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Roundtable on Nachiket Mor Committee Report on Committee on Comprehensive Financial Services for Small Businesses and Low Income Households

Introduction

CAFRAL conducted a Round Table on the Nachiket Mor Committee Report on Committee on Comprehensive Financial Services for Small Businesses and Low Income Households on February 4, 2014 at CAFRAL, Mumbai. The following is the summary of the discussions / deliberations on some of the major recommendations on the captioned Committee Report.

Payments Bank (Clause 3.9 and 3.10)

The report recommends that given the difficulties faced by PPIs and the underlying prudential concerns associated with this model, the existing and new PPI applicants should instead be required to apply for a Payments Bank license or become Business Correspondents.

The key issues faced by the existing PPIs

1. While the PPIs are allowed to offer payment services and hold balance up to Rs. 50,000 for the customer, they are not permitted to “cash out”. This makes the proposition very unattractive for the customer and the penetration of the PPI services is therefore restricted.

2. Many of the telecom companies are also BCs of banks. So can the BC route overcome the above issue of “cash out”? The BC business and the PPI business fundamentally see different type of customers and transaction flows – PPIs attract migrant labour with high remittance need and low savings need. BCs typically see customers with a stable KYC and desire for banking products. Secondly the KYC norm for telecoms and that for banks is different. Thirdly, telcos have got processes in place to do new account opening and activation in much shorter time than what is taken by banks. So overall, the BC business of the telcos has a much slower build up than the PPI business.

3. The proposal for conversion of PPIs into “payments bank” would address the cash out issue, contagion risk issue, KYC differences and also provide them direct access to the payments system which would allow them to offer better service to their customers and overall make the proposition attractive for the customers, as well.

4. Should the conversion into a payments bank by a PPI be optional or mandatory as recommended by the Report?

Role of Payments Bank in Financial Inclusion

1. For financial inclusion, it's important that access to all the products (savings, payments, credit and insurance) is provided to all. Therefore, what role would "payments bank" serve in meeting the goal of financial inclusion? While it is important that all products should be made available to all, but because of the low risk in savings and payments, it may be prudent to isolate the latter with specialized providers in addition to full service banks, in order to accelerate the process. Also one of the big stumbling blocks in improving bank lending to low-income households is lack of savings or credit history. The resultant rich data on customer transaction and savings behaviour through payments bank can be mined and used by lenders for credit due diligence and improve credit uptake as well. Thus there could be partnerships between banks that do retail lending and payments banks.

2. The bank BC model is already focused on providing a full range of banking services through deeper penetration. Creation of payments bank will take away the lucrative business of savings and payments from the banks and dilute the focus on the BC model.

3. While the banks through the BC model are providing a full range of products, it is true that a large proportion of the low-income households continue to prefer informal providers to keep their savings with. The average balance of the BSBD accounts opened by banks is very low and there is a large quantum of total payments and savings flow that continues to remain outside the banking system. The creation of payments bank will provide easy and convenient services available within their reach and should therefore facilitate mobilization of micro-deposits and move amounts from the informal sector into the electronic payment system. The telecom companies in a year digitize around Rs.2,00,000 cr cash by providing electronic talk time and through the e-wallet service.

4. The report does not specifically recommend how it would be ensured that the "payments bank" provides reach in the remote and unbanked areas.

Imperatives for success of a "Payments Bank"

1. In order to be successful in payments and savings business of low ticket, it's very important to build trust to be able to attract customers and to have scale to be relevant to them. Therefore "payments bank" would need to have goodwill and the staying power to achieve these.

2. "Payments bank" would need to have robust systems to manage the operational risks.

Viability of “payments bank”

1. The payments bank may not be viable since they would need to pay interest on savings at competitive rates with other banks, bear cost of deposit insurance and at the same time they will only earn interest at the govt. securities rates. In addition they would need to invest in building the functionality and scale of their business.

2. As competition increases, there would be pressure to charge less from the customer for various services and would further reduce the viability of “payments bank”.

3. The savings customer is not necessarily that sensitive to the interest earned, but is more sensitive to the convenience offered and the hidden costs to be borne by him in saving with a bank in terms of travel cost to the branch, restrictions in timings of branch, limit of number of transactions or value of transactions and maintenance of minimum balance. This is one of the main reasons that despite having access to bank branches in some locations, people continue to use informal service providers. It is possible that if the payments bank offers greater flexibility and convenience to the customer, it could then pay no/low interest on the savings and make itself more viable.

4. The low ticket savings and payments business is high volume and high scale business which in fact banks do not find viable to do. Payments business by itself presently does not generate profits for the telco due to two reasons: firstly in the absence of “cash out “facility, customers do not keep balances in their e-wallets and secondly customer conversion to the digital medium takes time. However, telcos are still interested in doing the payments business as it rides on their existing telecom infrastructure and it also increases customer stickiness for the telecom business. Thus PPIs due to their adjacencies with the telecom business and their technology network are best placed to penetrate this segment. Once the customer is acquired by the “Payments Bank”, full service banks could then engage with the customer to offer a full range of products.

Financial stability and regulatory arbitrage

The risk of failure of “payments bank” and the effect thereof on the financial system must be evaluated closely.

Specialised subsidiaries of banks for financial inclusion (clause 4.6)

Permitting banks to set-up specialized subsidiary for financial inclusion would enable banks to have the desired focus with a customized business model and differentiated cost structure suitable to cater to this segment. Permitting existing banks to set-up “Payments Bank” as a subsidiary is also a welcome step.

The following issues would need to be clarified by the regulator with respect to the setting up of such subsidiaries:

1. Does it need to be a wholly owned subsidiary only? If it need not necessarily be wholly owned subsidiary then investment by strategic partners specifically interested in the financial inclusion space would be possible. Also if it's not a wholly owned subsidiary, it would be easier to have a distinct business model and cost structure for this company. In case it's a wholly owned subsidiary, then eventually it would start to mirror its parent and defeat the very purpose of being set-up as a distinct entity.

2. Since the financial inclusion business would be done by the subsidiary, would the PSL targets for the bank be considered on a consolidated basis i.e. parent and subsidiary balance sheet combined.

3. Would the subsidiary have to independently comply with CRR, SLR and other banking regulations?

4. The new bank license guidelines provides the general principle that no financial services entity held by the NOFHC would be allowed to engage in any activity that a bank is permitted to undertake departmentally. Suitable modifications may need to be made to bring about consistency in regulation.

Wholesale Banks (Clause 4.27)

The motivation for recommendation of creating a new category under Banking Regulation Act, of a "wholesale bank" was mainly due to the various issues being faced currently by NBFCs viz. subject to dual regulation, lower rating and higher cost of borrowings in spite of healthy capital adequacy and asset quality and regulatory balancing to prevent arbitrage opportunities. In character, the "wholesale consumer bank" is expected to be very similar to a present NBFC i.e. primary role is lending through a network of branches and it is funded by bank borrowings and other wholesale borrowings.

The proposed "wholesale bank" will only accept deposits of Rs. 5 crore and above and hence would be expected to borrow large amounts from other banks. The committee recommends that the net liabilities from the banking system will be permitted to be deducted from their NDTL computation for the purpose of ascertaining their SLR obligations on par with the treatment currently given for CRR. Since other banks are expected to lend large amounts to Wholesale banks, those other banks will be permitted to deduct their net assets to the banking system from the computation of their ANBC. This recommendation would make it attractive for banks to lend to wholesale banks. By converting to a wholesale bank, the rating would improve and the cost of borrowing would come down and it would bring better synergies between other banks and wholesale consumer banks.

The wholesale investment banks are envisaged as having branch network of less than 20 and operating in the space of using their balance sheet to trade assets, make markets for priority

sector assets, etc. They become aggregator by building a market by deploying the wholesale funds. This kind of a structure may also be very suitable to foreign banks.

Conversion into a “wholesale bank” would enable the NBFCs to come out of the shadows and become fully regulated institutions and in a way create a path for them to over time become full service banks.

However, following concerns arise with respect to the recommendation on wholesale banks:

1. Post crisis it is borne out that having retail base and access to stable funds is crucial in ensuring overall stability. Regulator should be concerned whether it would like to create a bank with access to wholesale funding only. Based on the market experience, banks that had started out with wholesale focus have quickly moved towards branch expansion and retail operations.

2. The Wholesale bank would add to systemic risks in the industry. The reasons are (i)it is allowed to accept deposits of Rs.5 crore and above which is not under deposit insurance purview; (ii) No CRR/SLR for their bank borrowings and (iii) their business model deals with securitized assets which were the major reasons for recent global financial crisis.

3. How would the regulatory arbitrage be addressed due to creation of a separate category of bank called wholesale bank, which has lower capital requirement and also SLR dispensation on bank borrowings?

4. The report does not specify what kind of assets this bank would be permitted to create.

5. If smallness, newness, private participation and regulatory forbearance are the key elements, then it’s better to try these with full-scope banks instead of with narrow banks.

6. Two key elements in proposal for new category of banks are: private ownership and relaxation of norms relating to SLR. Can we apply these elements to the existing institutions such as urban co-operative banks, rural co-operative banks, and regional rural banks?

Priority Sector Lending (Clause 4.40)

In order to enable greater regional and sectoral specialization among banks, it is recommended that the RBI revise the PSL targets and require banks to meet an Adjusted PSL target of 50% against the current requirement of 40%. Districts and sectors are weighted based on the difficulty in lending to them, and a bank lending to a difficult sector in a difficult to reach district can benefit from a multiplier value based on the specific sector and district. Every sector-district combination has a weight associated with it and the bank will have to reach an adjusted PSL value of 50% taking these weightages into account. This structure would allow the banks to focus on the areas in which they have expertise. For example foreign banks may prefer to do SME lending rather than agriculture credit.

However, the following points are to be considered while implementing the recommendations under PSL:

1. Sector wise and district wise lending under PSL will create complications. Availability of reliable data would be crucial in ensuring smooth implementation.

2. In today's age of anywhere banking, how will district-wise lending of banks be tracked? There should be sufficient safeguards to ensure that banks do not manipulate the locations in order to meet district targets.

3. State wise GDP is fraught with inaccuracies and GDP at district level even more difficult to compile – the weightage to be used may need proxies like electricity penetration, teledensity, literacy level, availability of all-weather roads, etc.

4. Banks specialising in sub-segment only may leave some sectors like agriculture under served.

5. There should be clarity on lending to NBFCs under PSL as there are too many restrictions in this area which creates problem in PSL.

6. Developing the right skills, right assessment options and proper supervision will help the banks to achieve their PSL targets under segment wise as well as district wise norms.

Appointment of BC by banks (Clause 3.5)

The committee recommends restoring the permission of ND-NBFCs to act as BCs of a bank. This is a welcome step as it would enable the banks to use the reach and customer knowledge of existing NBFC MFIs to offer banking products. However, the following issues would need to be addressed while implementing this recommendation:

1. Would the NBFC BC offer its "own" loan products and "bank" loan products at the same time to the customers? Would it cause any conflict due to differing rates of interest and other terms on the two kinds of loan products on offer?

2. There may be a need to harmonise the KYC requirements for NBFC and banks to avoid confusion at the front end.

The committee also recommends the appointment of white-label BCs. This step would improve the viability of BCs especially in rural areas with low density. The white-label model has worked in the case of distribution of mutual funds, telecom services, etc. However, the following issues should be considered before implementation:

1. Data management and data privacy norms need to clearly laid out.

2. Consumer protection and customer service should not suffer and the bank should take responsibility and ensure its customer is well served by the BC.

3. The operations of the BCs are different from one bank to another and also within the same bank from one BC to another. This creates hurdle in providing services to the customers smoothly. There should be separate rules framed by the regulator with regard to the operations of the BCs.

4. There are neither capital requirements nor fair practices code applicable to BCs. The banks have not always taken full ownership of what is done by the BC. There is considerable cash risk carried by the BC based on the volume of transactions handled. Regulator should lay down some criteria and norms for BCs.

Universal Access to savings and payments (Clause 3.1)

As mentioned in the Report, an account of a person should be automatically opened at the time of receiving the Aadhaar number by him. The regulator should issue a circular indicating that no bank can refuse to open an account for a customer who has adequate KYC which specifically includes Aadhaar. It should also advice banks to insist only Proof of Identity (PoI) for each and every customer and a documentary proof of one national address. They should waive the requirement of documentary proof for the current address, for the purpose of opening a full-service bank account.

To implement the recommendations in this regard, the following issues may be addressed:

1. Implementing the Aadhaar Number as KYC proof will save cost to the banks. However, banks have lot of concerns in implementing the Aadhaar number as KYC as there is inadequate support from UIDAI in this regard.

2. Improving the technology towards pattern monitoring, instead of more stringent KYC, will minimize the issues of fraud, money laundering, etc. in a bank account.

3. As there are different KYC norms for different service providers like telecom, insurance, mutual funds, etc., it is suggested to have a simplified and single KYC norm for all the service providers to save the time and energy of the customers while opening the accounts with all the above service providers.

4. While regulatory norms on KYC for small ticket accounts are already relaxed like allowing the self-declaration with the attestation from the branch manager / branch official is sufficient to open an account for them, banks are continuing the stricter norms due to fear.

<u>The below mentioned recommendations are acceptable for immediate implementation:</u>

1. Every resident should be issued a Universal Electronic Bank Account (UEBA) automatically at the time of receiving their Aadhaar number by a high quality, national, full-service bank. The account would attract no account opening fee but the bank would be free to charge for all transactions, including balance enquiry with the understanding that such transactions' charges would provide the host banks with adequate compensation. (Clause 3.1)

2. RBI should require a strong Proof of Identity (POI) for each and every customer and a documentary proof of one national address but waive the requirement of documentary proof for the current address, for the purpose of opening a full-service bank account. (Clause 3.2)

3. The Taskforce on Aadhaar Enabled Unified Payment Infrastructure recommended that State Governments pay a fee of 3.14 % (subject to a cap of Rs.15.17 per transaction) for Direct Benefit Transfer (DBT) payments originating from governments. RBI should enjoy upon State Governments to implement the same. (Clause 3.6)

4. RBI to work with TRAI to ensure that all mobile phone companies, including those with Payment Bank subsidiaries be mandated to provide USSD connectivity as per recent TRAI regulations with the price cap of Rs.1.5 per 5 interactive sessions and to categorize all SMSs related to banking and financial transactions as Priority SMS services with reasonable rates and to be made available to the banking system. (Clause 3.11)

5. In order to encourage banks to actively manage their exposures to various sectors, including priority sectors, a number of steps would have to be taken:

   a. Banks must be required to disclose their concentration levels to each segment in their financial statements.

   b. RBI must represent to the MoF to restore the tax-free status of securitization SPVs as Pass-Through vehicles for tax treatment pointing out the role it would play in ensuring efficient risk transmission. (Identical to recommendations 4.11 and 4.38)

   c. Banks must be permitted to purchase portfolio level protection against all forms of rainfall and commodity price risks, including through the use of financial futures and options bought either within India or globally. (Clause 4.1)

6. Universal reporting to credit bureaus should be mandated for all loans, both individual and SMEs, but in particular SHG loans, Kisan Credit Card and General Credit Card. (Clause 4.2)

7. From the perspective of stability that entails sustainable pricing, banks must be required to freely price farm loans based on their risk models and any subventions and waivers deemed necessary by the government should be transferred directly to the farmers and not through

interest subsidies or loan waivers. The permission to price farm loans below the base rate should be withdrawn. (Clause 4.5)

8. The regulatory focus must be on total indebtedness of the small borrower in relation to their debt-servicing capacity and not just indebtedness per se or merely from NBFC-MFIs. Keeping this in mind, the total borrowing limit for the small borrower segment may be increased immediately to Rs.100,000 across a lenders, including bank-lending to this segment. In order to implement this, all lenders to this segment will need to be mandated to report to the credit bureau as has been the case with NBFC-MFIs. If total indebtedness is being tracked adequately, the stipulation of a maximum number of lenders appears redundant and can be gradually removed as this would also help in creating intensified price competition. (Clause 4.24)

9. All policy biases against consumption finance need to be removed. An example of this is restricting the proportion of consumption finance that is permitted for NBFC-MFIs. (Clause 4.25)

10. All loans given to landless labourers and small and marginal farmers should be counted as a part of Direct Agriculture and not merely the wages component of a loan given to a farmer for financing her agricultural production. (Clause 4.28)

11. Investment by banks in the form of non-fund based limits (such as guarantees) should qualify for PSL to the extent of the credit equivalent amount of the off-balance sheet facility where loans to these categories qualify for PSL. ANBC should also be adjusted to include such PSL-linked, non-fund based limits. (Clause 4.31)

12. PSL targets should be applicable on the last reporting Friday during the last month of each quarter in exactly the same manner as it is currently applicable in the month of March, so as to ensure more timely and continuous credit flow into priority sectors. In order to ensure administrative ease, requirements such as investment into RIDF can continue to be levied on an annual basis and computed on the basis of the average of the quarterly requirements. (Clause 4.33)

13. If the government does desire to provide relief in any form to the small farmers, it would be best carried out as a Direct Benefit Transfer (DBT) to the bank account of the farmer and not through the mechanism of either interest subvention or debt waiver. This would ensure that the banking system is able to price loans in a sustainable manner and also protect credit discipline amongst its borrowers. Adding a universal requirement to report all defaults to credit bureaus would ensure that the borrower also builds a strong interest in protecting his credit history, even if he is a recipient of DBTs. (Clause 4.34)

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