Local Area Banks in India: A Review

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Executive Summary

In the recent past, there has been a renewed discussion on the possibility of setting up narrow banks, which could focus on including the residual population left out of the formal financial sector. This paper reviews the experience of the four Local Area Banks that were set up in the early part of this century. After the initial grant of licences to Local Area Banks (of which four banks continue operations) no further licences were issued.

The paper reviews the landscape of financial inclusion and argues the case for local area banks. Having reviewed the changing policy stance on narrow banks both by the regulator as well as the State, the paper identifies the internal contradiction in these pronouncements – the objective of setting up these institutions being to serve the larger cause of inclusion; the design of these organisations mimicking mainstream banking institutions with all the limitations that such institutions have; and more limitations on the size and area of operation; and the evaluation parameters that do not consider the operating constraints laid on these narrow banks.

The paper concludes that these institutions are indeed performing, and do not give enough cause for any anxiety on solvency and stability. While they have continued to perform under severe constraints. The paper recommends that narrow banks like LABs should be encouraged and has laid out some specific recommendations on how the norms could be structured.

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1. Introduction: Rationale and Backdrop for setting up Local Area Banks

The over-arching objective of opening new narrow banks was to provide for an opportunity for deepening of financial services and a greater access to financial products and services from the formal sector. While that was a laudable objective, providing access to banking services (credit, deposit, transfers and other financial services) to the poor - and particularly in rural areas was always a difficult proposition. Therefore, while these objectives continued to be central, the policy had to be tempered with aspects of profitability, sustainability and growth.

Review of past efforts

In general the approach of the State towards providing access to financial services from the formal sector was through national level integrated institutions. A large part of the effort was through quotas, allocations and incentive/disincentive schemes. These schemes have penetrated to the extent that was economically viable for the institution as a whole. A review of the cumulative achievements of the banking system ever since it was nationalised, should lead to a fair degree of satisfaction from the public policy perspective. However, the existing institutions would be found wanting if they were examined from the prism of residual exclusion. The portion of the population that was not covered was the most difficult and the most expensive to cover.

The target setting with the banking sector also did not effectively address regional imbalances. While southern region had a greater penetration through the history of social banking, north-east and east continued to be the most under-banked regions. Therefore the problem now was not only about the most difficult and poorer customers; these customers were in rather difficult regions. Covering these customers profitably was a challenge.

One way to address this issue was to find a decentralised solution. It was hoped that the decentralised solutions would be responsive and would offer locally rooted solutions. The first phase of decentralised solutions came from the All India Rural Credit Survey (AIRCS) report, which encouraged state partnership with co-operatives. Co-operative societies were seen as local financial institutions. The second phase of decentralised solutions was in setting up Regional Rural Banks (RRBs).

Co-operative societies by and large worked for about two decades and later started failing. A detailed review of the evolution and performance of the credit co-operative structure could be found in the Vaidyanathan Committee Report.[2] The reasons for co-operative societies to fail were two fold - the first was that they were so local that the state was unable to provide a larger supervisory and governance framework; the second and a more important reason for failure was also the action of the State, which interfered on the transaction level between the co-operative and the member by announcing interest subventions, waivers, affecting the basic commercial relation between the member and the co-operative society. On the other hand, the story of RRBs did not make a good reading. There were multiple efforts of consolidation, recapitalisation and re-thinking on the design of RRBs. It appears that RBI and Government feel that the design of RRB as very small and local banks was flawed.

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[2] Government of India (2005): Report of the Task Force on Revival of Co-operative Credit Institutions (Chairman: Prof.A.Vaidyanathan) New Delhi: Ministry of Finance, GOI.

The private initiatives that came in the form of Microfinance Institutions (MFI) showed that a specialised, single purpose, focussed standardised offering could help. However, this approach needed multiplicity of institutions. MFIs could not establish the viability of sourcing savings from the rural poor.

In this backdrop, the coverage of the residual population in the formal financial sector was difficult with questions on its viability. While the efforts at consolidation of RRBs helped in making institutions stronger and profitable, reaching the last mile became more of a challenge. Innovative outreach models which were cash-less, technology enabled, integrated with the banking outlets and fully interoperable could be a solution. However, the multiplicity of the players made the solution very complex.

Local Area Banks

Local Area Banks (LABS) as an idea was conceived in 1996. The then Finance Minister delivering the budget speech on the 22nd July 1996 said that *"it has been agreed with RBI to promote the setting up of new private local area banks with jurisdiction over two or three contiguous districts. This would enable the mobilisation of rural savings by local institutions and, at the same time, make them available for investments in the local areas.[3]"* In the same budget speech the finance minister had made a mention of recapitalizing RRBs as well as increasing the share capital of the National Bank for Agriculture and Rural Development (NABARD). The idea of LABs was seen as an effort that encouraged the private sector to participate in small banks – in what was predominantly a State led agenda.

The announcement of a new form of private banks – LABs was made in the same year in which RRBs had to be re-capitalized. There was no engagement on the business model. Therefore, from the approach of the State it may be appropriate to infer that if the RRBs were broke, it was because they were state owned and had infirmities induced by the State and a similar structure in the private sector would work. Co-incidentally the same budget speech also had a very positive mention of the turnaround of the public sector banks and the possibility of three of these banks returning some of the recapitalization money back to the State in order to help the other banks. From the policy documents in 1996 it appeared that the problem of financial inclusion was occupying the mind space of the policy makers, and there was openness to examine the participation of private sector in an arena that was largely being addressed by the State for almost a century.

Following the announcement of the Finance Minister the Reserve Bank of India (RBI) released a set of guidelines for setting up local area banks in the private sector in August 1996.[4] The objective of opening up LABs for the private sector was *"with a view to providing institutional mechanisms for promoting rural savings as well as for the provision of credit for viable economic activities in the local areas"* and it was *"expected to bridge the gaps in credit availability and enhance the institutional credit framework in the rural and semi-urban areas"*.

The LABs were expected to focus on the local customers, adhere to the priority sector lending targets as applicable to other domestic banks, including the targets on loans to weaker sections. While the guidelines on new LABs had indicated that they would be eligible for inclusion in the Second Schedule of the RBI Act of 1934, none of the LABs were accorded that status. Having the status of a scheduled bank brought greater credibility and accountability; opening the gates for the business of government and local bodies.

The minimum capital required to set up a LAB when the guidelines were issued was Rs.5 Crore. While the initial guidelines appeared quite open, in practice it was very stringent. The conditions of licencing mandated that the promoters' contribution had to be at least 40% of the initial equity. The promoters had to have a road map to reduce concentration in shareholding. The RBI used other fit-and-proper criteria for the members on the board and mandated that the promoter companies stringently maintain an arm's length in transacting with the LAB. The guidelines specified that the list of possible promoters could be individuals, corporates, trusts, and societies. If these guidelines were to be compared with the recent guidelines of the RBI for licencing full-fledged banks, the difference in approach can be found to be stark. For full-fledged banks, RBI devoted considerable time to

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3 Chidambaram, P (1996): Budget Speech of 1996-97 accessed from http://indiabudget.nic.in/ub1996-97/BUDGET/bs/ on Thursday, 20 March 2014.

4 Reserve Bank of India (1996): http://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=5817 accessed on Thursday, 20 March 2014.

discuss in detail the nature of promoters after factoring the past experience and examining the international experience.

When the first guidelines were issued for LABs, the area of operation specified by the RBI was set at 3 contiguous districts. This area was enhanced to cover two more districts in the case of some LABs. The other requirements of prudential norms applicable to LABs were similar to any other banking entity. All aspects pertaining to capital adequacy, income recognition, asset classification and provisioning were the same as the mainstream banks. On licencing of branches, the guidelines mentioned that it would be governed by the "existing" policy. However, while the branch licencing policy for commercial banks changed since 1996, the changes were not made applicable to LABs. The most important change was that the commercial banks were not required to seek permission to open branches in Tier V and Tier VI locations. They were, however, mandated to open 25% of the new branches in these locations. This change was not made applicable to LABs and LABs continued to operate under some operational constraints that were not applicable to the scheduled commercial banks.

It has been seventeen years since the first set of in-principle licences were issued by the RBI. RBI initially received more than 50 applications[5] for setting up of LABs and it issued two in-principle licences. Eventually RBI received 227 applications for setting up of LABs over a period of four and a half years[6]. Of these applications only 10 were considered for issue of in-principle approvals. Eventually four approvals were withdrawn as the promoters were unable to fulfil the stipulated conditions. Six banks were issued the licence. The licence of one bank – Vinayak LAB located in Sikar, Rajasthan was cancelled after irregularities were noticed and another bank South Gujarat LAB was merged with Bank of Baroda after it went into distress. Four LABs continued to function.

2. Strands of discussion on the viability and desirability of LABs

From the time the LABs were set up, there were various strands of discussion on the desirability of LABs. One recurring strand indicated that the RBI was uncomfortable with the idea of small banks in the private sector, while the Government appeared keen to push this idea. From 2013 onwards, it appeared that there was a convergence of views between that of the government and the RBI. This section examines the broad discourse on LABs and concerns of RBI, the important reports that engaged with the idea of LABs or small banks.

Ramachandran Committee

A review group set up by the RBI in 2002 (Ramachandran Committee) reviewed the performance of four LABs that were present at that time (including South Gujarat LAB which was merged into Bank of Baroda, but excluding Subhadra LAB which was under consideration and was issued a licence after the committee submitted its report). Based on the review, the committee was of the view that no further LAB licences were to be issued till there was stability with the existing LABs.

Trend and Progress of Banking in India Reports

While the RBI had not issued any further licences for LABs following the recommendations of the Ramachandran Committee report, the discussions on LABs continued in the policy forums. The annual Trend and Progress of Banking in India (T&P) reported the verdict of the Ramachandran Committee in 2003 and indicated that the RBI had revised the policy for licencing LABs *"considering the poor inherent financial strength of LABs"*[7] The following year, the South Gujarat LAB was merged with Bank of Baroda due to its inherent

[5] Reserve Bank of India (1997): RBI gives in-principle approval for setting up two Local Area Banks (Press Release issued on Jan 15, 1997. Mumbai: Reserve Bank of India http://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=18556 accessed on Friday, 21 March 2014

[6] Reserve Bank of India (2002): Report of the Review Group on the Working of Local Area Bank Scheme (Chair: G Ramachandran), Mumbai: Reserve Bank of India. http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/32294.pdf accessed on Friday, 21 March 2014

[7] RBI (2003): Report of the Trend and Progress of Banking in India, 2003. Mumbai: Reserve Bank of India.

weakness and performance. The T&P continued to articulate its concerns: "*the two existing smaller banks, viz., The Subhadra Local Area Bank Ltd., which suffered net losses in the very first year of its operation and Krishna Bhima Samruddhi Local Area Bank Ltd., whose profits remained low and virtually stagnant during 2003-04, raise concerns about their sustainability"*[8]. The subsequent T&P reports just reported the performance of the LABs without making any comment on the larger issues of sustainability or viability of the business model. Even though the effects of the global slowdown also had an effect on the LABs, the T&P only reported performance till 2010, without getting into the design parameters. In the T&P report of 2010, the report not only raised the design issues in LABs but also invoked the 2002 Ramachandran Committee report to point out that except one bank – Capital LAB, the others had failed to reach a net worth of Rs. 25 Crore as recommended by the Ramachandran Committee. This had to be seen in the light of the recommendations of the Rangarajan Committee (discussed later) where the committee had recommended allowing new LABs to come into operation - indicating that the RBI was still not comfortable with the idea of specialised banks.

Rangarajan Committee

The Report on the Committee on Financial Inclusion (Rangarajan Committee, 2008)[9] observed that the LABs formed a part of the committee's strategy for building an inclusive financial sector. The committee recognised potential in LABs and stated that LABs could integrate well with local financial markets and *'offer a host of financial services including savings, credit, remittances, insurance, etc.'* It suggested that RBI could consider allowing new LABs to come into operation, especially in districts/regions that had high levels of exclusion, though with some regulatory prescriptions. A series of news reports during that time indicated that the then finance minister P Chidambaram stated that finance ministry was to take up with the RBI the issue of resuming licensing of LABs.[10] However neither the recommendation of the Rangarajan Committee nor the articulation by the Finance Minister resonated with the RBI.

Raghuram Rajan Committee

The report of the Committee on Financial Sector Reforms (Raghuram Rajan Committee, 2009)[11] laid faith on small banks and blamed of their 'not-so-stellar' performance on poor governance structures, excessive government and political interference and unwillingness/inability of the regulator to undertake prompt corrective action. It said that instead of '*large-bank-led, public-sector-dominated, mandate-ridden, branch-expansion-focused strategy for inclusion*'; local area banks with low cost, efficient structures would work better. The committee felt that the, LAB initiative was prematurely discontinued by RBI. The committee suggested exploring the possibility of setting up privately owned, well-governed deposit-taking, small finance banks similar to LABs but with a difference. The new banks were to be such that they *'would bring local knowledge to bear on the products that are needed locally, and would have the locus of decision making close to the banker who is in touch with the client, so that decisions can be taken immediately'*. These banks are also expected to be entry points *'into the banking system, which some entities can use to eventually grow into large banks'*.

The central government seemed comfortable with the idea of taking the recommendations of both the Rangarajan Committee and the Raghuram Rajan Committee forward. In 2009 it was reported that finance ministry and the central bank were planning to *'allow more local area banks from the next financial year to provide an impetus to the government's financial inclusion drive'*; after appropriate regulatory framework had been put in place. About 120 unbanked revenue blocks were identified in the country and the new banks were to be allowed to 'perform all functions of a scheduled commercial bank', though in a limited geographical area of operation[12].

[8] RBI (2004): Report of the Trend and Progress of Banking in India, 2004. Mumbai: Reserve Bank of India.

[9] Government of India (2008): Report of the Committee on Financial Inclusion. New Delhi: Government of India

[10] Report in Indian Express available at http://archive.indianexpress.com/news/finmin-will-ask-rbi-to-consider-local-area-bank-licences-pc/300860/ accessed on April 15, 2014.

[11] Government of India (2009): A Hundred Small Steps: Report of the Committee on Financial Sector Reforms, Planning Commission, Government of India. New Delhi: Sage Publications

[12] Anto, Antony (2009): RBI Push for Local Area Banks. Report in the Economic Times dated December 8th 2009. Available at http://articles.economictimes.indiatimes.com/2009-12-08/news/28492838_1_local-area-banks-small-banks-full-fledged-banks accessed on April 16, 2014.

These were followed by reports in January 2010 that RBI had *'granted an in-principle approval for a proposal that will allow private sector players to promote small local banks in what is seen as a new version of the local area bank schemes'*[13]. However, this news was refuted soon when Minister of State for Finance Namo Narain Meena told the Rajya Sabha in a written reply that RBI was not considering allowing setting up of any LABs in the country[14]. While the Raghuram Rajan Committee renewed the debate on licences for new LABs, the committee also had suggested that current institutions operating at local level, such as MFIs and community-based lending organisations, could choose to become small finance banks and raise their own deposits, provided they had a good track record and a substantial capital base. In 2011 the Ministry of Rural Development, in the wake of the crisis in the microfinance sector had suggested that MFIs could be converted to LABs and brought under a regulatory framework.[15]

Discussion Paper on Banking Structure in India: The Way Forward

In spite of the discussions, the RBI was either silent or slightly critical of the existing LABs in its discourse. The major change in RBI's approach was seen when it put out a discussion paper on the future of banking structure in India.[16] Through the paper, RBI, for the first time accepted the possibility of re-opening different forms of banks including small banks. It argued that small banks (LABs and UCBs) played an important role in supplying credit to small enterprises and agriculture and has potential for financial inclusion while maintaining that their past performance was not satisfactory. The paper noted that overall performance of functioning LABs has been less than satisfactory because they had high cost structures, affecting the competitiveness of their services. The paper argued that LABs were envisaged to be in the fourth tier of banking, along with Urban Cooperative Banks, State Cooperative Banks and District Central Cooperative Banks. Banks in the fourth tier were expected to *'specifically cater to the credit requirements of small borrowers in the unorganised sector in unbanked and under banked areas'*. In the process of re-orientation, well managed and financially sound LABs/small banks would have opportunities to expand their area of operations.

Reflecting the sentiment expressed in the discussion paper, for the first time the report of the Trend and Progress of Banking Report had a positive statement which said *"Notwithstanding these constraints, these institutions show promise of small-scale banking institutions that can be experimented with on a larger scale in future. The Reserve Bank Discussion Paper 'Banking Structure in India: The Way Forward' has hence recommended the creation of more number of smaller banks in the private sector with the objective of achieving financial inclusion at the local level. Such banks pose less threat to systemic stability given their limited-area operations with little financial interconnectedness. However, smaller banks should be promoted only after putting in place adequate safeguards in the form of corporate governance and a stronger resolution framework to handle the possibility of higher mortality.*[17]

Nachiket Mor Committee

The Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Chairman: Nachiket Mor)[18] made several recommendations on the banking structure, going beyond the issues raised in the discussion paper by RBI. The committee offered a menu of options including specialized banking structures like Payment Banks, Wholesale Banks and Wholesale Investment Banks. The report also suggested

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[13] Kuber, Girish (2010): Private companies can set up local banks: Report in the Economic Times dated January 5th 2010. Available at http://articles.economictimes.indiatimes.com/2010-01-05/news/28460817_1_local-area-banks-banking-services-urban-co-operative-banks accessed on April 16, 2014.

[14] Economic Times (2010): RBI Not to issue fresh local area bank licences. Report in Economic Times dated March 16th, 2010. Available at: http://articles.economictimes.indiatimes.com/2010-03-16/news/28479407_1_rbi-raghuram-rajan-committee-labs accessed on April 16, 2014.

[15] Report on the website of Moneycontrol.Com at http://www.moneycontrol.com/news/business/rural-min-seeks-to-convert-mfis-to-local-area-banks_634171.html accessed on April 16, 2014.

[16] Reserve Bank of India (2013): Banking Structure in India: The Way Forward – A Discussion Paper. Mumbai: RBI. Available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/DPBS27082013_F.pdf accessed on April 16, 2014.

[17] Reserve Bank of India (2013): Report of the Trend and Progress of Banking in India, 2013. Mumbai: RBI.

[18] Reserve Bank of India (2014): The Committee on Comprehensive Financial Services for Small Businesses and Low Income Households. Mumbai: RBI. Available at: http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CFS070114RFL.pdf accessed on April 16, 2014.

that a *'gradual transition of eligible and interested NBFC to Wholesale Consumer Banks or National Banks'* could be considered.

While the above discussion indicated that there were divergent views on the concept of a LAB or a small bank, most of these debates were at a conceptual level, with examples from international experiences. This paper has attempted to visit these issues by looking at the data pertaining to the performance of LABs and also by engaging with policy makers who were for and against the idea of a LAB to understand their concerns.

3. Analysis of the key features and covenants of LABs, as distinct from RRBs

LABs were set up as a peculiar animal. The intention was that they would be almost like RRBs in their structure having the following key features:

a. They would have a restricted area, and therefore their growth came from deepening the engagement with the customer group rather than a spatial growth or widening. While they were called Local Area Banks restricted to some geographies, the regulation ensured that they were Local Area **Rural** Banks. The regulation specified that they would have only one urban branch in a district which meant that in all there would be only three urban branches, irrespective of the business potential. While the Ramachandran committee (RBI, 2002)[19] suggested that the branch licensing be changed to offering one urban branch for every ten rural branches, the new policy statement that considered the report remained silent on the branch policy (RBI, 2002a)[20].

   While over a period of time, the branch licensing policy for scheduled banks was fully liberalized (discussed earlier) this facility was not extended to the LABs. Basically the policy on LABs prohibited what it expected the private sector operators to do – innovate, be agile and aggressive. There were regulatory constraints on LABs that prevented adoption of innovative outreach models.

b. Their initial capital specified for LABs was higher than RRBs and the ownership structure was distinctly different. RRBs had three major investors the central government contributed 50% of the capital, the sponsor bank contributed 35% of the capital and the state government contributed 15% of the capital. In case of LABs, the specifications were no different from the mainstream private banks in terms of the process. The promoters were expected to contribute a minimum of 40% of the capital (or a minimum of Rs.2 crores). If the equity holding pattern was not diversified, the banks had to diversify the holding to reduce the promoter holding to 40% over a reasonable period of time. This meant that every time there was an expansion in capital, the promoters could not pump in disproportionate amounts from their resources but had to continue to look for investors from outside as well. In addition there were restrictions on the concentration of non-promoter holdings. The non-promoter holdings were capped at 10% of the share capital for each member. In case of RRBs, the banks got doses of recapitalization from the State whenever they needed, even when the recapitalization requirement was a result of losses incurred on operations.

c. The capital adequacy norms for LABs were specified at 8% of the capital to risk weighted assets ratio (CRAR) from the date of establishment. Whereas for RRBs, the norms were first specified (only for reporting purposes) in 2007.[21] The norms were made applicable and were mandated to be followed only in 2013.[22] This significant difference affected the operations of any financial institution. Following the report

[19] Reserve Bank of India (2002): Op.Cit.,

[20] Reserve Bank of India (2002a): New Policy on the Working of Local Area Banks. Mumbai, RBI. http://rbidocs.rbi.org.in/rdocs/notification/PDFs/38589.pdf accessed on Monday, March 24, 2014

[21] Reserve Bank of India (2007): Application of Capital Adequacy Norms to RRBs. Mumbai: RBI http://rbi.org.in/scripts/NotificationUser.aspx?Id=3989&Mode=0 accessed on Monday, March 24, 2014

[22] Reserve Bank of India (2013): Imposition of Minimum Capital Adequacy Measure of 9% on RRBs. Mumbai: RBI http://www.rbi.org.in/scripts/NotificationUser.aspx/searchnew/Images/NotificationUser.aspx?Id=8595&Mode=0 accessed on Monday, March 24, 2014

of the Ramachandran Committee (2002)[23] the new policy of RBI (2002a) [24]increased the capital adequacy for LABs to 15%. Not only was the capital adequacy as a percentage was raised, the absolute capital required for the LAB was also raised to Rs.25 Crore. This was a steep target for the existing LABS and none of them except the Capital LAB has been able to achieve this capital in the timeframe provided by the RBI (2013)[25].

While operationally this norm did not impact the LABS in terms of business and profitability, it had significant implication on the ability of a LAB to attract more investments. A higher capital adequacy implied a lower leverage. Most of the banks had a CRAR between 12 and 14% and banks breached the 15% mark very rarely. Banks thrive on low-cost borrowings in the form of deposits, and a regime that restricted leverage stunted the bank's ability to attract deposits. While a higher capital resulted in a higher return on assets – as the profits come because of lower interest payments on borrowings, it also resulted in a lower return on equity – because the capital base to be serviced with these profits were significantly higher. It is very evident that banking was not an attractive business, unless the possibilities of leverage were fully exploited. A disproportionate CRAR requirement made the organization inherently unattractive for mainstream investment.

The non-banking finance companies (NBFCs) had higher CRAR requirements than the commercial banks. However, the business model of NBFCs were different because they did not have access to low cost retail deposits, they did not have the obligation of statutory liquidity ratio (SLR) and cash reserve ratios (CRR). They also did not have any priority sector obligation.

A disproportionate CRAR (compared to commercial banks), made the LABs inherently unattractive for further investments from the intended investor segment – the private sector. This infirmity was in addition to the perceived inherent infirmities of limited growth possibilities due to geographical restrictions, and the issue of concentration risk of the portfolio. The only way the LABs could grow was through the infusion of promoter capital. Therefore diversification of capital through external investments and even through a public issue of shares was expected to be difficult.

In addition, the norms of loan loss provisioning and income recognition were not different from the mainstream private banks. There was no special dispensation for the fact that LABs were operating in areas that were more difficult than the commercial banks. The only way the LABs could be as profitable as mainstream banks was by charging a significant risk premium on their loan book to reflect the concentration and other risks.

d. It was expected that the LABs would recruit locally. As they were in the private sector, their costs and HR practices could be different from RRBs making them more viable. While this was an advantage for the LABs and are borne out by the cost to income ratio and other financials (discussed later), the RRBs had one significant advantage. This was that they could fall back on the sponsor bank which was a full-fledged commercial bank which brought banking expertise and some backstopping arrangements. The RRBs consistently had officers deputed from the sponsor banks to head them. Whether this was beneficial to the RRBs is a moot point. The fact was that the LABs did not have any such luxury.

e. All the covenants applicable to the new private sector banks were applicable to LABs. These included a cap on voting rights at 10% irrespective of shareholding; compulsory diversification of share-holding through disinvestment after the initial period; and the appointments to the board and the CEO positions had to go through a fit and proper test and approved by the RBI. In cases where CEOs had to be changed, the process took time, while the RRBs could easily effect such a change through a transfer.

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[23] Reserve Bank of India (2002): Op Cit.,

[24] Reserve Bank of India (2002a): Op.Cit.,

[25] Reserve Bank of India (2013) Report of the Trent and Progress of Banking in India 2013. Pp.88. Mumbai: Reserve Bank of India.

f. While the RRBs went through a process of being scheduled banks, the LABs were never accorded that status. While the initial guidelines did indicate that they would be eligible to be listed under the second schedule, it never happened. Even the Ramachandran Committee that examined the working of the LABs recommended that the process of scheduling be held in abeyance.

g. RRBs along with rural co-operative societies and rural co-operative banks were inspected and supervised through NABARD. The urban co-operative banks were inspected and supervised by the Urban Banks Division of RBI. In case of LABs, the supervision was with the Department of Banking Supervision – the department that supervised commercial and foreign banks. While the expectation of the functions of LABs are similar to the RRBs, the supervisory mechanism was that of the commercial banks. Thus LABs were a small minority of four banks doing some distinct activities being supervised by a department that usually inspects and supervises the larger commercial banks – both in the private and the public sector.

h. The regulation of the LABs was initially vested with the Rural Planning and Credit Department, but following the recommendations of the Ramachandran Committee the responsibility was shifted to Department of Banking Operations and Development.

4. Analysis of issues faced in regulatory oversight; reasons for discontinuing the issuance of new licenses

The Committee set up in 2002 under the Chairmanship of G Ramachandran (Former Secretary, Finance, Government of India) went into the issues that were faced by the LABs and recommended that no further licenses be issued. While one LAB license – Subhadra LAB was issued after the submission of the report, it possibly represented one of the three licenses that were under consideration as the committee was carrying out its work.

A reading of the Ramachandran committee report showed that there were serious misgivings about the feasibility of the LABs much before it was given a fair chance. For instance while the report said: *"At the outset, it needs to be emphasized that these banks have been in existence only for a short period thus ruling out a definitive pronouncement on their success or failure",* it did not refrain from making some fundamental recommendations. The committee did not recognise the fundamental performance of the banks or their feasibility – in fact all the banks were profitable at the time of the report and did not have any serious solvency issues then. A review of the performance of these banks (discussed later) did not indicate any issues of business continuity or sustainability, even later. However, the report raised issues about the type of business that the LABs were undertaking. The major issues discussed in the report were:

a. Most of the branches of the banks were not located in unbanked centres;
b. Bulk of the business of the LABs emanated out of the head office;
c. The LABs were not significant players in their area of operation;
d. The LABs had concentration risks, their deepening had to happen in agriculture and rural areas, leading to stressed assets. The capital and the small size of the LAB did not give it enough cushion to absorb losses – as and when they occurred;
e. There were fundamental weaknesses inherent in the business model of the LABs;
f. That LABs were dealing in securities and bonds, which were risky;
g. The LABs were achieving their outreach through agents and quasi agents;

While the report suggested a stoppage to issue of new licenses, it also suggested augmenting the capital base of the existing LABs to Rs.25 crores with a capital adequacy of 15% over a five year horizon. It offered some sweeteners to the existing LABs: access to refinance; greater freedom in opening branches; and offering an urban branch license for every 10 rural/semi-urban branch opened. While the recommendations were accepted and notified in the revised policy on LABs, the sweeteners were never implemented.

The issues raised by the committee were internally contradictory, and were not borne out by the performance of the LABs. All LABs continued to be viable. None of them except Capital LAB was able to achieve the level of base capital that was suggested by the committee. However, this non-achievement did not affect the basic business model of the LABs. From the discourse available in the public domain, it was clear there was a contradiction between the design, the intended objective, the regulatory framework and the evaluation framework of LABs. The following section discusses these contradictions.

a. **The design principles** applied to LABs have been similar to a full-fledged commercial bank, except for two significant variations. The area of operation (and therefore the freedom to open branches) was restricted and in view of the size the capital requirements of the LABs were also much lower. Except for these two fundamental differences, the LABs were expected to follow all the other parameters applicable to the mainstream banks in risk provisioning, priority sector norms and the sub-targets for weaker sections. There was an inherent handicap on opening branches first by the larger restriction within the three assigned districts and later restriction on having only one branch in each of the district headquarters. The design dictated that these banks work in centers that had lesser population, would suffer concentration risks. They would not have the ability to cross-subsidize between bulk loans in diversified sectors and smaller loans to weaker sections. If the type and tenor of deposits that these banks attracted was factored and an assessment on the asset-liability management was made, there would be more infirmities, particularly if the banks were unable to issue long term liability products.

   If these banks were operating in a geographical area, with high concentration risks on their loan book, how should the assets be managed? How should the bank be de-risked from concentration risk? The answer for this would be to encourage these banks to open more and more branches within the area of operation, particularly where the business was feasible and lucrative and then wait for that success to spill over to the remote areas, as is being done in mainstream banking. The risk emanating from the assets side of the balance sheet has to be addressed on the asset side itself. So if one part of the portfolio suffers from concentration risk, the de-risking can happen only through permitting diversification of the assets side. It appears that the Ramachandran Committee looked at it from a pure liabilities perspective – which basically kept the depositor interest in mind. A greater capital requirement would reduce the exposure to depositors and keep the liabilities side of the balance sheet healthy from the depositors' perspective. However, that did not reduce the inherent weakness on the assets side of putting too many eggs in one basket. Therefore if from the perspective of stability and long term solvency of LABs, there was need for greater tolerance towards their business risk, particularly if the banks were meeting the priority sector and the other regulatory and statutory requirements.

   The costs of operation of these banks were bound to be higher because of the small ticket size of the loans and deposits compared to the commercial banks. Therefore the design had to build the flexibility that helped sharing the last mile costs across multiple activities. A correspondent/agent outreach model with exclusivity in banking and financial services but non-exclusivity in other activities could have addressed this problem. However, the Ramachandran Committee seemed to think that such an outreach model was risky.

   Apart from the concentration risk which emanated from geography, it was possible that the underlying portfolio was also exclusively risky (emanating from the type of activity), without adequate loss coverage. The one way in which this aspect could be addressed was to charge a risk premium, using the pricing freedom. A part of the premium so charged could be passed on to corporation that specialized in risk coverage – basically by negotiating a portfolio cover from the insurance sector as recommended by the Nachiket Mor Committee (2014)[26]. If the design aspect did not understand the exclusivity of this market segment, the fears expressed in the Ramachandran Committee would well come true.

   While the LABs may not be able to diversify their portfolio locally due to multiple reasons (i) lack of alternative opportunities in the limited geography they are operating in; (ii) inability to enter into types of

[26] Reserve Bank of India (2014): Report of the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households. Mumbai: RBI. p.9

lending due to issues pertaining to Asset Liability Management (ALM); and (iii) inherent lack of capability to assess the risks and the technical nature of the project.

In order to address the risks raised above, the LABs could have invested in a basket of instruments that financed activities outside the area of operation. Investing in a diversified portfolio would fetch good risk adjusted returns, but might not fetch the returns on par with what the LAB would get if they were involved in that business. In this context, the criticism that the LABs had a stream of income that came from trading of securities was unfounded. In fact the policy guidelines had to consider encouraging LABs to find alternative income generation routes and develop expertise in it over a period of time - subject to prudential norms on exposure and good internal management systems. However, guidelines also had to take care to ensure that the bank remained a bank and did not operate like a mutual fund.

If the design features of a LAB were like a mainstream commercial bank with diversified portfolio, then the expected reality of how the balance sheet should look had to mimic that world to the extent feasible. This could happen only if the institutions operating were given sufficient freedom to diversify their asset base both locally and also invest in non-local assets through financial instruments. The LABs could also keep churning their portfolio through sale and securitization to other banks in need of such portfolios and mitigate the concentration of risks while having a risk sharing formula that made it attractive for another mainstream bank to take the portfolio on to its balance sheet.

b. An examination of the Ramachandran Committee report and other literature put out by RBI it seemed to indicate that the **intended objective of LABs** was to serve the hitherto unserved segments of the population, and take up the issue of financial inclusion aggressively. The intended objectives contradicted what a good bank was all about. These objectives took the LAB towards risky activities, risky geographies and risky customers. If the markets were to find mechanisms to address this segment of the customers, then there was no need for a policy intervention; it only needed a regulatory framework. However, from decades of experience it is evident that there were no institutional mechanisms that addressed all the three components – risky activities, risky geographies and risky customers all at one go.

It was interesting to examine the 10 in-principle licences for LABs that was issued by RBI in the first place. The ten licensees covered three districts each, in diverse parts of the country. The data on area of operation for 8 licensees were available. From Table 1 below, it was evident that there were only two LAB applicants wanting to operate in areas where the banking density was significantly lower than the national average (Priyadarshini and Vinayak). Both these did not survive the test of time. One applicant wanted to do inclusive banking and opted for an area where banking density was marginally lower than the national average. The other three banks continued to operate in areas that were well banked. The most successful, Capital LAB was in an area that had the best banking penetration amongst all the districts.

Table 1: Details of Applicants issued in-principle approval for LAB licences, area covered and banking spread

Sl. No.	Applicant	Districts opted	Total Commercial Bank Branches	Population	Population per Branch	Average for all districts
1	Priyadarshini	Jalgaon	183	3682690	20124	
		Jalna	75	1612980	21506	
		Aurangabad	159	2897013	18220	19647
2	Manipal	DK	306	1897730	6202	
		UK	166	1353644	8154	
		Shimoga	157	1642545	10462	7780
3	Kongunadu - Salem	Salem	164	3016346	18392	

Sl. No.	Applicant	Districts opted	Total Commercial Bank Branches	Population	Population per Branch	Average for all districts
4	Central Gujarat - Dabhoi	Vadodara	335	3641802	10871	
5	KBS	Mahabubnagar	197	3513934	17837	
		Raichur	96	1669762	17393	
		Gulbarga	177	2174742	12287	15656
6	Coastal LAB	Krishna	342	4187841	12245	
		Guntur	332	4465144	13449	
		WG	277	3803517	13731	13098
7	Subhadra	Sangli	185	2583524	13965	
		Kolhapur	230	3523162	15318	
		Belgaum	321	4214505	13129	14023
8	Vinayak	Sikar	112	2287788	20427	
		Jhunjhunu	93	1913689	20577	
		Churu	115	1923878	16729	19142
9	Capital	Jalandhar	329	1953508	5938	
		Kapurthala	115	754521	6561	
		Hoshiarpur	152	1480736	9742	7028
10	South Gujarat	Navsari	142	1229463	8658	
		Surat	304	4275540	14064	
		Bharuch	121	1370656	11328	12126
	All India Figures		66195	1027015247	15515	
Source: Data on Banking outlets Branch Banking Statistics, 2002. Population figures: Census of India 2001						

If the objective was to penetrate deeper; reach the poorer segments and take up the cause of financial inclusion, (relatively) the districts that were chosen were not the ones that had a crying need for banking. Therefore, while the applicants were looking to carry out commercially viable and profitable banking functions, the policy makers were looking at a different output. Therefore the question on whether there was a congruence between the intended objectives; the design features offered in the guidelines; and the roll out of LAB licenses needed to be asked.

c. **The regulatory framework** applied was out of sync to achieve the objectives that were articulated in several documents of the RBI. If the objective of the LABs were greater financial inclusion, then the regulatory framework had to provide for concessions on capital structure, prudential norms and the general rules applicable to the ownership and governance. The other two major players carrying out the inclusion agenda – the co-operatives (particularly the District Co-operative Banks and the State Co-operative Banks) as well as the RRBs did not have much of the capital adequacy and prudential norms imposed on them for a long time. RRBs routinely got the status of a scheduled bank. Co-operative Banks had a framework under which they could apply for being a scheduled bank. LABs on the other hand were expected to maintain the same levels of performance parameters as the large private banks; they were hamstrung on expansion; and had greater CRAR requirements than large banks. Thus, it was appropriate to conclude that LABs were established in a regulatory and governance framework that did not aid the larger agenda of inclusion.

For this paper the performance of Capital LAB – the most successful LAB was chosen for a detailed analysis. The objective was to examine how it performed on the stringent requirements of ownership structure, governance and professional management. Capital LAB was chosen because it stood out as a significantly different bank amidst the other three LABs.

If the stringent framework that RBI has been adopting for issuing new commercial bank licenses were to be adopted, then one could rightly raise questions about the licenses issued for Capital LAB but also for Krishna Bhima Samruddhi LAB. These questions pertained to identification of the promoter group, the conditions on divestment, expansion of capital and increased capital adequacy. In both these cases there were some obvious conflicts of interests. The promoter groups had a NBFC undertaking microfinance, while simultaneously running a LAB. While the BASIX group possibly did not undertake microfinance activities in the area of operation of KBS LAB, this might not be the case with Capital LAB. In case of Capital LAB, in addition to having a microfinance company (Midland Microfinance) the promoters' family had interests in other NBFCs as well – Samra Leasing Limited, Samra Finance and Properties Limited, Midland Financiers Doaba Limited and Midland Motor Financiers Limited. The promoter group also had interests in real estate. While arms' length was maintained between these companies and the bank, there were at least two directors of the bank were common with another finance company (Midland Microfinance) in which the promoters had significant interests. One director of the bank also had interests in a finance company. The question therefore was whether the regulatory framework should allow for interests in businesses that could be deposit taking on one hand (LAB) and organisations having only lending operations and significantly operating in the geography and portfolios where the bank was operating.

Smaller banks would not be under the intense regulatory scrutiny because of their size. They also were unlikely to be under intense public scrutiny unlike the other large banks which were not only answerable to the regulatory authorities, but were tracked by analysts, press and other parties not directly interested in the running the bank.

Till now, all the performance parameters of the LAB were satisfactory and the RBI's Annual Financial Inspection is giving a good report for Capital LAB (Samra, 2014)[27]. However, this was not an issue about an individual player, but had to be examined at a larger systemic level. The policy dilemma then was [i] whether to prohibit NBFCs from applying for bank licences, [ii] if they were a limited area bank as in this case, whether it would be fair to ask the NBFC in question to cease all old operations and transfer the portfolio to the LAB or [iii] to ask the NBFC to transfer the portfolio and cease operations in the area of the LAB but permit it to operate elsewhere.

Getting well qualified "fit and proper" board members for a small bank was a challenge. These directors had to stand up to possible conflicts of interest; ensure the solvency of the bank; and safeguard the depositor interests. This was a challenge, given the size and the location of the bank. This also had to be seen in conjunction with the issue of professional management which is discussed later.

d. When the **evaluation framework** was examined, the contradiction between the design, intended objectives, regulation and performance was more evident. The design and regulatory framework expected the bank to work like a mainstream bank. The objectives expected the bank to be pro-poor, pro-agriculture, pro-small accounts, operate in remote areas and undertake difficult business. The evaluation framework usually expected stellar achievement in both the profitability parameters and the outreach parameters. The primary expectations of the Ramachandran Committee were of stellar achievement in outreach parameters. The fear was that achieving and concentrating on these outreach parameters would affect the profitability parameters. This had impact on solvency. However, when LABs achieved the profitability parameters, the banks were criticized on aspects like making loans from their head office; not being relevant to the communities that they were operating in; being small compared to the commercial banks in the district and so on. If the LABs were to be seen as instruments of achieving deepening of financial services in under-served areas, then their design and evaluation parameters had to be built around those objectives. If only

[27] Samra, Sarvjit Singh (2014): Personal Communication during the field visit to Capital LAB on 27th March 2014

mainstream design parameters were applied, then the inclusion and deepening variables were to be seen as a by-product rather than as a basic output indicator for evaluation.

Moving on, it was important to examine the human resource aspect of LABs. On this aspect the argument was that LABs would hire locally, and therefore their employee costs would be lower, thereby giving them an advantage of achieving deepening. This had to also compensate for the risks emanating from concentration of portfolio. However, the staffing function had to be examined carefully. MFIs tend to be used as benchmarks for costs and Banks were unlike MFIs. MFIs were usually single product operations with high levels of standardization. A banking operation involved dealing with products on both sides of the balance sheet – offering a diversified set of loan products as well as accepting a range of deposits. In addition, if a bank were to provide comprehensive financial services to its customers, it would engage itself in offering not only payment products but also some risk related products. All these would need the staff dealing with the customers to be familiar with not only the product attributes but also be able to exercise judgment on the suitability of the product for the customer. The only way this issue could be addressed was by hiring professionals or by undertaking intense training. Either way, LABS would face intense competition from the mainstream banks (particularly from the private sector) for good employees, in such areas. The commercial banks also had their own requirements to open branches in these areas and achieve their targets on priority sector. Therefore, the argument of cost advantage that accrues to LABs might be short-lived. Benchmarking narrow banks with other forms of financial service organizations in the rural areas, therefore, would not be fair. These banks had to be benchmarked on performance from a pure banking perspective.

5. Assessment of existing LABs: Financial and operational performance

Misplaced concerns on stability and solvency

The concerns about the stability and solvency of LABs raised both by the Ramachandran committee and in other forums were largely unfounded, based on the examination of the performance of the four LABs together. While Capital LAB was the undisputed leader amongst the four banks right from the inception, the other banks were not causing concern either. Their financial performance was positive and healthy. The only aspect that the LABs were unable to rapidly achieve was scale. They also were unable to attract more investment in order to take their individual net worth to Rs.25 crore as recommended by the Ramachandran Committee. But these banks did not seem to pose a systemic threat; did not seem to be failing; and did not seem to suffer from all the apprehensions of concentration and covariance risks.

Table 2 has the figures pertaining to the financial performance of LABs. The table indicated a fairly good picture of LABs on most of the financial parameters.

Table 2: FINANCIAL PERFORMANCE OF LABs (Amounts in Rs. Crore)

Indicator	2008-09	2009-10	2010-11	2011-12	2012-13
Income	**90.6**	**104**	**124**	**150**	**180**
Interest income	74.9	86	107	140	160
Other income	15.8	18	17	20	20
Expenditure	**76.5**	**91**	**105**	**130**	**160**
Interest expended	41.7	51	55	80	100
Provisions and contingencies	7.8	8	13	10	10
Operating expenses	27	32	37	40	50
of which: Wage Bill	12.2	14	17	20	30
Profit					
Operating Profit/Loss	21.9	20	32	30	40
Net Profit/Loss	14.1	13	19	20	20

Indicator	2008-09	2009-10	2010-11	2011-12	2012-13
Spread (Net interest income)	33.2	34	52	60	70
Total Assets	786.6	946	1107	1360	1580
Financial Ratios@					
Operating Profit/Loss	2.8	2.4	3.1	2.6	2.4
Net Profit	1.8	1.4	1.9	1.5	1.6
Income	11.5	12	12.1	12.3	12.3
Interest income	9.5	9.9	10.4	11	11.1
Other income	2	2.1	1.7	1.3	1.2
Expenditure	9.7	10.5	10.2	10.8	10.7
Interest expended	5.3	5.9	5.4	6.2	6.5
Operating expenses	3.4	3.7	3.6	3.6	3.5
Wage bill	1.5	1.6	1.7	1.7	1.7
Provisions and contingencies	1	0.9	1.3	1.1	0.8
Spread (Net interest income)	4.2	4	5.1	4.9	4.6
Note: @Ratio to Total Assets					
Source: Trend and Progress of Banking in India, various years. Mumbai: Reserve Bank of India					

Early closure helps to quell downsides of failure and systemic risk

With a history of more than a decade and the consistent performance shown by the banks, it could be said that the banks did not raise serious issues of solvency, but for two banks South Gujarat and Vinayak LABs which were quickly closed down/merged with another bank. This meant that if the regulator was vigilant and could assess the potential failure cases early enough, then the future losses could be stemmed. The case of Vinayak LAB showed that the regulator sensed the trouble with the model very early. While it took some time to understand the failure of South Gujarat LAB, even that bank was closed down with minimal collateral damage. The only criticisms that would stick to LABs were that they did not grow fast and did not make a deep impact in their respective areas of operation.

Performance of LABS cannot be seen out of context

The performance of the LABs should be examined in a context. The context was where the regulator – RBI – inherently seemed to believe that they were flawed institutions. After the submission of the Ramachandran committee report, the only time that there was a positive discourse on the private sector small banks in the reports and documents of RBI was in 2013. The small banks found a favorable mention in the discussion paper on new banking architecture. Till then, most of the reports of the RBI were indifferent in considering the performance of LABs. The few positive recommendations made by the Ramachandran committee – on access to refinance facilities from NABARD and a benevolent branch licensing policy was never acted upon.

Given the more difficult conditions in which these banks were operating, it was not possible for LABs to be super-profitable. The restriction to three districts as an area of operation did not help in attracting equity investments and it was difficult for the banks to achieve a net worth of Rs.25 crore unless this came in from a calibrated set of investments not only from the promoter group, but also others who believed in the idea.

Then came the second constraint. Operationally the RBI would not look at any of the requests of these banks to expand until they were in the touching distance of a net worth of Rs. 25 crore. The exceptional growth of Capital LAB was explained by the fact that Capital LAB was able to meet this criterion in quick time, partly because they had started with a larger capital base, and had quickly garnered enough business to have retained profits. Capital LAB also was able to garner fair amount of equity investments from the local area and had a diversified shareholding. The shareholding pattern of Capital LAB was a-typical because a large part of the capital was held by people from its area of operation, in small lots. This was something that the other banks were not able to achieve, partly because of the areas in which they were operating.

Unlike other institutions where placement of capital with private equity is simpler, in case of banks with every single large investor the permission of RBI was necessary because the regulator had to ensure that the ownership structure did not change and these institutions were not subject to capture. This inherently imposed constraints on raising of capital.

On one hand, LABs were not growing at a fast pace, making it unattractive for investors. On the other hand RBI, was not giving approvals for opening branches. For instance, in case of KBS LAB *"After 2006, no approval was granted by RBI for opening a new branch till 2014. It was only after fresh investment came in after the rights issue in April-May 2013, that we received approval for two new districts and then for new branches"*.[28] This approach of the RBI did not give enough chance for the LABs to prove their model. Thus the general opinion was (including from the successful Capital LAB) that LABs were not given a fair chance in operations. This did not give the LABs a fair opportunity to prove that the model was as profitable, and more inclusive than the mainstream counterparts. It seemed that RBI was reluctant party to opening of the new generation local banks and through apparently '***even handed'*** regulation tried to prove the model wrong.

In order to get a flavour of the potential a LAB holds a case study was conducted. Box 1 has the field notes from Capital LAB.

6. LABs: Operational issues on products and services, pricing, cost structures and risk

In order to understand the operational issues of LABs, it was necessary to examine both the sides of the balance sheet. A look at the liabilities side provided insights into how the resources were generated and the assets side provided insights into how these resources were put to use in order to generate meaningful returns and revenues while achieving inclusion and outreach.

Understanding how resources are generated: The Liabilities side

On the resources side, the LABs could access capital, quasi-capital and borrowing. In a business like banking a higher leverage on the liabilities side and a higher deployment on the asset side lead to greater profitability assuming that the margins and the overheads were under control. However, a higher leverage would usually raise concerns on the safety of deposits – a large number of people who put money in the bank on the assumption of safety. Therefore the regulatory approach was to increase the risk capital or equity as and when the assets side became risky. This regulatory approach came from the concern of deposit protection rather than from the approach of examining the business model that lead to solvency. Therefore when somebody got a license to run a bank, the challenge on the liabilities side was not as great as a challenge on the assets side. However, in case of LABs raising equity – which formed the base for leverage – was a challenge. This challenge emerged largely from the perception of limited geographical growth and concentration risk.

The challenge of managing the portfolio and Assets Side

However, the larger challenge for the LABs or narrow banks came largely from the management of the assets side. Unlike MFIs LABs had a greater degree of regulation and had to adhere to all the fair practice codes. Being a LAB limited them to a geography, increased co-variance risks and risks emanating out of concentration in a small area. The only way in which they could overcome the problems of concentration was to charge a premium on the products as an acknowledgement of the higher risk emanating out of concentration. They could also overcome this problem by diversifying the portfolio as much as possible by deepening and widening the engagement with the clients in a given geography. Banks like Capital LAB were been able to achieve this diversification even within their limited portfolio.

The Ramachandran committee was accurate in identifying some of the problems of the LABs. The committee had also offered solutions. The recommendation to increase capital and CRAR reflected the committee's

[28] Nadkarni, Vijay (2014): Personal Communication. Vijay Nadkarni is the CEO of KBS LAB.

concern about the riskiness of the assets side of the bank's balance sheet. While that was so, the problem they identified was on the assets side and a solution had to be found on that side of the balance sheet. The solution thus was in diversifying the portfolio on the asset side and in having a good mix of fee and fund based activities.

The need for a portfolio mix on the assets side

Even while managing the funds there had to be a good mix of investments and advances. There was a need for an active investment portfolio. While the Ramachandran committee and several experts believed that small banks should not be participating in the treasury and money markets, it was important to unpeel this examine this issue further. The only way the LABs could get over the concentration risk was by putting a part of the resources in assets that were outside their area of operation. This was achieved by having a part of the resources invested in markets. However, the received wisdom including from the Ramachandran committee was that the small banks would not have the systems and resources (both human and financial) to manage this portfolio effectively. The recommendation was that permission to be in the investments market (debt, money market, and treasury) should be accorded only when the LAB reached a certain scale and/or maturity.

The other aspect that the LABs had to be concerned was about managing the loan book. The resource available for loaning was a function of both the statutory (SLR, CRR) and voluntary investments (Treasury) made. LABs as a class of institutions possibly would not come out in flying colors in deployment of resources towards building a loan book. The Credit-Deposit (CD) ratios of the LABs were no different than the other banks, and in many years lower than the most efficient bank classes. But given that the deposits as a proportion of total resources raised on the liabilities side itself was much smaller in proportion because of the higher capital requirements, the credit as a proportion of this lower deposit base indicated that a large part of the resources available with the LABs were not deployed with their targeted client group as advances. This statistic showed the need for deeper penetration. A deeper penetration and diversification across activities – agriculture, off farm, non-farm, small industries, consumer and other retail finance become imperative. Agriculture had its own cycles and therefore it was important to restrict the exposure to agriculture to ensure uniform liquidity. Given the area of operation of the LABs it was unlikely that there would be significant amount of term finance, and therefore the chances of a significant asset-liability mismatch was not going to be an issue. However, understanding the levers of the local economy and moving beyond agriculture was imperative. For LABs, this was the most significant issue to be addressed not only in the past but also in the future when new limited function small banks were licensed.

Costs and localization

LABs could cut on operational costs because of localization. Localization afforded the luxury of having innate knowledge about the customers and also about the geography. This made transactions more personal and relationship based, removed the sense of anonymity of dealing with large institutions. Intrinsically localization reduced the risk of adverse choice of borrowers and the resultant willful default. While the transaction costs for both the bank and the borrower would be lower due to localization, the bank was in a position to monetize it through a slight premium on pricing and a slight lower cost on loan losses as was the case of Capital LAB.

7. LABs: Issues of organizational mission, governance and management

The issue of mission, governance and management was the biggest challenge for LABs. They started on a small scale, with less capital and with concentrated shareholding. This made it unattractive for large investments to flow. Therefore the chances of a LAB being listed on a stock exchange were remote. Thus LABs were restricted to the oversight of its governance structure and to the supervision of the regulator. There were no signals emanating from the brokers and analysts and nobody would track the performance of LABs.

The concentration of holding, the limitation of size in attracting mainstream professionals and the limited oversight of the regulator made LABs vulnerable to capture. While there was an expected "mission" of the regulator on the outreach and deepening and inclusive agenda, the management had its own concerns of profitability. Therefore the challenge in case of a LAB was in ensuring that there was no capture, they maintained an arm's length relationship with other aspects of the promoters' business and the bank was insulated from the risks of related party transactions. Given the size of the LAB, a regular surveillance on adverse usage of the banking facilities was always a challenge. That may be the reason why RBI kept a tight leash and did not accord a scheduled bank status to LABs.

On the issue of governance and management, there was a challenge in finding truly "independent" directors who kept the depositors' interest above the shareholders' interest and always worried about reputation and solvency of the bank. Technology and computerization had helped these banks to be more transparent and accountable, but the size inherently made it difficult for external oversight and also getting excellent people on to the governance structure.

8. LABs: Issues of brand equity and viability

Through this study it was possible to establish that the inherent viability of the LABs were not in question. However, when RBI wanted to move ahead from four LABs to having several of them across the length and breadth of the country, particularly to accelerate the process of financial inclusion, there was a risk of failure. Even with the early LABs there were two failures. Therefor the questions that emanated were:

a. What was the institutional architecture for protection of depositors, considering that these depositors usually came from the most vulnerable sections of the society? The deposit insurance architecture had to be re-visited to make it work.
b. What was the tolerance level for failure? While a LAB failing might not cause systemic ripples because of inherent insularity built around it; not allowing LABs to embed themselves into the banking system very deeply, there was still a reputational risk. A few LABs failing would result in a reputational risk for LABs as a category. This has been evidenced in the co-operative sector, where the failure of a few co-operatives affected the sector. The challenge was to avoid the contagion of a few LABs failing causing a reputational risk for the others, causing a problem for all banks in the area for in the short term.

The LABs have not been tested under very diverse conditions, particularly in areas where the banking penetration was low; the monetization levels were low; the density of population was low; the road connectivity was not good; and commercial activities were low. The assumption of viability of LABs based on the performance of the existing four would not be appropriate. Areas like West Champaner, Shri Ganganagar, Keonjhar, Jagadalpur, Sidhi, had to be tested for viability. Going forward, this would be a significant issue.

9. Policy approach to small finance local area narrow banks: Recommendations

From the above discussions it was clear that a multiplicity of approaches were needed in order to ensure that the residual population of the country had access to organized and regulated financial services. A single approach would achieve some element of impact, but would still left elements uncovered. This is possibly why the Nachiket Mor committee observed that a centralized single idea approach was energetic, but "*its key weakness as well, because it has propelled highly engaged regulators and policy makers to move from one big idea to another, each time convinced that they have finally found the key to financial inclusion*"[29] Therefore it was imperative that newer forms of institutions were tried. While the LAB experiment came in along with the MFI initiatives in India, they were not impactful because they were not provided an environment to grow. The time has come for trying out multiple institutional forms – particularly small finance local area narrow banks.

There were some requirements in the eco-system for the differentiated banks to be permitted to operate. The regulator had to learn the hard way in case of MFIs on the effects of a weak regulatory architecture, or if the regulations were provided in response to a crisis.

[29] Reserve Bank of India (2014): Report of the Committee on Comprahensive Financial Services for Small Businesses and Low Income Households. Mumbai: RBI. p.4

If RBI was open to having specialised institutions, then the required ecosystem involved excellent database that helped in monitoring the customer base and avoid exploitation; a system that enabled taking informed policy decisions and reasonably good supervisory and regulatory apparatus. Above all the regulator needed tolerance for failure. The database was being built through the credit bureaus. The regulatory apparatus would be in only if RBI wanted to focus on this by setting up this structure or by enabling such a structure. The most difficult part was be to develop a tolerance for failure given the fact that poorer segments of the population would be involved and this would always invite political sensitivities.

From the reading of literature and interaction with experts it appeared that there was openness to re-opening the concept of specialised banks, particularly after the new governor assumed office with the RBI. The governor, in his earlier capacity as a chairman of the Committee on Financial Sector Reforms had strongly suggested that these issues had to be re-visited with adequate caveats. This was reinforced in his public speeches and also reflected in the recommendations of the Nachiket Mor committee.

Given the performance private sector LABs would work if provided with proper policy architecture. However this policy architecture had to address the issues and concerns raised by policy makers of the past as well as the critics of the policy.

Who should get the licence?

While the guidelines for setting up new LABs in 1996[30] indicated anybody, including a society, trust, a corporate body or a set of individuals could promote a LAB, with received wisdom, it made immense sense to have an ownership architecture that reduced any possibility of conflicts of interest. The first issue to be was whether NBFCs could convert themselves into LABs; or a set of promoters having interests in the financial sector should be allowed to promote LABs. The answer was available in the guidelines that were issued for next bank licences earlier last year;[31] and the later clarifications offered. LABS had to have minimal concessions for the types of promoters. However, whether the holding structure had to be similar as proposed to the commercial banks was a question to be considered. The system and structure could be much simpler.

With the larger objective of deepening, it would be desirable to rank the districts on the level of financial inclusion and start with promoters who would want to promote niche banks in areas/regions that had low penetration. Achieving a regional balance had to be an overarching consideration in granting a licence.

Our recommendation

a. Licences to be granted to promoters, corporates that demonstrate great rootedness and commitment to the local area;
b. Demonstrated financial solvency of the promoters.
c. Licencing based on indexation where areas that are underbanked get priority for LABs.

What should be the conditions of issue of licence?

The policy objective had to get translated into the terms on which the licences were to be given in future. Therefore, in addition to the background check of the promoters, the growth path for the niche bank had to be articulated. Unless this was done, there would be several applicants who would come in, and later request the central banker to incrementally dilute the objectives for the sake of profitability. Raghuram Rajan committee had suggested that there had to be some measures, over and above the measures taken for LABs for considering new small finance banks. These measures included capital adequacy norms, a strict prohibition on related party transactions, and lower allowable concentration norms (loans as a proportion share of capital that could be made to one party); creation of supervisory capacity to deliver the greater monitoring needed initially by these

[30] Reserve Bank of India (1996) Guidelines for setting up new local area banks in the private sector. RBI Notification dated 24th August 1996. Mumbai: RBI. Available at http://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/23726.pdf accessed on April 20, 2014.

[31] Reserve Bank of India (2013) Guidelines for licencing new banks in the private sector. RBI Notification dated February 22nd 2013. Mumbai: RBI. Available at http://rbidocs.rbi.org.in/rdocs/Content/PDFs/GFLNB2222013.pdf accessed on April 20, 2014.

banks and putting in place a tough and prompt corrective action regime that ensures these banks did not become public charges[32].

Our recommendations

a. While NBFCs could convert into banks, clear guidelines that there should be only one financial services business in the group in the geography. There cannot be overlapping financial services business in the area.
b. The area of operation to be defined somewhat dynamically – to cover a catchment area that is defined by population and physical area. It could be three large districts in one area as against six small districts in another.

Dealing with concentration risks

The biggest issue raised with the local banks with limited geographical area as a catchment was the issue of concentration risks. If successful co-operatives were studied, it would be found that co-operatives that survived for decades in spite of issues emanating out of concentration of a portfolio and also in spite of a regulatory assault (like loan waivers and interest write offs) did so because of some inherent diversification. To start with, most co-operatives had a "B" component of a crop loan, which got them some fertilizer business that fetched some commission income. Several co-operatives were operating multiple activities which helped them to cushion the possible loss with their inherently risky agricultural portfolio. This did not mean a recommendation that LABs should be fertilizer traders, but the question was, whether there is a way in which the inherent business could be diversified.

The corollary example to co-operatives was of RRBs. Historically, RRBs functioned better when they had size and they performed better when they had sizeable treasury income. Both these helped in diversification of their inherent concentration risks. However, whenever RRBs consolidated - their average customer size and loan size moved up. If their activities were to be deconstructed, it would appear that their business came predominantly from semi-urban rather than rural areas. Therefore any consolidation helped them to move more towards larger human habitations rather than the last mile.

The policy approach - to achieve inclusion – was to strictly restrict the area of operation of the narrow banks, so that they realised the growth potential within the restricted area, rather than spread wider and thinner. Offering new districts to existing LABs and consolidation of RRBs had the same effect –it diluted the inclusion and deepening agenda of the policy makers. Once the area was restricted, then the approach had to be almost hands off – for business generated in the local area, subject to the conditions of priority sector and other obligations. The other prudential norms on concentration at portfolio level and at customer level; asset liability management; and good risk management practices applicable to mainstream banks had to be applicable to these banks as well. The overall restriction in the area of operation would ensure that there was diversification of portfolio in the area and the growth happened through relationship building, deepening and having a greater understanding of the underlying economy. The branch licencing policy had to be on par with the other banks – putting them on par with the freedom to open branches, with the restriction applicable only to the area of operation.

Should the policy allow for spreading outside the original earmarked area? This question had to be addressed at a larger level. If the policy objective was to achieve inclusion and deepening, then the question to be asked before allowing expansion was whether the deepening and inclusion objective was achieved and if the existing area was saturated. Multiple indices on financial inclusion and deepening could be used to benchmark level of inclusion. These criteria could be articulated well in advance. Similarly the expansion into newer areas had to be calibrated in a manner that the expansion happened in districts that had a lower inclusion index than the LAB's existing area. These restrictions, provides an architecture under which the LABs operated. But the policy had to keep away from dictating anything operational or specific to the narrow banks that made it uncompetitive against the other players in the same area.

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[32] Government of India (2009): A Hundred Small Steps: Report of the Committee on Financial Sector Reforms, Planning Commission, Government of India. New Delhi: Sage Publications

An alternative approach for dealing with the concentration risk, (apart from diversifying the portfolio) was to permit these banks to hold financial assets that went beyond their area of operation. There were concerns expressed by the Ramachandran committee and some others on whether the niche banks would be able to manage these portfolios effectively, and particularly if they would have the internal capability to deal with it. The Ramachandran committee seemed to suggest that they would be able to manage this as they gained experience and became larger. This needed to be consideration.

Our recommendation

a. No expansion of area ever to be permitted, unless backed up by an application for a fresh licence with a different business plan – provided that such a licence would be on offer from RBI.
b. All banks to mandatorily insure their portfolios, irrespective of whether the underlying assets are insured/insurable or not.
c. All deployment of credit should be only in the local area, with a sufficient amount permitted to be deployed in the money market – to overcome concentration risk of the geography.
d. Banks not to be given scheduled status, so that they deal with local small and retail clients. The integration with the mainstream financial system would only be through clearing house, interconnection of ATMs, and investments in money markets. Otherwise LABS should be insulated and local institutions.

Dealing with failure

The biggest challenge for new niche banks was the approach to deal with failure. Both the discussion paper on the banking structure in India as well as the Nachiket Mor committee suggested that as a there was a need to develop a greater tolerance for failure and the policy approach should allow failures. The larger political situation made this difficult to implement – particularly given that a large part of the customer base was from the poorer sections of the society. However, this was a good time to examine the institutional architecture that dealt with failure – this included deposit insurance; the institutional arrangement to settle claims; and the quickness with which the failure was dealt with so that the contagion effect was minimised.

Our recommendation

a. Be vigilant during the early days and ensure quick mortality of doubtful cases.
b. Streamline of deposit insurance mechanism particularly in cases of liquidation.
c. Allow for failure.

Box 1

Field notes from Capital LAB

Capital LAB was set up in three districts that had the best banking penetration at the time, amongst the applicants who were issued in-principle approvals. Capital LAB started its operations in January 2000. It had 32 running branches, of which 15 were in rural, 12 semi urban, 3 urban and 2 metropolitan (Jalandhar and Hoshiarpur) locations. In addition they also had 10 'Suvidha Kendras' – extension outlets that serve the branches as outreach models. The bank operates on all seven days a week (except for Suvidha Kendras that operate six days). Almost all the branches have an on-site Automated Teller Machine (ATM), along with a couple of off-site ATMs, mostly on the site of the Suvidha Kendras.

If Capital LAB were to be examined from the intended perspective of **inclusion and penetration of banking**, then, by those standards, the districts chosen by Capital LAB were possibly not the most appropriate districts. However, if Capital LAB was examined in comparison with the numbers of the other private sector and public sector banks in the area, then the logic of how a LAB could contribute to the larger cause of inclusion even in a well banked area would be evident.

From the numbers given in Table 3 it was evident that the Capital LAB had performed on par, or better than most of the parameters on which the banks were usually evaluated. The main aspects that appeared in the performance was:

a. They had the ability to price the loan products at a lucrative interest rate. Capital LAB had the best Retrun on Advances adjusted to the cost of funds. While it's cost of funds were not the lowest, returns were better because they were able to price products according to the local condition and seek a premium because of the localized service.
b. In addition, they kept the non-performing assets (NPA) very low (a zero net NPA throughout) and the employee costs as a proportion of total costs were the lowest in the industry. According to the CEO of Capital LAB, a reason for low NPAs was because the relationship banking model adopted by them. The staff would be recruited locally; they would have a long tenure; and would move only when they were expected to accept higher responsibility. This went against the usual canons of banking where it was required that the staff as well as the portfolio be churned in order to avoid the development of vested interests. The principles applicable for large banks were possibly not appropriate for narrow and focused banks.

In addition to the parameters of profitability and performance benchmarked with the mainstream banks, it was important to look at the performance of Capital LAB[33] from the perspective of the expectations (please refer to **Table 3**). On deepening of banking to the under banked sector, the numbers given by Capital LAB indicated a much greater penetration than the national average. For instance as of March 2013 the achievements on Agriculture was about 32% percent of adjusted net bank credit as against a requirement of 18%. What was more important is that a large portion of this (29.9%) came from direct lending to agriculture, an area where the mainstream banks were struggling to achieve their targets. Overall the achievement on priority sector was 51.8% as against a national requirement of 40%. On the deposit side, the bank had about 32% of its savings accounts classified a no-frills savings accounts needing minimal balance and transactions.

[33] Based on the brief profile of the bank prepared by Capital LAB and submission made by Capital LAB to the Reserve Bank of India on the discussion paper on new bank licences. Jalandhar: Capital Local Area Bank, Mimeo.

The terrain of operations of Capital LAB was significantly different from the national averages and therefore any comparison with the national averages was not fair. Unfortunately the granular data for the banking system at the district level was not available to make a comparison. Irrespective of the detail, Capital LAB showed that banking was being deepened in the area, and the people had one more reliable outlet.

Capital LAB was technology enabled from its inception and is networked with the banking system through the Ru-Pay network. The upper-end customers were able to access financial services through their debit cards.

The broad approach taken by Capital LAB was as follows:

Open branches in places that are visible – largely on the main streets and highways, which created visibility

a. Break-even business for a branch was about 7 crores, which was usually achieved in about 2 years.
b. They recruited locally and gave a sense of ownership to the branch head for performance; monitored performance on a moving average on business rather than year-end achievements; had a system of financial and non-financial incentives for generating business and had clearly identified matrices that were communicated to the staff.

The performance of Capital LAB over its 14 years of existence indicated that there was reason to believe that specialised narrow banks with specific areas would work. However, it was not possible to test for the following conditions:

a. If the bank got scheduled status; was eligible to refinance; could handle government schemes; and subjected itself to being a routing agency for agricultural loans that had subventions both from the Central and State governments, would the credit culture continue in an environment of freebies and waivers?
b. Would the bank be as effective and as tightly controlled and monitored once it moved into two or three more large districts. Expansion would reduce the concentration risk, but take the "narrow" nature of banking out and would need more systemic controls rather than controls imposed through work ethic and work norms and cultural practices?
c. Would the nature of investments flowing in to the bank change with this possibility of increase in area and business and move to more mainstream investors?
d. Would the bank become vulnerable to greater protection from the RBI as the contagion of a risk of failure increases?

These questions had to be addressed when there were proposals of migrating a local bank into a regional sphere. Sufficient data and experience was not available on how this would pan out on ownership structure, management, governance and internal control systems.

Table 3: Benchmarking Capital LAB with the Banking Sector, 2012-13 (Rs. in million)								
Details	**Banking Sector**	**Nationalised Banks**	**State Bank Group**	**Old PVt Sector Banks**	**New Pvt Sector Banks**	**Foreign Bank**	**RRBs**	**Capital LAB**
No. of offices	92114	54478	21301	6283	9718	334	17564	29
No. of employees	1096984	507694	293965	66208	203733	25384		450
Business per employee	121.33	142.23	101.97	97.24	93.03	217.33		35.3
Profit per employee	0.83	0.65	0.60	0.75	1.18	4.56		0.278
Capital, Reserves & Surplus	7089300	2832832	1253189	330127	1599334	1073817	31600	712.8
Deposits	74295324	41272523	16184449	3738964	10219391	2879997	2064000	9777.8
Investments	26132752	12861079	4729979	1344993	4916070	2280631	45830	3131.63
Advances	58797025	30935500	13792240	2699373	8733113	2636799	1366900	6031.8
CD Ratio	79%	75%	85%	72%	85%	92%	66%	62%
Interest income	7636115	3911088	1637677	399275	1265589	422486	196000	1108.3
Other income	977866	370370	197442	41452	256475	112127	12000	85.4
Interest expended	5138027	2813956	1065334	278598	792733	187406	118000	710.3
Operating expenses	1565855	647182	370940	77459	327392	142882	54	310.97
Net Interest Margin	2.79	2.39	2.98	2.94	3.30	3.89		3.72
Cost of Funds (CoF)	6.12	6.39	5.96	7.27	5.77	4.05	5.59	5.50
Return on advances adjusted to CoF	4.21	3.76	3.93	4.88	5.57	5.50	3.00	6.42
Wages as % to total expenses	13.02	11.81	16.20	12.28	11.40	18.22	20.97	13.62
Return on Equity	13.84	12.34	15.29	16.22	16.51	11.52		18.8
Return on Assets	1.03	0.74	0.88	1.26	1.74	1.94		1.17
CRAR	13.88	12.26	12.67	13.73	17.52	17.88		15.58
Net NPA ratio	1.68	2.00	2.04	0.77	0.45	1.01		0

Source: Capital LAB Data from the *Annual Report of Capital Local Area Bank*; RRB Data from *Trend and Progress of Banking in India 2013* (RBI, 2013) and *Statistical Tables Relating to the Banking Sector in India* (RBI 2013); Data for other banks are from *A Profile of Banks 2013* (RBI 2013)

Annexure 1

List of people who were consulted in preparing this report:

Personal Meetings:

1. Vijay Mahajan, Chairman BASIX Group
2. Sarvjit Singh Samra, MD, Capital LAB
3. Dinesh Gupta, Director, Capital LAB
4. Amardeep Samra, MD, Midland Microfinance
5. Shyamala Gopinath, former Deputy Governor, RBI

Telephonic Conversations

1. YV Reddy, Chairman 14th Finance Commission and former Governor RBI
2. Usha Thorat, Former Deputy Governor, RBI
3. YSP Thorat, Former Chairman, NABARD
4. Vijay Nadkarni, MD KBS LAB
5. AV Sardesai Former Executive Director RBI (in charge of RPCD and a member of the Ramachandran Committee)

Field Visits

Capital LAB Headquarters and

Branches at:
Jamsher (Rural)
Samrai (Rural)
Malsian (Rural)
Shankar (Rural)
Nakodar (Semi-Urban)

Suvidha Kendra at
Daduwal (serves branch at Samrai)
Poonia (serves branch at Lohian)

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