Mor report on financial inclusion

Some key issues

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Key issues/ideas

I. Progress on Inclusion
II. Do we leverage existing institutions or create new ones?
III. What sort of new institutions?
IV. If we want to leverage existing institutions, what could we do better?
V. Getting better results with priority sector lending (PSL) targets
VI. Different provisioning norms based on asset class
VII. Summary

I. Progress on inclusion

- Progress in inclusion unsatisfactory. Situation can be said to be alarming.
- Report targets full access by Jan 1, 2016. Says we need not one “big idea” but multiple approaches.
- Suggests Aadhar-linked bank account

Comment:

- Setting artificial deadline for full inclusion fraught with systemic risk, apart from being unrealistic.

I. Progress on inclusion

- We have had a series of “big ideas”:
  - cooperatives
  - bank nationalisation
  - regional rural banks
  - business correspondents
  - partnership with MFIs.
- The first three did produce results

II. Old versus new institutions

- Need to await the results of the last two because it’s only recently that deregulation of pricing of small loans has taken place. Freedom to price does change incentives for banks.
- New ideas and approaches are, however, welcome
- Since Aadhar is not mandatory, link to Aadhar may not lead to universal access.

- Do we leverage the existing institutional structure or do we need a fresh set of institutions?

II. Old versus new institutions

- Mor committee contention: let market, not regulator, decide what institutions we should have. Provides the basis for “differentiated licensing” to allow plurality of institutions.

Comment:

- There is no bar on banks specialising in particular areas (wholesale, retail, capital markets, etc) in the present scheme of things.

- However, all players have tended towards a model that encompasses all areas of banking, including the sale of third party products such as mutual funds and insurance.

II. Old versus new institutions

- We had specialised DFIs for long-term finance but they had to convert themselves into banks once concessional finance was withdrawn.

- The two points above suggest that, **given a level playing field**, the market favours a model that tends towards universal banking.
- Mor committee appears to accept this logic when it argues for differentiated licensing: specialised players would not be viable except with special dispensations.

II. Old versus new institutions

- Issue no 1: how uneven should be the field be for different players in terms of minimum capital, capital adequacy, SLR, CRR, priority sector requirements etc. Impossible to determine this precisely- that is, ensure "neutrality" of norms.
- So, we will be favouring one type of institution over another, in another words, creating regulatory arbitrage.

II. Old versus new institutions

- Issue no 2: Specialised or focused players imply ‘narrow banking’ in one form or another. This raises issues of viability and concentration risk.
- Issue no 3: We already have differentiated licensing where banks and NBFCs are concerned and two types of NBFC (deposit, non-deposit). Those who do not wish to be encumbered by banking regulation can offer a variety of products as NBFCs.
- Do we want to create differentiation amongst banks? Does amount to turning the clock back.

III. What sort of new institutions?

- Suppose we accept that financial inclusion cannot happen without new players and new players need to be incentivised through differentiated licensing. What sort of players?
- Mor committee:

i. Payments bank

ii. Wholesale investment bank

iii. Wholesale consumer bank

III. What sort of new institutions?

i. Payments banks

- Payments banks will take deposits, make payments, no credit
- All PPIs (pre-paid issuers) should convert to payment banks or become BCs. (Now they take up to Rs 50,000 from individuals and store them in “digital wallets” for making payments)
- RRBs which are unviable can become payments banks

III. What sort of new institutions?

- Rationale for payments banks: PPIs are subject to ‘contagion risk’ should their sponsor banks fail; they don’t pay interest on cash handed to them
- Payments bank features: Will collect up to Rs 50,000 as deposits; minimum capital: Rs 50 crore; all deposits invested in three month SLR securities; CRR requirements will apply

Comments

- No compelling argument for all PPIs to convert.

III. What sort of new institutions?

- Getting people into payments system or deposits does not translate into their getting credit or insurance, which are the more critical ingredients for fostering growth. (Inclusion has four critical elements: deposits, remittances, credit and insurance).
- Issue of viability: Is return on three month SLR sufficient to pay suitable return on deposits? At what scale do they become viable?
- Will drive for viability lead to large charges for payment services and inhibit inclusion?

III. What sort of new institutions?

- If alternative institutions become available over time and customers switch, what happens to viability of payments banks? Why would a customer prefer a payments bank to a full-scope bank or a sound NBFC?
- Case for existing banks to create payment bank subsidiaries not clear when payment banks are expected to progress towards NBFCs and full-scope banks.

III. What sort of new institutions?

- Argument: why not offer licenses and let market decide? Problem: unless viability is clear, could create regulatory headaches down the road.

Wholesale Bank

- Can only accept deposits larger than Rs.5 cr
- Minimum entry capital requirement – Rs.50 cr
- 20 or fewer branches - Wholesale Investment Banks
- More than 20 branches – Wholesale Consumer Banks

Comment:

- Not clear what role these banks can play which is not provide by existing players or large NBFCs

III. What sort of new institutions?

- Worldwide trend in banks (especially post crisis) is towards profitability in retail banking rather than wholesale or investment banking, so basis for viability is doubtful
- Banks that started out with wholesale focus have quickly moved towards branch expansion and retail operations. Again, market seems to have answered this question
- Potential risk of entry of players with objective of channelising large private flows, creating more regulatory headache.

III. What sort of new institutions?

<u>Alternative institutions</u>

- If the answer is to have small players with less stringent regulatory norms, why not revisit the small bank concept (with fuller range of products as per Raghuram Rajan committee report)?
- Apprehensions about small banks based on experience with LABs (local area banks).

III. What sort of new institutions?

- We have moved on: better appreciation of risk management and better regulatory capability, cost effective and growing versatile IT infrastructure.
- If smallness, newness, private participation and regulatory forbearance are the key elements in any new initiative, try these with full-scope banks instead of with narrow banks.
- Full scope banks stand better chance of attracting entrepreneurs in non-metro locations.

IV. Can we better leverage existing institutions?

- To repeat: two key elements in proposal for new banks are:
  - Private ownership
  - Relaxation of regulatory norms
- Can we apply these elements to the existing institutions (UCBs, RCBs, RRBs)?
- Underlying principle: banks focused on financial inclusion can expect a more benign regulatory dispensation

IV. Can we better leverage existing institutions?

- Convert some of these institutions into companies and bring in private shareholders (whether minority or majority)
- Remove or significantly reduce SLR requirements for these institutions to improve viability (contribution towards total SLR borrowings by these institutions would be quite small)
- Market discipline and cost restructuring associated with private ownership may infuse life into existing players.

V. Better results with PSL

- Committee suggests weights for sectors (agriculture, direct and indirect, SMEs and weaker sections).
- Adjusted PSL target of 50% instead of current 40% unadjusted. Eg. if you lend 40% entirely to direct agriculture, you get credit =40*1.25; if you lend entirely to SMEs, you will lend 50% of ANBC to meet target.

V. Better results with PSL

- Rationale: let banks focus on areas in which they have expertise- urban banks can focus on SMEs, RRBs and others can focus on agriculture.
- Problem 1: PSL portfolio that results may not be diversified. True, diversification can be achieved by trading of PSL-linked securities recommended by committee but pricing could be a deterrent for such purchase.
- Potentially long lead time required for trading of small-size lots of PSL-linked securities to develop. Current PSL deals are wholesale and sporadic.

V. Better results with PSL

- Problem 2: If only banks in rural areas focus on agriculture to the desired extent, overall flow to agriculture could suffer. We want large banks' funds to flow into agriculture
- Problem 3: We have seen decline in rural/agricultural expertise in many PSBs in post-liberalisation phase. In the larger national interest, we need to build broad-based expertise in agriculture in banking system, expertise should not be confined to a few rural banks
- Bottom line: Sectoral weighting not an attractive proposition

V. Better results with PSL

- District-wise weighting: This seems a better idea. Principle: overall PSL targets do not tell us how inclusive credit flows are. We need credit to flow into under-served **areas**, not just to some proportion of under-served sectors or households.
- District weighting proposed on the basis of two parameters: backwardness of district (as measured by a CRISIL index) and distance from desired credit/GDP ratio of 50% for every district.

V. Better results with PSL

- Comments:
  - use of two parameters complicated
  - estimates of credit/GDP ratio may not be reliable, hence weights derived therefrom could be flawed
  - firms may borrow in one district for deployment elsewhere, so rationale for credit/GDP targets for districts not clear.
- To begin with, use weights based only on measure of performance of district.

V. Better results with PSL

- Other good ideas: sale of PSL-linked bonds and certificates; removal of ceiling on interest rate on securitised assets; interest subvention to be given directly to borrower, banks to charge market rate of interest, etc.
- To get better results, we need more transparency on PSL. Banks must disclose in their annual report break-up of business (deposits and loans) by segments: Rural, Semi-Urban, Urban and Metro. RBI must provide the same consolidated data bank-wise for each of these centres and also district-level data.

VI. Asset-class based provisioning

- Provisioning norms should be based on underlying risk of asset. If agriculture is riskier based on NPA/asset ratio, have higher provisioning for agricultural assets
- Problem 1: NPA/asset ratio can fluctuate both on account of numerator and denominator; do we keep tweaking norms?
- Problem 2: Why confine 'asset class' to broad categories. Why not higher provisioning for 'infrastructure', sectors that are 'distressed' or 'negative' (according to rating agencies).
- Better to go for provisioning that covres assets in totality- in some cases, there could be under-provisioning, in other over-provisioning, the two cancel out.

VII. Summary

i. New players welcome; need not be specialised players but small, full-scope banks
ii. Viability of payments banks not clear
iii. Priority sector weighting: yes to district performance alone to start with; no to sectoral weighting
iv. Risk-based provisioning raises implementation issues

THANK YOU