Additional views on the report received from two members of the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households

January 6, 2014

The Chair,
Committee on Comprehensive Financial Services,
Central Board Member,
Reserve Bank of India,
Mumbai.

Dear Nachiket,

Views on Report from Committee on Comprehensive Financial Services for Small Businesses and Low Income Households

With reference to the periodic discussions on the captioned report and also keeping in view the objective of achieving Financial Inclusion while ensuring viability, scalability and sustainability for all the stakeholders, we seek to make the following observations in the committee report:

1. ***Chapter 1.2 - Vision 2*:-**

The Committee Report envisages Ubiquitous Access to Payment Services by January 2016. It is estimated in the report that a very large number of access points which are evenly spread out across the country would be required, so that every single resident would be within a fifteen minute walking distance of such a point anywhere in the country. Looking at the enormity of the task, more particularly in low density rural areas, and the need of supporting physical as well as virtual infrastructure vis-à-vis their present state, the timeline rather looks pressing. While January 2016 can be an aspirational goal, given the scale of the task a target date of January 2018 may be more realistic and implementable.

The ubiquitous access also intends to include at least one deposit product that would offer a positive rate of return over the Consumer Price Index (CPI). To enable banks to offer such a deposit product, suitable mechanisms to hedge such risks may need to be provided.

The said Vision also states that each such point would allow residents to deposit and withdraw cash to and from their bank accounts and transfer balances from one account to another, in a secure environment, for both very small and very large amounts. While it is possible to handle large value transfer transactions through these points, very large cash withdrawals may not be workable in service points using self-service mode or assisted mode.

2. ***Chapter 3.5 - White-Label BC (WLBC):-***

Introduction of the concept of WLBC shall aid in overcoming various challenges presently being encountered in the BC model. However, it is felt that appropriate corporate structure & regulatory framework needs to be introduced as it primarily involves participation of non-financial entities (dealing with banking/financial products), which may be governed by diverse regulators.

Further, in order to ensure homogeneity of service standards and commercial considerations etc., it is suggested that a Model Agreement for functioning of WLBCs may be worked out within the applicable regulatory framework.

3. **Chapter 3.7 - Payments Bank:-**

As a recommendation in the report, it has been outlined that a Payments Bank (PB) shall be allowed to provide payment services and deposit products to the target segment. It is evident that while creation of such banks is a step forward from Pre-paid Instrument Providers (PPIs) and shall improve accessibility to the low-income households, it may however not help in achieving the desired level of Financial Inclusion on account of the following:

i. The overall objective of financial inclusion is to provide access to a complete bouquet of financial services including credit, insurance and risk management products, which may be difficult to achieve through the PB framework, vis-à-vis, a BC/Branch model, which stands greater chances of achieving Vision 3 to 6;
ii. Leveraging the existing BC/Branch infrastructure and promoting the partnership model may be a prudent approach, vis-à-vis creation of new/additional infrastructure and therefore may be encouraged with suitable enablers;
iii. The Banks may be suitably incentivized to focus on proactively pursuing the desired segment for deposit generation through branch / BC network, which will act as a starting point in providing access to the gamut of basic financial services including credit availability, investment products, insurance products etc.;
iv. While PB may act as a short term measure to achieve Vision 1 and 2, in the medium to long run, same may act as an indirect deterrent towards achievement of Vision 3 to 6.

4. ***Chapter 4.2 - Recommendation Para 4.3:-***

Recommendation: In view of the fact that banks may choose to focus their strategies on different customer segments and asset classes, it is recommended that the regulator provide specific guidance on differential provisioning norms at the level of each asset

class. A bank's overall NPA coverage Ratio would therefore be a function of its overall portfolio asset mix.

On standard assets, provisioning levels as well as asset classification guidelines specified by RBI would need to reflect the underlying level of riskiness of each asset class (combination of customer segment, product design and collateral) and not be uniform across all the asset classes.

The essence of the recommendation is well served by adhering to the proposed Advance Internal Rating Based (IRB) approach under Basel II which is expected to be implemented by commercial banks in due course, wherein, banks will be allowed to develop their own empirical models to quantify the required provisioning norms for different asset classes to manage the credit risk and capital requirements thereof. This will be done based on a Banks' understanding of the business and the performance of the respective asset classes over the past years.

This would additionally ensure that the accounting treatment is consistent with international standards and shall facilitate benchmarking with global peers. Therefore, the proposition of provisioning norms for asset classes based on Advanced IRB approach may not be altered.

5. <u>Chapter 4.2 – Recommendation Para 4.4:-</u>

Recommendation: All banks should be required to publicly disclose the results of their stress tests both at an overall balance sheet level as well as a segmental level at least annually.

Stress tests are a reflection of a potential adverse economic shock than a projection of the future. Accordingly, public disclosures may cause the market participants/ depositors to put excessive weight on select information without appropriately assessing the context, thereby causing speculation and instability which may induce systematic risk.

Accordingly, disclosure on the results at an overall balance sheet level and at a segmental level may be submitted to the regulator at a periodic interval. Public disclosure of the results may lead to unintended consequences and therefore, may be considered at a subsequent stage.

6. ***Chapter 4.7 – Recommendation Para 4.18:-***

In the discussion on NBFCs, no convergence has been proposed for Priority Sector Lending (PSL). Looking to their widespread presence across the country and the recommendation of the Committee to give them the shape of a bank with improved access to resources, it would only be in order to mandate NBFCs to fulfill PSL obligations in the interest of financial inclusion and deepening.

7. ***Chapter 4.7 – Recommendation Para 4.27* - Wholesale Bank:-**

The committee has also recommended for creation of "Wholesale Banks" under the Banking Regulation Act. It is however felt that formation of such banks may not result in any substantial value-add in achieving the overall Vision as envisaged in the report. The proposed characteristics of a Wholesale Bank (WB) may not be substantially different from that of the existing deposit-taking NBFCs etc.

In order to ensure system stability and level playing field across players, the following principles may be adhered to:

a) Fit & Proper Criteria as detailed in the RBI's Guidelines for Licensing of New Banks in the Private Sector should be made applicable for new WBs;
b) To ensure that only financially sound & stable entities operate as WBs the capital requirement may be kept in line with the minimum capital requirement for existing Banks;
c) The Reserve Requirements may be kept identical with those for existing banks.

8. ***Chapter 4.8 - Market for Sale and Purchase of Agricultural Credit:-***

As indicated in the report, the banks capable of originating PSL generally restrict their origination only to the extent of its mandated requirements as against its overall potential. Any policy action taken should ensure that banks with a capability to originate PSL do it to their full potential irrespective of the mandated thresholds.

Accordingly, in addition to a mandatory lending approach with full transfer of credit risk in secondary market, alternate models for incentivizing the banks to do PSL need to be evolved.

As indicated in the Report of the committee on Financial Sector Reforms, "A hundred Small Steps" submitted to Planning Commission in August 2007, an efficient way of achieving the same could be by introducing the concept of "Priority Sector Loan Certificates (PSLC)". Any entity which originates eligible PSL portfolio may be issued PSLC for amounts equivalent to the value of such portfolios. These could be sold to the banks short on PSL Targets through a transparent market mechanism. The amount received by the originating entity would improve their returns on the PSL portfolio. The PSLC purchasing bank would also be a net beneficiary through more appropriate allocation of resources. Overall capital efficiency of the system would improve and this would be a win-win situation for all stakeholders.

The above mechanism shall encourage the PSL originating entities do such activities on the strength of their balance sheet. The market based pricing of the PSLC would reflect the demand supply dynamics for PSL portfolios and the regulator can take actions as they deem appropriate using such information.

9. <u>Chapter 4.8 - Recommendation Para 4.40 and 4.41:-</u>

Recommendation: In order to encourage differentiated priority sector strategies, RBI may consider having sectoral and regional weights that enable these with superior origination capabilities in some sectors and regions that have relative under supply to receive more liquidity. RBI can replace the current 40% PSL requirement with a 50% Adjusted PSL (APSL) Requirement. Banks could achieve their APSL requirement either by concentrated origination in a sector of their choice or through market purchases of qualified assets.

While the underlying principle of introducing the APSL methodology is appreciated, staggering the implementation of the proposed framework over a period of 2 – 3 years shall smoothen the transition, specifically given the data infirmities on district level Credit/ GDP ratios.

Therefore, it is suggested that-

a. Initially, within the overall PSL target, a sub-category for the under-banked districts may be created wherein, a threshold level of achievement, say about 5%, shall be applicable for next couple of years, which shall be reported to the regulator;
b. The threshold level of the applicable APSL may be stipulated after considering the industry-wide historical APSL data and be made applicable thereafter.

Further, while arriving at the threshold of APSL, it may be examined and ensured that the same does not have crowding out effect on other productive sectors of economy.

10. <u>Chapter 4.8 - Recommendation Para - 4.32, 4.44 and 4.48:-</u>

Recommendation 4.32 and 4.44: Equity investments by Banks in complementary infrastructure within the purview of PSL guidelines, such as rural warehouses, market yards, godowns, silos, and NBFCs in low financial depth districts. These equity investments may be eligible for contribution to the overall priority sector lending targets. They should be permitted where debt already qualifies for PSL but with a multiplier of

four, to reflect the higher risk and the illiquid character of these investments. The benefit must accrue as long as the equity investment is held by the Bank. This list of eligible equity investments may be varied from time-to-time.

Recommendation 4.48: Equity investments by banks in private companies engaged in the task of installing and operating weather stations, or in creating markets for second-hand assets should be eligible for PSL treatment. These investments should also get a multiplier of four, to reflect the higher risk and the illiquid character of these investments.

While the banks primarily act as an enabler in economic growth by providing requisite debt capital, it is generally expected to refrain from investing in equity in unrelated activities, which is also delineated in the overall regulatory framework. In view of the same, the recommendations, in the present form may be revisited.

11. <u>Section 6 - Right to Suitability:-</u>

<u>Recommendation 6.1 c:</u> The requirement to conduct a due diligence should include the requirement to obtain relevant information about the customer's personal circumstances……".

Applying this principle across products of all types and size and all geographies may not be implementable given the paucity of such information source.

While we appreciate the above recommendations in the report and the guiding principle of suitability, the regulatory framework should ensure that there are adequate safeguards for actions of banks based on inaccurate/ misleading information.

<u>Priority Sector Deposits - An innovative approach</u>

While we had not discussed this at the committee meeting, we thought Priority Sector Deposits may be an interesting idea to examine.

With a view to encourage affordable formal credit for small businesses and low income households, there are regulatory guidelines for mandatory lending to the aforesaid groups, which qualifies under the head PSL.

However, easy access to an electronic bank account with payment & deposit products is expected to provide multifold benefits in achieving the Vision Statement.

With a view of ensuring a bank account for every Indian Resident above 18 years and also to improve the overall deposit & investment ratio for the financially weaker section of society, it is suggested that RBI may consider identifying certain deposits as **Priority Sector Deposit ("PSD")** and provide certain enablers to the Banking system towards achievement of the same. Introducing the concept of "PSD" would act as a catalyst for the banking system to penetrate into hitherto unbanked regions, which shall lead to expeditious inclusive growth. The above shall also aid secular distribution of banking network across the country.

Based on the impact on overall financial inclusion and the difficulty / cost in originating the deposits, the following category of deposits may be considered as PSD:-

a. Deposits originating from Identified Districts – The banks may be incentivized to channelize their efforts to canvass deposit products in under-banked / unbanked districts / regions. A methodology similar to the one suggested in Chapter 4.8 of the report may be used for identification of the regions; and
b. Deposits from Weaker Section and BPL etc.

As Banks shall incur relatively higher costs for origination and servicing of PSD and therefore, may suitably be incentivized for actively pursuing the origination of PSD, viz.,-

a. Priority Sector Lending (PSL) targets be reduced by an amount equivalent to PSD; and / or
b. Banks may be exempted from maintaining the requisite investments in CRR and SLR securities corresponding to these PSD.

The adoption and implementation of the aforesaid recommendation is expected to,

- Reduce overall cost for the Banks, which shall enable them to (1) go for expanded branch network; (2) promote and expand the BC network (including the proposed WLBCs) by sharing the benefits appropriately;
- Result in proliferation of various banking / insurance / investment products in the desired markets and also re-energize & strengthen the BC network.

This shall have a multiplier effect in achieving Vision Statements in entirety.

We believe that the above recommendations would further complement the other measures in the Report and ensure a more viable, scalable and sustainable model of "Financial Inclusion".

Yours sincerely,

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