*Differentiated Banks: Design Challenges**

R. Gandhi

In a dynamic growth-oriented economy, the financial sector needs to keep pace with the demands of the real sector. It is crucial that the financial system is flexible and competitive to cope with multiple objectives and demands made on it by various constituents of the economy. The financial sector comes of age when it has diverse institutions, catering to different segments, ranging from retail to wholesale, micro-finance to project finance, nurturing specific sectors and offering specialised services and tailor-made products to niche segments.

2. In India, banking industry is the most important channel which provides financial services. One of the key objectives of bank nationalisation in 1969 and 1980 was to spread the banking habit through opening branches in hitherto un-banked areas. The post nationalisation decades witnessed rapid spread of bank branches in hitherto un-banked areas and banking has since increased in scale and complexity.

3. Over the years the Reserve Bank has completely liberalised and has put it at the banks' end the decision about their geographical expansion and coverage; banks are effectively free to decide how many branches and other channel outlets they should open, when and where these touch points should be located, *etc.* Consequently, as on March 31, 2014, there were 1,16,415 branches of scheduled commercial banks, 19,082 branches of the RRBs, and 9,526 branches of UCBs. As on March 31, 2013, there were also 93,488 PACS in the country. Further, there were 3,98,408 Banking Correspondent touch-points as on March 31, 2014.

* 'Sri V Narayanan Memorial Lecture' delivered by Shri R. Gandhi, Deputy Governor, Reserve Bank of India, at Sastra University, Campus Kumbakonam on April 18, 2015. Assistance provided by Ms Sara Rajendra Kumar is gratefully acknowledged.

Financial Inclusion

4. Though the reach and scope of banking has thus increased, the huge demand for financial services remains unsatiated. It is a matter of concern that even with 150 domestic commercial banks [comprising 26 Public Sector Banks, 20 Private Sector Banks, 44 Foreign Banks, 4 Local Area Banks (LABs), 56 RRBs] and over 2,700 co-operative sector banks operating in the country, just about 40 per cent of the adults have formal bank accounts. The Reserve Bank is aware of this aspect and is committed to financial inclusion and is exploring various possibilities to foster inclusion of the unserved and under-served population and areas and facilitate provision of affordable financial services by increasing competition among the banks and encourage innovative approaches (including channels, products, interface, *etc.*).

5. The Government of India and the Reserve Bank are clear that financial inclusion is a massive requirement and therefore all financial sector participants will have to put in consistent efforts in that direction. The Reserve Bank created a conducive and enabling environment for access to financial services to extend door step banking facilities in all the unbanked villages in a phase-wise manner. During Phase I, 74,414 unbanked villages with population more than 2,000 were identified and allotted to various banks through SLBCs for coverage through various modes, that is, branches, BCs or other modes such as ATMs and satellite branches, *etc.* All these unbanked villages have been covered by opening banking outlets comprising 2,493 branches, 69,589 BCs and 2,332 through other modes.

6. In Phase II, under the roadmap for provision of banking outlets in unbanked villages with population less than 2,000, about 4,90,000 unbanked villages have been identified and allotted to banks for coverage in a time bound manner by March 31, 2016. As per the progress reports received from SLBCs, banks had opened banking outlets in 1,83,993 unbanked villages by March 2014, comprising 7,761 branches, 163,187

BCs and 13,045 through other modes. The Reserve Bank is closely monitoring the progress made by the banks under the roadmap.

7. The Reserve Bank has encouraged banks to adopt a structured and planned approach to financial inclusion (FI) with commitment at the highest levels through preparation of board approved financial inclusion plans (FIPs). The first phase of FIPs was implemented over 2010-13. The Reserve Bank has used FIPs to gauge the performance of banks under their FI initiatives. With the completion of the first phase, a large banking network has been created and a large number of bank accounts have also been opened. However, it has been observed that the accounts opened and the banking infrastructure created has not seen substantial operations in terms of transactions. In order to continue with the process of ensuring meaningful access to banking services to the excluded, banks were advised to draw up fresh three-year FIPs for 2013-16. Banks were also advised that the FIPs prepared by them are disaggregated and percolate down to the branch level so as to ensure the involvement of all the stakeholders in FI efforts and also to ensure uniformity in the reporting structure under FIPs. The focus under the new plan is now more on the volume of transactions in the large number of accounts opened. A brief of the performance of banks under FIP up to March 31, 2014 is:

i. The number of banking outlets has gone up to nearly 3,84,000. Out of these, 1,15,350 banking outlets were opened during 2013-14.

ii. Nearly 5,300 rural branches were opened during 2013-14. Out of these, nearly 4,600 branches were opened in unbanked rural centres (Tier V and Tier VI centres).

iii. Nearly 33,500 BC outlets were opened in urban locations during 2013-14 taking the total number of BC outlets in urban locations to 60,730 as at the end of March 2014.

iv. More than 60 million basic savings bank deposit accounts (BSBDAs) were added during the 2013-14 taking the total number of BSBDAs to 243 million.

v. With the addition of 6.2 million small farm sector credits during 2013-14, there are 40 million such accounts as on March 31, 2014.

vi. With the addition of 3.8 million small non-farm sector credits during 2013-14, there are 7.4 million such accounts as on March 31, 2014.

vii. Nearly 328 million transactions were carried out in BC-ICT accounts during 2013-14 as compared to 250 million transactions during 2012-13.

8. As you all know, greater impetus to the Financial Inclusion plans has since been received through the Prime Minister's Jan Dhan Yojana. Under this programme, in a short span of seven and a half months, a world record breaking achievement in the form of opening JDY Accounts for 14.71 crore persons as at end March 2015 has been accomplished.

Need for more Banks & Differentiated Banks

9. While thus the Financial Inclusion efforts through the existing set of banks have been continued, the Reserve Bank is conscious of the position that these may not be adequate to speed up the process and achieve the goals early. A Govt of India's High Level Committee on Financial Sector Reforms headed by Dr. Raghuram G. Rajan submitted in 2008 its Report titled 'A Hundred Small Steps'. Among its various recommendations, the Committee recommended that there is a need for paradigm shift in the strategy for financial inclusion. It said the emphasis should be shifted from large-bank-led, public-sector-dominated, mandate-ridden, branch-expansion-focussed strategy. It said the poor need efficiency, innovation, and value for money which can come from motivated financiers who have low cost structure and thus see poor as profitable, but who also have the capacity to make decisions quickly, and with minimum paperwork. It therefore recommended that entry to private, well-

governed, deposit-taking small finance banks be allowed.

10. The available options for the Reserve Bank to facilitate expansion of banking in the country are through private sector banks and foreign banks. The policy for approving foreign bank applications to open maiden branch and further expand their branch presence has been liberalised in 2005. However, for well documented reasons, we have been very cautious of allowing unrestricted and unbridled growth of foreign banks in India through their branch banking mode. Hence, after a long process of consultation since 2005, finally in November 2013, we came out with our policy for allowing the foreign banks through Wholly Owned Subsidiary (WOS) model. The scheme is yet to take off, though two foreign banks have since approached us formally in this regard.

11. The licensing policy for the private sector banks has been to grant universal bank licences as a 'stop and go' licensing system. In the above background, in 2010, the Reserve Bank brought out a Discussion Paper for licensing of new banks in the private sector, which was followed by draft guidelines and the issue of final guidelines in February 2013 and culminated in issuing of banking licences to two applicants. It may be recalled that the last two rounds of licensing took place way back in 1993 and 2004. We have since granted in principle approval for two new private sector universal banks. We have also expressed our intention to make the universal bank licences available 'on tap'.

12. The concept of differentiated banks was first discussed in 2007 when it was felt that the time was not yet opportune for such banks. Thereafter, the concept was once again discussed in a Paper 'Banking Structure in India – The Way Forward', brought out by the Reserve Bank in August 2013. The Paper looked into various aspects of the banking structure, licensing of banks, banking models and suggested a transition path for some banks.

13. Another initiative taken by the Reserve Bank was setting up of a Committee headed by Shri Nachiket Mor, on Comprehensive Financial Services for Small Businesses and Low-Income Households to look into the issues relating to financial inclusion. The committee came up with two broad designs for the banking system in the country – the Horizontally Differentiated Banking System (HDBS) and the Vertically Differentiated Banking System (VDBS) based on the functional building blocks of payments, deposits and credit.

14. In a HDBS design, the basic design element remains a full-service bank that combines all three building blocks of payments, deposits, and credit but is differentiated primarily on the dimension of size or geography or sectoral focus. In a VDBS design, the full-service bank is replaced by banks that specialise in one or more of the building blocks of payments, deposits, and credit. Among others, the Committee suggested licensing of Payments Bank and wholesale banks as differentiated banks.

15. The Nachiket Mor committee opined that in the Indian context it would be important to have the regulatory flexibility to approach payments, savings, and credit independently (the Vertically Differentiated Banking Design) and to bring them together when the efficiency gains are high and the other costs are low. Some of the examples of such niche and specialised institutions are the South Korean Post Office Bank (only payments and deposits), GE Capital (credit and payments), MasterCard and Visa (only payments).

What are differentiated banks

16. Differentiated banks are distinct from universal banks as they function in a niche segment. The differentiation could be on account of capital requirement, scope of activities or area of operations. As such, they offer a limited range of services/products or function under a different regulatory dispensation. The concept is not entirely new. In fact, and in a sense, the UCBs, the PACS, the RRBs and LABs could be considered as differentiated banks as they operate in localised areas.

17. Some countries, for example, USA, Australia, Singapore, Hong Kong, Brazil, and Indonesia, have a

differentiated bank licensing regime where differentiated licenses are issued specifically outlining the activities that the licensed entity can undertake. It is observed that the criterion for differentiation for the purposes of issuing differentiated licenses could be anchored either to capital conditions, as is practiced in Indonesia or to the activity as is the case in Australia, Singapore and Hong Kong.

18. In our country too, diverse opportunities in the banking sector reflecting significant macro-economic growth potential could be utilised by niche banking by facilitating specialisation thereby enhancing optimal use of resources. Each of the niches has the potential to be individually large to sustain significant balance sheets and specialised entities can play a major role in all of them. Currently, while the banking sector is evolving depending on the needs of the economy, it is felt that given a choice, some banks and non-bank financial companies may choose to operate as a specialised niche bank to derive the obvious advantages of lower absolute capital requirements, lower cost of funds and specialisation. As a regulator, the Reserve Bank felt that an enabling environment should be provided for niche banks also to operate and leverage upon them to contribute to the objective of financial inclusion.

The advantages of differentiated banks

19. There are several advantages of having differentiated banks. They are as follows:

- There are diverse opportunities in the banking and financial landscape reflecting significant macro-economic growth potential in India and differentiated licensing could enable unlocking potential of these opportunities as it encourages niche banking by facilitating specialisation thereby reducing potential non-optimal use of resources.
- Very large ticket, long term infrastructure lending requires risk management expertise that goes beyond traditional credit appraisals at banks. There is significant space for specialised entities in risk assessment and structuring of infrastructure finance.
- Very low ticket unsecured credit requires risk management methodology and cost control that is not easy in the business model of conventional banks.
- Increase in competition among banks could lower costs of transactions.
- Gaps in SME finance can be filled with asset and cash flow based lending, operating leases, and factoring.
- Issues of conflict of interest when a bank performs multiple functions would not arise, where differentiated licenses are issued.
- Risk management systems and structure for regulatory compliance could be customised according to the banking type.
- Customised application of supervisory resources according to the banking type could result in greater optimisation of such scarce resources.
- Core competency could be better harnessed leading to enhanced productivity in terms of reduced intermediation cost, better price discovery and improved allocative efficiency.

The Policy on Differentiated Banks

20. After a careful analysis of the advantages of and the challenges from licensing differentiated banks, we came to the conclusion that in balance, the advantages outweigh the challenges, and the challenges can be effectively met with appropriate arrangements. As mentioned by the HLCFSR, the environment is conducive for experimentation with small banks. The Reserve Bank has, accordingly, decided to licence differentiated banks and guidelines on licensing of small banks and payments banks have been issued in November 2014.

Objectives

21. The objectives of licensing small finance banks are furthering financial inclusion by (a) provision of savings vehicles, and (b) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities, through high technology-low cost operations. We hope to achieve the stated objectives by stipulating target segments where the credit should be directed and by indicating the ticket size of the advances to ensure that the target segment is serviced.

22. The objectives of setting up of payments banks are to further financial inclusion by providing (i) small savings accounts and (ii) payments/remittance services to migrant labour workforce, low income households, small businesses, other unorganised sector entities and other users. We hope to achieve the stated objectives by specifying the services that the payments bank could undertake and by indicating the manner in which the funds need to be deployed.

Promoters

23. The Small Finance Banks can be promoted by individuals who have at least 10 years of experience/ expertise in financial or banking field or by private sector companies or societies with good track record. Existing MFIs, NBFCs or LABs can opt for conversion. The promoters will have to be resident Indians or owned and controlled by resident Indians. They will have to conform to stringent 'fit and proper' criteria. The promoter's minimum initial contribution to the paid-up equity capital of such small finance bank shall at least be 40 per cent and gradually brought down to 26 per cent within 12 years from the date of commencement of business of the bank.

24. The promoters of Payments Banks can be individuals who have at least 10 years of experience/ expertise in financial or banking field or by telecom companies, PPI issuers, private sector companies or societies, super-market chains with good track record. Existing PPIs can opt for conversion. The promoters will have to be resident Indians or owned and controlled by resident Indians. They will have to conform to stringent 'fit and proper' criteria. There can be strategic partnership with other banks. The promoters can retain 100 per cent ownership.

Responsibilities and permissible activities

25. The Small Finance Banks will be small sized universal banks. They have to finance priority sector to the extent of 75 per cent of their NDTL; while 40 per cent should be as per standard priority sector norms, the other 35 per cent can be in any of the priority sector. 50 per cent of their credit portfolio will have to be of ticket size of less than ₹25 lakh.

26. The Payments Banks can undertake payment and deposit services only. They can accept deposits from a customer upto ₹1 lakh only. They will have no credit portfolio. They should invest 75 per cent of their NDTL only in Government securities. They will not be subject to priority sector norms. They can perform Banking Correspondent functions to other banks.

Area of operation

27. Both the Small Finance Banks and the Payments Banks can operate all over India.

Challenges of designing the differentiated banking structure

28. Given our objective of furthering financial inclusion, it was relatively easy to determine what type of differentiated banks that can subserve this objective. It was amply clear that the Small Finance Banks and Payments Banks are such entities. However, designing their structures was not that easy. We encountered several competing options, dilemmas and confusion. We resolved these through internal deliberations and external consultations. The feedback to our draft guidelines were also valuable in resolving some of these issues. Let me explain certain key challenges and how did we resolve them.

Safety of the banking system

29. The real challenge before the regulator would be maintaining systemic stability and protecting the

interests of the depositors. Many niche-banking models typically depend on inter-bank liquidity, and wholesale funding which is a potential source of risk and vulnerability. Therefore, we decided that at least to begin with, the niche-banking should not be exposed to such liquidity risk. That is why we decided to design Small Finance Bank and Payments Bank which will not have such liquidity risk.

30. While encouraging the presence of different kinds of banks, the regulator has to ensure that risk management is robust as niche banks are susceptible to risks such as concentration risk which needs to be mitigated through adequate capital requirements and other suitable regulatory measures such as appropriate exposure norms and limits on leverage. This approach guided us in letting Small Finance Banks operate across the country, rather than limited to a narrow geography; in prescribing ₹100 crore as capital to ensure a decent size of balance sheet; in limiting exposures to single and group borrowers of Small Finance Banks to 10 per cent and 15 per cent of their net worth respectively; and in prescribing CRAR at 15 per cent for the Small Finance Banks. Likewise, these risk management considerations determined in prescribing that Payments Banks cannot extend loans and advances and not less than 75 per cent of their assets to be in Government securities only.

Managing public perception

31. Another challenge is to build trust in the minds of depositors and public in general. Considering that in India we have been only licensing universal banks which engage in all types of financial activities, it may be a challenge to manage the public perception and provide enough confidence to the public to enable them to place deposits in differentiated banks. There will be a need for creation of awareness through proper communication strategy and depositor education. We are conscious of this need.

Legal provisions for licensing of differentiated banks

32. Section 22 of the Banking Regulation Act, 1949 provides that a company intending to carry on banking business must obtain a licence from RBI except such of the banks (public sector banks and RRBs), which are established under specific enactments. Every bank in India, *i.e.*, domestic and foreign, apart from banking business, can carry out all the activities permitted under Section 6 of the Banking Regulation Act. However, the Act also provides for the Reserve Bank specifying the terms and conditions and other requirements, along with the licences. We have to employ these provisions for licensing of differentiated banks.

Viability of the models

33. Concentration risk: The differentiated banks will be fraught with concentration risk and a downturn in a particular sector or region can jeopardize the operations of a bank.

34. Asset Liability mismatches: Sector-specific banks run the risk of asset-liability mismatches. Asset liability mismatches will be posing a challenge to liquidity management by differentiated banks. It is therefore, imperative to have specific asset-liability management (ALM) tools for such banks.

35. Absence of cross subsidisation: Universal banks function by engaging in cross-subsidising loss making business in one segment with earnings from another which will not be possible for specialised banks thereby, impacting their revenues. The localised operations or restriction on the banks to engage in a particular activity could lead to non-availability of cross-subsidisation impacting the viability of such models.

36. Avenues for income generation: Providing avenues for income generation for the differentiated banks is a challenge. To begin with, other fee-based business like distribution of insurance and mutual fund products, credit card business, remittances, payment and settlement business, *etc.* could be permitted to augment the revenue streams.

37. These model related issues we have addressed through prescribing single and group borrower limits and higher CRAR for Small Finance Banks, high quality liquid assets for the Payments Banks, cost minimisation

through technology and letting them undertake agency functions to augment revenue.

Ownership of differentiated banks and corporate governance issues

38. The question of what kind of promoters should be allowed access to banking system is also relevant in the context of the high standards of corporate governance needed for the banking industry. There are existing non-bank financial sector entities, micro finance entities, Local Area Banks and Urban Cooperative Banks who would like to convert themselves into Small Finance Banks; telecom companies who would like to set up and Pre-Paid Instrument Issuers (PPI) who would like to convert themselves into Payments Banks. Real sector companies, societies, partnership firms, industrial and business houses, and even individuals would be interested in obtaining a banking license. Thus the choice is innumerous.

39. Critical factors to the selection are the promoters' credentials, experience and track record. We recognised that the aspirations of NBFCs, MFIs, LABs and UCBs are genuine and hence provided for their conversion, except that of UCBs. UCBs we are awaiting enabling statutory amendments. As regards individuals, we prescribed 10 years of experience in banking and finance as a precondition. In the case of real sector companies and societies, we prescribed track record of five years.

40. Since there are separate guidelines for foreign ownership of banks, we prescribed that the promoters of these Small Finance Banks and Payments Banks will have to be resident individuals or resident owned and controlled entities.

41. Further, in India we have pursued a policy of diversified ownership in private sector banks to prevent self-dealing by promoters and to enable the management to run the banks professionally. However, for a new bank to take sound roots, a determined and well-endowed promoter is an absolute requirement. We balanced these two conflicting ideas, in the case of Small Finance Banks by prescribing higher minimum locked in promoter's stake in the initial five years and a gradual divestment thereof over a period of 12 years. Since in the Payments Banks case there is no conflict of interest as they are prohibited from lending activities, there are no such limitations on higher promoter's holdings.

Challenges to regulation and supervision

42. Providing a level playing field in development obligations: Introducing differentiated banks would take away the level playing field which is now available to all banks uniformly where the banks are required to contribute to the priority sector obligations and other welfare measures of the Government. Implementing such obligations would become difficult through differentiated banks. Therefore, to ensure participation of these banks in the developmental needs of the economy, appropriate modifications may have to be set keeping in view the nature of the business model.

43. Accordingly, for Small Finance Banks we prescribed a higher level of Priority Sector Lending requirement at 75 per cent, as the very purpose is financial inclusion. For Payments Banks, as they will not have lending activities, we have ensured their participation in development by prescribing 75 per cent investment in Government securities.

Elimination of regulatory arbitrage

44. As universal banks are permitted to do all or any of the activities mentioned in Section 6 of Banking Regulation Act, 1949, regulating the universal banks is easier for the regulator as the regulations could be principle based and common to these banks. However, once the differentiated banks are licenced, there would be a need for having a different regulatory and supervisory approach specific for such banks depending on the specialisation. It also needs to be ensured that there is no scope for regulatory arbitrage across different types of banks.

Multiple regulations and complexity in regulations

45. Also, there may be a need for more types of regulations for differentiated banks because of the

different products lines, service offerings, clientele, areas and modus operandi of doing business. Multiple regulations need to work in tandem to ensure effective regulation. Further, there would be increase in complexity due to various types of banks and the different regulations applicable to each type of specialised category of banks. The regulatory and supervisory resources would have to be reoriented to ensure that effective regulatory and supervisory oversight is put in place.

Resolution regime for banks

46. More number of banks may mean more number of failures. It is a big risk in licensing of differentiated banks. However, as noted by the HLCFSR, failure of a few small banks may not have systemic consequence. Further, the Resolution regime is being strengthened.

Conclusion

47. There is enormous unmet potential demand lying in the rural areas and other unbanked centres which needs to be tapped. To tap this unmet demand for financial services, it is felt that it is worth experimenting on new types of institutions for financial inclusion. However, in a country like India where there exists differentiated markets and consumer groups, the concept may have to be contextualised according to the needs of the customers. As regards the health of the differentiated banks, there is a need for creating a balance between long term sustainability and the financial inclusion goals. We in the Reserve Bank believe we have carefully crafted suitable policy guidelines for the Small Finance Banks and Payments Banks keeping this balance in perspective. We have received 72 applications for the Small Finance Banks and 41 applications for the Payments Banks. We are processing them and hope to issue licences to the fit and proper applicants in a few months' time. We hope that these new entities will speed up our financial inclusion efforts in a big way.

48. Thank you.