

Poorest States Inclusive Growth Programme

Supported by DFID

'Banking Structure in India – The Way Forward'
Policy Roundtable on “Small Finance Banks: Pathways to Financial Inclusion?”

Organized by SIDBI and ACCESS ASSIST

25th September 2013
SIDBI, Mumbai

KEYTAKEAWAYS

SAMRIDHI (Poorest State Inclusive Growth Programme) is being implemented by SIDBI with support from the Govt. of UK's Department for International Development (DFID) to enhance the income and employment opportunities of poor households in underserved states in India. The purpose of the program is to improve income and reduce vulnerability of poor people and small producers by expanding their access to finance and markets. The program, inter-alia, aims to reach out to 10 million credit clients during the period of 7 years in the four states of Uttar Pradesh, Bihar, Madhya Pradesh and Orissa by way of capacity building of MFIs, facilitating technology led models, product development and roll-out, setting up risk funds etc.

ACCESS-ASSIST, a specialized affiliate of ACCESS Development Services for Financial Inclusion, is the consortium partner for SAMRIDHI and has been assigned the task of implementing the critical policy and enabling environment component under the programme.

The Reserve Bank of India has released on its website a Discussion Paper on 'Banking Structure in India – The Way Forward', which included among other aspects, the issue of setting up Small Banks as separate institutional structures to facilitate financial inclusion. To discuss the same, a consultation of financial inclusion sector stakeholders was organised on 25th September 2013 at Mumbai.

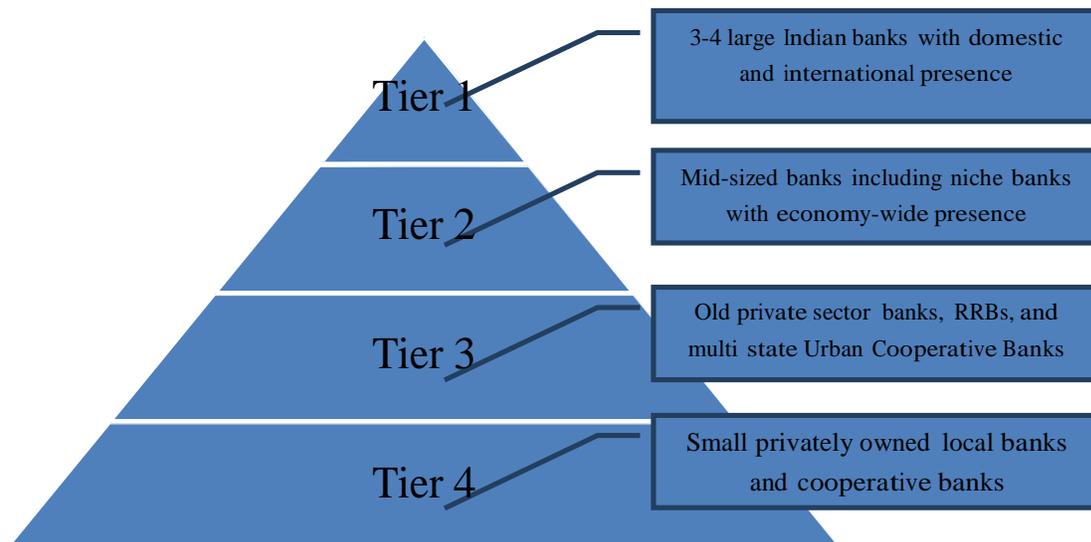
Context and Objectives

The Reserve Bank of India has released on its website a Discussion Paper on 'Banking Structure in India – The Way Forward'.

The Discussion paper has identified certain building blocks for the reorientation of the banking structure with a view to addressing various issues such as enhancing competition, financing higher growth, providing specialized services and furthering financial inclusion. It has also emphasized the need to address the concerns arising out of such changes with a view to managing the tradeoff for ensuring financial stability. The envisaged policy will have to be in the backdrop of a strong regulatory and supervisory regime with increased intensity of supervision for the systemically important banks. The overall thrust of the reorientation is to impart dynamism and flexibility to the evolving banking structure, while ensuring that the structure remains resilient and promotes financial stability.

The important issues that have implications for financial inclusion covered in the Discussion Paper are:

- iii. Small banks vs. large banks: Small local banks play an important role in the supply of credit to small enterprises and agriculture and banking services in unbanked and under-banked regions in the country. While permitting large number of small banks, however, the issues relating to their size, numbers, capital requirements, exposure norms, regulatory prescriptions, corporate governance and resolution need to be suitably addressed.
- iv. Tiered Structure of Banks: RBI has proposed a reoriented banking system with distinct tiers of banking institutions



1. Participants

The consultation was attended by banking and microfinance sector representatives i.e. RBI, SIDBI, NABARD, LAB, IIBF, MFIs, MFI network (MFIN), rating agencies (M-CRIL), investors, donors. The list of participants is provided in Annexure 2.1

2. Summary of Proceedings

OPENING PRESENTATION – FINANCIAL EXCLUSION IN INDIA

The extent of financial exclusion in India is found to be higher as compared with many developed and some of the major emerging economies. The wide extent of financial exclusion in India is visible in the form of high population per bank branch and low proportion of the population having access to basic financial services like savings accounts, credit facilities, and credit and debit cards.

Under-penetration of formal banking facilities in most parts of the country. Just one in two Indians has a savings account, and only one in seven Indians has access to banking credit.

Wide disparity in financial inclusion: India's six largest cities have 11 per cent of the country's bank branches.

Deposit penetration is the key driver of financial inclusion: The number of savings bank accounts, at 624 million, is close to four times the number of loan accounts at 160 million.

More focus on Credit Penetration (CP) is needed: Overall financial inclusion is constrained by lack of CP. CP score is the least amongst all three parameters across all regions, except South.

In the bottom 50 districts, there is an encouraging improvement in branch efficiency.

Southern Region shows highest financial inclusion: The Southern region leads the financial inclusion drive in the country, with a CRISIL Inclusix score of 62.2 in 2011.

OPENING REMARKS BY MS SUDHA DAMODAR, CGM, DBOD, RBI

Ms Damodar began with an overview and background of the discussion paper. She mentioned how the world is emerging from the Global Financial Crisis and new structures need to be explored. RBI is keen to explore new banking structures; there is data and recommendations from various committees like 2008 Report of the Committee on Financial Sector Reforms, C Rangarajan Committee etc.

RBI is keen to explore the "Small Bank" as a separate category and is happy to be represented at this policy retreat to hear views and suggestions

In 1993, 10 bank licenses were granted and 2 additional licenses in 2003. The new-generation private banks licensed since the 90s have led to a marked improvement in customer service, adoption of better technology, aggressive deployment of ATMs, and also product innovation, especially on the retail side.

On 22nd February 2013, The Reserve Bank of India announced guidelines for issuing 'New Banking Licenses' in the private sector wherein a mandatory 25% of all branches are to be set up in sub <9,999 population centers and a comprehensive 'viable and reliable' business plan elaborating financial inclusion needs to be submitted. The differentiating factor for the new banks to be licensed in 2013 would inter alia be innovation, technology and most importantly financial inclusion.

In the present context, two different approaches are being seen at the same time – (1) scope for further consolidation and (2) more number of banks.

The system needs to be prepared for failure of some banks; it is important to look at resolution of bank failures. In India there is limited experience of dealing with bank failures.

In view of maintaining the stability and strength of the banking system and catering to all segments, four levels of banking institutions are being proposed, with the lowest level consisting of the new 'Small banks' category along with small cooperative banks.

The key questions for RBI are:

- Is there a case for small banks for facilitating financial inclusion?
- How many such banks would be required?
- How small is small?
- Do the small banks need separate regulatory prescriptions?
- What should be broad level entry norms and other prescriptions?

Last date for receiving inputs on the paper has been extended till October 31st 2013

SETTING THE CONTEXT - VIJAY MAHAJAN

To add to this broad context, Vijay Mahajan shared some key highlights from the recent policy paper "Inclusive Banking Architecture for India- 2019: Fifty Years after Bank Nationalization" released in August 2013¹.

There are at least four ways exclusion can be defined:

1. Spatial – metro-urban-rural and across regions, states and districts
 - a. Stark differences in percentage of savings and loan outstanding between rural/semi urban vs. metropolitan areas
 - b. Rural savings are still largely in gold, silver, land and livestock, financialization of savings has not happened in India
 - c. High inter-state differences in CD ratio – While CD ratio reached 68% in rural areas on all India basis, regional disparities for CD ratio for rural and semi urban areas for some states such as West Bengal, Jharkhand, Bihar, Odisha etc.
2. Sectoral – agriculture, industry, services and sub-sectors within them.

¹ Vijay mentioned that this paper precedes the RBI discussion paper and therefore does not directly respond to the points raised in the discussion paper, though broadly addresses some issues pertaining to financial inclusion covered in the paper.

- a. There is no equity between GDP share and credit share in large and small industry
- b. There is persistent structural gross inequality; however it needs to be evaluated what part of this is due to lack of access to banking and how much is due to developmental inequalities.
- 3. Segmental – sections of population – women; scheduled tribes, scheduled castes; minorities; and the disabled
 - a. Only one woman gets a loan for every six men
 - b. Muslims as a community are more than proportionately excluded – partly due to higher level of poverty in the community and partly because interest free banking does not exist
- 4. Size and status – large and formal/organized vs. small and informal
 - a. Marginal farmers who constitute 70% of the farmers got less than 25% of total agricultural credit (2006-07)
 - b. Less than 3% of net bank credit goes to micro and small enterprises

Megatrends that Define Potential in near term

Incomes are going up, and therefore demand for a wider range of financial products is increasing

The three new connectivity avenues – roads, mobile network and identity (Aadhar) – bring immense potential for financial inclusion going forward.

Demographically, it is the best time in India to introduce a universal pension system, and separate universal health insurance system.

Urbanization and rural-urban migration and remittances are rising

Intermediation is becoming accepted and acceptable

Lessons from other countries

This lesson is the most obvious one – from the US, from Germany, from South Africa – different types of banks are needed to meet different needs – Global banks, Nation wise banks, State level and Zonal banks, Community development banks and rural banks. An international bank needs 500 times more capital in Indonesia than a rural bank.

OPENING BY THE MODERATOR, ALOK MISRA, CEO, MCRIL

Alok began with explaining the structure of the discussion (Annexure 2.2)

Various Structures, Risks, Opportunities and Challenges

Empirical Evidences etc

Role of MFIs

SUMMARY OF DISCUSSIONS:

RBI's RESPONSIBILITY: THE FINANCIAL INCLUSION DIMENSION

- Hitherto Price Stability and Growth were the two prerogatives, now “How inclusive the financial inclusion system” is must be added
- At the height of the financial crisis the G20 Leaders recognized this need for financial infrastructure by setting in motion the G20’s commitment to financial inclusion at the Pittsburgh Summit. Financial inclusion supports balanced economic growth, as well as giving the poor and small businesses better tools to manage their financial needs.
- It was discussed that today’s regulation should not be treated as ruling consideration. Financial sector regulation for low income segments requires that for up to a certain size of transaction, an entity should be able to operate on economy of scope rather than economy of scale.

TIERED STRUCTURE: RBI has proposed a reoriented banking system with distinct tiers of banking institutions:

- The first tier may consist of three or four large Indian banks with domestic and international presence along with branches of foreign banks in India.
- The second tier is likely to comprise several mid-sized banking institutions including niche banks with economy-wide presence. These are capable of offering a broad range of banking products and services to the domestic economy such as investment banking, wholesale banking and funding large infrastructure projects.
- The third tier may encompass old private sector banks, Regional Rural Banks, and multi state Urban Cooperative Banks.
- The fourth tier may embrace many small privately owned local banks and cooperative banks, which may specifically cater to the credit requirements of small borrowers in the unorganized sector in unbanked and under banked areas.

Recommendations:

Four tiers will still not be able to reach the excluded – bottom of the pyramid. Another tier for Community based financial institutions (since cannot use the term bank) should also be provided legitimacy and included as a separate fifth tier.

KEY FEATURES FOR INCLUSION

- Reach and Teach - Awareness is very important along with enhancing access; this has to be in the DNA of the institution, should be in the mission of the organization and not forced up on the organization
- Cultural compatibility is important - Institution should take a pride in serving the client segment
- Role of high touch, client interface is non-negotiable
Financial Inclusion is a high touch and therefore high cost business. As a business model, its greatest challenge is to lower operating costs in order to reduce the cost of service borne by borrowers.
- Consumer protection
The prime concerns of regulators revolve around ensuring financial stability and consumer protection, while addressing risks of fraud and money laundering.
- Reducing costs is imperative, but pricing needs to be freed up

- Technology is critical
 - Cost of delivery of services is higher for small ticket size; so technology is critical to reduce costs.
 - Resolving technology related issues is the key. One of the major constraints of the technology based financial inclusion model has been the technical problems associated with the model. It has been reported that devices, such as hand held machines, smart cards, PoS terminals and utilities which are crucial to the functioning of the model are not properly functioning in many areas of the country.

FINANCIAL INCLUSION AS A BUSINESS OPPORTUNITY

- Desire to do business with poor rather than helping them is core
- Should Bigger institutions should subsidize small banks; low cost funds from commercial banks; so that small banks can work on financial inclusion
- It is crucial to work out the financial model and ensure it is a sustainable one.
- No cross subsidizations / subsidies – but business opportunity should be the Key Driver.
- Policy push (PSL etc) exchequer loses more, people gain less; proportional gain is not achieved
- What makes the small banks viable? – Management, bouquet of products, technology, sharing of services among banks through technology, drawing up on collective resources/

There was emerging consensus on “A Market Based Solution” rather than driven by mandates and assigned targets and the following are key aspects for transformational business model:

1. Seeing the opportunity in the base of the pyramid.
2. Applying business principles to solve social problems.
3. Delivering low-cost solutions.
4. Thinking differently. Providing services for the base of the pyramid using the same infrastructure, distribution system, and cost structure won't work. An entirely different way of thinking, distributing, and marketing is necessary.
5. Partnering with the community.

EXISTING INSTITUTIONS AND PROVISIONS

- Local Area Banks (LABs):
 - The Reserve Bank of India introduced the Local Area Bank scheme via an August 1996 circular with a minimum capital of Rs 5 crore, to operate in an area comprising three contiguous districts.
 - 1996-2010, In fourteen years, only six local area banks were licensed under Section 22 of the Banking Regulation Act 1949, of these, one license was withdrawn, one LAB was merged with Bank of Baroda, the other four LABs i.e. KBS LAB, Capital LAB, Subhadra LAB and Coastal LAB are continuing to function well, all profitably meeting statutory requirements and are pleading their case with RBI to expand to a “few” more districts.
 - NABARD does not refinance LAB's who are in most need for subsidized funds

- Primary Agriculture Cooperative Societies (PACS)
 - A large number of financially-weak PACs with vast geographical spread and large- scale financial exclusion. This arrangement speaks of the step-by-step approach to strengthen PACs on the one hand and on the other, effective utilization of PACs for furthering financial inclusion. Some well performing examples of PACS exist which can potentially apply for (small bank) banking license.
- Regional Rural Banks (RRBs)
 - RRBs were established by the Government of India with the objective to provide loan to small and marginal farmers and thus uplift the agrarian economy of the country. That said, RRBs are more attached to the rural populace and leveraging on this aspect can bring in more rural customers to their fold. However, RRBs have moved away from mandate of inclusion and there is not much difference between RRBs and commercial banks except physical presence in rural areas.
- Cooperative Banks
 - Various committees on cooperatives have untiringly repeated 'Cooperatives have failed but must succeed.'
- PSL requirements – PSL requirements will be more effective if imposed on quarterly basis rather than annual; strategically however this is again imposition rather than internal mandate of the bank, therefore not effective for larger impact
- Post Offices as an Option - Post offices are more 'approachable' for low income than banks
- The structural and functional weaknesses of existing structure need to be mapped out

SCALE UP REGULATORY ABILITY FOR SUPERVISION

- RBI will need to scale up its regulatory and supervisory capacity to deal with the challenges of many small banks.
- RBI could perhaps carve out a separate division to look after the "Small (Finance) Banks"

INTERNATIONAL EXPERIENCES

Germany: The German banking system is structured in three different pillars, totally separated from each other. They typically differ in their legal form and the ownership. Private Banks, represented by banks like Deutsche Bank or Commerzbank as listed companies or Hauck & Aufhäuser or Bankhaus Lampe as less known private companies, are part of the first tier. The second tier is composed of co-operative banks like the numerous Volksbanken and Raiffeisenbanken. They are based on a member-structure where each member, independently from its capital share, has one vote. The third tier consists of public banks that are a legally defined arm of the banking industry in Germany and separate into two main groups.

- The German Savings Banks Finance Group (Sparkassen-Finanzgruppe) is the most numerous sub-sectors with 431 savings banks using the Sparkasse brand. Based on OECD studies, the German public banking system had a

share of 40% of total banking assets in Germany.] This shows the important and significant role of this group of banks in Germany.

Indonesia: Bank Rakyat Indonesia (BRI) is a state-owned bank in Indonesia, with most extensive branch network covering the entire nation. It also has an extensive network of more than 4,000 retail outlets at the sub-district level, known as BRI village units (Unit Desa). Unit Desas operate on a full commercial basis, with each unit acting as a semiautonomous entity serving micro and small customers, predominantly in rural areas. BRI offers loans, voluntary savings products, fund transfer services as well as training and consulting services. Viable not as individual units; integrated into systems.

What India needs to learn from International Experiences?

- Regulatory Structures of various countries need to be examined in their entirety to distill specific learning and understand its applications for Indian context
- Broadly these show that small universal banks are viable
- However, for being viable, they would need to be integrated into support systems, including:
 - Apex structures/holding company structure (for centralized functions such as licensing, branding, fund mobilization, compliance MIS, technology etc.) to combine local touch and economies of scale
 - Sector owned control, audit and protection system (will decrease supervisory burden on Central Bank)
 - Professional standardization and certification systems
- Indonesia is a good example to look at how some operational/supervision issues were resolved by Central Bank; investments/efforts made by Central Bank to set up systems for supporting small banking institutions

KEY RECOMMENDATIONS FOR SMALL BANKS/SMALL FINANCE BANKS/MICRO-RETAIL BANKS

- A new category of banks for catering specifically to the needs of the 'small' ticket size clients with specific regulatory prescriptions is recommended.
- Existing entities fulfilling the eligibility norms could convert/transform into small banks
- Micro-retail banking is faced with the following trilemma:
 - Specialization for delivery to the target segment
 - Sustainability
 - Scale

The following broad regulatory prescriptions were proposed for the new Small (Finance) Bank category:

Eligibility Criteria	"Fit and Proper", as decided by RBI
Entry level capital	Rs 50 Crores
Services and Products	Distinguishing factor is client segment focus Small loan or loan that can be mainstreamed.

	Loan size restrictions – 80% portfolio should be loans below INR 25 lakhs
Minimum CRAR	15%; monitored monthly
Geographic	Local; knowing your bank 10 contiguous districts not restricted to a state Additional INR10 crores for additional districts
Cap on RoA	2.5%
Technology	Mandatory leveraging of technology
Eligibility	Proven track record of a financial services business
Conversion	Open to existing players like MFIs, NBFC, Cooperatives
Others	No pricing caps Availability of Refinance for small banks such as from NABARD

NEXT STEPS

- One more Round of Discussion could be organized in October at Kolkata / New Delhi with participation from commercial banks, cooperatives and RRBs, before sending a consolidated response to the RBI discussion paper.
- Invite senior representatives from other countries such as Indonesia for sharing of experiences on regulation of Small banks – best practices, lessons and challenges. Dr Holloh, GIZ and Vijay Mahajan, BASIX offered to help with inviting the appropriate officials

List of Roundtable Participants

S. No	Name	Position, Organization
1	Sudha Damodar	CGM, DBOD, RBI
2	Brij Mohan	Expert
3	Alok Prasad	CEO, MFIN
4	Ashoka Chatterjee	Head, Institutional Finance, Bandhan
5	Santanu Mukherjee	Janalakshmi Finance
6	Ashish Damani	SKS Finance
7	Detlev Holloh	Programme Director, GIZ
8	Vijay Nadkarni	MD, KBSLAB
9	R Bhaskaran	CEO, IIBF
10	R Kummur	CGM, NABARD
11	Alok Misra	CEO, M-CRIL
12	Vijay Mahajan	Founder and CEO, BASIX Group
13	Sushil Muhnot	CMD, SIDBI
14	N K Maini	DMD, SIDBI
15	Raghavan	Equitas
16	Jonna Bickel	GIZ
17	Anu Gupta	Deputy Head, Private Sector, DFID India
18	Meenakshi Nath	Deputy Head, DFID India
19	N K Madan	CGM, SIDBI
20	Prakash Kumar	GM, SIDBI-PSIG
21	Vipin Sharma	CEO, ACCESS
22	Radhika Agashe	ED, ACCESS ASSIST
23	Vibhu Arya	The Flat Pyramid

AGENDA

Moderators:

Vijay Mahajan, Founder and CEO, BASIX Group

Alok Misra, CEO, M-CRIL

Start	End		
10:45	11:00	High Tea and Networking	
11:00	11:10	Introduction	Radhika Agashe
11.10	11:20	Opening Remarks	Ms Sudha Damodar, CGM, DBOD, RBI
11.20	11:50	Setting the Context: Kick Off Presentation	Vibhu Arya Consultant – Access Vijay Mahajan, Founder BASIX Group
11.50	13:00	Moderated Discussion Existing Banking Institutional Infrastructure: Potential for Financial Inclusion	Moderators
13:00	14:00	Lunch	
14:00	16:15	Moderated Discussion Small Banks/ Small Finance Banks: Scale, Scope and Viability	Moderators
		Working Tea	
16.15	17:00	Consolidation of Key Recommendations	Moderators
16:00	17:10	Closing Remarks	Meenkashi Nath, DFID

RESPONDENTS TO THE QUERY RAISED ON UN-SE-MF.

1. Vijay Kulkarni, Development Sector Professional, Bangalore
2. N Srinivasan, Independent Consultant, Development Finance
3. Alok Misra, CEO, M-CRIL, Gurgaon
4. Jayshree Vyas, SEWA Bank, Ahmedabad
5. Dr. Ritesh Dwivedi, Department of Rural Management, Amity Business School, NOIDA
6. S.C Upadhyay, National Cooperative Development Corporation , New Delhi
7. Savita Shankar, Asian Institute of Management, Philippines
8. Mohammad Azhar, National Resource Center of Women (NRCW), Ministry of Women & Child Development, GoI, New Delhi
9. Vibhu Arya, Co-Founder, The Flat Pyramid, New Delhi
10. Prabhat Labh, The MasterCard Foundation, Canada
11. Satyen Yaadav, HPMI & IPL, Uttar Pradesh & Uttarakhand
12. Resham Singh, Micro finance Consultant, Mohali,Punjab
13. Sunil Kumar , Bankers Institute of Rural Development (BIRD), Lucknow
14. Rajesh K Verma, Vanachal Gramin Bank, Latehar, Jharkhand
15. Aruna Sharma, Department of Panchayat, Rural Development & Social Justice, Government of Madhya Pradesh
16. Hemantha Kumar Pamarthy, Independent Consultant and Adviser, Chennai, Tamil Nadu, India
17. G K Agrawal, Ex - ED NABARD, Rural Development & Micro-Finance Consultant & Advocate, Mumbai
18. Alka Parikh, DAIICT, Gandhinagar, Gujarat, India