Discussion Paper

On

Wholesale & Long-Term Finance Banks

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1. Introduction

1.1 Banks act as intermediaries between the savers and the borrowers and it is widely acknowledged that a robust banking system contributes significantly to economic development. While traditionally, the banks have been facilitating a near exhaustive boutique of products and services, there is merit in leveraging expertise in niche areas while transforming the financial system into a more mature and deeper one.

1.2 It may be recalled that the concept of differentiated banks in India was first discussed in a RBI Technical Paper on Differentiated Bank Licences dated October 19, 2007. It was concluded then that the time was not yet opportune for such banks. However, in 2008, the Committee on Financial Sector Reforms (Chairman: Dr. Raghuram G. Rajan) had envisaged differentiated banks to further financial inclusion, by examining the relevance of small banks in the Indian context. The Committee had opined that there was sufficient change in the environment to warrant experimentation with licensing of small banks, and had recommended allowing more entry to private well-governed deposit-taking small finance banks offsetting their higher risk from being geographically focussed by requiring higher capital, a strict prohibition on related party transactions, and lower allowable concentration norms.

1.3 At the same time, the Reserve Bank was exploring the possibility of issuing new bank licences to private sector players to enable a wider distribution and access to financial services. Based on the announcements made in the budget speech for the year 2010-11 by the Hon. Finance Minister and Annual Policy Statement for the year 2010-11 by the Governor, Reserve Bank, a discussion paper on Entry of New Banks in the Private Sector was released by the RBI on August 11, 2010, seeking public view/comments. The discussion paper explored issues such as the minimum capital requirements, ownership and control of the new banks, eligibility of the promoters etc.

1.4 The Guidelines for Licensing of New Banks in the Private Sector were issued on February 22, 2013, taking into consideration various discussions and comments / suggestions received on the discussion paper and the draft guidelines that were issued on August 29, 2011. The Guidelines stipulated a minimum capital requirement of ₹500 crore, and permitted entities / groups in the private sector that are ‘owned and controlled by residents’ to promote a bank through a wholly-owned non-operating financial holding

company (NOFHC). Under the said Guidelines, RBI issued two banking licenses in 2015.

1.5 The Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Chairman: Shri Nachiket Mor), 2013 espoused the concept of differentiated banks to further the cause of financial inclusion and deepening the strategies, using the functional building blocks of payments, deposits and credits. Specifically, the Committee recommended licensing of Payments Banks, whose primary role would be to provide payment services and deposit products to small businesses and low-income households. Later, the need for setting up of small banks with local character to cater to the requirements of rural and unorganised sectors was also re-emphasized in the RBI's policy discussion paper on 'Banking Structure in India – The Way Forward' (August 27, 2013). The discussion paper had, among other issues, also made a case for continuous authorisation of bank licensing, as it would increase the level of competition and bring in fresh ideas to the system.

1.6 In pursuance of the recommendations of the Committee on Financial Sector Reforms (Chairman: Dr. Raghuram G. Rajan), 2008, and the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Chairman: Shri Nachiket Mor), 2013, draft guidelines for small finance banks and payments banks were issued on July 17, 2014 for comments / suggestions. The (final) Guidelines for Licensing of Small Finance Banks in the Private Sector and the Guidelines for Licensing of Payments Banks were issued on November 27, 2014, based on the comments / suggestions received from the public on the draft guidelines.

1.7 The Guidelines for small finance banks / payments banks stipulated a minimum capital requirement of ₹100 crore and permitted entities that are 'owned and controlled by residents' to promote such banks. Subsequently, in-principle approvals were given to 11 applicants to set up payments banks and to 10 applicants to set up small finance banks as notified vide press releases dated August 19, 2015 and September 16, 2015 respectively.

1.8 The first Bi-monthly Monetary Policy Statement 2014-15 dated April 1, 2014 indicated that the Reserve Bank would start working on the framework for on-tap licensing as well as differentiated bank licences using the learning from the recent licensing process. The draft Guidelines for On-Tap licensing of Universal banks in the

Private Sector were prepared based on the experience gained from the previous rounds of licensing of universal banks, payments banks and small finance banks. These Guidelines were issued on May 5, 2016, inviting comments from the public till June 30, 2016. Subsequently, after examination of the comments received, the (final) Guidelines for On-Tap licensing of Universal banks in the Private Sector were issued on August 1, 2016. Some of the key features of the 2016 Guidelines vis a vis the 2013 guidelines include: (i) eligibility of resident individuals and professionals having 10 years of experience in banking and finance at a senior level to promote universal banks; (ii) excluding large industrial houses as eligible entities to promote banks but permitting them to invest in the banks up to 10 per cent; (iii) making the Non-Operative Financial Holding Company (NOFHC) structure non-mandatory in case of promoters being individuals or standalone promoting/converting entities, who/which do not have other group entities; (iv) changing the requirement of having a wholly owned NOFHC to at least 51 per cent owned by the promoter/promoter group; and (v) permitting specialised activities of the group to continue from a separate entity proposed to be held under the NOFHC subject to prior approval from the Reserve Bank and subject to ensuring that similar activities are not conducted through the bank as well.

1.9 Against this backdrop, the first Bi-monthly Monetary Policy Statement 2016-17 dated April 5, 2016 had stated that, in addition to the recently licensed differentiated banks such as payments banks and small finance banks, the Reserve Bank will explore the possibilities of licensing other differentiated banks as well, and had identified custodian banks and banks concentrating on whole-sale and long-term financing, as two other classes of differentiated banks on which a discussion paper will be prepared.

1.10 The Discussion Paper provides a brief on the present banking and non-banking scenario in India, the Reserve Bank's preliminary views on the need for, the pros and cons of setting up the banks concentrating on whole-sale and long-term financing (called Wholesale and Long-Term Finance Banks or 'WLTF Banks' hereon), and international experience with regard to similar differentiated banks.

The present paper invites public discussion on whether there is a need for Wholesale and Long-Term Finance Banks.

2. Present banking and non-banking scenario in India

A typical financial system in any economy consists of banks and other financial institutions, financial markets, financial instruments, and financial services. Structurally, India's financial system can be categorized into two broad segments, i.e. financial intermediaries, viz. Banks (commercial banks, regional rural banks, local area banks, and cooperative banks), Non-Banking Financial Companies, and All-India Financial Institutions / Development Finance Institutions, insurance companies, mutual funds, pension funds, and financial support services, viz. credit rating agencies, credit information companies, securitisation/asset reconstruction companies, depositories, etc.

2.1 Banks

2.1.1 The existing banking structure in India, evolved over several decades, is elaborate and has been serving the credit and banking services needs of the economy. In 1966, through an amendment to the Banking Regulation Act, 1949 banking laws were made applicable to cooperative societies giving rise to cooperative banks in rural and urban centres. There are multiple layers in today's banking structure to cater to the specific and varied needs of different types of customers and borrowers. While commercial banks today can be seen as universal banks, cooperative banks originated from the cooperative movement were chiefly catering to the credit needs of the agricultural sector in rural areas and that of the tiny, micro and small business enterprises in urban areas.

2.1.2 At present, the Scheduled Commercial Banks (SCBs), provide the entire gamut of banking products and services across all geographies in India and abroad, to retail, corporate and government sector alike. Based on their ownership structure, banks in India are grouped as Public Sector Banks [State Bank of India, Nationalised Banks (19), and IDBI Bank Limited], Private Sector Banks [Indian banks (32) and foreign banks (44)] and Regional Rural Banks (56), which were created with a view to serve primarily the rural areas of India with basic banking and financial services.

2.1.3 Local Area Banks (LABs) are non – scheduled commercial banks which were established as local banks in the private sector with jurisdiction over two to five

contiguous districts to enable the mobilisation of rural savings by local institutions and make them available for loans and investments in the local areas. Following the commencement of business by one of the four LABs as a Small Finance Bank, presently there are three LABs in operation.

2.1.4 The co-operative banking structure in India comprises Urban Cooperative Banks (UCBs) and Rural Co-operative Credit Institutions. These entities are registered under the provisions of State Cooperative Societies Act of the respective states or Multi State Cooperative Societies Act, 2002 (if the area of operation of the bank extends beyond the boundaries of a State). At present, India's co-operative banking sector comprises of State Cooperative Banks (18 Scheduled and 14 Non-Scheduled State Cooperative Banks), Urban Cooperative Banks **(**54 Scheduled and 1528 Non-Scheduled Urban Cooperative Banks), and District Central Cooperative Banks (366).

2.1.5 The differentiated banks, viz. Small Finance Banks (SFBs) and Payments Banks (PBs) are new entrants to the banking system. In 2015, RBI issued in-principle approval for setting up of 10 SFBs and 11 PBs, and six SFBs and two PBs have since commenced business.

2.2 Non-Banking Financial Companies (NBFC)

2.2.1 NBFCs comprise mostly of private sector institutions providing a variety of financial services including housing, equipment leasing, hire purchase, loans, and investments among others.

2.2.2 Based on their liability structure, the NBFCs are classified into two broad categories: (a) deposit taking NBFCs, and (b) non-deposit taking NBFCs. As on January 1, 2017, there were 11,542 NBFCs registered with the Reserve Bank; out of which 187 were deposit-taking (NBFCs-D) and 11,355 were non-deposit taking (NBFCs-ND) entities.

2.2.3 Also, depending upon the line of activity, NBFCs are categorised into different types such as Asset Finance Company, Loan Company, Infrastructure Finance Company, securitisation/asset reconstruction companies, Investment Company, (Systemically Important) Core Investment Company, Infrastructure Debt Fund – NBFC,

NBFC – Micro Finance Institution, NBFC – Factors, Mortgage Guarantee Companies, NBFC– Non-Operative Financial Holding Company.

2.3 All-India Financial Institutions / Development Finance Institutions

2.3.1 Financial Institutions are an important segment of the Indian financial system as they provide medium to long term finance to different sectors of the economy. These institutions have been set up to meet the growing demands of particular sectors, such as export, import, rural, housing and small industries. These institutions have been playing a crucial role in channelizing credit to these sectors and addressing the challenges / issues faced by them.

2.3.2 The Industrial Finance Corporation of India (IFCI) was the first Development Finance Institution (DFI) set up in 1948 and marked the beginning of the era of development banking in India. Later, DFIs such as Industrial Credit and Investment Corporation of India (1955), Unit Trust of India (1963) and the Industrial Development Bank of India (1964), various State Financial Corporations (SFCs), Export-Import Bank of India (1982), National Bank for Agriculture and Rural Development (1982) and Small Industries Development Bank of India (1990) were set up to cater to specific needs of various sectors of the economy.

2.3.3 Over the past few years, while some of the major development finance institutions have amalgamated with their banking outfits (such as ICICI and IDBI), other DFIs have been reclassified as systemically important non-deposit taking NBFCs (such as IFCI). The remaining four all-India financial institutions - Exim Bank, National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI), which are primarily refinancing agencies, are under the oversight of the Reserve Bank.

2.3.4 Going forward, considering the existing landscape of banking and non-banking services in the country, it is felt that there is a need to explore the possibilities of permitting other types of differentiated banks to facilitate progression to a more mature and deeper financial sector. Accordingly, the specific need for wholesale and long-term finance banks, in the above scenario, has been presented in this paper.

3. Need for Wholesale and Long-Term Finance Banks

3.1 Indian financial sector is dominated by banks. As of June 2016, commercial banks account for about 67% of the total financial sector assets in the country. Combined with cooperative banks, they account for almost three-fourths of the financial sector assets. Today, the universal banks operate in retail as well as corporate segments and offer varieties of financial products and services. These range from the basic deposit accounts, personal loans, and investments on the retail side to the more complex services on the wholesale side such as term loans, project finance, debt syndication, investment banking, and trade finance, among others.

3.2 However, with the deepening of financial sector, it may be necessary for the system to evolve towards a structure where apart from the universal banks, multiple differentiated banks also operate in their specialized domain and provide services in their areas of competitive advantage. As the niche banks develop core competency, expertise will be fostered in the banking system that could lead to enhanced efficiency in terms of reduced intermediation cost, better price and improved allocation of capital. Therefore, specialized banks could cater to the wholesale and long-term financing needs of the growing economy and possibly fill the gap in long-term financing.

3.3 In the recent times, due to asset quality impacts on the banks' balance sheets, there is an overall declining trend in bank credit, primarily towards services sector, industrial segment, and small and medium enterprises. This is also reflected in the decline in the share of the long-term assets (*assets with maturity more than three years*), relative to total assets, on the banks' balance sheets. The Report of the Committee on Financial Sector Reforms, chaired by Dr. Raghuram G. Rajan, had made a notable argument that on the wholesale side, the financial sector has not been able to meet the scale or sophistication of the needs of large corporates, as well as of public infrastructure, and does not penetrate deeply enough to meet the needs of small and medium-sized enterprises in many parts of the country. This scenario, thus, presents an opportunity for specialized banks to take up long-term financing of the corporate and refinancing of the MSME sector lenders within the existing banking structure. Gaps in

SME finance can also be filled by securitization of asset backed lending, operating leases, factoring, and other similar services facilitated by such niche banks.

3.4 The Twelfth Five Year Plan had projected the infrastructure financing requirement for the country at US$ 1 trillion during the plan period and the funding gap is estimated to be above ₹5000 billion. Outside of budgetary support, which accounts for about 45 per cent of the total infrastructure spending, commercial banks are the second largest source of finance for infrastructure (about 24 per cent). However, banks have since been saddled with non-performing and restructured assets in the infrastructure sector. As on June 2015, 24 per cent of the total advances to infrastructure sector were classified as 'stressed assets'. As at end - December 2015, loans to the infrastructure sector accounted for 13 percent of NPAs in the banking sector. About 34 per cent of restructured standard advances were in infrastructure sector, of which, three sectors viz., power, transport, and telecom constituted nearly 90 per cent. The Financial Stability Report of the Reserve Bank of India, issued in December 2015, had stated that in view of the riskiness on account of the tenor of the loan, the banks' current processes and business models may not yet be adequately prepared to make, monitor and manage long-term project loans. In that context, it is felt that differentiated banks, with focus towards long-term and project finance, could possibly be able to quickly build / leverage expertise, in terms of people, processes, and systems, to develop sophisticated methods of credit appraisal and credit enhancement to fulfill the financing needs of the infrastructure sector.

3.5 The report of the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households, chaired by Dr. Nachiket Mor ('Nachiket Mor Committee Report') had envisaged a class of differentiated banks called Wholesale Banks. Extending the committee's recommendations on Wholesale Banks, the Wholesale and Long-Term Finance (WLTF) banks will focus primarily on lending to infrastructure sector and small, medium & corporate businesses. They will also mobilize liquidity for banks and financial institutions directly originating priority sector assets, through securitization of such assets and actively dealing in them as market makers.

3.6 They may also act as market-makers in securities such as corporate bonds, credit derivatives, warehouse receipts, and take-out financing etc. These banks will provide refinance to lending institutions and shall be present in capital markets in the form of aggregators.

3.7 WLTF banks may also offer services related to equity / debt investments, and forex / trade finance to their clients. These services, although similar in nature to the services offered by financial institutions traditionally known as 'Investment Banks', would be ancillary to the primary activities of WLTF banks, which is deposits / loan products for wholesale clients and financing of infrastructure sector and core industries.

3.8 Primary sources of funds for WLTF banks could be a combination of term deposits, debt / equity capital raised from primary market issues or private placement, and term borrowings from banks and other financial institutions. According to the Nachiket Mor Committee Report, since the primary role of the Wholesale Banks is lending and not the provision of retail deposit services, they may be permitted to accept deposits only above a large threshold amount. Same may be applicable in the context of WLTF Banks. Therefore, they may have negligible retail segment exposure on their balance sheet.

3.9 The pros and cons of licensing differentiated banks focusing on wholesale and long-term financing are:

- Pros
  - Differentiated banks concentrating on wholesale and long-term financing could act as steady and additional source of funding for small, medium and large businesses, and infrastructure sector over a longer term.
  - Entry of such banks as market makers in debt, equity, forex, securitization, and other markets would further expand the markets and encourage product innovation, appropriate price discovery and superior market liquidity.
  - WLTF banks may ease up the pressure of long maturity loan assets on the books of commercial banks, and in turn, moderate their asset-liability mismatch as these banks are expected to finance infrastructure projects,

participate in take-out financing and securitize such assets to generate liquidity.

- Large ticket, long term lending requires superior expertise and skill in project appraisal and credit monitoring; and impeccable risk management systems that go beyond the traditional domain knowledge of commercial banking. It is expected that WLTF banks would acquire and maintain high quality assets on their portfolio to be able to generate enough revenues. They would, therefore, help build such expertise through selection of skilled manpower, training and suitable compensation.

- Cons
  - Raising of long term deposits and debt at competitive cost would not be easy, and funding of long term and infrastructure projects at higher interest costs could make the projects economically unviable.
  - Lack of access to savings and other retail deposits would push the cost of funds for the WLTF banks upwards.
  - Reputed and well-rated corporates would prefer to access the debt markets directly at comparatively lower interest rates than those offered by WLTF banks.
  - WLTF banks could be subject to ALM mismatches, which may be difficult to manage, whereas commercial banks would have more flexibility in their asset liability structure.
  - Cyclical nature of industrial activities / performance could place enhanced risk of non-performing assets on the books of wholesale banks, which may not have the cushion of sustained earnings that retail credit portfolios normally provide, in times of economic downturn.
  - Lack of enabling market infrastructure and issues such as absence of secondary markets in securitized assets, low demand for long-tenor instruments, and small investor base for such assets among others could be impediments for the WLTF banks.
  - Development Finance Institutions (DFIs) in the past had played a similar role in filling the gap in meeting the financing needs of medium and large enterprises, industry and infrastructure sector. However, due to change in

the operating environment coupled with dearth of low cost long term funds as a result of withdrawal of Government guarantee for bond issuance and resultant non-SLR status of their bonds, high level of concentration risk caused serious stress to their financial position.

- Given the constraints and limited scope for raising long term funds without sovereign guarantees, financing of infrastructure and commercial projects could be a challenge for the WLTF banks and their viability could be an issue for debate.

4. International Experience

4.1 Euro Area

4.1.1 The European Central Bank maintains a list of four groups of institutions, based on the information provided by all the member states, under the Statute of the European System of Central Banks. These institutions are Monetary Financial Institutions (MFIs), Investment Funds, Financial Vehicle Corporations and Payment Statistics Relevant Institutions.

4.1.2 "Monetary financial institutions" are resident credit institutions as defined in European Union (EU) law, and other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic terms), to grant credits and/or make investments in securities. “Investment funds" are collective investment undertakings that: i) invest in financial and non-financial assets, to the extent that the objective is to invest capital raised from the public; and ii) are set up under community or national law. "Financial vehicle corporations" are undertakings set up under national or Community law which primarily carry out securitization transactions and which are insulated from the risk of bankruptcy or any other default of the originator. “Payment statistics relevant institutions” are payment service providers (including electronic money issuers) and payment system operators. PSRIs offer payment services and/or are entitled to do so.

4.1.3 Apart from the above, 15 bilateral European Development Finance Institutions (DFIs) are mandated by their respective governments to foster growth in sustainable businesses by investing in profitable private sector enterprises in developing countries.

4.1.4 Eight of the 15 European DFIs have private entities as shareholders. The private shareholders are typically banking institutions and other private companies based in the DFI's home country. They own a significant minority of shares while the state controls a majority. Several DFIs, and especially the five that operate with a banking licence, also have leverage on their balance sheets from institutional investors, typically with factors of two to six times between their shareholders’ capital and total investment commitments.

4.1.5 DFIs source their capital from national or international development funds or benefit from government guarantees which ensures their credit-worthiness. DFIs can thus raise large amounts of funds on the international capital markets and provide loans or use equity on very competitive terms, frequently on a par with commercial banks. Their efficiency and expertise make them self-sustaining and even profitable.

4.1.6 DFIs provide funds, either as equity participation, loans or guarantees, to foreign or domestic investors. These investors will initiate or develop projects in industry fields or in countries in which the traditional commercial banks are reticent to invest in without some form of official involvement. DFIs are equally fundamental in the SME sector (small and medium enterprise) where micro loans, traditionally viewed as high-risk, form the bulk of investment activity.

4.2 Brazil

4.2.1 Prospective banking companies need to obtain authorization from Central Bank of Brazil to conduct banking business in the country. Among different categories of banking companies such as Universal Banks, Commercial Banks, Cooperative Banks, Investment Banks, and Foreign Exchange Banks, Central Bank of Brazil also gives authorization to Development Banks.

4.2.2 The stated corporate purpose of a development bank, as per the regulations, is to provide a timely and adequate supply of funds needed to finance, in the middle and long terms, programs and projects aimed at fostering the economic and social development of the state of the Federation where the bank headquarters is located, granting support primarily to the private sector. Development Banks are eligible to receive cash deposits, in savings accounts or term deposits and are covered under Fundo Garantidor de Crédito – FGC, which is a private institution responsible for the protection of checking/saving account holders and investors against financial institutions in case of intervention, liquidation or bankruptcy. Development banks are not permitted to engage in foreign exchange securities acceptances for offering in the capital market, establish and manage investment funds, perform rediscount operations, acquire real property, except for their own use or leasing operations, and finance land division for

sale and the development and sale of real estate, except for operations related to the development of industrial districts.

4.2.3 Banco Nacional de Desenvolvimento Econômico e Social or BNDES is the largest development bank and the main provider of long-term financing in Brazil. It is a 100% state owned company established in June 1952. Its main emphasis is on financing investment projects but its current strategic priority is providing support to Brazilian MSME sector.

4.2.4 Primary sources of funding of BNDES are Government Treasury, social contributions payable by companies to the Government and foreign funds from foreign governments and other multilateral institutions. Majority of investments by BNDES are made in industry, and infrastructure sectors with remaining in agriculture, and small & medium enterprises.

4.3 Japan

4.3.1 As of March 2015, the Japanese financial system consisted of 141 banks (5 city banks, 16 trust banks, 105 regional banks, and 15 other banks), 267 credit associations (Shinkin banks), 155 credit associations, 679 agricultural associations, 252 security companies, 68 insurance companies, and other small financial and insurance agents. Further, Japan has four Development Finance Institutions viz., Japan Finance Corporation, Development Bank of Japan, Okinawa Development Finance Corporation and the Shoko Chukin Bank Ltd. All DFIs are either state owned or affiliated, and geared towards advancement of particular set of industries such as SMEs, international trade companies or a sector of the economy such as agriculture, fisheries etc.

4.3.2 Japan Finance Corporation (JFC) is a policy based financial institution established under The Japan Finance Corporation Act, 2008 and is wholly owned by the Government of Japan. Its stated aim is to complement financial activities carried out by private financial institutions and contribute to the improvement in the living standards of Japanese people. Its main business activity is lending towards individual unit & micro businesses, and SME units. Further, it finances the activities in the Agriculture, Forestry, Fisheries and Food Business and facilitates crisis responses. As on March 31, 2014, its capital was 3.7 billion yen and total assets were 24.65 trillion yen.

4.3.3 Development Bank of Japan began as Japan Development Bank, established under The Japan Development Bank Law in 1951 to fund the post-World War 2 economy and industry in Japan. Japan Development Bank commenced accommodation loans to facilitate the development of power supply, which forms the basis of the economy and industry, and the rationalization, modernization and cultivation of coal, steel, marine transportation and other major industries. In 1999, the Japan Development Bank and the Hokkaido-Tohoku Development Finance Public Corporation were dissolved and the Development Bank of Japan (DBJ) was established. DBJ focused its operations in three areas—community development, environmental conservation and sustainable societies, and creation of new technologies and industries. In 2008, a New Development Bank of Japan Inc. Act was passed by the Japanese Diet which aimed at full privatization of the bank. However, keeping in line with the various measures taken by the Government in view of the global financial crisis of 2008, Government continued to hold its shares in the DBJ with a revised aim of completely privatizing the bank in five to seven years from March 2012. As on end-March 2015, the bank had a total capital of 1.21 trillion yen and total assets of 16.28 trillion yen.

4.3.4 The Okinawa Development Finance Corporation (ODFC) was established in May 1972, under “the Okinawa Development Finance Corporation Law”, with the purpose of providing policy-based finance in Okinawa in a centralized and comprehensive manner. It is wholly owned by the Japanese Government and has a total capital of 75.8 billion yen.

4.3.5 The Shoko Chukin Bank Ltd. was established in October 1936 under the “Shoko Chukin Bank Limited Act” (SCBL Act) with the objective of facilitating financing for SME cooperatives and their members. Although it is a Government-affiliated institution (approx. 46% capital owned by the Japanese Government), its transition towards privatization began in 2008 with the revision to the SCBL Act.

4.4 South Korea

4.4.1 The financial sector in South Korea includes banks, non-bank depository institutions, insurance companies, securities companies and collective investment

companies. Within that, the banking sector comprises of 13 commercial banks (seven national and six local), 39 foreign bank branches, and 5 specialized banks.

4.4.2 The specialized banks are a set of financial institutions set up by the Government of Korea, following the post Korean War period from late 1950s, with the initial objective of rebuilding economy by directing funds towards certain sectors of the economy such as agriculture, infrastructure etc. and certain vital industries such as fisheries, export-import etc. The proportion of Government funds and Government loans were higher in terms of their funding when these specialized banks were set up. In some cases, the entire capital was subscribed to by the Government only. They also concentrated on financing specified industries / sectors.

4.4.3 Gradually, they began to rely more on deposits and debentures. The funding sources of the other four specialized banks has moved from mainly deposits (excluding Korea EXIM Bank as it does not deal in deposits) and borrowings from Government fund till 1990, to more of financial debentures and other sources of funding since 2010. As part of their liabilities, these banks also issue specific bonds such as Industrial Finance Bonds (issued by Korea Development Bank (KDB)), and Small and Medium Industry Finance Bonds (issued by Industrial Bank of Korea (IBK)) etc. Their scope of activities also began to expand, particularly the securities businesses. Korean Development Bank conducts corporate and merchant banking activities, Industrial Bank of Korea conducts securities-related activities, such as SME stock subscription and underwriting and SME bond subscription, underwriting and guarantees, and like commercial banks, the National Federation of Fisheries Cooperatives (NFFC) deals in general loans and deposits, domestic and foreign exchange, loan guarantees and mutual instalment deposits, securities investment, bond trading and factoring, and trust and credit card affairs.

4.4.4 Although, most of them are owned by the Government, the June 2009 amendment of the KDB Act initiated the process of privatizing the bank. The IBK is the only specialized bank listed on the Korea Exchange and it was subsequently transformed from a government invested corporation to a government contributed corporation in November 1997.

4.4.5 To sum up, international banking and financial structures in some countries support banks concentrating on wholesale and long-term financing. Such banks are operating in each of the private, public and foreign sector only in a few jurisdictions. Their operations are restricted by nature of their liabilities and the nature of the assets created. Some of these institutions in the public sector, which began as part of the Government-backed development policy, have begun their transition towards privatization.

5. Key aspects of design

5.1 Minimum Capital Requirement

5.1.1 Under the recently released Guidelines for 'on tap' Licensing of Universal Banks dated August 1, 2016 ('*on tap Guidelines*'), the initial minimum paid-up voting equity capital for a bank was fixed at ₹500 crore. Further, in the case of differentiated banks such as Payments Banks (PBs) and Small Finance Banks (SFBs), the initial minimum paid-up equity capital was fixed at ₹100 crore. From the above, it may be perceived that differentiated banks were mandated lower initial capital requirements than the full service or universal banks. This fits with the idea that since PBs and SFBs were specialized banks with restricted activities and wouldn't offer sophisticated products, they would carry less risky asset portfolios in their books than that of the universal banks. Therefore, entry point capital was relaxed for such differentiated banks, to allow small, but experienced promoters with good track records to set up these banks.

5.1.2 In the report of the "Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households", chaired by Dr. Nachiket Mor ("*Nachiket Mor Committee Report*"), it was stated that in view of the fact that wholesale banks will not take retail deposits, the minimum entry capital requirement for them may be ₹50 crore compared to the ₹500 crore required for scheduled commercial banks.

5.1.3 WLTF banks will be a set of differentiated banks. However, these banks are expected to be very large institutions ab initio to take on large exposure to industrial, commercial and infrastructure sector. Further, they are expected to carry substantial credit-concentration and devise sophisticated financial products. Their risk perception may be thought of as higher than that of universal banks. Therefore, they have to heavily invest in information technology and skill building to mitigate the risks.

5.1.4 Accordingly, a higher level of initial minimum paid-up equity capital, say ₹1,000 crore or more, may be considered for these banks.

5.2 Eligible Promoters

The eligible promoter(s) for setting up universal banks are already specified in the Guidelines for 'on-tap' Licensing of Universal Banks. The same may be considered applicable in case of WLTF banks.

5.3 Nature of Business

5.3.1 As the name suggests, Wholesale and Long-Term Finance Banks are envisaged to provide financial services predominantly in the wholesale segment of the market. WLTF banks shall focus on lending long-term to cater to the funding needs of certain sectors of the economy which create assets with long gestation period such as infrastructure and core industries. These sectors traditionally remain deprived of regular bank credit due to asset-liability mismatch issues which arise on the balance sheet of banks because of long gestation / repayment period of assets in such sectors. Therefore, to channel necessary credit from WLTF banks to these sectors of the economy, a target percentage of their total credit portfolio may be prescribed for infrastructure and long term projects.

5.3.2 WLTF banks are not expected to have significant retail exposure. Retail exposure may be as defined under regulatory retail exposure for the purpose of calculation of capital charge for credit risk for commercial banks.

5.3.3 With regard to the sources of funding, WLTF banks are not expected to accept savings deposits. Current Account and Term Deposits may be mobilized by these banks. A higher threshold for term deposits, say above ₹10 crore, might be considered. There could be reasonable restrictions on premature withdrawal of these deposits.

5.3.4 Another major source of funds for WLTF banks will be issuance of bonds. These could be issued locally or abroad in rupee-denomination. Further, other funding sources such as commercial bank borrowing, certificate of deposits, securitization of assets etc. shall be available for WLTF banks.

5.4 Deposit insurance, CRR / SLR, Liquidity Norms and Rural sector obligations

5.4.1 WLTF banks shall be registered with DICGC, as statutorily mandated under DICGC Act, 1961, for the purposes of customer deposit protection.

5.4.2 WLTF banks may be required to maintain CRR as may be stipulated by RBI from time to time. However, WLTF would be eligible for exemption from CRR requirement for the liabilities under infrastructure bonds. Exemption from SLR requirements may be considered for the WLTF banks.

5.4.3 Some relaxation in respect of prudential norms on liquidity risk and compliance with liquidity ratios such as Liquidity Coverage Ratio / Net Stable Funding Ratio may be considered for WLTF banks.

5.4.4 Opening of rural and semi-urban branches and compliance to priority sector lending norms would not be mandated for WLTF banks.

6. Issues for Discussion

6.1 Whether there is a need for setting up of dedicated banks concentrating on wholesale and long term financing, as envisaged in the discussion paper, and whether the time is opportune for the same?

6.2 Whether any public purpose would be served by setting up of a separate class of wholesale and long-term financing banks?

6.3 Whether banks concentrating on wholesale and long term financing would have a viable business model considering the limited avenues for raising long-term resources and significant mismatches on their asset-liability profile, to name a few?

6.4 Whether the proposed regulatory framework is appropriate?

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