an administration fee and an additional fee if they choose to use any additional service (e.g. legal advice etc.), which the platform may provide. The platform provides the service of collecting loan repayments and doing preliminary assessment on the borrower's creditworthiness
6. **Angel Investor:** A group of people or an individual who invest their own money in the company's early (concept) stages in exchange for a stake in the company. They do not interfere in the functioning of the company. So, their objective may be more than just focusing on economic returns.
7. **Venture Capital:** The term "venture capital" refers to financing provided by individuals or businesses that invest in start-up, privately held businesses. It a type of private Equity. It actively participates in the functioning of the company.

8. **Equity Financing:** Equity financing means in return of a portion of the ownership of the business for a financial investment in the business. The ownership stake resulting from an equity investment allows the investor to share in the company's profits. It normally done in later stages of startups.
   Equity involves a permanent investment in a company and not repaid by the company at a later date

9. **Hedge Funds:** Before diving into the definition of Hedge funds , first understand the meaning of Hedge. It is a strategy to limit financial risks. Hedge fund may look like private equity but Hedge funds differ from private equity firms in the following ways: time-to-hold, liquidity, leverage and strategic direction of investments which in turn dictates differences in their exit strategy, risk tolerance and desired rate of return of the two types of funds.
   Hedge funds seek a quick flip of their investments with the average length of their investments being 6-18 months, whereas private equity firms stay invested for around 3-5 years.
10. **Warrants:** A warrant is a security that gives the owner the right to buy stock in the company that issued it at a pre-determined (exercise) price in the future (before a specified expiration date).