Recommendations on
Draft Guidelines for Licensing of "Small Banks" in the Private Sector

Submitted to the Reserve Bank of India
under Poorest States Inclusive Growth (PSIG) Programme
Date: 14th August 2014

Disclaimer

This material has been funded by UK aid from UK Government's Department for International Development; however the views expressed do not necessarily reflect the UK Government's official policies.

I. Introduction

Poorest States Inclusive Growth Programme (PSIG) is being implemented by SIDBI with support from the DFID to enhance the income and employment opportunities of poor households in underserved states of India. While SIDBI is the principal implementing agency of PSIG, ACCESS ASSIST is assigned with the responsibility of coordinating the policy component of the programme.

As part of the policy agenda of the PSIG programme, efforts are being made towards advocating for setting up of Small Finance Banks as specialized/differentiated banks for enhancing financial inclusion. The latest draft guidelines on Payment Banks and Small Finance Bank (http://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/IEPR121SMA0714.pdf) released on July 17th is a positive development in this regard.

ACCESS-ASSIST organized a Roundtable on Small Finance Banks on Tuesday, July 22, 2014 at Hotel Taj Lands End, Mumbai to discuss the draft guidelines and offer consensus based comments to the RBI. The list of participants who attended this discussion is provided in Annexure 1.

Other background documents provided to the participants for supporting their inputs in the discussion are also attached as follows:

Annexure 2 – Comparative analysis of draft guidelines for Small Banks

Annexure 3 – Policy paper on Local Areas Banks

Specific recommendations/feedback has been inserted after each point of the draft guidelines below. These are fully based on the deliberations held in the Roundtable.

II. Recommendations on Draft Guideline

2. Objectives

The objectives are in line with the policy objectives for furtherance of financial inclusion while ensuring the Sustainability, Profitability and Scalability of these institutions. Some suggestions for further improvement are as below:

- The definition of 'small' in Small Banks criteria must also be related to the transaction size and not only by the geographical coverage ('limited area of operations' as mentioned in the section)
- Definitions of underserved and un-served could be mentioned in the guidelines.
- The small banks need to work as genuine and real 'inclusion banks' while being profitable and sustainable businesses.
- 'High technology and low cost operations' is more appropriate to mention as part of the 'process' in the guidelines and not in the objective.

3. Eligible promoters

- In case of group of individual promoters, 10 years of financial sector experience may not be insisted from all promoters. If one or two promoters have the relevant financial sector experience and others have experience of relevant fields such as agriculture and allied sectors, SSI, law, accountancy, administration, technology, skills etc., it should be taken as fulfilling the requirements.
- Preference should be given to existing financial institutions serving the poor and low income clients, such as NBFCs and non-profit MFIs, who have a track record of providing financial services in the rural areas. However, while MFIs are mentioned as eligible promoters, for NBFC-MFIs expecting to convert themselves into Small Banks, geographical limitation (restricting them to a few contiguous districts) will be a challenge since many large MFIs have operations across states.
- "Small" should not be equated with being local; a bank serving small customers can achieve scale. If there are institutions that have already achieved scale serving microfinance clients, they should be allowed convert in to a bank as long as they have been serving the current areas for a stipulated minimum number of years (3 years may be appropriate)
- Such institutions should be permitted to operate in all those states where they have a significant presence (defined for example in terms of number of customers, a minimum share in portfolio from the state etc.) with track record for minimum 3 years of working in the area.

4. Scope of activities

Area of operations "The area of operations of the small bank will normally be restricted to contiguous districts in a homogenous cluster of States/Union Territories so that the bank has the "local feel" and culture."

- Homogeneity is not confined to state boundaries; hence it is a positive that guidelines allow for multiple states/UTs in defining area of operations.
- However, contiguity should not be mandatory but desirable. Many MFIs currently have locally rooted operations across multiple states. Instead of strictly limiting area of operations to contiguous districts, guidelines may be made flexible to allow Small Bank to operate across non-contiguous areas based on clear evidence of their 'experience, localness and commitment' in all the proposed geographies including number of years, number of customers, local staff etc. A clear definition of "Localness" should be provided.
- Another advantage of non-contiguous multi-state licenses would be reduction in risk concentration due to weather, natural calamities and any man made events.
- Urban financial inclusion needs adequate emphasis; currently the guidelines are biased towards rural geographies. Small customers in urban locations also need inclusion – institutions that intend serving urban and peri-urban customers should also get an opportunity to apply for a license.
- Expansion of small banks should be linked to institutional performance, which can be measured based on a customized rating mechanism/system.
- Border districts in the states are mostly backward and underserved; these should be given greater focus while allocation of licences.

Services "Therefore, the small bank shall primarily undertake basic banking activities of acceptance of deposits and lending to small farmers, small businesses, micro and small industries and unorganised sector entities. It can also undertake other simple financial services activities with the prior approval of the RBI."

- Remittances should specifically be a part of banking services, while defining the scope of activities for small banks
- Distribution of insurance and pension products needs to be a part of the portfolio under simple financial services

5. Capital requirement

- Capital adequacy ratio can be relaxed because of the area of operations across the states, thereby taking care of concentration risk; also these banks will not have frequent equity infusion. In case of NBFC-MFIs, average CAR is maintained around 18-20% as against the min. requirement of 15%. With CRR and SLR on the liabilities, regulatory capital may be kept at par with other banks, if not lower. Small Banks should not need to have 15% CAR requirement.
- Capital adequacy ratio may be kept close to that of banks – around 12% with Basel I norms to be adhered. It is recommended to further reduce the ratio over time based on performance and scalability. This will ensure viable return to the stakeholders and create interest for good aspirants.

- Assigning different weights to the particular risk segments based on risk distribution and profiles for Capital adequacy may be considered.

9. Prudential norms

"At least 50 per cent of its loan portfolio should constitute loans and advances of size up to Rs. 25 lakh in order to extend loans primarily to micro enterprises."

- One view is that INR 25 lakhs is too high as range in view of the financial inclusion objective. 250 districts where credit to deposit ratios are very low, this loan amount limit is very high. This range is likely to lead to majority of the portfolio of the small banks catering to larger loan sizes in this range, resulting in clients with small credit needs continuing to be excluded. It is therefore suggested that the portfolio distribution favouring inclusion of small loans be followed as below:
    - 40% of the loan portfolio should constitute loans and advances of size below INR 1 lakh
    - 40% of the loan portfolio should constitute loans and advances between INR 1 lakh to 25 lakh
    - 20% of the loan portfolio should constitute loans and advances of size above INR 25 Lakh
- Another view is that prescribing too many limits on loan sizes may lead to micromanagement and jeopardize the financial viability of small banks, particularly in some geographies. Therefore a broad range as currently prescribed in draft guidelines is appropriate. This will help the Bank to reduce their costs and ensure competitiveness with overall low cost lending to small borrowers below Rs 25 lacs. This will enable the Banks to scale up their operations with profitability.
- A third view was that the loan ceiling can be kept at Rs 10 lakhs for 50% of the portfolio leaving the remaining portfolio for the bank to decide as per the exposure norms.
- Alternatively, in order to encourage small banks to lend to micro-borrowers, space for appropriate incentives for achieving specific inclusion indicators may be created rather than assigning limits on portfolio distribution.
- The loan limits should be linked with dynamic indices such as poverty income levels or per capita GDP etc., and reset annually on a given date. This will avoid the current practice where institutions have to represent to RBI for notification of changes.

The maximum loan size and investment limit exposure to single/group borrowers / issuers would be restricted to 15 per cent of its capital funds

- The limit of 15% of capital funds is exorbitant from the inclusion perspective. A high figure may lead to related party transaction risk. In the initial years when the equity is the dominant part of liabilities it would be preferable to keep exposure limits lower. Only when the capital funds are double the equity, single party/group exposure should be raised to 15%.
- The prudential norms can be different for the small banks considering the higher costs and event risks.

11. Business plan

- There is a need to mention the parameters basis which the viability of the business plan will be decided.
- Small Banks should be accountable and responsible against the submitted and approved Business plan. These banks should not be compelled to implement government programmes and subsidy based schemes.
- Small banks should be specifically providing pricing freedom so that they are able to attract capital and service the shareholders.

13. Other conditions

- Deposit insurance should be specifically mentioned in the guidelines.

- Small Banks should be covered under Banking Ombudsman; this needs to be mentioned in the guidelines.

- The role and type of credit bureau reporting needs to be established. Currently, the credit information of microfinance borrowers is available on microfinance credit bureaus (Equifax, Highmark). Small Banks should be required to report to these bureaus for loans < INR 1 lakh for effective credit risk appraisal and avoidance of multiple lending and over-indebtedness.

III. Other Recommendations

- Small Banks should be given scheduled bank status based on clearly laid down criteria through the required process of application and approval. Unscheduled status leads to many disadvantages and issues currently being faced by Local Area Banks such as smaller loans not covered under credit guarantee scheme, inability to mobilize certain deposits etc.

- Small Banks will require close supervision and monitoring. There is a need for a different supervisory approach for Small Banks than that followed for the commercial banks.

- The road map for graduating from one bank to another can be clearly articulated at the time of developing operational guidelines.

- RBI should promote a number of small banks during the first phase. At least 20 to 25 banks should be initiated in different geographic regions across the country so that adequate cross-country experiences are available for policy making and refinement.

- Inclusion incentives (incentives based on performance on achieving inclusion linked performance indicators) such as access to refinance, exemption from SLR on refinance and borrowings from bulk financiers etc. can be provided. These can be assessed on the basis of thorough assessment through customized rating mechanism

- Tax exemptions/incentives may be considered for Small Banks at least in the initial years.

- Small Banks should have some enabling and supportive mechanisms in place such as common capital raising, sharing of common technology, common back-office functions etc.

IV. Divergent views

Two points specifically raised by Capital Local Area Bank (not reflective of views of all stakeholders present in the roundtable) are as below:

6. Promoters Contribution

- In case of existing Local Area Banks proposing to convert themselves to Small Banks, the initial minimum requirement of 40% should not be made applicable to such banks as the same has been diluted over a period of time as per the extant Local Area Policy.

9. Prudential norms

- Suggested to keep the exposure limit it in line with the existing individual limit of 15% and group exposure limit of 40% as is being experienced by existing local area banks and other small banks. With extant strict regulations and monitoring all these banks have been following the exposure limits without any risk even with low capital funds. The present exposure limits are very appropriate for reducing the lending cost to the borrower and will ensure the growth and sustainability of these banks.

V. Conclusion

The draft guideline is a well thought out document. The laudable objectives should be fulfilled through application of appropriate norms in both organizational structure and business focus. The norms relating to focus on small and vulnerable sectors and scope for doing business with other (not small) segments should be revisited to ensure that these small banks contribute to financial inclusion.

Some aspects of existing institutions converting to small banks require in-depth consideration. These relate to area of operations, definition of 'local' feel and ring-fencing of other businesses. Pricing freedom is a critical aspect of their viability. The cost of doing business with 'small' segment is very high. The logic of allowing MFIs to charge 26% is relevant in the context of the small banks too. Once the banks stabilize and are able to mobilize adequate savings, they will be able to reduce interest rates, but will not be able to compete with high street banks on interest rates on loans. There is no doubt that the final guidelines will reflect the consensus of views across the sector and make it possible for promoters with a vision and commitment to make a difference in banking with the poor.

Annexure 1

List of Participants

Roundtable on Small Finance Banks

Taj Land Ends, Mumbai

22nd July, 2014

Sl. no.	Name	Organisation
1.	Sudha Damodar	RBI
2.	N. Sara Rajendra Kumar	RBI
3.	K. S. Singhwan	SIDBI
4.	Amareesh Gulati	Standard Chartered Bank
5.	Rekha Kulkarni	Mann Deshi Coop Bank
6.	Chetna Sinha	Mann Deshi Coop bank
7.	Munish Jain	Capital Local Area Bank
8.	Dinesh Gupta	Capital Local Area Bank
9.	C P Rangarajan	Janalakshmi Financial Services
10.	P N Vasudevan	Equitas
11.	Alok Misra	M-CRIL
12.	Alok Prasad	MFIN
13.	Vijay Mahajan	BASIX
14.	Vijay Nadkarni	Ex-MD, KBSLAB
15.	N. Srinivasan	Consultant & Sector Expert
16.	Ajay Tankha	Author, State of Sector Report
17.	Anu Gupta	DFID India
18.	Ragini Chaudhary	DFID India
19.	Vipin Sharma	ACCESS-ASSIST
20.	R Bhaskaran	IIBF
21.	Radhika Agashe	ACCESS-ASSIST
22.	Sarthak Luthra	ACCESS-ASSIST

Annexure 2

Comparison of Small Finance Banks Policy Recommendations
(Developed as background note for Small Bank Roundtable – 22nd July 2014)

Sl. No	Broad Policy Element	Draft Small Bank Guidelines	Local Area Bank Guidelines	First Small bank Roundtable	Raghuram Rajan Committee	Banking Architecture Paper – Vijay Mahajan
		17 July 2014	June 2014	September 2013	2009	October 2013
1	Objective	Furthering financial inclusion by providing savings to under and un-served sections and credit to small businesses, small farmers, micro and small industries and other unorganised sector entities	To cater to credit needs of local people and provide efficient and competitive financial intermediation in the area	Focus on servicing low income with low ticket size products; Income level - less than INR 10 lakhs		CDB - Economically active poor; small farmers; self employed; SFB - Households; agri-farms; micro and small enterprises
2	Promoters	Individuals with 10 years of banking/finance exp., Companies and Societies; NBFCs; MFIs and LABs can also convert; Local focus and ability to serve small customers will be key criterion	Individuals, corporate entities, societies; Number of NRI promoters not to exceed 20% of no. of promoters	Proven track record of financial services business; Open to existing entities like MFIs, NBFCs, Coops	MFIs, private entities, community financial institutions; Track record of promoters	
3	Minimum Capital	INR 100 crores	INR 5 crore; Raised to Rs 25 crore (2002)	INR 50 crore	Initial capital low consistent with intent	Community Development Bank - INR 6 crore; Small Finance Bank - INR 24 crore

Sl. No.	Broad policy element	Draft Small Bank Guidelines	Local Area Bank guidelines	First Small bank roundtable	Raghuram Rajan Committee	Banking Architecture Paper – Vijay Mahajan
4	Minimum Capital Adequacy Ratio	15% of RWAs on continuous basis	Earlier 8%; raised to 15% (2002)	15% (monitored monthly)	More conservative because they operate in small geographies And lend to riskier businesses	
5	Area of operation	Restricted to contiguous districts in homogenous cluster of States/UTs; If considered necessary will be allowed to expand beyond contiguous district	3 contiguous districts	10 contiguous districts not restricted to a state; Additional Rs 10 crore capital for additional districts	Small banks should have choice to decide area and focus	CDB - One district; SFB - One of more states
6	Branches	Branch expansion for initial 3 years by prior approval by RBI; 25% of branches in unbanked rural centers	Only one urban branch in a district (Ramachandran committee suggested 1 urban branch per 10 rural branches)		Restrict initial license to certain no. branches and asset size; and remove restrictions after performance review	
7	Ownership	Promoter contribution at least 40%; (locked in for 5 yrs); Excess promoter shareholding to be brought down to 40% in 3 years, 30% in 10 years and 26% in 12 years; Foreign shareholding as per FDI policy; Non promoter entities not permitted shareholding in excess of 10% of voting equity capital	Promoters min 40% capital (min of Rs 2 crore); non-promoter holdings capped at 10% of share capital; Individual voting rights capped at 10%		Could be majority owned by a single promoter; Ensuring appropriate incentives	

Sl. No.	Broad policy element	Draft Small Bank Guidelines	Local Area Bank guidelines	First Small bank roundtable	Raghuram Rajan Committee	Banking Architecture Paper – Vijay Mahajan
8	Business/products and services	Basic banking activities - acceptance of deposits and credit to small businesses, small farmers, micro and small industries and other unorganised sector entities; Other simple financial services with prior approval of RBI: Cannot set up subsidiaries for non banking activities	Focus on local customers; Lending expected to agriculture and allied activities, SSI, agro-industrial activities, trading activities and the non-farm sector	Full range of services - bank accounts, payments (from govt. and to utilities), remittances, savings, credit (working capital and asset creation), insurance (life, health, crop, livestock, assets), pensions and mutual funds (as inflation protected savings)	Comprehensive suite of financial services (credit, savings, insurance, remittance and investments)	Full range of services - bank accounts, payments (from govt. and to utilities), remittances, savings, credit (working capital and asset creation), insurance (life, health, crop, livestock, assets), pensions and mutual funds (as inflation protected savings)
9	Priority sector norms	As applicable to existing domestic banks	Priority sector lending targets - 40% of net bank credit; 25% of PSL (10% of NBC) to weaker sections			
10	Other prudential norms and regulations	As applicable to existing commercial banks including maintenance of CRR and SLR; Max loan size and investment exposure to borrowers/issuers restricted to 15% of capital; At least 50% of portfolio to constitute loans and advances up to Rs 25 lakh	As application to commercial banks	80% portfolio comprised of loan products below INR 25 lakhs; No pricing caps; Caps on exposure to industries and sectors	Exposure limits set at a lower fraction of capital than for SCBs; Allowing greater ticket sizes with growth; Interest rates deregulated; Strict norms for self lending to promoters	Compulsory deposit insurance; no loan more than 1% of the capital of the bank; Loan size range - Community Bank - INR 1,500-150,000; Small Bank - INR 10 -100 crore

Sl. No.	Broad policy element	Draft Small Bank Guidelines	Local Area Bank guidelines	First Small bank roundtable	Raghuram Rajan Committee	Banking Architecture Paper – Vijay Mahajan
11	Governance	Majority of independent directors; Fit and proper criteria for Directors as issued by RBI	Majority of independent directors; Fit and proper criteria for Directors as issued by RBI		Fit and proper criteria	
12	Supervision and Regulation		Department of Banking Supervision, RBI (RRBs and Coops which are closer to LAB in nature are supervised through NABARD); Regulation earlier with RPCD, later shifted to DBOD		Need greater monitoring; Regulatory capacity should adapt to the needs	Supervision could be assigned to other apex organization such as NABARD in case of RRBs and CCBs
13	Process	High tech and low cost; high powered customer grievance mechanism		High tech and high touch	Low cost structure and low staffing costs will allow small loans to be profitable	Both high tech and high touch - door step service backed by tech
14	Support infrastructure			Availability of refinance such as from NABARD	Creation of low cost tech platforms; Banks may be encouraged to pool back office functions, and a centralised skill base	Need inter regulator collaboration; Specialised financial institutions with sectoral, spatial and segmental niches