RESPONSE TO RBI DISCUSSION PAPER ON 'BANKING STRUCTURE IN INDIA: THE WAY FORWARD'

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(Under the aegis of the Poorest States Inclusive Growth (PSIG) Programme supported by DFID and SIDBI)

BACKGROUND

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

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

i. ***Small banks and Financial Inclusion:*** Small local banks can play an important role in the supply of credit to small enterprises and agriculture and extending 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.
ii. **Indicative Reorientation of Banking Structure:** RBI has proposed a reoriented banking system with distinct tiers of banking institutions.

This response attempts to provide feedback and suggestions on the above issues.

ACCESS-ASSIST, a national agency promoting responsible finance and supporting financial inclusion, has attempted to build this response through sectoral consensus. As a part of this effort ACCESS-ASSIST has gathered responses from a wide range of stakeholders via a policy roundtable, commissioning a detailed policy paper by Vijay Mahajan (Chairman BASIX and member of the Raghuram Rajan Committee) and responses from the microfinance community on the United Nations Solution Exchange Community Forum. **These efforts have been undertaken under the aegis the Poorest States Inclusive Growth (PSIG) Programme supported by DFID, Govt. of UK and implemented by Small Industries Development Bank of India (SIDBI).**

Input A – Policy Paper

Vijay Mahajan, Founder and CEO, BASIX Social Enterprise Group (also a member of the Raghuram Rajan Committee on Financial Sector Reforms) has authored a policy paper titled, "**Call for an Inclusive Banking Structure for India by 2019, Fifty Years after Bank Nationalization**". This paper has been written in the backdrop of the Discussion Paper, "Banking Structure in India - The Way Forward. The scope of the RBI Discussion Paper is necessarily wider, as it covers not only the issue of financial inclusion, but also looks at banking models, structures and licensing policy, legal framework for banks, financial stability, resolution mechanisms and deposit insurance, consolidation and emergence of large banks and how to help India build at least a few global sized banks, government ownership of a significant part of the banking system and the issues of cross-border banking (both foreign banks in India and Indian banks abroad). This paper however is confined to the theme of financial inclusion. We hope that the RBI will take into consideration the detailed rationale and wider scope of suggestions provided in this paper, than this response which is restricted to the question of Small banks and Tiered structure proposed in the RBI discussion paper. Paper appended as **Annexure 1**

INPUT B: Policy Roundtable

To discuss the aspects related to Small Banks in discussion paper on 'Banking Structure in India – The Way **Forward', a consultation of financial inclusion sector stakeholders was organised on 25th September 2013 at SIDBI, Mumbai.** 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 summary of proceedings of this Roundtable is appended as **Annexure 2**.

INPUT C: United Nations SE-MF Query

A query was raised on the Solution Exchange for the Microfinance Community. The Solution exchange connects the professional and practitioners of microfinance Community helping them share and apply each other's knowledge and experience to fast track financial inclusion through increased effectiveness. It brings changes in microfinance sector at three levels – Individual, Organizational and External Environment level. The respondents are listed in the **Annexure 3**.

SMALL BANKS AND FINANCIAL INCLUSION

This response **supports the proposal for setting up of a separate category of Small Banks** for enabling access to the vast excluded population - geographical regions (spatial exclusion), segments (women, SCs, STs, minorities), sectors (agriculture, small industry, and sub sectors), and poor and low income (small, unorganized). The existing banking institutions (RRBs, Cooperative Banks, and Commercial Banks) have not been able to cater to the needs of these excluded areas, one of the reasons being that these areas need specialized institutional mechanisms.

Local Area Banks concept was introduced in 1996. The four LABs i.e. KBS LAB, Capital LAB, Subhadra LAB and Coastal LAB are continuing to function well, and meeting statutory requirements and are pleading their case with RBI to expand to a "few" more districts. There is also a strong case for allowing for refinance of LABs.

Chapter 4 of the RBI Discussion Paper clearly lays down the various advantages of Small Banks that highlight their potential for achieving levels of financial inclusion that the existing banking structures comprising mostly of 'large' banks including the RRBs and Cooperatives Bank have not been able to achieve.

In addition, the paper enumerates some 'cons' of Small Banks that pose potential risks of bringing these institutional entities into the system. The table below provides possible mitigants for these risks:

1. Small banks are potentially vulnerable to sector and geographical concentration risk. For instance, community banks in the US suffered losses due to their excessive reliance on lending to commercial real estate (Daniel Tarullo, 2010).	***Diversification of Risk is the Key:*** *Smaller banks should be working across a minimum 2 states and across 5-10 districts.* ***Strict Caps on Industry and Sector Exposures:*** *The strict caps would ensure the exposure to certain specific sectors is capped.*
2. Small banks are vulnerable to shocks from the local economy and hence require higher level of CRAR.	***Diversification of Risk is key:*** *Smaller banks can be working across 5-10 districts across at least two different* ***agro-climatic zones,*** *which would help mitigate some of the risk related to local economy and natural shocks*
3. Small banks cannot finance big-ticket investments, including infrastructure.	*Focus of small banks should be retained on servicing low income customers with low ticket size product offering rather than get drifted towards big ticket investments*
4. They lack economies of scale and scope.	*Economies of scale will be limited. However, a diversified suite of products and services to provide a one stop shop for multiple financial products and services for the excluded would build economies of scope.*
5. Small banks are prone to capture by local influence.	*Strong corporate governance and regulatory supervision is key.*
6. There are some recent studies arguing that instead of relationship banking, which is generally followed by small banks, lending practices adopted by big banks - involving arms-length lending approaches and centralized	*For the low income, poor and excluded segments 'high touch' relationship banking offering customized products is very important for bringing these clients into the*

organizational structures - could have a comparative advantage (Oxford Handbook, 2010a).	*fold of formal banking services.*
7. A large number of small banks put pressure on the supervisory resources of the central bank.	*Perhaps true, RBI would need to augment its supervisory function to deal with more number of small banks. The systems will need to be prepared for failure of some banks. Supervision could also be assigned to other apex organizations like NABARD, as in the case of RRBs, CCBs.*

The suggestions that were proposed in the Policy roundtable towards broad regulatory prescriptions for the Small Bank category are summarized in the table below:

Eligibility Criteria	"Fit and Proper", as decided by RBI
Minimum Capitalization	Rs 50 Crores
Services	Full range of financial services: • Bank accounts • Payments (from government and to utilities) • Remittances (from family members who have migrated to cities for work) • Savings (to enable small amounts to be saved) • Credit (both for consumption and for working capital and asset creation) • Insurance (including life, health, crop, livestock and assets) • Pensions (can be seen as very long-term savings, with life insurance) • Mutual Funds (as inflation protected savings)
Client segment	Income Levels of Households - Less than Rs 10 Lakhs
Product Qualifying Criteria	• Small loan or loan that can be mainstreamed. • Loan size restrictions – 80% portfolio comprised loan products below INR 25 lakhs
Minimum CRAR	15%
Geographic	Minimum 6 districts across two or more agro climatic zones
Cap on RoA	2.5%
Delivery mechanisms	Both high tech (using information technology, mobile telephony and biometric identification) and high touch (door step and user friendly service, locally rooted

	relationship banking)
Eligibility	Proven track record of a financial services business
Conversion	Open to existing players like MFIs, NBFC, Cooperatives

REORIENTATION OF BANKING STRUCTURE

Vijay Mahajan in his paper suggests that the lesson from international experiences – from the US, from Germany, from South Africa – is that different types are 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. So, can India have hundreds of rural banks with just Rs 1 crore capital? Even our local area banks, the closest thing to private rural banks, are required to have an entry level capital of Rs 25 crore.

He suggested the regulatory framework to look at six different levels of banking licenses, namely the Community, Region, State, Zone and the Country as a whole and one for International banking. The entry level capital would accordingly be different for different institutions. The sectoral specializations would be different too, while ensuring there is adequate diversification to prevent co-variant risk. Indian states are large, many larger than some of the developed countries. With reasonable assumptions about the national GDP growth rate, credit to GDP ratio, credit needed by the excluded districts, share of regional banks in the total credit outstanding, the expected size of different banks can be computed.

- **Community Microfinance Banks** must be numerous; at least four per district and their deposits must be insured, with differential pricing based on rating. As many as 1700 of the current 1800 urban cooperative banks can be converted into this category.
- **Regional Banks**, unlike the past, should cut across agro-climatic zones and across state boundaries, to minimize co-variant risk arising from climate and political economy. The current four local area banks and the largest 100 odd urban cooperative banks are candidates for this license and it should be opened up to NBFCs, etc.
- The candidates for State Banks are (i) the 90-odd Regional Rural Banks crated from merging 196 RRBs belonging to one sponsor bank in each state. The next step would be to merge all RRBs across one state to create a State Bank, already owned 15% by the State Government and where they cannot be merged, leave them to be Regional Banks as defined above. But in all cases, these banks should be brought out of the Regional Rural Banks Act, 1976 and brought under the Banking Regulation Act, 1949 (hopefully to be amended soon) and (ii) the 300 odd licensed District Central Cooperative Banks and 20 odd State Cooperative Banks, to be merged into one State level bank per state. Many of them are effectively run under a unified management and share IT systems.

- The Zonal Banks are needed to get out of the co-variant risk of state politics and agro-climatic zone. Some of the smaller private banks and larger RRBs (after merger among themselves) can become these.
- Nation-wide banks – we need fewer but bigger. The 27 public sector banks can be merged across their original geographies into about 10, of which two or three can be made into India's global banks.

Level of banks	**Covering**	**Main focus**	**Entry level capital**	**Capital by 2019, so, loans o/s**	**By 2019 loans mainly in range of**
Community Microfinance Banks (1800)	One district at a time; additional possible	Poor but active households, small farmers; self-employed	INR 6 cr (USD 1 mn)	INR 24crore (USD 4 mn); loans o/s INR 150cr	INR 1500 to INR 150,000
Regional Banks (200-300)	5-6 contiguous districts across agro-climatic zones	Households, agriculture farms and micro and small enterprises	INR24cr (USD 4 mn)	INR240 cr (USD 40mn); loans o/s INR 1500 cr	INR 150,000 to INR 15Cr
State-wide Banks (30-50)	One full state	Above plus housing, medium enterprises	INR120 cr (USD 20 million)	INR1000 cr(USD 163mn); loans o/s INR 15000 cr	INR 10cr to INR 100 cr
Zonal Banks (20-30)	Two to four large states or four to eight smaller contiguous states.	Above plus infrastructure, large enterprises and exports	INR600 cr (USD 100 million)	INR 2400 cr (USD 400 mn); loans o/s INR 24000 cr	INR 10crore to INR 240 cr
Nation-wide Banks (8-10)	All India	Full range, but loans mainly above INR 50 cr	INR 6000 cr (USD 1 billion)	INR 24000 cr (USD 4 bn); loans o/s INR 240,000 cr	INR 100 crore to INR 2400 cr

Indian Global Banks (2 or 3)	All over the world, as needed	Full range, but loans mainly above INR 50 cr	INR 24000 cr (USD 4 billion)	INR 120000 cr (USD 20bn); loans o/s INR 1,200,000 cr	INR 100 crore to INR 12000 cr

ANNEXURE 2

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

KEY TAKE AWAYS

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

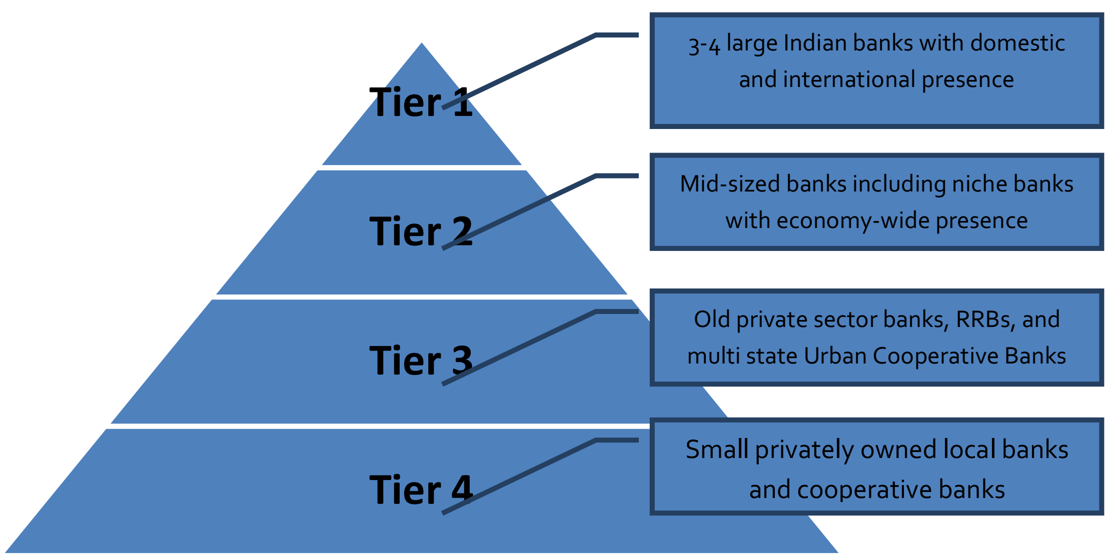
The Reserve Bank of India has released on its website a Discussion Paper on 'Banking Structure in India – The Way Forward'.

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 2013[1].

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, *finacialization* 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 are 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 INSITUTIONS 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, lesions and challenges. Dr Holloh, GIZ and Vijay Mahajan, BASIX offered to help with inviting the appropriate officials

Annexure 2.1

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

Annexure 2.2

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

ANNEXURE 3

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