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Strengthening the Resilience of Small and Medium Banks in India: Challenges, Performance, and Regulatory Landscape

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ABSTRACT

Small banks in India, comprising regional rural banks, cooperative banks, and small finance banks, serve as the backbone of grassroots banking by catering to underserved and rural populations. Their contribution to economic development, financial inclusion, and local entrepreneurship is vital, yet often overlooked in mainstream financial discourse. The critical impact of India's small and medium banks on the nation's economy often remains understated, especially on the front of driving financial inclusivity. Their pivotal role is overshadowed by the multifaceted challenges they face, including fluctuating financial performance and issues with non-performing assets which have failed to catch the eyesight of the regulator. By examining the regulatory and governance hurdles these banks encounter, such as a web regulatory governance structure, heightened mandate for priority sector lending, and increased interference by political entities, the paper advocates for a separate and comprehensive overhaul of resolution mechanisms for small banks. The paper underscores the necessity for adaptive and long-due policy interventions which would bolster operational stability of these banks, enabling them to continue their essential contributions

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to India's economic fabric without succumbing to systemic vulnerabilities.

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I. INTRODUCTION

As of February 2025, there are 11 operational Small Finance Banks (SFB), 43 Regional Rural Banks (RRB), and approximately 1,539 Urban Cooperative Banks (UCB) in India.[1] Collectively, these banks have brought millions into the formal banking fold, offering products tailored to the needs of individuals and businesses which traditional commercial banks might overlook. The Reserve Bank of India (RBI), along with the National Bank for Agriculture and Rural Development (NABARD), oversees their operations to ensure financial stability and depositor protection. The RBI has recently expanded this consortium of small and medium banks in India, by including SFBs, thereby broadening the scope of financial inclusion. As a specialized segment within the banking sector, SFBs primarily provide banking services such as deposits and loans to underserved sections of the financial market, including entities in the unorganized sector, micro and small industries, and small farmers.

In comparison to larger commercial banks, the performance of small banks, present in such consortium, has been shown to be more sensitive to factors such as revenue diversification, capital ratio etc.,[2] indicating that volatility may suddenly arise, potentially delivering a blow to the economic structure. In the recent past, such financial instability has resulted in the cancellation of licenses of seven cooperative banks, including that of Banaras Mercantile Co-operative Bank and City Co-

[1] Reserve Bank of India, 'Banks in India' (September 2024) <https://rbi.org.in/commonman/english/scripts/banksinindia.aspx#rrb> accessed 25 February 2025.

[2] Neeraj Gupta, Jitendra Mahakud, 'Ownership, bank size, capitalization and bank performance: Evidence from India' [2020] Cogent Economics & Finance 8(1).

operative Bank, that too within a span of six months.[3] Indicators such as lower earning prospects and inadequacy of capital, resulted in liquidation and winding up proceedings due to failure to abide by the regulatory requirements.[4] Such undulations have also been reflected in foreign economies with the recent shockwave coming from the collapse of the Silicon Valley Bank in 2023, amounting to the second largest failure in US banking history.[5]

The forecasts for the immediate future display a similar path. For instance, a recent report by ICRA Ltd. highlights that among SFBs although there is a gradual shift towards more secure deposits, the stress in the microfinance sector in the upcoming financial quarter, shall witness rising operating costs, impacting asset quality and result in moderate profits.[6]

Towards this end, the paper discusses the resolution challenges related to small banks and explores the best way forward for dealing with small bank failures. The first part of the paper entails a discussion on the ambit of small banks and their impact on the economy of India. The second part highlights the trends in the performance of small banks in India, followed

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[3] Surbhi Gloria Singh, 'RBI has cancelled license of 7 co-operative banks since Jan: Here's why' (*Business Standard*, (05 July 2024) <https://www.business-standard.com/finance/personal-finance/rbi-has-cancelled-licence-of-7-co-operative-banks-since-jan-here-s-why-124070500411_1.html> accessed 29 January 2025.

[4] *Ibid*.

[5] Board of Governors of the Federal Reserve System, 'Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank' (April 2023).

[6] Investment Information and Credit Rating Agency, 'Uptick in delinquencies to dampen growth and profitability of small finance banks in the near term: ICRA' (January 14, 2025) <https://www.icra.in/CommonService/OpenMediaS3?Key=cd8be38d-f824-43b7-80a4-69ea538a50d1> accessed 29 January 2025.

by the certain key and distinct issues which plague the functioning of such banks. The third part of the paper elaborates upon the current resolution and solvency mechanism which is in place in India for such banks, contrasting it with examples of banks whose solvency issues had been tackled by the regulators. The last part of this paper seeks to provide certain considerations and factors which need to be taken into account in formulating a resolution regime for small banks in India.

II. PERFORMANCE OF SMALL BANKS IN INDIA

The introduction of small and medium banks, particularly SFBs, UCBs, Local Area Banks (LAB) and RRBs in the Indian banking sphere, has witnessed a mixed trajectory of financial performance which has been influenced by operational efficiencies, external economic conditions, and regulatory changes.

A. Small Finance Banks

SFBs, with a focus on extending credit to underbanked and underserved segments, have achieved remarkable growth in recent years. Illustratively, AU Small Finance Bank reported a 30% year-on-year increase in net profit, supported by a stable gross non-performing assets (NPA) ratio of 1.78%.[7] For future forecasts, CRISIL has indicated that the growth rate of SFBs will remain could be progressive, estimating around 25-27% in 2024-2025, with 28% growth having been achieved in 2023-

[7] Press Trust of India, 'AU Small Finance Bank Q1 results: Net profit surges 30% to Rs 502 cr' (*Business Standard,* 25 July 2024) <https://www.business-standard.com/companies/results/au-small-finance-bank-q1-results-net-profit-surges-30-to-rs-502-cr-124072501015_1.html> accessed 19 December 2024.

2024. This is attributed to factors including an increasing presence in semi-urban and rural markets and continued geographical expansion.[8] However, the profitability for SFBs in terms of Return of Assets (RoA) is expected to decline to come around 1.7% this fiscal year, compared to 2.1% in the previous financial year, primarily due to higher credit costs and lower net interest margins (NIM).[9]

Challenges such as the increasing share of lower yielding secured assets still persist for SFBs, and diversification of funding routes - particularly addressing their overdependence on microfinance portfolios and mobilization of deposits - has been suggested.[10] With regard to diversification of portfolio, the share of microfinance to non-microfinance loans has typically remained between 98-81%,[11] resulting in a high proportion of unsecured loans. The RBI's informal directive to

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[8] CRISIL Ratings, 'Small finance banks to grow advances 25-27% this fiscal' (26 August, 2024) <https://www.crisilratings.com/en/home/newsroom/press-releases/2024/08/small-finance-banks-to-grow-advances-25-27-percent-this-fiscal.html> accessed 27 January 2025.

[9] Press Trust of India, 'Profitability of small finance banks expected to decline in FY25: Crisil' (*The Economic Times*, 11 October, 2024) <https://economictimes.indiatimes.com/industry/banking/finance/banking/profitability-of-small-finance-banks-expected-to-decline-in-fy25-crisil/articleshow/114149122.cms?from=mdr> accessed 27 January, 2025.

[10] CRISIL Ratings, 'Small finance banks to grow advances 25-27% this fiscal' (26 August 2024) <https://www.crisilratings.com/en/home/newsroom/press-releases/2024/08/small-finance-banks-to-grow-advances-25-27-percent-this-fiscal.html> accessed 27 January 2025.

[11] Amulya Neelam, 'Tracking Performance of Small Finance Banks against Financial Inclusion Goals' DVARA Research, (November 2019) <https://dvararesearch.com/wp-content/uploads/2024/01/Tracking-Performance-of-Small-Finance-Banks-against-Financial-Inclusion-Goals-2.pdf> accessed 15 December 2024.

limit new microfinance loans to borrowers with existing debts has further constrained growth.[12]

Even though certain SFBs are attempting to diversify, expansion of their client base is intrinsically tied to their 'small' tag, a limitation which is further reinforced by the central bank, through their policies,[13] possibly because of blatant financial irregularities.

Moreover, with pre-existing policies such as Priority Sector Lending (PSL) obligations and restrictions on scope of operations and activities which SFBs can undertake, a significant shift in their business models remains unlikely.

These give way to the twin problems being faced by them: (1) riskier lending by virtue of having high exposure to the microfinance sector and geographic pockets of higher stress;[14] and (2) high dependency on deposits in conjunction with the prohibition of undertaking activity in the capital markets. Such structural issues have resulted in an increase

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[12] Reuters, 'Indian banks' microfinance loan stress to persist after new, informal regulation, bankers say' (*The Economic Times*, 08 November 2024) <https://economictimes.indiatimes.com/industry/banking/finance/banking/indian-banks-microfinance-loan-stress-to-persist-after-new-informal-regulation-bankers-say/articleshow/115072482.cms?from=mdr> accessed 28 January 2025.

[13] Mahua Venkatesh, 'To Sustain Growth, India's Small Finance Banks Look to Shed 'Small' Tag' (*The Secretariat*, 10 April 2024) <https://thesecretariat.in/article/to-sustain-growth-india-s-small-finance-banks-look-to-shed-small-tag> accessed 19 December 2024.

[14] Atmadip Ray, 'RBI expresses concerns over small finance banks: Mergers suggested to mitigate risks' (*The Economic Times*, 30 January 2025) <https://economictimes.indiatimes.com/industry/banking/finance/banking/rbi-expresses-concerns-over-small-finance-banks-mergers-suggested-to-mitigate-risks/articleshow/117703105.cms?from=mdr> accessed 19 December 2025.

in average gross non-performing assets (NPA) to 11.6% till September, 2024.[15] This brought them under close scrutiny by the RBI and the government, with mergers emerging as a viable solution,[16] – seen in the merger of Fincare FSB and AU SFB, and the acquisition of North East SFB by fintech firm Slice.[17]

B. Regional Rural Banks

For RRBs, a similar picture is created, where they are not able to deploy credit for socio-economic development stemming from a poor deposit performance.[18] Although the GNPA ratio has recently dropped to 6.1%, the lowest in the previous 10 years, and banks recorded the highest-ever consolidated net profit of Rs. 7,571 crores in 2023-24,[19] strengthening their capital position, this improvement can largely be attributed to the government's recent substantial capital infusion.

Thus, while improvement in the financial metrics is occurring, it is majorly through reforms and initiatives of NABARD and the respective

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[15] FE Business, 'RBI raises red flag on asset quality of small finance banks, says mergers best way to mitigate risks' (*Financial Express*, 30 January 2025) <https://www.financialexpress.com/business/banking-finance-rbi-expresses-concerns-over-small-finance-banks-rising-asset-quality-stress-says-mergers-best-way-to-mitigate-risks-3730885/> accessed 19 December 2025.
[16] *Ibid*.
[17] Mahua Venkatesh, 'To Sustain Growth, India's Small Finance Banks Look to Shed 'Small' Tag' (*The Secretariat*, 10 April 2024) <https://thesecretariat.in/article/to-sustain-growth-india-s-small-finance-banks-look-to-shed-small-tag> accessed 19 December 2024.
[18] Jaynal Ud-din Ahmed, 'Performance Evaluation of Regional Rural Banks: Evidence from Indian Rural Banks' [2015] Global Business Review 16(5S).
[19] Press Information Bureau, 'Union Finance Minister Smt. Nirmala Sitharaman chairs the review meeting of the Regional Rural Banks (RRBs) in New Delhi' (19 August 2024) <https://pib.gov.in/PressReleasePage.aspx?PRID=2046720> accessed January 10 2025.

governments. For instance, in two years, FY 2021-22 and 2022-23, Rs. 10,890 crores had been infused in RRBs, which was equivalent to infusion of Rs. 8,393 crores by all stakeholders from 1975 till FY 2020-21, almost a period over 45 years.[20] Although the move is aimed at rejuvenating the RRBs through technology adoption, the effectiveness of the temporary measure to prevent recurrence and resolve a structural issue, is yet to be deciphered.[21]

Recently, the Finance Ministry of India sought RBI's intervention for clearing pending dues of RRBs with state governments.[22] A proposal has been given by the Central Government for merging regional rural banks to reduce their number from 43 to 28, effectively leaving a single RRB in each state.[23] What is still going unnoticed is that this temporary pill will lead to stronger banks with an inorganic and sustainable growth trajectory, with an adverse impact on the need for competition in the domestic banking sector[24].

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[20] National Bank for Agriculture and Rural Development, 'Annual Report 2023-2024' (24 May 2024) <https://www.nabard.org/annual-report/empowering-rural-financial-institutions.html> accessed 20 January 2025.

[21] National Bank for Agriculture and Rural Development, 'Key Statistics & Financial Statements of Regional Rural Banks 31 March 2023' (July 2023) <https://www.nabard.org/auth/writereaddata/WhatsNew/0109235107final-key-statistics-of-rrbs-2022-23.pdf> accessed 20 January 2025.

[22] Harsh Kumar, 'FM Nirmala Sitharaman seeks RBI help to clear RRB dues with states' (*Business Standard*, 22 August 2024) <https://www.business-standard.com/industry/banking/fm-sitharaman-urges-rbi-to-intervene-to-clear-dues-of-rrbs-from-state-govts-124082201195_1.html> accessed 18 January 2025.

[23] Reuters, 'India proposes merging regional rural banks to help them shore up capital' (*Business Standard*, 05 November 2024) <https://www.business-standard.com/india-news/india-proposes-merging-regional-rural-banks-to-help-them-shore-up-capital-124110500459_1.html> accessed 18 January 2025.

[24] Department of Banking Operations and Development & Department of Economic Policy and Research, 'Banking Structure in India - The Way Forward'

C. Cooperative Banks

The balance sheets of State Cooperative Banks (StCBs) and District Central Cooperative Banks (DCCBs) have exhibited accelerated growth. UCBs have strengthened their capital buffers and reduced gross NPAs through better governance and improved operational efficiencies. Additionally, there has been credit growth of 7.4% in September 2024, with corresponding increases in RoA and Return on Equity (RoE). However, similar to other small banks, the asset quality is yet to be tackled with GNPA and Net NPAs rising from March 2024.[25] From 2016-2024, the RBI has cancelled licenses of about 70 UCBs,[26] which were majorly for non-scheduled UCBs[27]. The reasons for the cancellation pointed towards deteriorating financial position, inadequate capital, or

(August 2013) <https://www.agloc.org/pdf/Banking-Structure-in-India-The-Way-Forward.pdf> accessed 17 January 2025.

[25] Rohit Gupta, 'RBI highlights resilience of UCBs in Financial Stability Report 2024' (*Indian Cooperative,* 5 January 2025) <https://www.indiancooperative.com/banks/rbi-highlights-resilience-of-ucbs-in-financial-stability-report-2024/> accessed 17 January 2025.

[26] Rohit Gupta, 'UCBs' have improved their financial performances: RBI Report' (*Indian Cooperative*, 29 December 2022) <https://www.indiancooperative.com/featured/ucbs-have-improved-their-financial-performances-rbi-report/> accessed 17 January 2025; Dr. M. Srikanth, 'Urban Cooperative Banks in India: A performance analysis through the CAMELS rating system' (*ET Government*, 6 January 2025) <https://government.economictimes.indiatimes.com/blog/urban-cooperative-banks-in-india-a-performance-analysis-through-the-camels-rating-system/116968584#:~:text=Also%2C%20the%20UCBs%20witnessed%20a,signifying%20their%20productive%20track%20record> accessed 17 January 2025.

[27] Rohit Gupta, 'UCBs' have improved their financial performances: RBI Report' (*Indian Cooperative*, 29 December 2022) <https://www.indiancooperative.com/featured/ucbs-have-improved-their-financial-performances-rbi-report/> accessed 17 January 2025.

poor earning prospects.[28] With the introduction of the new Prompt Corrective Action (PCA) framework for UCBs, around 60-65 weak UCBs are expected to exit this supervisory mechanism.[29]

III. CHALLENGES FACED BY SMALL BANKS IN INDIA

Despite the mushrooming presence and increasing growth rates, small and medium banks often face several impediments such as operational constraints, governance challenges, and heightened vulnerability to external shocks. Their size, business model, and customer-base-demand-tailored regulatory and developmental interventions to strengthen their resilience and ensure their long-term sustainability. Although they face issues similar to ones faced by the banking industry in general, certain key attributes further weaken their financial standing in the Indian setup.

A. The Priority Sector Lending Mandate

A major contributing factor to the strained functioning of small banks is the heightened mandate on them to undertake priority sector lending. On account of the widespread economic diversity in India, a key distinct feature of the Indian banking structure is found in the different types of institutions catering to the divergent banking needs of the manifold

[28] Rohit Gupta, 'RBI cancelled license of 78 UCBs after 2014: Minister' (*Indian Cooperative*, 31 July 2024) <https://www.indiancooperative.com/co-op-news-snippets/rbi-cancelled-license-of-78-ucbs-after-2014-minister/> accessed 22 February 2025.

[29] Abhijit Lele, 'Up to 65 weak Urban Cooperative Banks to exit turnaround regime by March' (*Business Standard*, 14 October 2024) <https://www.business-standard.com/industry/banking/60-65-weak-ucbs-to-exit-supervisory-regime-by-march-2025-on-performance-124101400850_1.html> accessed 18 January 2025.

sectors.[30] Towards this end, the policy initiative of 'Priority Sector Lending' (PSL), emanating from the Credit Policy of 1967-68,[31] had been put into effect with the foundational objective of ensuring sufficiency of accessible funds at reasonable rates to certain segments of society[32]. The terminology of 'priority sector' was originally meant to refer to the sectors of agriculture, micro and small manufacturing enterprises, and exports,[33] sectors that significantly contributed to the Gross Domestic Product of a nation but faced limited access to financial assistance.[34] Over time, its scope was widened.

In the early stages of the banking history in India, in alignment with the social objectives of India, this task of financial inclusion by supplying credit to such sectors, was considered a task suitable for public sector banks, especially after nationalization. However, soon, because of structural inadequacies and lack of market powers acting

30 Jayadev M, Himanshu Singh, Pawan Kumar 'Small finance banks: Challenges' [2017] IIMB Mgt Review 29(4) 311-325.
31 Rural Planning and Credit Department, Reserve Bank of India, 'Draft Technical Paper by the Internal Working Group on Priority Sector Lending' (September 2005) <https://rbi.org.in/upload/content/pdfs/66391.pdf> accessed 02 February 2025.
32 Basri Savitha, Naveen Kumar, 'Non-performance of financial contracts in agricultural lending: A case study from Karnataka, India' [2016] Agricultural Finance Review, 76(3) 362-377.
33 M Manickaraj, Elizabeth James, 'Lending by Banks to NBFCs for On-lending to Priority Sectors: Recent RBI Guidelines and Way Forward' [2022] NBIM Working Paper Series 20 <https://www.nibmindia.org/static/working_paper/NIBM_WP20_MMEJ_ghzH827.pdf> accessed 02 February 2025.
34 Karona Cahya Susena et. al, 'A study on impact of PSL on gross NPAS of nationalised banks: an empirical approach', [2021] Linguistics and Culture Review 5(S3) 81-96.

independently,[35] the same proved to be unsuccessful or at the very least unsustainable. Ultimately, in 1972, commercial banks were given directives by the RBI to lend to the priority sectors, and by 1979, they were advised to raise their share to 33.3%.[36] Showing promising results, the regulators realised that small banks indeed had better adaptability to the larger goal of financial inclusion, owing to their simple organisational structure, which led to a discussion paper by RBI, where the institution preferred small and localised banks for financial inclusion.[37]

However, because of the mushrooming of smaller banks such as RRBs, SFBs, LABs, UCBs etc., many closure of such banks by the RBI had been witnessed. For instance, between 2006 and 2008, the colossal capital erosion twinned with losses led to closure and consolidation of RRBs to 61 in number.[38] Around 31 UCBs from 2011 and 2013 had failed due to which the Deposit Insurance and Credit Guarantee Corporation (DICGC) had to pay around Rs. 437.31 crore as compensation.[39] Even for LABs,

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[35] KC Chakrabarty, 'Revised guidelines on priority sector lending - rationale and logic' FIBAC [2012] <https://www.bis.org/review/r120906b.pdf> accessed 03 February 2025.

[36] Reserve Bank of India, 'Master Circular - Priority Sector Lending-Targets and Classification' (01 July 2013); M Jayadev, Himanshu Singh, Pawan Kumar, 'Small finance banks: Challenges' [2017] IIMB Mgt Rev 29(4) 311-325.

[37] Department of Banking Operations and Development & Department of Economic Policy and Research, 'Banking Structure in India - The Way Forward' (August 2013) <https://www.agloc.org/pdf/Banking-Structure-in-India-The-Way-Forward.pdf> accessed 17 January 2025.

[38] Deepali Pant Joshi, Speech at 'Conference of Principal Code Compliance Officers and Chairmen of RRBs' (July 15, 2013) <https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=820> accessed 29 January 2025.

[39] Press Trust of India, '13 co-op banks turned insolvent last fiscal' (*The Hindu Business Line*, 27 May 2013) <https://www.thehindubusinessline.com/money-and-banking/13-co-op-banks-turned-insolvent-last-fiscal/article23117503.ece> accessed 29 January 2025.

the Ramachandran Committee in 2002 recommended the halt of issuing licenses,[40] but the Rangarajan Committee suggested a revisit to new licenses, in light of the potential which still lay[41].

Although in recent times, it has been observed that credit provided to priority sectors by public sector banks appears to be less risky in comparison to non-priority sectors[42] – with even RBI economists indicating that PSL between March 2006 and March 2023, has improved overall asset quality of banks[43] – whether this has been fruitful for small banks as well has still not been ascertained.

Currently, according to the Master Directions on PSL, RRBs and SFBs are supposed to achieve 75% of Adjusted Net Bank Credit (ANBC) or of Credit Equivalent of Off-Balance Sheet Exposure (CEOBE), which is significantly higher than for other domestic commercial banks which

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[40] Planning Commission of India, 'Report of the Committee on Financial Inclusion' January 2008 <https://www.findevgateway.org/sites/default/files/publications/files/mfg-en-paper-report-of-the-committee-on-financial-inclusion-jan-2008.pdf> accessed 29 January 2025.

[41] Planning Commission of India, 'A Hundred Small Steps: Report of the Committee on Financial Sector Reforms' 2009 <https://www.jrvarma.in/reports/Raghuram-Rajan/cfsr_all.pdf> accessed 29 January 2025.

[42] Kavita Kanyan, Shveta Singh, 'Priority and non-priority sector GNPAs in Indian commercial banks: a comparison between sub-sectors' [2024] Vilakshan-XIMB Journal of Management 21(1) 155.

[43] Gayatri Nayak, 'Lending to Priority Sector helps improve banks asset quality: RBI economists' (*The Economic Times* 22 September 2024) <https://economictimes.indiatimes.com/industry/banking/finance/banking/lending-to-priority-sector-helps-improve-banks-asset-quality-rbi-economists/articleshow/113574614.cms?from=mdr> accessed 18 December 2024.

have a target of 40%.[44] Whether or not PSL as a policy measure should be pursued is not a discussion which the authors wish to pursue here.[45] Realising that being commercial banks, small banks have different business strategies,[46] with several regulatory restrictions,[47] the constituent importance of PSL to small banks is a separate marker for their distinctiveness.

B. Structural and Operational Gaps

Recently the Deputy Governor of RBI, Swaminathan J, had suggested for a categorical delineation and division of responsibilities of the Board and Management of SFBs, emphasising the role of formulating policies and giving a direction by the Board, with the Management responsible for execution.[48] Additionally, continuance of sustainable growth strategies and business models along with credit risk underwriting had been highlighted as challenges still faced by SFBs.[49] The impact of such banks,

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[44] Reserve Bank of India, 'Master Directions - Priority Sector Lending (PSL) - Targets and Classifications' (04 September 2020) <https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11959#Categories>

[45] Rural Planning and Credit Department, Reserve Bank of India, 'Draft Technical Paper by the Internal Working Group on Priority Sector Lending' (September 2005) <https://rbi.org.in/upload/content/pdfs/66391.pdf> accessed 02 February 2025.

[46] Fitch Solutions, 'Industry Research Report on the Banking Sector in India' (23 July 2023) 42 <https://www.janabank.com/images/PDF/disclosures/FSIAPL-Industry-Research-Report.pdf> accessed 28 January 2025.

[47] M Jayadev, Himanshu Singh, Pawan Kumar, 'Small finance banks: Challenges' [2017] IIMB Mgt Rev 29(4) 311-325.

[48] Swaminathan Janakiraman, 'Governance in Small Finance Banks - Driving Sustainable Growth and Stability' (Conference of Directors of Small Finance Banks 27 September 2024) <https://www.bis.org/review/r241001e.htm> accessed 12 January 2025.

[49] Ibid.

such as small local banks providing a supply of credit to small farmers and enterprises[50], has stirred a debate as to prioritizing a larger number of small banks or a small number of large banks for the purpose of financial inclusion.

This is further exacerbated with the persisting volatility of demand and corresponding supply for rural credit, with the growth rate in bank credit ranging from 64% in 1980-81, 2.58% in 1990-91, 35.38% in the interim period, 14.13% in 1990s, 20.24% in the 2000s to 13.36% in 2010.[51] At times, the performance of Universal Commercial Banks (UCBs) and LABs have not been satisfactory, which requires targeted policy measures towards their exposure, corporate governance, numbers, capital requirements etc.[52]

Another unexpected issue which is recently gaining traction for SFBs and other small banks has been the high accelerating attrition rate among frontline and junior management employees to approximately 40%, witnessing an increase of 25%, which in turn translates into operational

[50] Fernando Restoy, 'Resolution and Deposit Guarantee Schemes in Europe: Incomplete process and uncertain outcomes' (IADI-ERC International Conference 23 March 2018) <https://www.bis.org/speeches/sp180323.htm> accessed 25 December 2024.
[51] Pradeep Kumar B, 'Reflections on the performance of Regional Rural Banks (RRBs) and the Need for their Revitalization on the lines of Enhanced Access and Service Excellence (EASE)' (2023) MPRA Paper No. 120492 <https://mpra.ub.uni-muenchen.de/120492/1/MPRA_paper_120492.pdf> accessed 25 December 2024.
[52] Department of Banking Operations and Development & Department of Economic Policy and Research, 'Banking Structure in India - The Way Forward' (August 2013) <https://www.agloc.org/pdf/Banking-Structure-in-India-The-Way-Forward.pdf> accessed 17 January 2025.

risks for such banks.[53] A similar problem had been highlighted by NS Vishwanathan, where such banks lacked professional management, lack of skill and no effective recruitment policy.[54]

C. The Impact of Political Undulations on the Functioning of Small Banks

An additional key issue prominent in India, majorly owing to the socio-economic policy approach, is the perennial political interference and influence on banks. The governance structure of small banks, such as RRBs and UCBs, are designed in such a manner which allow for significant political manoeuvring to the extent of policy design or even churning loans, essentially for political gain or, at the very least, public trust.[55]

In a study, it had been pointed out that the average agricultural sector lending was 9.4 times higher during election years, in comparison to

[53] Reserve Bank of India, 'Trends and Progress of Banking in India 2023-24' [December 2024]; Press Trust of India, 'High employee attrition of 25 per cent in private banks pose operational risk: RBI Report' (*The Times of India*, 29 December 2024) <https://timesofindia.indiatimes.com/business/india-business/high-employee-attrition-of-25-per-cent-in-private-banks-pose-operational-risk-rbi-report/articleshow/116766407.cms> accessed 04 January 2025.

[54] Avinash Nair, 'Madhavpura bank collapse is behind us, says RBI executive director' (*Indian Express*, 7 June 2014)<https://indianexpress.com/article/business/banking-and-finance/madhavpura-bank-collapse-is-behind-us-says-rbi-executive-director/> accessed 04 January 2025.

[55] Shishir Arya, 'Politicians should be barred from running district cooperative banks' (*The Times of India*, 21 July 2013) <https://timesofindia.indiatimes.com/city/nagpur/politicians-should-be-barred-from-running-district-cooperative-banks/articleshow/21210358.cms> accessed 04 January 2025.

non-election years, whereas, for manufacturing firms, the same decreased by 2.7% in election years.[56]

Although the Prime Minister, at the outset of his regime in 2014, had indicated that there would be "no call from the PMO" for political interference with the banks' activities, he differentiated the same from political intervention.[57] But with certain banks, such as United Bank's Executive Director still recognising political influence as a challenge to recovery,[58] in addition to the recent prohibition by the RBI of MPs, MLAs and members of municipal corporations or other local bodies from holding office of MD or WTD in UCBs,[59] still casts serious aspersions on the political sway on such banks.

D. Web of Regulatory Authorities

Further, small banks vary widely in their size, purpose, and operational scope, necessitating tailored regulatory and resolution frameworks,

[56] Nitish Kumar, 'Political interference and crowding out in bank lending' [2020] Journal of Finance Intermediation 43.

[57] Economic Times Bureau, 'Government not to interfere in working of state owned banks: PM Narendra Modi' (*Economic Times*, 04 January 2015) <https://economictimes.indiatimes.com/industry/banking/finance/banking/government-not-to-interfere-in-working-of-state-owned-banks-pm-narendra-modi/articleshow/45744431.cms?from=mdr> accessed 06 January 2025.

[58] Manish Basu, 'Political interference a challenge for recovery: United Bank's Sanjay Arya' (*Live Mint*, 20 February 2014) <https://www.livemint.com/Companies/vAXxxKhu0aAXUiwkxVWQ9O/Political-interference-a-challenge-for-recovery-United-Bank.html> accessed 06 January 2025.

[59] Indo-Asian News Service, 'Curbing Political Interference: RBI Bars MPs, MLAs from Holding MD Post in Urban Cooperative Banks' (*Swarajya*, 27 January 2021) <https://swarajyamag.com/news-brief/curbing-political-interference-rbi-bars-mps-mlas-from-holding-md-post-in-urban-cooperative-banks> accessed 21 January 2025.

leading to a web network regulatory system. With the three-fold objective of (1) containing bank's risk through prudential regulation, (2) protection of consumers from arbitrary actions of the banks through business conduct regulation,[60] and (3) the underlying socio-economic politico, the plurilateral webbed regulatory system was chosen. The same prevented the unilateral control of either the autonomous central bank or the government, and also regulated the varying institutions catering to the divergent banking needs of the respective sectors[61]. Resultantly, this led to fragmented oversight, especially for cooperative banks, which leads to inefficiencies in governance and risk management.

For example, UCBs are subject to dual regulation - by the government and the RBI. For UCBs located in a specific state, the state registrar of co-operative societies governs their functioning, but for UCBs having multi-state presence, the Central Government through the Central Registrar of Co-operative Societies plays a role instead of the Registrar of Cooperatives (ROC) (of the respective states).[62] Typically, a joint regulator by the registrars of cooperatives is formed for both rural and

[60] Biswamohan Mahapatra, 'Need for differentiated regulation for differentiated banks' (*Money Control*, 13 August 2015) <https://www.moneycontrol.com/news/business/economy/need-for-differentiated-regulation-for-differentiated-banks-1525917.html> accessed 21 January 2025.

[61] Department of Banking Operations and Development & Department of Economic Policy and Research, 'Banking Structure in India - The Way Forward' (August 2013) <https://www.agloc.org/pdf/Banking-Structure-in-India-The-Way-Forward.pdf> accessed 17 January 2025.

[62] Usha Thorat, 'Urban cooperative banks - evolution of the banks, current issues in corporate governance and challenges in their regulation and supervision' (6 December 2006) <https://www.bis.org/review/r061211f.pdf> accessed 19 January 2025.

urban banks.[63] With regard to the RBI's supervision, a further distinction is drawn between cooperative banks, the rural cooperatives are regulated by NABARD, largely covering the rural sector banks including RRBs, whereas the urban cooperatives are governed by the Board for Financial Supervision, a unit of the RBI[64].

Although the Standing Advisory Committee has been established comprising representatives from the RBI, Central and State governments and the Federation of UCBs, however, the mandate practically is restricted to policy oversight and recommendations.[65] Even between the RBI and the government, the former would be solely concerned with the banking function, with the management resting with the latter.[66] Till date, there has not been any witnessed public shakedown between the government's domain and the RBI's mandate, suggesting towards a joint discussion, but this does not vitiate the scenario, where a differing viewpoint may arise in terms of directions as to the functioning or even the resolution of a UCB.

Towards this end, the Financial Sector Legislative Reforms Commission had suggested that through Article 252 of the Constitution of India, State

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[63] Manas Chakravarty, 'Regulatory Structure for Financial Sector Emerging Trends' (Asian Institute Of Transport Development) (2001)<https://www.aitd.net.in/pdf/monograph/10.%20Regulatory%20Structure%20for%20Financing%20Sector.pdf>.

[64] Ibid.

[65] Usha Thorat, 'Urban cooperative banks - evolution of the banks, current issues in corporate governance and challenges in their regulation and supervision' (6 December 2006) <https://www.bis.org/review/r061211f.pdf> accessed 19 January 2025.

[66] Y V Reddy, 'Issues in choosing between single and multiple regulators of financial system (Public Policy Workshop at ICRIER, 22 May 2001) <https://www.bis.org/review/r010524c.pdf> accessed 19 January 2025.

governments relinquish their right of legislation on regulation and supervision of these banks to the Parliament, failing which the RBI may impose restrictions on being eligible to offer certain financial services.[67] The probability of such a "relinquishment" by the state government and "imposition" by the RBI is tangible; however, given the significant political implications of federalism, in conjunction with the RBI's statutory obligations and restrictions, it still seems bleak.

IV. RESOLUTION PATHWAYS AND CASE INSIGHTS FOR SMALL BANKS

In light of such challenges faced by small banks, tailored approaches, tools, and processes are essential for their resolution which also must align with the regulatory and developmental structures of the respective countries. Towards such an end, interestingly, in India no earmarked tools are available for the restructuring or resolution of banking institutions. The Banking Regulation Act, 1949 (BRA), specifically Section 35A, provides for three tools at the disposal of the Central Bank, namely voluntary merger, compulsory merger or winding up.[68]

1) Under the voluntary merger route, two-third majority of shareholders approve a scheme for amalgamation which is then sanctioned by the RBI for merging two banking companies.[69] This is followed by the amalgamating bank being dissolved by the RBI, which is then struck off by the Registrar before whom that bank

[67] Financial Sector Legislative Reforms Commission, 'Report of the Financial Sector Legislative Reforms Commission' (March 2013).
[68] Banking Regulation Act 1949, s 45; Banking Regulation Act 1949, s 38.
[69] Banking Regulation Act 1949, s 44A.

was registered. Essentially, a transfer of assets and liabilities occurs here.

2) Under the compulsory merger route, there is a direct application by the RBI to the Central Government requesting for a moratorium on the banking company, during which a scheme for merger with a healthy bank is then prepared, which is then sanctioned by the Central Government.[70] Another situation of acquisition may arise, on the order of the Central Government which depends on a report by the RBI.[71]

3) The last resort is for an application to be given to the High Court by the RBI for winding up a banking company.[72] However, the same is inapplicable on RRBs[73] and SBI[74] whose liquidation orders can only be issued by the Central Government.[75]

The authority under Section 35A is contingent on the grounds of public interest, banking policy, prevention of conduct detrimental to depositors or even proper management of any banking company. Over a period of time, these powers have resulted in the allocation of unique and colossal powers to the RBI for the end goal of protection of stakeholders, especially bank depositors and the financial stability of the economy.

[70] Banking Regulation Act 1949, s 44A.
[71] Banking Regulation Act 1949, s 36AE.
[72] Banking Regulation Act 1949, s 38(1)(b).
[73] Regional Rural Banks Act 1976, s 23D.
[74] The State Bank of India 1955, s 45.
[75] State Bank of India Act 1955, s 35.

In the mechanism of resolution, the RBI is not the sole regulatory body, since the role of the DICGC also props in. The DICGC assists in mergers by meeting the shortfall in depositors' claim up to the coverage limit and also by making payouts for banks placed in liquidation. The DICGC also expeditiously settles the claim of depositors, however because of delays in the submission of claim lists, court intervention, delays in receipt of liquidation orders, the process invariably is stretched. But to counter the same, monitoring measures have been introduced to minimise such delays.

In most cases of bank failures, the RBI adopts the 'merger approach' as per Section 44A, in conjunction with Section 56 of the BRA.[76] This grants the authority to approve amalgamation schemes for banks, including smaller ones, wherein the assets and liabilities of the merging bank are transferred to the acquiring bank.

The reason behind choosing this 'merger' approach and this grant of power to the Central Bank, emanates from the suggested policy measures towards countering inefficiencies in the operational and distribution activities of commercial banks. Certain committees had been established by the Government of India in consultation with RBI towards this end, including the Banking Commissions, 1972 under the chairmanship of R.G. Saraiya,[77] 1976 under the Chairmanship of Manubhai Shah,[78]and

[76] Banking Regulation Act 1949, s 56.
[77] Banking Commission, 'Report of the Banking Commission' (1972) <https://archive.org/details/dli.ministry.19883> accessed 19 January 2025.
[78] Extraordinary Gazette of India (1976) No. 1976 256 <https://archive.org/details/in.gazette.e.1976.256..> accessed 21 January 2025.

the Committee for the Functioning of Public Sector Banks, 1978[79]. The recommendations pointed towards having three to four large banks pan India with multiple ones at the regional level. However, it was the Narsimhan Committee in 1991,[80] which accelerated the focus on consolidation and convergence with the aim of making the size of Indian commercial banks comparable to those of globally active banks.[81] The route of mergers has since been used as the tool to tackle the sickness of weak and small banks stemming from non-performing assets, decline in capital adequacy ratio or even erosion in net worth. Thus, the RBI imposes a moratorium under Section 45(1) of the BRA, during which a financially robust bank is asked to prepare a scheme of merger accounting for assets, liabilities and payment to depositors who choose to withdraw their claims. But no provision either provides a power or places a mandate on the RBI to ensure continuity of certain essential services of the failing bank.[82]

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[79] Reserve Bank of India, 'Report of the Committee - Functioning of Public Sector Banks' (June 1997) <https://rbidocs.rbi.org.in/rdocs//PublicationReport/Pdfs/412239_JUNE1977361EDD91A2C44C208F6BE7ABCF04A9B0.PDF> accessed 23 January 2025.

[80] Reserve Bank of India, 'Report of the Committee on the Financial System' (November 1991) <https://ibbi.gov.in/uploads/resources/Narasimham%20Committee%20I-min.pdf> accessed 21 January 2025.

[81] Reserve Bank of India, 'Harmonising the Role and Operations of Development Financial Institutions and banks (Part 1 of 2) Discussion Paper' (January 29, 1999) <https://www.rbi.org.in/scripts/PublicationsView.aspx?Id=225> accessed 21 January 2025. This focus was concretised when the Narasimhan Committee in 1998 had suggested the tool of mergers among banks even with non-Banking Finance companies and financial institutions. For further reference see, Ibid.

[82] Department of Banking Operations and Development & Department of Economic Policy and Research, 'Banking Structure in India - The Way Forward'

The adoption of the 'merger' approach, and the concomitant conferment of enhanced powers upon the Central Bank, can be traced to the policy initiatives aimed at addressing systemic inefficiencies in the operational and distributional functions of commercial banks. In pursuit of these objectives, the Government of India, in consultation with the Reserve Bank of India (RBI), constituted several expert committees, notably the Banking Commission of 1972 chaired by R.G. Saraiya, and the subsequent 1976 Commission. These committees articulated a line of reasoning which emphasised that consolidation would bolster the financial soundness of the banking sector, foster economies of scale, and facilitate more efficient allocation of credit. Furthermore, they identified the fragmented structure of the banking industry, disparities in regional credit flows, and the operational vulnerabilities of smaller banks as critical impediments to national economic development. Accordingly, mergers were advocated as a strategic mechanism to create larger, more resilient banking institutions capable of supporting the broader objectives of planned economic growth and financial inclusion.

Within the merger approach, there have been variations in the manner of implementation. For instance, post 2005, the RBI had put a halt to the liberal licensing policy, and instead introduced a supervisory strategy which merged weak banks with stronger ones for resolution, and closed the unviable ones.[83] A system of incentives had been introduced in 2005 for mergers within UCBs, which included shifting/relocating/closing down the loss-making branches of transferor banks alongside issuance

(August 2013) <https://www.agloc.org/pdf/Banking-Structure-in-India-The-Way-Forward.pdf> accessed 17 January 2025.

[83] M Jayadev, Rudra Sensarma, 'Mergers in Indian Banking: An Analysis' [2007] SAJM 14(4) 20-49.

of licenses to open new branches.[84] In 2010, separate guidelines for transfer of assets and liabilities of weak UCBs to commercial banks had been implemented,[85] which in 2014 had been modified to the extent that large value depositors (having deposits more than the insurance ceiling) had to make sacrifices in proportion to the deposit erosion of the transferor bank[86].

Various tools for resolution of banks, as highlighted by the Report of the Working Group on Resolution Regime for Financial Institutions,[87] carry the merger approach as its underlying conceptualization. For instance, the Good Bank – Bad Bank method entailed splitting of the institution, with the good and performing assets being transferred to a newly licensed institution, and the bad segment being liquidated. A tool of last resort had also been placed, of temporary public ownership, where the role of the government, either central or state places a decisive role in the continuance of the bank. An indicative example can be seen from the influence which the Central Government played in the initial non-liquidation of the Madhavpura Mercantile Cooperative Bank, which will

[84] Guidelines for merger/amalgamation of UCBs (30 January 2009) RBI/2009-09/365 UCB Cir. 43/09.16.900/08-09.
[85] Guidelines for transfer of assets and liabilities of Urban Cooperative Banks to commercial banks (24 February 2010) RBI/2009-10/325 UBD.BPD(PCB). Cir. No. 47/ 09.16.900/2009-10.
[86] Implementation of Section 51-A of UAPA, 1967 - Updates of the UNSCR 1267(1999) /1989(2011) Committee's Al-Qaida Sanctions List - Primary (Urban) Co-operative Banks (UCBs) (27 November 2014) RBI/2014-15/324 DCBR.BPD (PCB/RCB) Cir. No.1/14.01.062/2014-15.
[87] Reserve Bank of India, 'Report of the Working Group on Resolution Regime for Financial Institutions' (January 2014) <https://dea.gov.in/sites/default/files/Report%20of%20the%20Working%20Group%20on%20Resolution%20Regime%20for%20Financial%20Institutions%20_1.pdf> accessed 18 January 2025.

be discussed in the following paragraphs. Thus, the merger approach is certainly a foundation for formulating tools for resolution strategies, however the suitability of it being the sole tool for resolution is doubtful.

Plausibly recognising such unsuitability, the RBI introduced the circular Revised Framework for Resolution of Stressed Assets on February 12, 2018 after the enactment of the Insolvency and Bankruptcy Code (IBC), which provided for a procedure pre-initiation of CIRP within a timeline of 6 months, following which a reference needed to be attained by RBI.[88] The intent had been for attaining a harmonised and simplified generic framework.

This was soon challenged before the Supreme Court, on grounds of exceeding the authority granted under Section 35AA of BRA. Section 35AA explicitly vests the Central Government with the power to issue an order, authorising the RBI to issue directions to any banking company to initiate CIRP under the IBC, 2016.[89] The Supreme Court in the case of *Dharani Sugars v Union of India*[90] upheld regulatory powers under the BRA, however held that the RBI Circular was ultra vires to Section 35AA as it had been sanctioned without the authorisation of the Central Government, and covered all debtors, going beyond the mandate of specific defaults by specific debtors under Section 35AA. Following the whip of the Supreme Court, the Prudential Framework for Resolution of Stressed Asset had been released for SFBs, NABARD, and scheduled

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[88] Resolution of Stressed Assets - Revised Framework (12 February 2018) RBI/2017-18/131 DBR.No.BP.BC.101/21.04.048/2017-18.
[89] Banking Regulation Act 1949, s 35AA.
[90] Dharani Sugars and Chemicals Ltd v Union of India AIR Online 2019 SC 305.

commercial banks aimed at early identification and reporting mechanism for stressed assets.[91]

Even for UCBs, there had been earlier the Supervisory Action Framework (SAF)[92], an intervention tool for improving weaker UCBs, which is now replaced with the PCA framework[93], effective April 01, 2025. The objective of the PCA Framework is to enable supervisory intervention at an appropriate time and require the UCBs to initiate and implement remedial measures in a timely manner, to restore their financial health. The PCA Framework does not preclude RBI from taking any other action as it deems fit at any time, in addition to the corrective actions prescribed in the Framework. The same offers more flexibility for designing supervisory action plans while maintaining the same rigorous supervisory standards.[94]

The varied application of such frameworks and powers of the central bank can be seen in certain recent examples of bank instability or failure. These cases highlight the importance of robust governance, prudent lending practices, and effective regulatory oversight. At the same time,

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91 Prudential Framework for Resolution of Stressed Assets (7 June 2019) RBI/2018-19/203 DBR.No.BP.BC.45/21.04.048/2018-19.

92 Supervisory Action Framework for Primary (Urban) Co-operative Banks (UCBs) (06 January 2020) RBI/2019-20/135 DOR (PCB). BPD. Cir No. 9/12.05.001/2019-20.

93 Prompt Corrective Action (PCA) Framework for Primary (Urban) Co-operative Banks (UCBs) (26 July 2024) RBI/2024-25/55 DOS.CO>PPG.SEC. No.8/11.01.005/2024-25.

94 Fox Mandal Solicitors, 'Prompt Corrective Action Framework Introduced for UCBs' (8 August 2024) <https://www.foxmandal.in/News/prompt-corrective-action-framework-introduced-for-ucbs/#:~:text=Compared%20to%20the%20SAF%2C%20the,based%20on%20individual%20risk%20assessments> accessed 02 February 2025.

they indicate the response of the RBI and the government in dealing with instances of banking failures.

A. The Regulatory Tussle Over Madhavpura Mercantile Cooperative Bank

One of the earliest cases of bank failures in small banks was the sudden collapse of the Madhavpura Mercantile Cooperative Bank (MMCB), which in 2001 was the largest urban cooperative bank in Gujarat having a deposit base of around Rs. 1200 crore back in 2001. At the time, there had been no prohibition for small banks to lend to individuals associated or actively engaging in business with the stock market, rather a cap of total lending of Rs. 15 crores for each bank existed. MMCB had significantly crossed this threshold in lending to Ketan Parekh and other stock brokers through guarantees, loans etc., to the tune of around Rs.1200 crores.

After the 2001 dot com bubble burst, an immediate crash of the stock market resulted, placing the bank's reputation at stake, cascading to mass withdrawals by depositors.[95] Such financial irregularity through overexposure to the stock market led to RBI's immediate suspension of the management, and investigation which revealed that the gross NPA was around 99.9% of its gross advances.[96]

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[95] Dinesh Unnikrishnan, Maulik Pathak, 'RBI cancels Madhavpura bank license; liquidator to be appointed' (*LiveMint*, 8 June 2012), <https://www.livemint.com/Companies/937331yO9WKLcphLvyjYoN/RBI-cancels-Madhavpura-bank-licence-liquidator-to-be-appoin.html> accessed 2 February 2025.

[96] Ruby Jacob, 'Madhavpura Mercantile Co-operative Bank Ltd looses banking license' (*FinTotal*, 8 June 2012)

Despite the RBI leaning in favour of liquidation of the bank, the NDA government decided to attempt a revival of the bank, reposing the trust of the depositors, through a restructuring scheme for a period of 10 years.[97] Rs. 800 crores were infused, with the Centre and State contributing 70:30. However after its expiry, there was no major improvement in the bank's performance, prompting the RBI to advise the Government to liquidate the bank. Another proposal for infusion around Rs. 5,000 crore was rejected by the RBI[98], which subsequently cancelled the banking license of MMCB and liquidated it.

B. The Punjab and Maharashtra Cooperative Bank Fiasco

A recent prominent example is the fall of the Punjab and Maharashtra Cooperative (PMC) Bank, which had more than 137 branches spread across 7 states, and had deposits from more than 35,000 cooperative housing societies and small businesses. In the initial two years of its establishment, it was on the verge of closure, however the Wadhawan's parked big volumes of deposits into the bank to help the bank build its

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<https://web.archive.org/web/20140525214118/http://www.newsanalysis.fintotal.com/Madhavpura-Mercantile-Co-operative-Bank-Ltd-looses-banking-license/1926> accessed 2 February 2025.

[97] Priya Ranjan Dash, 'Centre unveils bailout package for Madhavpura Bank' (*The Times of India*, 20 June 2001) <https://timesofindia.indiatimes.com/business/india-business/centre-unveils-bailout-package-for-madhavpura-bank/articleshow/116977578.cms> accessed 2 February 2025.

[98] Ankur Jain, 'Has RBI move sunk Madhavpura Mercantile Co-operative bank revival plan?' (*The Times of India,* 06 June 2012) <https://timesofindia.indiatimes.com/business/india-business/has-rbi-move-sunk-madhavpura-mercantile-co-operative-bank-revival-plan/articleshow/13857740.cms> accessed 2 February 2025.

credibility among depositors, which recurred in 2004 where US $20 million had been provided to sustain the liquidity crunch.[99]

Through the years there had been several allegations of fabrication of accounts, generation of false reports, and concealment of loans. For instance, the loan portfolio provided to a single borrower, Housing and Development Infrastructure Ltd (HDIL) and its group entities, amounted to around 73% of the total loan portfolio of PMC, covering around US $ 1.24 billion. This was primarily due to HDIL's real estate operations which took a slump because of the declining demand in 2011 and 2012 and was further exacerbated by the change in Maharashtra government' policy and restrictions placed on the resale of transferable development rights. The two auditing firms had also been associated with the HDIL group. On an immediate basis, PMC was placed under business restrictions, with the RBI superseding the bank's board, which led to a further decline in the net worth of the bank.[100]

In the resolution plan for PMC, an amalgamation was chosen with Unity Small Finance Bank with the resolution plan being termed as one of its own kind schemes. The DGIC Corporation was used to pay depositors Rs. 5 lakhs through Unity Small Finance Bank, which would have to be

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99 ENS Economic Bureau, 'Centrum to takeover PMC Bank, partner BharatPe to launch SFB' (*Indian Express*, 19 June 2021) <https://indianexpress.com/article/business/economy/centrum-to-takeover-pmc-bank-partner-bharatpe-to-launch-sfb-7365575/> accessed 09 February 2025.

100 Dinesh Unnikrishnan, 'RBI to work on PMC Bank resolution 'very quickly', says Governor Shaktikanta Das' (*Money Control*, 08 December 2021) <https://www.moneycontrol.com/news/business/rbi-to-work-on-pmc-bank-resolution-very-quickly-says-governor-shaktikanta-das-7803331.html> accessed 2 February 2025

reimbursed over a period of 20 years. Interestingly, United Small Finance Bank had been a joint venture between BharatPe and the Centrum Group, where Centrum Group had gotten 'in principle approval' in an unseen circumstance, by the RBI, to set up the SFB.[101] Following which, a phased manner of repayment of deposits was implemented over a period of 10 odd years.

Accordingly, the insured amount by DICGC stood at Rs. 5,464.86 crore out of the total pending amount of Rs. 7,836.77 crore by 9.09 lakh individual depositors.[102] Surprisingly, even the bail-in tool was utilized, although in a less intensive manner, wherein 80% of the outstanding deposits would be converted to perpetual non-cumulative preference shares, with the remaining 20% being converted to equity warrants of Unity Small Finance Bank.[103] After a period of 10 years, Unity Small Finance Bank would undertake buyback of the preference shares on a pro rata basis.[104]

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[101] Money Control News, 'PMC Bank acquisition by Centrum-Bharatpe was smartest corporate move in history, claims Ashneer Grover' (*Money Control*, 18 May 2022) <https://www.moneycontrol.com/news/business/pmc-bank-acquisition-by-centrum-bharatpe-was-smartest-corporate-move-in-history-claims-ashneer-grover-8529631.html> accessed 2 February 2025;

[102] Vishwanath Nair, 'PMC Bank Resolution Scheme Approved by Government with Staggered Deposit Pay-Out' (*NDTV Profit*, 22 January 2022) <https://www.ndtvprofit.com/business/pmc-bank-resolution-scheme-approved-by-government-with-staggered-deposit-pay-out> accessed 2 February 2025.

[103] M&A Critique, 'Inside BharatPe-Centrum proposed JV to acquire troubled PMC Bank' (*M&A Critique*, 20 July 2021) <https://mnacritique.mergersindia.com/news/inside-bharatpe-centrum-proposed-jv-to-acquire-troubled-pmc-bank/> accessed 2 February 2025.

[104] Press Trust of India, 'Centrum-Bharatpe JV to infuse Rs 1,800 crore into PMC Bank on merger' (*Business Today*, 21 June 2021) <https://www.businesstoday.in/latest/corporate/story/centrum-bharatpe-jv-

This incident resulted in several reforms by the RBI and the Central Government, with the UCBs of worth more than USD 100 million to provide quarterly reports to the Central Repository of Information on Large Credits (CRILC). A massive data centre had been set up by the RBI, and the Banking Regulation (Amendment) Bill had been introduced in 2020, which recently was passed by the Lok Sabha, increasing the regulatory whip of RBI over cooperative banks in terms of their management, capital, audit, and liquidation, leaving over administration matters under the RoCs.[105]

C. The Rescue of Lakshmi Vilas Bank

A more recent instance also occurred with Lakshmi Vilas Bank (LVB) in 2020. Having obtained its banking license in 1958, it was classified as a scheduled commercial bank. Originally aimed to providing financial services to small businesses and SMEs, for the larger objective of growth it shifted its primary focus to large businesses, taking inspiration from other private banks such as ICICI Bank and Axis Bank,[106] by providing huge loans, for its size, to the tune of Rs. 720 crores to former promoters of Ranbaxy and Fortis Healthcare, against fixed deposits of Rs. 794 crores, which was ultimately turned out to be a bad loan.

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to-infuse-rs-1800-crore-into-pmc-bank-on-merger-299210-2021-06-21> accessed 2 February 2025.

[105] Vishwanath Nair, 'PMC Bank Resolution Scheme Approved by Government with Staggered Deposit Pay-Out' (*NDTV Profit*, 22 January 2022) <https://www.ndtvprofit.com/business/pmc-bank-resolution-scheme-approved-by-government-with-staggered-deposit-pay-out> accessed 2 February 2025.

[106] Venkatesh Ganapathy, Varshini Sharma, Vidyashree, Sunidhi Kumari, 'Case Study - An Analysis of Corporate Governance Deficit in Lakshmi Vilas Bank' (2021) CJBM 3(2).

LVB was later sued by Religare Finvest in 2018, for redeeming the fixed deposit of around Rs 800 crore against the loan provided. To cover the same, the bank went for a rights issue, indicating less losses in the following financial quarter however a rise in non-performing assets. The share price dipped from Rs. 185 to Rs. 10, ensuring complaints to both SEBI and RBI.[107] This prompted the RBI to place the bank under PCA in 2019. However, the PCA had no impact on the financial standing of the bank, during which the gross ratio of non-performing assets to advances rose to 25.4%.[108] During this time, the shareholders ousted seven directors from the company including the MD. Although discussions were in place between LVB and IndiaBulls Housing Finance, however after a month, RBI refused such a proposal without any reason.[109] Negotiations between Clix Capital and LVB also were subdued on such news.

Later in 2020, the Central Bank placed a one-month moratorium on LVB and simultaneously announced the scheme of amalgamation between DBS Bank and LVB,[110] which entailed capital infusion of Rs. 2,500

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[107] Economic Times Banking, Financial Services and Insurance, 'What went wrong with Lakshmi Vilas Bank? Here is all you need to know' (*ETBFSI*, 1 October 2020) <https://bfsi.economictimes.indiatimes.com/news/banking/here-is-all-you-need-to-know-about-what-went-wrong-with-lakshmi-vilas-bank/78404094> accessed 9 February 2025.

[108] The Hindu, 'Another bailout: On Lakshmi Vilas Bank' (*The Hindu*, 20 November 2020) <https://www.thehindu.com/opinion/editorial/another-bailout-the-hindu-editorial-on-lakshmi-vilas-bank/article33135626.ece> accessed 9 February 2025.

[109] Business Standard, 'What is the Lakshmi Vilas Bank (LVB) crisis?' *Business Standard* <https://www.business-standard.com/about/what-is-lakshmi-vilas-bank-crisis> accessed 9 February 2025.

[110] The Hindu, 'Another bailout: On Lakshmi Vilas Bank' (*The Hindu*, 20 November 2020) <https://www.thehindu.com/opinion/editorial/another-

crores.[111] Surprisingly, the Madras High Court refused to intervene in the merger of LVB and DBS, probably in light of time constraints and swift decision making.[112] Such an instance is recorded to be the first one in terms of granting a foreign bank to rescue an Indian bank, a proposal which was at one time denied for MMCB.

On analysing the above three cases, it is seen that the RBI has taken very different and innovative gateways in reaching a time-based solution, depending on the expanse and impact of the bank, and the political climate. However, the result in all three cases has been either a merger/amalgamation or liquidation of the bank. Such strategies may function for standalone instances, however their effectiveness and viability for a scenario witness to multiple bank failures will probably fail to withstand the pressures of the financial economy. The present regulatory mechanism for small banks, suffers from an expanded and formalised take on the resolution mechanism, which is currently not the case for several jurisdictions. Keeping aside the validity of such frameworks when tested with their source authority, there are still several tools such as the bail in mechanism, transfer, or even a formal bank insolvency procedure would help provide adept and effective

bailout-the-hindu-editorial-on-lakshmi-vilas-bank/article33135626.ece> accessed 9 February 2025.

[111] M&A Critique, 'RBI merges Lakshmi Vilas Bank with DBS Bank India' (*M&A Critique*, 1 December 2021) <https://mnacritique.mergersindia.com/lakshmi-vilas-bank-dbs-merger/> accessed 9 February 2025.

[112] Dinesh Unnikrishnan, 'Banking Central | What makes HC order on Lakshmi Vilas Bank-DBS India merger important?' (*Money Control*, 29 April 2024) <https://www.moneycontrol.com/news/business/banks/banking-central-what-makes-hc-order-on-lakshmi-vilas-bank-dbs-india-merger-important-12710028.html> accessed 9 February 2025.

decision making, which if not included, may soon show its adverse impact in times of crisis.

V. A STRATEGIC FRAMEWORK FOR RESOLVING SMALL BANK CRISIS

Having understood the unique positioning of small banks in the Indian banking sphere and its undervalued enormous impact on its economy, this part of the paper seeks to discuss what factors and considerations need to be addressed in devising a framework or at the bare minimum altering the strategy which is currently being undertaken by the regulatory authorities.

For prevention of financial failure of banks, certain safety nets have been traditionally developed and used, such as prudential supervision, deposit insurance and as the last resort liquidity support or capital infusion. A key issue which arises is that different stakeholders, broadly covering the RBI, DGIC, State Governments, the Central Government, with their further encompassing web of regulatory framework, have the authority to exercise differing tools for the aims of financial stability of the economy and depositor's protection. An effective resolution mechanism, predominantly owing to time constraint which is heightened in the banking sector, requires a single autonomous agency with comprehensive and encompassing powers to take such measures in a swift manner. It needs to be clarified that a single agency would not translate into a single regulatory mechanism for supervision and regulation of all different types of financial institutions, since the intensity of measures adopted, the specific challenges and considerations for financial institutions would differ basis their positioning.

To elaborate further, the proposed single autonomous agency would function as a specialised resolution authority, distinct from prudential supervisors and regulators, with a clear mandate focused exclusively on the timely resolution of failing banks. Its powers would encompass a broad range of interventions including, but not limited to, forced mergers and acquisitions, bridge bank operations, recapitalisation, asset recovery, and, where necessary, the facilitation of orderly liquidation. Unlike the fragmented authority currently spread across multiple stakeholders such as the RBI, DICGC, and various governmental entities, the single agency would centralise decision-making to ensure expedited action within strict timeframes critical to the banking sector. Importantly, this would not entail a unified supervisory regime across all financial institutions; rather, sector-specific regulators would continue their distinct supervisory roles. The resolution authority's interventions would be calibrated according to the nature, size, and systemic importance of the distressed institution, thereby respecting the differentiated challenges faced by small banks, such as the pressures of priority sector lending obligations and greater political sensitivities. Embedding such an institution within a clear statutory framework would thus enhance the resilience of the financial system while safeguarding depositor interests.

For small banks, considerations range from their mandate for PSL to heightened political interference. Within the current framework, the choice of selection being the RBI or even the DGIC would be infeasible, not only constitutionally, as witnessed from the debacle occurring in the overreach of the RBI in creating an insolvency framework for financial institutions and its curtailment by the Supreme Court of India[113], but operationally it would take a high toll in light of the advantages of a specialised institution. The expansion of the mandate of the DICGC, although deliberated over[114], would still fail to cater to the political interests. A corollary advantage to the creation of a new institution would be the authority to exercise varied nature of tools, extending its ambit beyond the typical tool of mergers and amalgamations.

The wherewithal of capital infusion may be brought in by government intervention, expertise from the Insolvency and Bankruptcy Board of India (IBBI) and RBI may conjointly allow for a bridge service provider, or even as the last resort of liquidation. Further delays in decision making and implementation of measures would be highly curtailed, by taking prompt corrective measures, information gathering, recovery of assets etc. The legal incorporation of the proposed institution could be achieved either through a standalone legislative framework or by amending existing statutes such as the DICGC Act, 1961 or the Banking Regulation Act, 1949. A dedicated enactment, similar to the Insolvency and Bankruptcy Code, 2016, would allow for a comprehensive and coherent structure, clearly defining the institution's powers, functions, and governance mechanisms. This would include authority over capital infusion, management of bridge service providers, coordination with the RBI and IBBI, and, where necessary, liquidation proceedings.

113 Dharani Sugars and Chemicals Ltd v Union of India AIR Online 2019 SC 305.
114 Reserve Bank of India, 'Report of the Working Group on Resolution Regime for Financial Institutions' (January 2014) <https://dea.gov.in/sites/default/files/Report%20of%20the%20Working%20Group%20on%20Resolution%20Regime%20for%20Financial%20Institutions%20_1.pdf> accessed 18 January 2025.

Embedding these powers within a statutory framework would ensure regulatory certainty, operational independence, and effective oversight, thereby strengthening the broader financial stability architecture.

Another key area is the limitation on small banks to expand their activities to the secondary market or the capital market. The idea of being 'small' has naturally been synchronised with the regulatory oversight of 'growth.' Being small necessarily implies not growing beyond a certain threshold. However, the threshold can be increased, if small banks are permitted to extend their financial activities to the secondary market. Such activities do definitely carry a high risk, which considering the scale of small banks can have a big impact on their functioning, but in a regulated manner this also provides opportunities for experimental growth. A similar idea of a secondary market for stressed assets is growing under IBC, which may lead to efficient management of credit exposures by the lending institutions.[115] Although a self-regulatory body has been proposed therein[116], the ability to tackle any adverse impacts would be better absorbed by a single all-encompassing statutory agency overlooking such operations, while promoting liquidity, efficiency, and growth of the secondary market as well.

A tentative solution which may be a way out in addressing the concerns of solvency issues of small banks in India requires a revisit to the

[115] Shaktikanta Das, 'Insolvency & Bankruptcy Code - Towards Achieving Full Potential' (Conference on Resolution of Stressed Assets and Insolvency and Bankruptcy Code (IBC), 11 January 2024) <https://ibbi.gov.in/uploads/resources/707813fd9a649eee9402ff5d355ef2f1.pdf> accessed 13 January 2025.

[116] Reserve Bank has brought together a core group of major banks to set up a Self-Regulatory Body – i.e. Secondary Loan Market Association (SLMA).

Financial Resolution and Deposit Insurance (FRDI) Bill, 2017. Aimed at monitoring and resolving failing financial firms, including banks, insurance companies, stock exchanges, depositors, etc, it sought to establish a single body – Resolution Corporation – to anticipate, monitor and take corrective actions in the case of failure of a bank.[117] However the political and economic climate of the country in addition to the inability of the government to satisfy the general populace, led to a huge uproar which cast away the futuristic initiative. Certain issues which resulted in its demise were the prohibition of jurisdiction of any court on the decision of the Resolution Corporation evading judicial scrutiny, the presence of bail-in tool as a resolution strategy, which arguably had raised several concerns of the Indian population losing their deposits in case of a bank failure, and in the scenario of the financial firm being classified as critical, the absolute control of the Resolution Corporation as the administrator. The legislation was not specifically intended to cover small banks in India, but rather broadly covered all financial institutions.

What may be suitable would be to tweak the ambit of the Resolution Corporations for the systematically non important banks, leaving RBI with the mandate to tackle and utilise tools for addressing solvency issues of systemically important banks. The underlying reason for this distinction is that this would help bring a broad representation from the

[117] Ministry of Finance, 'Financial Resolution and Deposit Insurance (FRDI) Bill, 2017 seeks to protect and enhance the depositors' existing rights and bring in a comprehensive and efficient resolution regime for financial firms' (*Press Information Bureau*, 02 January 2018) <https://dea.gov.in/sites/default/files/PressRelease02012018.pdf> accessed 13 January 2025.

current stakeholders including RBI, DICGC, Central Government, the respective state government, IBBI, and other regulators such as NABARD etc., for addressing concerns for functioning of small banks within a specified sphere. The utilisation of mergers, whether forced or voluntary, or capital infusion for systemically important banks may be better served by the ambit of the RBI and the Central Government, especially owing to its rare occurrence. Moreover, this system may accrue benefits such as, expansion of tools at the disposal of the "Resolution Corporation," avoidance of delays, adequate coverage of insurance for depositors largely owing to the low amount of deposit in small banks (when compared to large banks), a single platform for deliberation and decision making.

Additionally, here a system of differential treatment for premium on insurance may be conducted by the agency. For instance, an issue which persists is that although banks are heterogeneous, a uniform premium for insurance is imposed on all such banks by the DICGC[118]. This has led to enhanced contribution by the commercial banks, which are ultimately channelled into the cooperatives. For instance, commercial banks have contributed around 92% of the premium received by the DICGC, with the amount being dished to co-operative banks, whose contributions are around 14% of the deposits insured.[119] The body may also be able to alter the quantum of insurance per depositor for each category of bank,

[118] The Deposit Insurance and Credit Guarantee Corporation Act, 1961, s 15.
[119] Reserve Bank of India, 'Report of the Working Group on Resolution Regime for Financial Institutions' (January 2014) <https://dea.gov.in/sites/default/files/Report%20of%20the%20Working%20Group%20on%20Resolution%20Regime%20for%20Financial%20Institutions%20_1.pdf> accessed 18 January 2025.

depending on the risk intensity, number of depositors, deposit amount etc. This may still need to be tested against the increased burden on commercial banks.

The aspect of whether such a system would be able to provide a sufficient and ready repository of funds to be utilised in case of any exigency where there may be multiple failures will still need to be deliberated over. If such a solution is targeted only for small banks, and not for systemically important banks, the coverage of deposits may suffice and ensure adequate protection for systemically non-important banks. There may be a need to either craftly increase the insurance premium, the contributions made by the respective banks, or keep a balance of fund utilisation and utilisation of tools such as bail-in, run-off strategies, mergers, bridge service providers, capital infusion etc., towards addressing solvency issues. However, what is certain is that the current strategies adopted in standalone circumstances and for large banks would not suffice the needs of small banks, requiring a separate framework.

VI. CONCLUSION

In light of the foregoing discussion, it can be conclusively stated that small and medium-sized banks in India serve as a critical linchpin in advancing the nation's agenda of inclusive and sustainable economic growth. Their unique positioning catering to underbanked populations, rural enterprises, and microfinance sectors has entrenched their indispensability within the broader financial ecosystem. However, their continued effectiveness is severely constrained by deep-seated challenges, including systemic governance lapses, fragmented regulatory oversight, heightened operational vulnerabilities, and exposure to politically-induced distortions. These systemic deficiencies, if left unaddressed, risk not only undermining depositor confidence but also destabilising broader financial stability, which remains essential for India's economic aspirations.

Strengthening oversight, enhancing inter-agency coordination, and tailoring resolution mechanisms to the specific operational realities of small banks are therefore non-negotiable imperatives. However, beyond identifying what needs to be done, there must be a clear articulation of how these reforms are to be operationalised. It is within this context that the establishment of a specialised, autonomous resolution authority emerges as a pivotal reform.

This proposed institution must be vested with comprehensive and pre-emptive powers, extending beyond traditional regulatory supervision to include crisis resolution, structured asset recovery, imposition of moratoria, facilitation of bridge banks, recapitalisation, mergers and acquisitions, and, where necessary, the orderly liquidation of distressed banks. Crucially, its authority must be codified within a robust statutory framework, distinct from the supervisory mandates of existing bodies such as the RBI and DICGC, ensuring clarity of purpose, operational independence, and protection from political or commercial interference. The legislative design should provide for built-in accountability mechanisms such as mandatory public disclosures, judicial review of critical decisions, and performance audits to safeguard the balance between autonomy and transparency.

Operationally, the authority must implement a calibrated, risk-based intervention framework. It should mandate real-time regulatory reporting, enforce periodic stress testing tailored to the asset-liability profiles of small banks, and establish early warning systems capable of triggering tiered corrective actions based on the severity of financial deterioration. Furthermore, differentiated supervisory strategies must be developed to reflect the heterogeneity of small banks in terms of their size, clientele, and geographic spread. For instance, cooperative banks operating under localised mandates would require distinct stress thresholds compared to small finance banks with regional or national reach.

Additionally, in recalibrating the resolution architecture, a crucial focus must be placed on enabling small banks to diversify their revenue streams through cautiously regulated entry into secondary markets and limited capital market activities. While such moves introduce additional layers of risk, the establishment of clear exposure limits, capital buffers, and liquidity coverage requirements under the oversight of the resolution authority would mitigate systemic vulnerabilities, while simultaneously promoting innovation and resilience.

The experience of recent high-profile bank failures including those of Madhavpura Mercantile Cooperative Bank, Punjab and Maharashtra Cooperative Bank, and Lakshmi Vilas Bank — underscores the dangers of fragmented, reactive regulatory interventions and the inadequacy of existing resolution frameworks for dealing with the distinct vulnerabilities of small banks. These cases demonstrate that while ad hoc mergers and capital infusions can address immediate crises, they fail to provide a systematic, scalable response in the event of multiple contemporaneous failures—a risk that cannot be discounted given the rising financial interconnectivity and evolving risk landscape.

The creation of a single, specialised resolution authority, therefore, is not merely a matter of regulatory convenience but a structural necessity to ensure systemic preparedness. Its establishment would also allow for the deployment of innovative resolution tools such as bail-in mechanisms (subject to depositor protection thresholds), bridge banks for continuity of critical services, asset separation, and differential insurance premiums based on risk exposure — a significant step forward from the blunt instrument of merger-driven resolution strategies currently favoured.

Finally, embedding this authority within a legally autonomous yet operationally integrated architecture with institutional linkages to the RBI, DICGC, IBBI, and relevant state and central government agencies would ensure a coordinated and harmonised response across regulatory silos. This would not only enhance depositor protection and systemic stability but would also lay the groundwork for more resilient, competitive, and innovative small banking institutions capable of contributing meaningfully to India's ambitious economic and social development goals.

In sum, without decisive, structured, and future-facing reforms, the small and medium banking sector risks becoming a point of systemic fragility rather than a catalyst for inclusive growth. A coherent, legally empowered resolution authority represents the cornerstone of any serious strategy to safeguard the future of small banks and, by extension, the health of India's financial system itself.