CAFRAL
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Conference on Banking Structure For India

Background

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. There are multiple layers in today's banking structure to cater to the specific and varied requirements of different customers and borrowers. The banking system has played a major role in the mobilisation of savings and promoting economic development. In the post financial sector reforms (1991) phase, the performance and strength of the banking structure improved perceptibly. Financial soundness of the Indian commercial banking system compares favourably with most of the advanced and emerging countries.

As the real economy is dynamic, it is imperative that the banking system is flexible and competitive to cope with multiple objectives and demands made on it by various constituents of the economy. The critical segments are infrastucture, small and medium industry and businesses, agriculture and allied activities . During the period since 1991, 12 new commercial banks licenses have been issued while none of the Indian banks has acquired the size and reach on a global scale. The percentage of population without access to formal financial services is still significant. It is, therefore, imperative that the expansion in the banking sector keeps pace with the dynamism and competitive nature of the real economy. Further, there is a need to relook the structure of the banking system keeping in view the international experience and the current debate on banking structure so as to evolve a structure most suited to our needs while enhancing financial stability.

At present, the banking structure in India comprises 150 banks (26 public sector banks, 7 new private sector banks, 13 old private sector banks, 43 foreign banks, 4 local area banks (LAB) and 57 Regional Rural Banks (RRB). There are also 1606 Urban Co-operative banks (UCBs) and 93550 Rural Co-operatives operating in the country.

Indian Banking System – Share by Asset size

Rs. Billion

Institution	**Total Assets (As on March 31, 2013)**	**Market Share of Total Banking Assets (As on March 31, 2013) (Percentage)**
Public Sector Banks	69619.67	64.4
New Private Sector Banks	15450.70	14.3
Old Private Sector Banks	4447.33	4.1
Foreign Banks	6215.63	5.8
Regional Rural Banks	2758.00	2.5
Urban Co-operative Banks	3372.00	3.1
Rural Co-operative Banks	6213.00	5.7
Of which		
STCBs	1479.00	1.4
DCCBs	2573.00	2.4
PACs	1605.00	1.5
SCARDBs	294.00	0.3
PCARDBs	262.00	0.2
Local Area Banks	15.76	0.1
Total	**108092.10**	**100**

Source :- Statistical tables relating to banks in India – 2012-13 / Bank Group-Wise Assets of Scheduled Commercial Banks In India : 2013 / Report on Trends & Progress of Banking in India 2012-13

Rs. Billion

NBFCs	Total Asset size (As on March 31, 2013)	% to Total Banking Sector Asset (As on March 31, 2013)
NBFCs D	1249.00	1.2
RNBCs	73.14	0.1
NBFCs ND SI	11177.00	10.3
NBFCs ND NSI	200.00 (app)	0.2

Source : Trends & progress of banking in India 2012-2013

Differentiated Licenses For New Varieties Of Banks

In India, the universal banking model is followed. As regards the structure of universal banks, the conglomerate structure is bank-led, i.e., banks themselves are holding companies which operate certain businesses through Subsidiaries, Joint Ventures and Affiliates. The policy has evolved over a period of time and inevitably there are legacy issues. The current policy has been expounded in the FAQs on the New Banks Guidelines dated 3rd June 2013. The general principle in this regard is that there should be a move towards a NOFHC (Non Operating Financial Holding Company) ; para-banking activities, such as credit cards, primary dealer, leasing, hire purchase, factoring etc., can be conducted either inside the bank departmentally or outside the bank through subsidiary/ joint venture /associate. Activities such as insurance, stock broking, asset management, asset reconstruction, venture capital funding and infrastructure financing through Infrastructure Development Fund (IDF) sponsored by the bank can be undertaken only outside the bank. Lending activities must be conducted from inside the bank. Investment banking and insurance services can be provided by the universal banks as an in-house departmental activity or through subsidiary in the manner described above. However, limits on equity investments, by a bank in a subsidiary company, or a financial services company including financial institutions, stock and other exchanges, depositories, etc., which is not a subsidiary restrict expansion of investment banking services and insurance business by the universal banks. Consequently, India does not have large investment banking and insurance activity within the banking groups. India also does not have stand-alone investment banks.

However, SEBI does register various intermediaries under its regulations such as stock brokers, mutual funds, portfolio managers and merchant bankers etc.

In the context of financial inclusion, there has been a long standing debate on whether we need small number of large banks or large number of small banks. The Indian experience so far shows that while small banks with geographical limitations play an important role in the supply of credit to small enterprises and agriculture, risk management and governance have been the key challenges with these banks. There have also been sectoral focussed institutions in India (erstwhile DFIs) but their ability to manage funding and concentration risks would be the key to their success. A third approach proposed by the recent Nachiket Mor Committee is a “vertically differentiated banking design”, wherein specialised banks using wholesale funding undertake retail lending (“wholesale bank”) and specialised banks focussed on retail payments and savings (“payments bank”).

There is a view that given the CRR, SLR and PSL requirements determine a significant part of asset allocation, there are very few strategic options for banks to specialise in a particular spehere or niche segment and it is in this context that differentiated licensing is an option. With the broadening and deepening of financial sector, a need is felt that banks move from the situation where all banks provide all the services to a situation where banks find their specific realm and mainly provide services in their chosen areas. With the new Basel III guidelines and RBI’s Risk Based Supervision framework, increasingly, each bank will need to become inherently stronger, focus more sharply on their core capabilities and have the flexibility and regulatory mandate to collaborate actively with other market participants who have complementary capabilities.

<u>Points for discussion</u>

1. In what way can differentiated licensing policy help the banking system achieve the objectives of growth, stability and inclusion?
2. What could be the criterion for differentiation for the purposes of issuing differentiated licences – capital conditions, activity, sector, geography?
3. How should the threshold for capital be arrived at for smaller banks – so as to allow for more entry at the same time not become a threat to financial stability as there is likely to be an increase in the mortality. What kind of concomitant changes will be needed in the deposit insurance system?

4. What are the lessons from earlier experiences with Local Area Bank and Regional Banks?
5. In order to have a vibrant financial sector with various varieties of banks, what mechanisms need to be developed for an active transfer of assets, liabilities and risks between financial sector participants?
6. What kind of transition path should be provided for specialised banks to become full-fledged universal banks?
7. What could be the ways of handling regulatory arbitrage between different categories of banks?

Role and Regulatory Framework of Non-Banking Financial Companies (NBFCs)

The total number of registered NBFCs was 12,225 as on March 31, 2013 comprising 254 deposit taking NBFCs, and 418 systemically important non-depoist taking NBFCs whose asset size exceeds Rs. 100 crores. NBFCs are classified on the basis of their activity into six categories: Loan companies, Investment companies, Asset Finance companies, Infrastructure Finance companies, Systemically Important Core Investment companies and Micro-finance Institution NBFCs. NBFCs historically have been involved in providing financial services such as offering of small ticket personal loans, financing of two/three wheelers, truck financing, farm equipment financing, loans for purchase of used commercial vehicles/machinery, secured/unsecured working capital financing, etc. Further, NBFCs also often take lead role in providing innovative financial services to Micro, Small, and Medium Enterprises (MSME) most suitable to their business requirements. The characteristics of NBFC include simpler processes and procedures in sanction and disbursement of credit; timely, friendly and flexible terms of repayment aligned to the unique features of its clientele, albeit at a higher cost.

The recent global financial crisis has however highlighted the importance of widening the focus of NBFC regulations to take particular account of risks arising from regulatory gaps, from arbitrage opportunities and from the inter-connectedness of various activities and entities comprising the financial system. The regulatory regime for NBFCs is lighter and different in many respects from that for the banks. The steady increase in bank credit to NBFCs over recent years means that the possibility of risks being transferred from the more lightly regulated NBFC sector to the banking sector in India can no longer be ruled out. That said, given the growing importance of this segment of the financial system, it has become equally important to ensure that the dynamism displayed by NBFCs in delivering innovation and last mile connectivity for meeting the credit needs of the productive sectors of the economy is not curbed. In the context of financial inclusion, it is important to examine whether improving and strengthening the relationship between banks and NBFCs especially MFIs, is a better way to promote access to finance? There has emerged therefore a need to rationalise the type and nature of NBFCs being regulated so that the objectives of regulation are met in an optimal and balanced manner.

Points for discussion

1. What should be the role of NBFCs in the financial sector ?
2. What should be the regulatory framework to enable the NBFCs to play their role ?
3. In particular, what are the implications of allowing NBFCs larger access to external funding and allowing them to act as BCs of banks?
4. Given the experience during the financial crisis, how can issues of liquidity risks for NBFCs be addressed if they are dependent only on wholesale funding?
5. What should be the transition path for an NBFC which has grown up to a significant size?
6. Should an NBFC be permitted to convert to "Wholesale Bank" which will allow them to raise wholesale deposits and access payment systems and be regulated like a bank?
7. What would be the effect of the FSLRC recommendation to keep NBFCs outside the regulatory domain of RBI?

Future of Co-operative banks and Regional Rural Banks (RRBs)

As on March 31, 2013, there were 64 RRBs (consolidated from 196 RRBs originally set up), 1,606 urban Co-operative banks (UCBs), 31 State Co-operative banks (StCBs), 371 district central Co-operative banks (DCCBs), 20 State Co-operative Agriculture and Rural development Banks (SCARDBs), 697 Primary Co-operative Agriculture and Rural development Banks (PCARDBs) and 92432 Primary Agricultural Credit Societies (PACS).

Regional Rural Banks (RRBs)

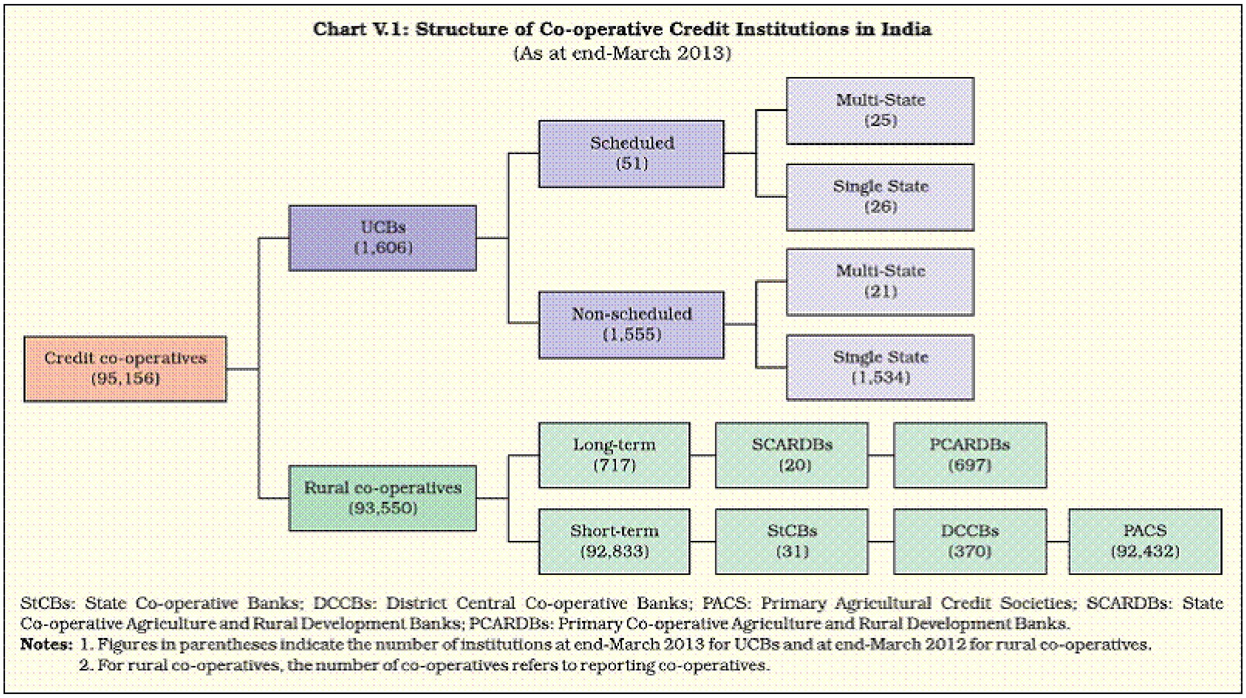
Regional banks are likely to be lower cost and closer to the customer and therefore, better equipped to originate vis-à-vis large national banks, but their local nature also makes them prone to "capture". This has led to persistent governance problems and they also face higher concentration risk. The RRB which was conceived as a subsidiary of larger national banks was potentially a stronger design because it successfully dealt with the challenge of “capture”, but eventually did not perform as expected because gradually the culture and the cost structure of the parent bank permeated into it. On the other hand, technology of information gathering, aggregation and reporting has improved dramatically and allows firms to address traditional problem of adverse selection and moral hazard in a completely different manner, thereby reducing the need to have “local” or “regional” banks. One of the reasons why the German Regional Banks continue to thrive is due to various steps they have taken to improve the risk management capability of these banks. RRBs account for around 2.6 per cent of the banking assets. Gross loans and deposits of 64 RRBs went up by 20.2 per cent and 13.5 per cent during 2012-13, respectively, thus raising the CD ratio to 66.1 per cent as at end March 2013 from 62.5 per cent of March 2012. The GNPA as per cent of gross loans increased to 5.7 per cent as at March 2013 from 5.0 per cent of March 2012.

The process of consolidating RRBs was initiated in the year 2005. In the first phase of amalgamation of RRBs which took place between 2005 and 2010, RRBs of the same sponsor banks within a state were amalgamated bringing down their number to 82 from 196. In the current phase of amalgamation, which started from October 1, 2012, the Government of India (GoI) plans to mainly amalgamate geographically contiguous RRBs within a state under different sponsor banks to have just one RRB in medium sized states and 2 or 3 RRBs in large states. GoI has so far issued 18 notifications amalgamating 41 RRBs into 17 new RRBs within 11 states bringing down their effective number to 58. Consequent to the consolidation of RRBs a minimum CRAR of 8 per cent has been prescribed on an ongoing basis with effect from March 31, 2014.

Points for discussion

1. Recapitalization of RRBs: The proposed amendment of RRB Act suggests that RRBs be permitted to raise capital from other than central and state government and sponsor bank. Would this provide them adequate access to capital to encourage growth? Can we experiment with privatising a few RRBs and inviting impact capital or social enterprise type of investment?
2. Have RRBs become extended arms of PSBs? Should they be made fully owned subsidiaries of banks exclusively for financial inclusion?

Co-operative Banks



Source :- Trends and Progress of Banking in India – 2013-14

Urban Co-operative Banks (UCB)

There has been a phenomenal growth in the UCB sector since 1966 in terms of number of banks, volume of banking business (deposits plus loans and advances), and geographical outreach. UCBs are ideally placed as “the friendly neighbourhood bank” that can meet the objectives of financial inclusion. Well functioning UCBs have furthered access to finance among small households , business and trade. At the same time, low capital base, poor governance, lack of professional management, poor credit management and diversion of funds have led to multi-faceted problems. In the absence of adequate technology platform in the UCBs, they have not been able to leverage their potential for financial inclusion. There has been a continued reduction in the number of UCBs from 1872 as at the end of March 2005 to 1606 as at the end of March 2013, inter alia, due to amalgamation of UCBs. Out of the total 1606 UCBs, only 43 UCBs had presence in more than one state. There are some aspects of the structure viz the Co-operative form that constrains their growth, especially in the matter of raising capital.

Points for discussion

1. Can the issue of dual regulation, be addressed through the creation of Board of Management in addition to the Board of Directors as suggested by the Malegam Committee and FSLRC?
2. How has the system of MOUs with the State Governments worked in improving the strength of the UCB sector? Can there be ways in which this forum can be made to function to ensure UCBs role in providing access to finance to small customers?
3. How can well performing UCBs raise capital to facilitate their growth aspirations?
4. What are the regulatory restrictions that continue to prevail that impede the growth of well functioning and sound UCBs?
5. What should be the road map for conversion of UCBs to commercial banks?

Rural Co-operatives

The role of rural Co-operatives in providing agricultural credit has weakened over the years due to myriad factors as reflected in the decline in the share of these institutions in total agricultural credit from 64 per cent in 1992-93 to around 17 per cent in 2011-12. Within rural co-operatives, the short-term credit Co-operatives occupy a significant position in providing credit to the agriculture sector. The share of short-term credit Co-operatives, comprising State Co-operative Banks (StCBs), District Central Co-operative Banks (DCCBs) and Primary Agricultural Credit Societies (PACS), continued to be above 90 per cent of the total assets of the rural Co-operative credit institutions at end-March 2012 while the long-term credit Co-operatives accounted for the remaining 10 per cent of total assets. However, the financial performance of these institutions has been very weak as a result of poor governance and risk management.

NPA to loan ratios of rural Co-operative banks

Banks	**NPA to Loan ratio (as on March 31, 2012)**
DCCBs	9.7%
PACs	26.8%
SCARDBs	33.1%
PCARDBs	38.6%

Points for discussion

1. The last attempt to reform the Co-operative structure under the Vaidyanathan Committee does not seem to have achieved its objective. What are the reasons and can they be addressed?
2. How can the recapitalisation needs of these institutions be addressed? Prakash Bakshi Committee has made specific recommendations in this regard which require changes in various acts to be made.
3. Appointment of PACs as BCs of commercial banks, RRBs and CCBs – what are the opportunities and challenges of doing it?

Presence and Structure of Foreign Banks in India

The significance and need for foreign banks' participation in India arises primarily to increase competition, promote efficiency of the local banking system and also for bringing in sophisticated financial services and risk management methodologies which can be adopted by the domestic banks. The share of foreign banks in total assets of the banking sector in India is just 7 per cent which is less as compared to other jurisdictions. Moreover, the operations of foreign banks are mainly concentrated in urban and metropolitan areas. Out of the total of 333 foreign bank branches, 331 are in urban and metropolitan areas (out of which 44 branches are in under-banked districts).

The experience of the recent global financial crisis suggests that (i) complex structures (ii) too big to fail (TBTF) and (iii) too connected to fail (TCTF) structures could exacerbate the crisis. During the crisis, jurisdictions hosting foreign banks realised that they were exposed to risks generated in the home countries of these banks. Foreign banks significantly withdrew from the credit market in several jurisdictions and more so where they had branch presence. This was the experience in India too where the growth in foreign banks' lending fell to 4 per cent and (-) 1 per cent during the years 2008-09 and 2009-10, respectively.

As per the new guidelines issued in November 2013, foreign banks are allowed to operate in India either through branch presence or they can set up a wholly owned subsidiary (WOS) with near national treatment. The foreign banks have to choose one of the above two modes of presence and shall be governed by the principle of single mode of presence.

Foreign banks which have commenced banking business in India after August 2010 or foreign banks which are not at present carrying on banking business in India but wish to do so in the future shall carry on banking business in India only through a wholly owned subsidiary, if any of the matters as mentioned below are applicable:

- Banks incorporated in a jurisdiction having legislation giving a preferential claim to deposits of home country in a winding up proceedings;
- Banks that do not have adequate disclosure requirements in their home jurisdiction;
- Banks with complex structures;
- Banks which are not widely held;
- Reserve Bank of India is not satisfied with the adequacy of supervisory arrangements (including disclosure arrangements) and market discipline in the country of their incorporation; and
- For any other reason that the Reserve Bank of India considers necessary for subsidiary form of presence of the bank; or If a foreign bank, which has set up its presence in India through branch mode after August 2010, is considered by RBI as being systemically important by virtue of the size of its business.

<u>Points for discussion</u>

1. What role should foreign banks be allowed in the takeovers and mergers with Indian banks?
2. Should differentiated licensing be offered to foreign banks to make it more attractive for them to set-up WOS in India?
3. How can foreign banks be encouraged to play an active role in expanding financial inclusion in India?

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