

Banking Structure in India - The Way Forward

Discussion Paper



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Executive Summary

1. The existing banking structure in India, evolved over several decades, is elaborate and has been serving the credit and banking services needs of the economy. There are multiple layers in today's banking structure to cater to the specific and varied requirements of different customers and borrowers. The banking structure played a major role in the mobilisation of savings and promoting economic development. In the post financial sector reforms (1991) phase, the performance and strength of the banking structure improved perceptibly. Financial soundness of the Indian commercial banking system compares favourably with most of the advanced and emerging countries.

2. Since 1991, the size of the Indian economy in terms of GDP at market prices has increased by almost fifteen times, whereas the household financial savings have expanded by sixteen times and the gross domestic savings by almost seventeen times during the same period. The economic structure diversified substantially and the economy has been opening up and getting increasingly integrated with the global economy. As the real economy is dynamic, it is imperative that the banking system is flexible and competitive to cope with multiple objectives and demands made on it by various constituents of the economy. From the financial inclusion perspective too, there is a pressing need to extend the reach of financial services to the excluded segments of the society. Viewed from this perspective, today's banking structure in India has both the need and scope for further growth in size and strength.

3. Many jurisdictions, world over have taken up the task of reviewing their banking systems with a view to strengthen them based on the lessons from the global crisis. While the primary motivation for the current exercise of reviewing the Indian banking structure is to cater to the needs of a growing and globalizing economy as well as deepening financial inclusion, it is important to incorporate lessons from the global crisis, even when the Indian banking system has remained largely unaffected by the global crisis. The

Discussion Paper has therefore taken into consideration the specific requirements of the Indian economy as well as the lessons learnt from the global crisis particularly relating to banking structure while reviewing the Indian banking structure.

4. The Discussion paper has identified certain building blocks for the revised banking structure with a view to addressing various issues such as enhancing competition, financing higher growth, providing specialized services and furthering financial inclusion. It also emphasizes the need to address the concerns arising out of such changes with a view to managing the trade off for ensuring financial stability. The issues considered are as under:

- (i) ***Small banks vs. large banks:*** There is an ongoing debate on whether we need small number of large banks or large number of small banks to promote financial inclusion. Small local banks with geographical limitations play an important role in the supply of credit to small enterprises and agriculture. While small banks have the potential for financial inclusion, performance of these banks in India (LABs and UCBs) has not been satisfactory. If small banks are to be preferred, the issues relating to their size, numbers, capital requirements, exposure norms, regulatory prescriptions and corporate governance need to be suitably addressed.
- (ii) ***Universal Banking:*** With the failure of many investment banks during the crisis, the universal banking model remains the dominant and preferred model in most of the post crisis world. The structural reforms in Europe (Vickers and Liikanen) and US (Volcker) have implications for the existing banking structures which need to be factored in any discussion on banking structure in India. In India, the universal banking model is followed with banks themselves as holding companies. However, under the universal banking model, the Financial Holding Company (FHC) structure has distinct advantages and may be a preferred model. Additionally, in a changing economic environment, there is a need for niche banking and differentiated licensing could be a desirable step in this direction, particularly for infrastructure financing, whole sale banking and retail banking. There is also a need to promote investment banks/ investment banking activities.
- (iii) ***Continuous authorisation:*** There is a case for reviewing the present ‘stop and go’ or ‘block’ bank licensing policy which promotes rent seeking and considering ‘continuous authorisation’ of new banks. Such entry would increase the level of competition, bring new ideas and variety in the system.

However, it is important that the entry norms should be stringent. Authorities should seek to facilitate and encourage entry by only well-qualified entities in order to improve the quality of the banking system and promote competition.

- (iv) ***Conversion of UCBs into commercial banks:*** In the context of extending banking services, there is a case for exploring the possibilities of converting some urban co-operative banks into commercial banks/local area banks or small banks. These banks, freed from dual control and with more avenues to raise capital, could extend banking services in the regions characterised by poor banking outreach.
- (v) ***Consolidation:*** The issue of consolidation in the banking sector has assumed significance, considering the need for a few Indian banks to cater to global needs of the economy by becoming global players. Consolidation in the banking sector may pave the way for stronger financial institutions with the capacity to meet corporate and infrastructure funding needs. Taking into account the pros and cons of consolidation, it has to be borne in mind that while consolidation of commercial banks with established synergies and on the basis of voluntary initiatives is welcome, it cannot be imposed on banks. Nevertheless, a measured approach is to be made both on consolidation and global presence even if attaining global size is not imminent.
- (vi) ***Presence of Foreign Banks in India:*** In view of the inherent potential for sustained growth in the domestic economy and also growing integration into the global economy there needs to be commensurate expansion in the presence of foreign banks in India. However, post crisis, the support for domestic incorporation of foreign banks through the subsidiarisation route has acquired importance. Comprehensive policy in this regard is being proposed.
- (vii) ***Indian banks' presence overseas:*** Indian banks are allowed to expand overseas under a policy framework of Reserve Bank of India and Government of India. Indian banks abroad are facing challenges due to a highly competitive environment, enhanced regulation, more intensive supervision and growing emphasis on ring fencing of operations in host jurisdictions in the wake of the crisis. The way forward could be, apart from Representative Office and branch form of presence overseas, local incorporation by large banks either individually or in joint venture mode with other banks or with overseas banks. This will enable the large Indian banks to engage in a much wider range of activities and have greater potential for growth. Eventually this may facilitate banks increasing their global reach.

(viii) Government Ownership: On the ownership issues, proponents of private sector banks advocate that Government should reduce its ownership stake in the public sector banks as private sector banks score over public sector banks in profitability and efficiency. However, broadly over the years, the performance of public sector banks has converged with that of new private sector banks and foreign banks. On one hand, the predominance of government owned banks in India has contributed to financial stability, on the other, meeting their growing capital needs casts a very heavy burden on the Government. What is, therefore, needed is an optimal ownership mix to promote a balance between efficiency, equity and financial stability. Going forward, there is a better pay-off in enabling PSBs to improve their performance while promoting private sector banks. As regards the reduction in fiscal burden on account of recapitalisation of the Public Sector Banks (PSBs), it can be achieved by considering issue of non-voting equity shares or differential voting equity shares. Government could also consider diluting its stake below 51 per cent in conjunction with certain protective rights to the Government by amending the statutes governing the PSBs. Another alternative would be to move to a Financial Holding Company (FHC) structure.

(ix) Deposit Insurance and resolution: The crisis has brought into sharp focus the need for effective deposit insurance and resolution regimes to deal with the failing/failed banks with least cost. In India, failures of commercial banks have been rare, and the beneficiaries of the deposit insurance system have mainly been the urban co-operative banks. The FSB key attributes could be the guiding principles for setting up a resolution framework in India. The existence of an effective resolution regime is essential for any type of banking structure India may pursue.

5. Once the relevant policies are appropriately liberalised, possibly, a reoriented banking system with distinct tiers of banking institutions may emerge. The first tier may consist of three or four large Indian banks with domestic and international presence along with branches of foreign banks in India. The second tier is likely to comprise several mid-sized banking institutions including niche banks with economy-wide presence. These are capable of offering a broad range of banking products and services to the domestic economy such as investment banking, wholesale banking and funding large infrastructure projects. The third tier may encompass old private sector banks, Regional Rural Banks, and multi state Urban Cooperative Banks. The fourth tier may embrace many small privately

owned local banks and cooperative banks, which may specifically cater to the credit requirements of small borrowers in the unorganised sector in unbanked and under banked areas.

6. It is recognised that a dynamic and externally competitive real economy can be served better by a responsive banking system. While there can be no ideal 'one-size fits all' banking structure as such, it is recognised that a banking system should not only be able to meet the needs of the economy, but also be resilient enough to withstand shocks and promote financial stability. The envisaged policy will have to be in the backdrop of a strong regulatory and supervisory regime with increased intensity of supervision for the systemically important banks. The reoriented banking system with a continuum of banks may also help to improve the efficiency of the monetary policy transmission mechanism.

Chapter 1

Introduction

1.1 The financial sector, with banking sector at its core, owes its existence to the real sector and assists its progress. However, the recent global financial crisis has demonstrated that the financial sector had expanded out of alignment with the real sector which led to the precipitation of the crisis. With the lessons learnt from the crisis, many countries have been reviewing their banking structures post crisis.

1.2 It is important to review the banking structure in the Indian context also with a view to enabling the banking sector to cater to the needs of a growing and globalizing economy as well as furthering financial inclusion. While this is the primary motivation of this exercise as Indian banks came out relatively unscathed from the crisis, it is equally important to factor in the lessons learnt from the crisis, particularly on structural issues.

1.3 An exercise to review the structure of banking is not new in India. Earlier, in this context, a number of expert committees in India have gone into the structural issues pertaining to the Indian banking system. Against this setting, the Discussion Paper reviews the current banking structure in India and the structural issues thrown up by the crisis, particularly, in the advanced economies. The Paper also intends to stimulate informed discussions on making the banking system more dynamic and competitive to meet the emerging needs of a growing and increasingly open economy as well as make it more responsive from the perspective of financial inclusion.

Motivation

1.4 The existing banking structure in India, evolved over several decades, is elaborate and has helped to serve the credit and banking services needs of the economy; there are multiple layers to cater to the specific and varied requirements of different customers and borrowers. Undoubtedly, India's banks have played a major role in the mobilisation of savings and have promoted economic development.

1.5 Several Committees¹ on the Indian banking sector over the course of the past two decades had facilitated significant changes in the then extant banking environment. The sector and the enveloping economic environment have since continually and progressively changed, with accompanying changes in the structure of financial markets, which are now different from earlier times by orders of magnitude.

1.6 Much of the previous thinking regarding financial markets has been changed by the events during the global financial crisis, with the consequent need for a fresh assessment of financial and banking sectors, including institutional and regulatory structures. In addition, changes in regulatory requirements and approach envisaged by Basel III, requiring increased analytic and risk assessment capacity in banks, call for a fresh look at the desired and optimal contours of a dynamic banking sector.

1.7 Despite significant progress, one aspect of banking in India that requires deeper analysis is the still inadequate coverage of the banking and financial sectors. It is instructive that even with 157 [26 Public Sector Banks, 7 New Private Sector Banks, 13 Old Private Sector Banks, 43 Foreign Banks, 4 Local Area Banks (LABs), 64 RRBs] domestic banks operating in the country, just about 40 per cent of the adults have formal bank accounts. Deepening the engagement of formal banking for low income households and providing access to the unbanked will require increasingly innovative approaches (including channels, products, interface, etc.).

1.8 Part of the improved engagement is to ensure enhanced access to credit for small and medium enterprises (SMEs), which are expected to be the major contributors to future growth and employment creation. Credit to SMEs will require an innovative combination of banks, private equity, with a potential role of state in providing credit enhancement

¹ Committee on Financial Sector Reforms (Chairman: Shri M. Narasimham) 1991; Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) 1998; Report of the Committee on Fuller Capital Account Convertibility (Chairman Shri S.S. Tarapore) 2006; and Report of the Committee on Financial Sector Reforms (Chairman: Shri Raghuram G. Rajan) 2009.

mechanisms/ solutions. At the other end of the credit spectrum is infrastructure finance, with a requirement of large ticket, long maturity funds, and appropriate mechanism for allocating risks to intermediaries and stakeholders best suited to intermediate and/or hold them.

1.9 Credit Bureaus with extensive databases and credit scoring analytics have increasingly enabled banks to finance India's growing demand for consumption, while maintaining a reasonably high asset quality in the retail segment. Increasing incomes and aspirations will drive demand for retail credit; at present retail credit penetration in India is amongst the lowest in the peer group of emerging market countries.

1.10 Many of these 'capabilities' might be expected to develop endogenously; but some might require policy or regulatory intervention for increasing scale. Some aspects of the regulatory structure may (inevitably) need to be revisited to achieve multiple objectives with different costs and risk – reward tradeoffs. One of these is to assist the introduction of innovative instruments, to enable diverse types of institutions in achieving the desired objectives, through market mechanisms which price the provision of relevant services.

1.11 Since the Indian economy is dynamic, the banking system needs to be flexible and competitive in the emerging milieu. An approach that balances flexibility with effective oversight may be an unexceptionable principle to inform potential steps and requisite changes. Competition is the touchstone, which has increasingly informed the discussion on the future landscape of the financial sector. Competition can be effective in producing desired outcomes if accompanied by a level playing field for all participants; it diminishes the scope to price discriminate, whereas a level playing field reduces the ability to game the system, or both. Furthermore, some of the current mandated requirements might be supplemented with incentives if a sufficiently competitive financial sector were to emerge.

1.12 It may be mentioned that in the Monetary Policy Statement 2013-14, issued on May 3, 2013, the Governor, Reserve Bank of India announced that the Bank will review the extant Banking Structure in India. In this context, the Reserve Bank has decided to prepare

a policy Discussion Paper keeping in view the recommendations of, *inter alia*, the Committees on Financial/Banking Sector Reforms, 1991 and 1998 (Chairman: Shri M. Narasimham), the Committee on Financial Sector Reforms, 2009 (Chairman: Shri Raghuram G. Rajan) and a few other relevant viewpoints. It was explicitly stated that the Discussion Paper would discuss issues such as

- Consolidation of large-sized banks with a view to having a few global banks;
- Desirability and practicality of having small and localised banks as preferred vehicles for financial inclusion;
- The need for having investment and other specialised banks through ‘differentiated licensing’ regime for domestic and foreign banks instead of granting of universal banking license;
- Policy regarding presence of foreign banks in India;
- Feasibility of conversion of urban cooperative banks into commercial banks; and
- Periodicity of licensing the new banks – ‘ad hoc issue’ or ‘continuous licensing’.

Chapter 2

Banking Structures – Theoretical Aspects

2.1 A number of studies have sought to examine whether the nature of the financial structure matters for the economic growth of a country. While some studies have suggested that financial structure did not matter for economic growth, the others studies establish that the structure of the financial system can matter for growth. In this debate, Rajan and Zingales (1998) observed that rather than the nature of financial structure, it is the financial system's overall level of development that matters for growth. Empirical research on the comparative merits of 'bank-based' and 'market-based' financial systems has centered on Germany and Japan as 'bank-based systems' and the United States and the United Kingdom as 'market-based systems'. Despite their differences various models exhibit similarities.

Appropriate Banking System

2.2 Jaffe and Levonian (2001) argue that the demand for banking services varies across economies and is dependent on economic, demographic and geographic features of each country. Available literature highlights a few strands of thinking, which are relevant to the debate on what is an appropriate or optimal banking structure for an economy. **Strand 1** The institutional theory, as discussed by DiMaggio and Powell (1983), which examines the factors that influence organisations to change their performance and the responses as per the demands made on them. **Strand 2** The work of Lin, Sun and Jiang (2009) mentions about the 'factor endowment' in an economy at each stage of its development, which determines the optimal industrial structure in the real sector. This in turn constitutes the main determinant of the size distribution and risk features of viable enterprises with implications for the appropriate institutional arrangement of financial services at that stage. **Strand 3** According to Reid (2010), some financial structures may be better suited to growth at certain stages of development but they may be less well suited in other circumstances. The above thinking points out to the fact that developments in the

macroeconomic environment and structural changes in the economy are crucial variables that may decide the banking structure and the changes in it required from time to time.

2.3 Drawing on the above thinking and the relevant literature one can visualise that changes in banking structures are influenced mainly by developments in the macro-level environment in which banks function. As the real economy evolves and structural changes take place, the need for large quantum and type of finance and services required by various entities also varies. It is very hard to say with certainty if there is an optimal size and if there is, what it might be. If one definition of the optimal size is that all borrowers and lenders find access to financial intermediation on their preferred conditions, then there may never be an optimal size, as this will always be changing and there will always be leads and lags involved in the adjustment process. Perhaps a more fruitful approach is to think instead about the degree to which the financial system is suited to the current needs of the real economy. In sum, an appropriate or optimal banking structure is one, which evolves in such a way that it accommodates the changing requirements of various constituents of the economy.

2.4 The broad functions and objectives of the banking structure can be similar across countries. But, globally, one can see different models of banking structures, different ownership patterns, and different emphasis on size of the banks. Country-level studies show that small, regional and local banks may perform very differently from large banks. Greater access to local information, greater commitment to local prosperity, differences in costs and risk management, and competition policy could explain the specific influence of such type of banks on local economic development. In developing countries where economic development is hampered by insufficient and inadequate access to financial services in rural areas, local banks could improve financing opportunities to small and medium size enterprises and encourage entrepreneurship. Economies at different stages of development require different blends of financial services to operate effectively. Depending upon the structure and needs of an economy, the country's banking system should be dynamic and competitive to cater to the diverse needs of the economy.

Chapter 3

Macroeconomic Environment and the Indian Banking System

3.1 India has a large bank-dominated financial system. Over the decades, the macroeconomic environment in which the banking structure traversed and functioned has changed significantly. On account of various policy initiatives and reform measures, resilience of the Indian banking system has improved over the years and it was able to withstand adverse economic and financial conditions from time to time. The muted impact of the global crisis on the Indian banking system stands testimony to this fact. However, viewed from the perspective of the growth in the size of the economy and diversified needs, the present structure may need to be reoriented to further increase its capacity to serve the economy better.

The Rationale for Reorientation of the Indian Banking Sector

3.2 The Indian banking sector has come a long way since independence, more so since the nationalisation of 14 major banks in 1969 and 6 banks in 1980. There has been a substantial increase in banking business over the years, captured by the ratio of banking business (credit plus deposits) to GDP. The test for structural breaks suggested three breaks in the series of ratio of banking business to GDP, which coincided with the major changes in the banking landscape *viz.*, bank nationalisation of 1969, initiation of economic and banking sector reforms in the early 1990s, and the high growth phase of the 2000s (Chart 1 in *Annex I*). Over the years, the reach of banking has widened significantly to include relatively under-banked regions, particularly in rural areas. Commercial bank credit as per cent of GDP picked up steadily from 5.8 per cent in 1951 to 56.5 per cent by 2012. The population per bank branch came down from 64,000 in 1969 to 12,300 in 2012 (RBI, 2013).

3.3 The key feature that distinguished the Indian banking sector from the banking sectors in many other countries was the fostering of different types of institutions that catered to the divergent banking needs of various sectors of the economy. Credit

cooperatives were created to cater to the credit, processing and marketing needs of small and marginal farmers organised on cooperative lines. Cooperatives expanded also in urban and semi-urban areas in the form of urban cooperative banks to meet the banking and credit requirements of people with smaller means. Regional Rural Banks were created to bring together the positive features of credit cooperatives and commercial banks and specifically address credit needs of backward sections in rural areas. Further, there was an experiment of establishing Local Area Banks, *albeit* on a smaller scale, to bridge the gap in credit availability and strengthen the institutional credit framework in the rural and semi-urban areas.

3.4 While fostering a multi-tier structure, the regulatory effort has been to ensure stability and soundness by addressing weaknesses as and when they arose. The soundness of the system was evident from the way it withstood the recent financial crisis, even as the banking systems in many countries across the world were adversely affected.

3.5 Notwithstanding the development of various types of banks, Indian banking sector is yet to meet the desired banking penetration and inclusion as witnessed in most advanced and some of the emerging economies. Based on data given in Basic Statistical Returns, it is estimated that rural India had only 7 branches per 1,00,000 adults in 2011 in sharp contrast with most of the developed and even BRICS economies having over 40 branches. Regionally, north-eastern, eastern and central regions are more excluded in terms of banking penetration.

3.6 As the Indian economy expands with increasing focus on manufacturing and infrastructure, the credit intensity is higher and more resources will be needed for supporting the growth process. In order to support an annual economic growth of 8 per cent, as envisaged by the 12th Five Year Plan, banking business needs to expand significantly to an estimated ₹. 288 trillion by 2020 from about ₹. 115 trillion in 2012 (Chart 2 in *Annex I*).

3.7 Expansion of the existing banking business requires additional capital support. Indian banking is dominated by the public sector, which accounted for about 73 per cent of total assets of the banking sector at end-March 2012. Hence, an important way to achieve an expansion in capital of the banking sector, while managing fiscal consolidation, would be to widely distribute the ownership stake in banking. The ways to achieve this could be to bring down the floor of public stake in the banking sector to 33 per cent from the existing 51 per cent, issue of non-voting or differentiated voting shares or go in for structural change by setting up Financial Holding Company.

3.8 A cross-country comparison using the World Bank Financial Sector Database with several other economies, which have bank-dominated financial systems, reveals that banking sector in India is yet to match the size and outreach of the banking sector as prevailing in various other comparable economies. Further, given the fact that there is a large unbanked population in the country and a large informal sector that still does not have access to the formal banking sector, there is considerable scope for the expansion of India's banking sector. This would also require greater presence of private entities at national and local levels. An assessment of the overall performance of the Indian banking structure *vis a vis* its core functions has been given in *Annex II*. The assessment and comparison with other economies brings to the fore the need for imparting dynamism through expanding the commercial banking system in terms of its size and number of banks; need for expanding smaller banks in unbanked and under banked areas; need for focus on consolidation; need to relax barriers to entry for improving competition; and the need for enhancing operational efficiency.

Gaps in the Flow of Credit

3.9 A high proportion of socially and economically underprivileged sections of society in India is concentrated in the informal economic activities. This sector holds importance due to growing interlinkages between informal and formal economic activities. Fostering a speedy and inclusive growth warrants special attention to informal economy as well. Sustaining high levels of growth is, therefore, also intertwined with demand of those

engaged in informal economy, and addressing the needs of the sector in terms of credit, skills, technology, marketing and infrastructure. Available data indicate that the cooperatives, commercial banks, and other formal financial sector programmes in rural areas have not displaced informal sources of credit altogether as 43 per cent of rural households continue to rely on informal finance in 2002, when the last All India Debt and Investment Survey was undertaken (Table 1 in *Annex I*). One way of bridging the gap is through creation of more small privately owned banks with local character to take care of the credit needs of the unorganised and small sector.

Recent Thinking on Banking Structure

3.10 The issue of structural changes to the banking system has been examined by a number of Expert Committees in the recent past. These Committees suggested various approaches towards reforming existing banking structure. The Committee on Financial Sector Reforms (Chairman: Shri M. Narasimham), 1991; the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham), 1998; the Committee on Fuller Capital Account Convertibility (Chairman: Shri S.S. Tarapore), 2006; and the Report of the Committee on Financial Sector Reforms (Chairman: Shri Raghuram G. Rajan), 2009 have dealt extensively about the need for structural reforms in the Indian banking system. While the suggestions of these Committees may vary in nature, the distilled wisdom behind the recommendations is unambiguous.

3.11 The recommendations of some of these Expert Committees favoured consolidation in the Indian banking structure to create well-capitalised, automated and technology-oriented banks through mergers and acquisitions; fostering competition in the banking structure through permitting more private sector banks; setting up of small banks with local character to cater to the requirements of rural and unorganised sectors; more active foreign banks participation; strengthening of the existing structure through enhancing appropriate risk management capabilities; and putting in place legal, insurance, resolution and prudential measures to enable the banking structure to discharge its core functions in an efficient and inclusive manner.

Chapter 4

Small Banks and Financial Inclusion

4.1 There has been a long standing debate on whether large banks with their financial strength and resources and ability for greater reach are better vehicles for financial inclusion than the small banks with limitations in these aspects but having ‘local feel’ and cultural synergy with the local population. In other words, whether we need small number of large banks or large number of small banks to promote financial inclusion? It is undeniable that small banks play a very important role in the supply of credit to small business units, small farmers and other unorganized sector entities. The need and the relevance of small banks have been debated in India from time to time and accordingly, various initiatives were put in place to promote small banks geared towards small borrowers. As on March 31, 2013, there were 64 RRBs (consolidated from 196 RRBs originally set up), 1,606 urban co-operative banks (UCBs), 31 State co-operative banks (StCBs), 371 district central co-operative banks (DCCBs), 20 State Cooperative Agriculture and Rural Development Banks (SCARDBs) and 697 Primary Cooperative Agriculture and Rural Development Banks (PCARDBs).

Cross-country experience

4.2 The United States has got a banking structure comprising both big banking institutions, hand in hand, with small community banks focusing on specific geographical areas. Small community banks form a very important segment of the US banking system, though they account for a very small share of the total banking assets of the country. These banks are closely tied to the local communities and focus on mainly ‘relationship banking’.

4.3 In the US, there are about 7,000 small community banks with asset size ranging from less than US \$10 million to US \$10 billion or more. They account for about 46 per cent of all small loans to businesses and farms and in terms of the number, they constitute about 92 per cent of the all the FDIC insured institutions (FDIC, 2013).

4.4 Enactment of the Mutual Banks Act of 1993 in South Africa was an attempt to add depth to the financial system by creating a banking category that had less stringent capital adequacy prerequisites but similar risk management requirements. In an attempt to ensure effective financial inclusion following the perceived failure of the commercial banks and the state-owned development banks in Nigeria, over 1,400 community banks were set up in both rural and urban areas.

4.5 In Indonesia, the banking system is multifarious, with simultaneous existence of commercial banks in big cities, branches of provincial banks in small towns, the Unit Desa (village banks) of Bank Rakyat Indonesia (BRI), the local small banks, cooperative banks and private rural banks.

4.6 The pros and cons of encouraging small banks as preferred vehicles for financial inclusion are as under:

Pros:

- i) Small banks have a small capital base and therefore lend to small borrowers.
- ii) Banks with limited area of operation would require less infrastructure and staff and, hence, the operational expenses would be low.
- iii) Small banks would help improve penetration of banking sector to unbanked areas and mobilize resources.
- iv) Such banks are expected to extend basic banking services and, therefore, would attract people of small means who would require basic banking services.
- v) Their operations are confined to a district or few contiguous districts and hence they would be in a better position to understand the needs and priorities in their area of operation. They would be able to explore business potential more tailored to the socio economic background in the area of operation and extend banking services to the people in that area. For instance, community banks in the US transform local deposits into loans to communities where depositors live and work (Daniel Tarullo, 2010).
- vi) Small banks may develop core competence through relationship banking in financing agriculture, SMEs, industries, in a particular geographical area, and, thereby, able to serve their credit needs better. Illustratively, community banks in the US, which are locally owned and grounded in their communities, are able

to provide services that are personalized and tailored to meet local preference and needs. Community banks thus epitomize the notion of relationship banking. (Daniel Tarullo, 2010).

- vii) Small banks have simple structures. Their failure will have less contagion effects and resolution would be easier.

Cons:

- i) Small banks are potentially vulnerable to sector and geographical concentration risk. For instance, community banks in the US suffered losses due to their excessive reliance on lending to commercial real estate (Daniel Tarullo, 2010).
- ii) Small banks are vulnerable to shocks from the local economy and hence require higher level of CRAR.
- iii) Small banks cannot finance big-ticket investments, including infrastructure.
- iv) They lack economies of scale and scope.
- v) Small banks are prone to capture by local influence.
- vi) There are some recent studies arguing that instead of relationship banking, which is generally followed by small banks, lending practices adopted by big banks - involving arms-length lending approaches and centralised organisational structures - could have a comparative advantage (Oxford Handbook, 2010a).
- vii) A large number of small banks put pressure on the supervisory resources of the central bank.

4.7 On balance, however, it would seem that small banks do embody the potential for furthering the cause of financial inclusion.

Indian Experience with small banks

Experience with LABs

4.8 Following an announcement by the then Finance Minister in the August 1996 Budget, the concept of Local Area Banks (LABs) was conceived as low cost structures and for providing efficient and competitive financial intermediation services in their areas of operation in the rural and semi-urban areas. The Scheme envisaged a Local Area Bank with a minimum capital of ₹. 5 crore² and an area of operation comprising three contiguous districts. Six LABs were licensed by RBI, of which 2 were closed down due, *inter alia*, to

² 100 crore = 1 billion

mismanagement and only 4 are functioning. The overall performance of functioning LABs is less than satisfactory as they have become high cost structures. The cost income ratios of the 4 LABs ranged from 58.24 per cent to 87.20 per cent as on March 31, 2012.

4.9 The LAB model has inherent weaknesses owing to their small size and concentration risk. This has resulted in unviable and uncompetitive cost structures, adverse selection, constraints in attracting and retaining professional staff /management due to locational disadvantage.

Experience with UCBs and other small banks

4.10 There has been a phenomenal growth in the UCB sector since 1966 in terms of number of banks, volume of banking business (deposits plus loans and advances), and geographical outreach. At the same time, low capital base, lack of professional management, poor credit management and diversion of funds have led to multi-faceted problems. In the absence of technology platform in the UCBs, they have not been able to leverage their potential for financial inclusion.

Views of various Committees on small banks in India

4.11 Notwithstanding the above-mentioned poor performance of small banks in India, various Committees have made out a case for small banks. Among the various studies, reports authored by Dr. C. Rangarajan and Dr. Raghuram G. Rajan have been influential.

4.12 The Committee on Financial Inclusion (Chairman Dr. C Rangarajan) has, *inter alia*, observed in January 2008 that keeping in view the inherent potential of LABs, RBI may consider revisiting the same and keep the option open to allow new LABs to come into operation, especially in districts / regions manifesting high levels of exclusion without compromising on regulatory prescriptions. LABs can integrate well with local financial markets and offer a host of financial services including savings, credit, remittances, insurance, etc.

4.13 The Committee on Financial Sector Reforms (Chairman: Dr. Raghuram G. Rajan), 2009 examined the relevance of small banks in the Indian context. The Committee opined that there has been sufficient change in the environment to warrant experimentation with licensing small banks. In view of the fact that the failure of even a few small banks will not have systemic consequences, it recommended allowing more entry to private well-governed deposit-taking small finance banks (SFBs) offsetting their higher risk from being geographically focused by requiring higher capital adequacy norms, a strict prohibition on related party transactions, and lower allowable concentration norms. Further, the Committee suggested implementation of a strong prompt corrective action regime so that unviable cooperatives are closed, and recommended that well-run cooperatives with a good track record explore conversion to a small bank, with members becoming shareholders. The Committee suggested the following features for small banks:

- i) Small banks should have some leeway to decide where they will grow and what they will focus on.
- ii) It would be appropriate to restrict the initial license to a certain maximum number of branches and asset size, with these restrictions removed after a review of performance.
- iii) To facilitate appropriate diversification and smaller loan ticket sizes, their exposure limits would be set at a lower fraction of capital than for SCBs, allowing them to increase ticket sizes as they grow.
- iv) Initial total required capital should be kept at a low level, consistent with the initial intent behind LABs.

Small banks and financial inclusion: The Way forward

4.14 As explained above, while small banks have the potential for financial inclusion, performance of the small banks in India (LABs, RRBs and UCBs) has been unsatisfactory. There are fundamental weaknesses inherent in the business model of small banks, such as, narrow capital base, restrictive geographical jurisdiction, lack of diversification in source of funds and the concentration risk.

4.15 Essentially, therefore, whether small banks would be preferable to large banks for catering to the needs of financial inclusion is a matter of policy. Further, it is possible that in the event of an increase in the number of small banks, there may be an overall increase in the number of bank failures given the inherent vulnerability of the small banks. For instance, between January 2008 and December 2011, 414 insured U.S. commercial banks and thrifts (banks) failed. Of these, 85 percent (353) were small banks with less than \$1 billion in assets [Lawrence L. Evans (2013)]. While common underlying causes for failure were excessive credit growth and non-performing real estate loans, the fact that these causes led to large-scale failure among the small banks indicate that they are more vulnerable to shocks than others.

4.16 There may be a need for greater tolerance from political economy perspective of higher mortality and a robust resolution framework and quick settlement of deposit insurance claim. At present, procedures involving bank liquidations is a long-drawn process in India. There are a number of bank liquidation proceedings underway, which have been pending for many years. Similarly, settlement of deposit insurance claims takes inordinately long time. With a view to reducing hardship to small depositors, the Deposit Insurance and Credit Guarantee Corporation has been taking various steps to ensure quicker settlement of deposit insurance claims.

4.17 In sum, small local banks with geographical limitations play an important role in the supply of credit to small enterprises and agriculture. In India, where, the reach of banking is an issue from financial inclusion perspective, there is merit in considering access to bank credit and services through expansion of banks in unbanked and under-banked regions. The specific risks on account of the business model may have to be addressed by calibrating the prudential regulations together with developing the resolution regime and process reorientation for shortening the time period for settlement of deposit insurance claim. In the deregulated interest rate regime, the small banks will have freedom to decide their lending rates based on the cost of funds. Similarly, the improvement in communication facilities would enable them to reap the efficiency gains driven by

technology similar to the medium and large banks. In this context, the emerging cloud computing technology would be very helpful for small banks from cost perspective.

The following questions arise:

- i) Do small banks serve better the cause of financial inclusion or is it the large banks which have sustaining financial strengths?
- ii) If small banks are to be preferred, what should be the criteria for determining their size, capital requirements, exposure norms, and numbers? Do they need to have separate regulatory prescriptions?
- iii) Do we need to address the resolution framework and delays in settlement of deposit insurance claims before setting up such small banks?

Chapter 5

Banking Models, Structures and Licensing Policy

Banking Models

5.1 Economic theory provides conflicting views on the need for and the effect of regulations on entry into banking. Some argue that effective screening of bank entry can promote stability. Others stress that banks with monopolistic power possess greater franchise value, which enhances prudent risk-taking behaviour. Others, of course, disagree, stressing the beneficial effects of competition and the harmful effects of restricting entry.

5.2 Lax regulations can undermine financial systems by allowing the entry of unqualified owners and managers into the industry or by failing to step in when weak internal governance has allowed excessive exposures and risk-taking. But, this view was contested by many. Claessens and Leaven (2003) claimed that being open to new entry is the most important competitive pressure in a system. This is consistent with Besanko and Thakor's (1992) assertion that the threat of new entrants can be a more important determinant of the behaviour of market participants. Barriers to entry, expansion and exit are important determinants of competition in markets. The threat of losing business can spur innovation, provide strong incentives to keep costs and prices down and meet customers' requirements for quality of service and range of products. If firms face significant difficulties in entering and competing in the market, incumbent firms will not face the threat of new firms challenging them for business and will have little incentive to reduce costs, innovate and price competitively to retain and attract customers.

5.3 Notwithstanding the theoretical debate, the necessity of regulating the financial system and banks in particular is universally accepted on financial stability and consumer protection concerns. In fact from the lessons of the current crisis, the regulatory framework for banks has become more stringent and intrusive.

5.4 There are basically two pure models of banking: commercial banking and investment banking. Universal banking represents a combination of the two banking models in

varying proportions. Thus there are commercial banking oriented Universal banks (Bank of America, Citi Group, HSBC, etc.) and Investment banking oriented Universal banks (Barclays, BNP Paribas, UBS, Deutsche Bank, etc.). From a cross-country perspective, in the US, universal banks were outlawed for about two-thirds of the 20th century under the famous Glass-Steagall Act due to the perceived conflict of interest between commercial and investment banking. However in most of the rest of the world, the incentive to derive economies of scale and scope promoted development of diversified or universal banks, which was significantly aided by deregulation. A particular mention may be made of the easing of restrictions on business lines within traditional banking and other activities, such as investment banking, asset management and insurance. These developments provided a boost to universal banking. In fact, of the 28 Global Systemically Important Banks (G-SIBs) that were identified by the Basel Committee on Banking Supervision, 20 can be classified as universal banks.

5.5 In the US also the rigours of the Glass-Steagall Act got progressively relaxed and it finally moved to a Universal banking model in 1999 under a Financial Holding Company (FHC) structure with the enactment of the Gram Leach Bliley (GLB) Act.

5.6 The stand-alone investment banks in the US failed in the wake of the recent financial crisis due to excessive leverage and reliance on predominantly short-term debt funding for the long-term mortgages (Brunnermeier, 2008). It is illustrative to look into the regulatory framework for investment banks in the US and the impact of the crisis on them so as to draw appropriate lessons in the context of the future of Investment banking in India.

5.7 As regards the regulatory framework for the investment banks, the approach of the sectoral regulator, the Securities and Exchange Commission (SEC) was not focussed on the safety and soundness of the firms it regulated but rather on maintaining fair and orderly markets and protecting investors from fraud. Though SEC had enforced a net capital rule applicable to all registered broker dealers which was very close to the risk weighted capital requirement for banks, it had no authority to intervene in broker/ dealer's business if they took excessive risks that could lead to the floor for net capital being breached. Moreover,

the SEC had no authority comparable to the banking regulator's prompt corrective action powers: it could not pre-emptively seize a troubled broker/ dealer or compel it to merge with a sound firm (Jickling, 2010). Further, the SEC did not prescribe capital requirement at a consolidated investment bank level. In 2004, the SEC amended the net capital rule for the larger broker dealers permitting them to use internal models for computing the net capital requirement and also introduced a voluntary supervisory scheme for the largest investment banks, called the Consolidated Supervised Entities (CSE) program. As a substitute to the net capital rule, the firms agreed to abide by the Basel risk based standards and maintain capital at the holding company level. Many argue that these two developments allowed the investment banks to increase their leverage substantially. The CSE being a voluntary program did not prevent excessive risk taking by the participants. By the end of September 2008, all five CSE investment banks had either failed (Lehmann Brothers) or merged to prevent failure (Merrill Lynch and Bear Sterns) or applied for bank holding company status (Morgan Stanley and Goldman Sachs). The stepping in by the Federal Reserve (Fed) on the impending collapse of Bear Sterns to broker its sale to JP Morgan Chase due to its systemic importance by agreeing to purchase \$30 billion of toxic "Bear Sterns" assets highlighted the anomalies. The SEC lacked power to ensure safety and soundness even for systemically important entities regulated by it while the Fed had to commit funds to an investment bank over which it had no regulatory jurisdiction. The Fed subsequently established a lending facility to provide short term credit to other investment banks. Under the Dodd-Frank Act any securities firm that is deemed to be systemically significant by the Financial Stability Oversight Council (FSOC) will automatically come under the consolidated supervision of the Fed.

5.8 From a historical perspective, the move towards universal banking has been on account of perceived economies of scale and scope leading to increased economic efficiency even though the evidence on the importance and significance of economies of scale and scope has been mixed. Their emergence therefore also has partly been on account of regulatory considerations which liberalised the range of activities for banks based on a broad consensus that banks which offered a full range of finance services would be able to

provide the largest economic benefits in a rapidly growing economy. Diversification of business lines, innovations in risk management, and market based pricing of risks were seen as effective counters to the risks associated with the rapid expansion of large universal banks. The growth of universal banks in the last 15 years or so has been tremendous in size, complexity and concentration. The other factor has been the advantages of attaining a “too-big-to-fail” (TBTF) status. Such large universal banks typically tend to enjoy funding subsidy and enjoy higher returns through revenue and cost efficiency gains and better diversification of opportunities. Such banks are endowed to become significant global players and have a very large capital base to enable them to fund big projects like infrastructure.

5.9 There are, however, several potential downsides to the universal banking model particularly in the context of very large conglomerates. These institutions pose management challenges and are very difficult to regulate, supervise and resolve in an orderly manner in the event of failure on account of their complexity and integrated structure of operations. Universal banking may suffer conflict of interest between commercial and investment banking operations and by combining depository institution activity with other types of financial services, they may open new channels of contagion thereby increasing systemic risk. The universal banks may derive power to suppress competing institutions and market and thereby reduce the benefits of competition.

5.10 Notwithstanding the considerable downside risks of a universal banking structure, empirical and theoretical research showed enough evidence to suggest that the dangers associated with universal banking were less than what was believed and that the universal banks are positively efficiency enhancing. Therefore, universal banking model, notwithstanding its potential disadvantages, has been the model to follow, going forward. The Basel III framework addresses the negative externality, *i.e.*, systemic risk of such structures through enhanced regulatory framework, pro-active and intensive supervision and efficient resolution framework, enhanced transparency and disclosure and strengthened market infrastructure. In addition, there are proposals for structural reforms – Dodd-Frank

Act (under implementation in USA), proposals in Vickers Report (UK) and Liikanen Report (Euro zone) – under consideration for implementation.

5.11 With the demise of investment banks in the wake of the crisis, the universal banking model remains the dominant model. Out of the three structural reforms, the two reforms in Europe (Vickers and Liikanen) are within the universal banking framework whereas in USA under the Dodd-Frank Act, the Volcker rule is parallel to the Glass-Steagall Act though it is less stringent than the latter. It remains to be seen what implication this will have on the re-emergence of stand-alone investment banks in USA.

Structure of Universal Banking Model

5.12 The universal banks do not have a monolithic structure. Their structures involve corporate separateness based on many considerations – asymmetrical information problems, insulation against risk, legacy of mergers and acquisitions, tax considerations and regulatory requirement (regulators may often require that activities which they regulate should be conducted in separate legal entities. This ring fencing facilitates oversight and intervention in case of need). Broadly there are three different regulatory models viz.

- Complete integration
- Parent bank with non-bank operating subsidiaries
- Holding company parent with bank and non-bank affiliates.

5.13 European countries like Germany follow the first model with only minimal corporate separateness on regulatory considerations. Countries like India have followed the second structural model i.e., parent bank with non-bank operating subsidiaries. The dominant model in the USA in the wake of GLB Act is the third one where banks and non-bank affiliates operate under the Financial Holding Company (FHC). Moreover, the corporate separateness imposed on bank holding companies and financial services holding companies is reinforced by intra-group exposure norms. Under Section 23(a) and 23(b) of the Federal Reserve Act, the amount of credit from the bank to their affiliates is limited and it is required that such transactions be collateralized and made at market prices.

5.14 From the perspective of containing systemic risks, the FHC model offers some distinct advantages (Reserve Bank of India, 2011) over the other two models.

- i) FHC model is better in removing capital constraints and facilitating expansion in other financial services. Since under the FHC, the subsidiaries will not be directly held by the bank, the responsibility to infuse capital in the subsidiaries would rest with the holding company.
- ii) The model would also fare better in terms of direct impact of the losses of the subsidiaries, which would be borne by the holding company unlike in the case of BHC where it would be upstreamed to the consolidated balance sheet of the bank.
- iii) Unlike in the case of BHC model, under the FHC model, the bank's board will not be burdened with the responsibility of managing the group's subsidiaries. Management of individual entities in a disaggregated structure is also expected to be easier and more effective.
- iv) The FHC model may enable a better regulatory oversight of financial groups from a systemic perspective. It would also be in consonance with the emerging post-crisis consensus of having an identified systemic regulator responsible *inter alia* for oversight of systemically important financial institutions (SIFI).
- v) The FHC model would provide requisite differentiation in regulatory approach for the holding company *vis-à-vis* the individual entities.
- vi) The FHC model is likely to allow for neater resolution of different entities as compared with BHC model where liquidation of the parent bank may make the liquidation of subsidiaries inevitable.

Global Developments on structural reforms

5.15 Though studies show that neither of the models, *i.e.*, universal banks or investment banks did better than the other during the crisis, several jurisdictions have supplemented or propose to supplement the enhanced prudential regulations under Basel III with structural measures to combat systemic risks. The proposed structural measures range from moving businesses identified as too risky and complex into stand-alone entities to prohibiting banks from engaging in these activities altogether. The objective is to insulate certain types of financial activities regarded especially important for the real economy or significant on consumer/ depositor protection grounds from the risks that emanate from potentially riskier but less important activities. The presumption is that price based regulations (capital requirements and leverage ratios) alone are not sufficient in some areas and some

regulations may not be implemented in a consistent manner in all jurisdictions (bail-in and cross-border resolution framework, etc.). These measures also reflect the intention of limiting the benefits of public guarantees to certain systemically important banking services such as deposits and payments and limit contagion from financial markets.

5.16 Structural reform proposals include Volcker Rule under the Dodd-Frank Act in the US, Liikanen reform proposals in the EU and Vickers reform proposals in the United Kingdom. Salient features of these proposals as enumerated by Gambacorta and Rixtel (2013) are:

- i)** The Volcker Rule is narrow in scope but otherwise quite strict. It is narrow in that it seeks to carve out only *proprietary* trading while allowing market-making activities on behalf of customers. Moreover, it has several exemptions, including for transactions in specific instruments, such as US Treasury and agency securities. It is strict in that it forbids the coexistence of such trading activities and other banking activities in different subsidiaries *within* the same group. It similarly prevents investments in, and sponsorship of, entities that could expose institutions to equivalent risks, such as hedge funds and private equity funds. That said, it imposes very few additional restrictions on the transactions of banking organisations with other financial firms more generally (e.g.: such as through constraints on lending or funding among them).
- ii)** The Liikanen Report proposals are somewhat broader in scope but less strict. They are broader because they seek to carve out both proprietary trading and market-making, without drawing a distinction between the two. They are less strict because they allow these activities to coexist with other banking business within the same group as long as these are carried out in separate subsidiaries. The proposals limit contagion within the group by requiring, in particular, that the subsidiaries be self-sufficient in terms of capital and liquidity and that transactions between the legal entities take place on market terms.
- iii)** The Vickers Commission proposals are even broader in scope but have a more articulated approach to strictness. They are broader in that they exclude a larger set of banking business from the protected entity, including also securities underwriting and secondary market purchases of loans and other financial instruments. A very narrow set of retail banking business *must* be within the

protected entity [retail deposit-taking, overdrafts to individuals and loans to small and medium-sized enterprises (SMEs)]; and another set *may* be conducted within it (e.g. some other forms of retail and corporate banking, including ancillary operations to hedge risks to support them). The approach to strictness is more articulated because it involves both *intragroup* and *inter-firm* restrictions (the “ring fence”). As in the Liikanen Report, protected activities can coexist with others in separate subsidiaries within the same group but subject to intragroup constraints that are somewhat tighter, including on the size of the linkages. Moreover, a series of restrictions limit the extent to which the banking unit within the ring fence can interact with other financial sector firms.

5.17 Various pros and cons (IMF, 2013) of these proposals are:

Pros

- i) The structural measures proposed by the US, UK, and EU aim to decrease the probability of bank failure and its systemic implications by reducing complexity and interconnectedness.
- ii) It can prevent the subsidies that support the protected activities (deposit insurance and central bank lending facilities) from lowering the cost of risk taking and encouraging moral hazard in other business lines.
- iii) Ring-fencing facilitates lower cost bank resolution at the level of the retail bank (but not necessarily at the group level).

Cons

- i) The costs may arise from implementation challenges; risk migration; adverse impact on market liquidity, efficiency, and risk management capacity; and lower diversification benefits.
- ii) Implementation costs relate to the challenge of distinguishing proscribed trading from permitted transactions and the resulting burden of compliance and reporting.
- iii) Tightening activity restrictions on regulated banks may redistribute systemic risk by pushing certain activities particularly the prohibited ones to unregulated entities which may have implication for systemic risk.
- iv) Liquidity in home and host capital markets may be adversely impacted. National authorities in several jurisdictions have expressed concerns about the cross-border effects of the Volcker rule apprehending that pullback of US banks could reduce the liquidity of their government bond markets.
- v) The reduction in diversification benefits can be substantial.

- vi) The differences between national structural reform measures would create business models that would exacerbate the burden on consolidated supervision and cross-border resolution.

Competition and Licensing of Banks in India

5.18 Section 22 of the Banking Regulation Act, 1949 provides that a company intending to carry on banking business must obtain a license from RBI except such of the banks (public sector banks and RRBs), which are established under specific enactments. Every bank in India, *i.e.*, domestic and foreign, apart from banking business, can carry out all the activities permitted under Section 6 of the Banking Regulation Act. The RBI issues licence only after 'tests of entry' are fulfilled. One of the major objectives of reforms was to bring in greater efficiency by permitting entry of private sector banks, liberalised policy on entry of new foreign banks and increased operational flexibility to banks. Keeping these in view, several measures were initiated to infuse competition in the banking sector. Through the lowering of entry barriers, competition has significantly increased since the beginning of the 1990s, with the Reserve Bank allowing entry of new banks in the private sector.

Licensing policy for domestic private sector banks

5.19 Consequent to the recommendations of Narasimham Committee I in 1991, guidelines on new banks were released in 1993 with a minimum capital requirement of ₹.100 crore for the new banks. Under the 1993 guidelines, 10 new private sector banks were licensed. In the aftermath of the recommendations of the Second Report of the Narasimham Committee on Banking Sector Reforms, a new set of guidelines were issued in 2001 with capital requirement of banks at ₹.300 crore. Under the 2001 guidelines, 2 new private sector banks were licensed. Further, recently in February 2013, fresh guidelines for licensing of new banks were issued. The guidelines, *inter alia*, permit business/industrial houses to promote banks, conversion of NBFCs into banks and setting up of new banks in the private sector by entities in the public sector, through a Non-Operative Financial Holding Company (NOHFC) structure. The minimum capital requirement for setting up a bank is ₹.500 crore. As regards branch licensing policy, general permission has been granted to the domestic scheduled commercial banks for opening branches in Tier 2 to Tier

6 centres without RBI's prior approval subject to reporting. Further banks have to open at least 25 per cent of the total number of branches opened during a year in unbanked rural (Tier 5 and Tier 6) centres.

Licensing policy for foreign banks

5.20 At present, foreign banks operate in India as branches of the parent banks. Currently, permission for opening of branches by foreign banks in India is guided by India's commitment to WTO to allow 12 new branches in a year.

Banking Model and Banking Structure in India

5.21 In India, the universal banking model is followed. As regards the structure of universal banks, the conglomerate structure is bank-led, *i.e.*, banks themselves are holding companies which operate certain businesses through Subsidiaries, Joint Ventures and Affiliates. The policy has evolved over a period of time and inevitably there are legacy issues. The current policy has been expounded in the FAQs on the New Banks Guidelines dated 3rd June 2013. The general principle in this regard is that para-banking activities, such as credit cards, primary dealer, leasing, hire purchase, factoring etc., can be conducted either inside the bank departmentally or outside the bank through subsidiary/ joint venture /associate. Activities such as insurance, stock broking, asset management, asset reconstruction, venture capital funding and infrastructure financing through Infrastructure Development Fund (IDF) sponsored by the bank can be undertaken only outside the bank. Lending activities must be conducted from inside the bank.

5.22 Investment banking³ and insurance services are provided by the universal banks as an in-house departmental activity or through subsidiary in the manner described above. However, limits on equity investments⁴, by a bank in a subsidiary company, or a financial

³ Arranging financing for corporates and governments; trading in securities on behalf of clients and proprietary trading; underwriting; asset management; advising clients on mergers & acquisitions; and providing research to investing clients etc.

⁴ Equity investment by banks in such entities should not exceed 10 per cent of the bank's paid-up share capital and reserves and the total investments made in all subsidiaries and all non-subsi-dary financial services companies should not exceed 20 per cent of the bank's paid-up share capital and reserves

services company including financial institutions, stock and other exchanges, depositories, etc., which is not a subsidiary restrict expansion of investment banking services and insurance business by the universal banks. Consequently, India does not have large investment banking and insurance activity within the banking groups. India also does not have stand-alone investment banks as SEBI has no regulations in place for investment banks. However, SEBI does register various intermediaries under its regulations such as stock brokers, mutual funds, portfolio managers and merchant bankers etc.

Way Forward

5.23 Three issues arise while considering the future set up of the banking system: What should be the banking model and structure, whether India needs differentiated banking license regime and whether licensing should be on tap or in blocks as at present. These issues are discussed below:

5.24 *Banking Models and Structures:* Considering the fact that the universal banking model still remains the dominant model and has functioned well in India, it could be the model to persist with together with restricted banking license i.e., licenses for undertaking limited banking activities (discussed in detail later in this chapter). As regards the structure of the universal banks, the FHC model broadly on the lines of recommendations of the '*Report of the Working Group on Introduction of Financial Holding Company Structure in India*' would be suitable both for private and public sector banks on account of several advantages it offers over the currently existing bank holding company model. Moving to the FHC model will require legal enactment. One positive fallout of the FHC model would be that the structure would hold the key to unlocking the potential growth of investment banking and insurance as limits on investment by the FHC in the equity of the entities undertaking investment banking and insurance activities may not be restricted as is the case for the corporate structure under a Non-Operating Financial Holding Company (NOFHC) prescribed for new banks. There are estimates that investment banking will grow 10 times by 2020. In addition, as the wholesale debt markets deepen, the larger corporates would avail of advisory and capital market services from banks to access capital markets. The

revenue pool will shift from traditional corporate banking to investment banking and advisory. Reflecting all these developments, it is expected that investment banking will be among the fastest growing segments in the Indian banking industry rising from 4 per cent to 7 per cent of the entire corporate banking revenue pool (BCG, 2010). Given this, there is a need for orderly development of investment banking in India. The lessons from the US experience regarding regulatory gaps in the regulation of investment banks/investment banking activities, particularly the stand alone broker/dealer activities, will have to be factored in carefully for robust development of investment banks/entities offering investment banking activities.

5.25 In this context, a question arises whether and to what extent the recommendations of the Vickers and Liikanen Reports need to be factored in for restricting the universal banking model. It would appear from the Indian stand point that such proposals may be of limited relevance as Indian banks basically engage in plain vanilla banking. This position could be reviewed after say, 5 years keeping in view the riskiness and complexity of the investment banking services being offered by Indian banks and factoring in the experience from the implementation of the two Reports' recommendations.

5.26 Differentiated licenses: With the broadening and deepening of financial sector, some banks may choose to operate in niche areas. This has certain obvious advantages in terms of managing business and risk management. Some countries have a differentiated bank licensing regime where differentiated licenses are issued specifically outlining the activities that the licensed entity can undertake.

Select cross-country practices

5.27 There are jurisdictions practising differentiated licenses, viz., USA, Australia, Singapore, Hong Kong and Indonesia.

USA

5.28 The Office of the Controller of the Currency (OCC), an independent bureau within the United States Department of the Treasury established by the National Currency Act of

1863, *inter alia*, serves to charter not only national banks but also special purpose or narrow focus banks such as credit card banks, trust banks, community development banks, cash management banks and bankers bank.

Australia

5.29 The Australian Prudential Regulatory Authority (APRA) issues separate licenses to carry on credit card issuing and/or acquiring business to Specialist Credit Card Institutions (SCCIs). SCCIs are a special class of authorised deposit-taking institutions (ADIs) that are authorised to perform a limited range of banking activities.

Singapore

5.30 In Singapore, there are five types of bank licences — full bank, qualifying full bank (QFB), wholesale bank (WB), offshore bank, and representative bank. A full bank conducts a whole range of banking business for retail and corporate clients, but foreign banks in Singapore are restricted when it comes to branch expansion and expansion of ATMs. The QFB is for foreign banks in Singapore where it allows them to have additional branches or off-premise ATMs and share ATMs amongst themselves. Wholesale banking licence, permits a bank to only have one place of business in Singapore and cannot operate savings accounts and Singapore-dollar fixed deposits of less than \$250,000. The offshore bank licence allows banks to operate mainly in the Asian dollar market, foreign exchange and wholesale banking with non-residents. The offshore bank shall not operate savings accounts or accept fixed deposits denominated in Singapore dollars. Finally, the representative office licence prevents banks from conducting regular banking operations, but promotes business and correspondent banking business between their home offices and the region.

Hong Kong

5.31 Hong Kong has a three-tier banking system based on licensed, restricted licence, and deposit taking companies. Licensed banks may operate current and savings accounts, and accept deposits of any size and maturity from the public and pay or collect cheques drawn by or paid in by customers while restricted licence banks are principally engaged in

merchant banking and capital market activities. Restricted licence banks may only take deposits of any maturity of HKD 500,000 and above. Deposit-taking companies are mostly owned by, or otherwise associated with, banks. These companies engage in a range of specialised activities, including consumer finance and securities business. They may take deposits of HKD 100,000 or above with an original term of maturity of at least three months.

Indonesia

5.32 In January 2013, Indonesia migrated to multiple licensing policy from the single license policy. Under the new plan, licenses will be issued based on the “capital condition” of banks, and only those institutions with hearty capital reserves will be eligible for the multiple licenses permitting multiple activities. To promote capital strengthening in the banking sector, banks will be categorized according to the amount of their core capital.

5.33 The broad picture that emerges from the above survey of select country practices is that typically open economies with large and growing financial sector (in terms of its contribution to GDP) seem to be favouring differentiated licensing policy. What is interesting is that the policy of differentiated licensing is followed in Malaysia and Brazil in spite of the fact that promoting financial inclusion has been an important thrust in the Central Bank's developmental role in these countries.

5.34 The criterion for differentiation for the purposes of issuing differentiated licenses could be anchored either to capital conditions, as is practiced in Indonesia or to the activity as is the case in Australia, Singapore and Hong Kong.

Is there a case for differentiated licensing in India?

5.35 Gradually, but discernibly, market focus is shifting to customer specific and niche products. Many banks keep the plain vanilla banking as a small necessary segment. In October 2007, Reserve Bank had prepared a Discussion Paper on Differentiated Bank Licensing (RBI, 2007), wherein it was stated that the case for differentiated licensing may

be reviewed after a certain degree of success in financial inclusion is achieved and Reserve Bank is more satisfied with the quality and robustness of the risk management systems of the entire banking sector.

5.36 With the broadening and deepening of financial sector, a need is felt that banks move from the situation where all banks provide all the services to a situation where banks find their specific realm and mainly provide services in their chosen areas. As the economy grows and becomes more integrated with the global economy, need would be felt for sophisticated financial services and products which will require the presence of different types of banks. In this context, the Twelfth Five Year Plan has projected the infrastructure financing requirement for the country at US \$ 1 trillion during the plan period. Therefore, for instance, specialised banks which can cater to the infrastructure needs of the growing economy may be required. Similarly, there could be a need for wholesale banking facilities. Currently, the wholesale banking space in India is occupied mostly by foreign banks and the new generation private sector banks. According to Mckinsey (2011), wholesale banking revenues, which in India account for close to 30 percent of total banking revenues, are expected to more than double, from roughly \$16 billion in fiscal 2010 to \$35 to \$40 billion by 2015. It is widely recognized that banks providing services to retail customers have different skill sets and risk profiles as compared to banks which deal with some specific clientele like large corporate clients, infrastructure firms, etc. For a wholesale bank dealing with corporate clients only, it becomes a costly adjunct to maintain a limited retail banking presence. Moreover it becomes difficult for such a bank to meet the obligations for doing inclusive banking.

5.37 The pros and cons of a differentiated licensing regime are:

Pros

- i) There are diverse opportunities in the banking and financial landscape reflecting significant macro-economic growth potential in India and differentiated licensing could enable unlocking potential of these opportunities as it encourages niche banking by facilitating specialisation thereby reducing potential non-optimal use of resources. Each of the niches mentioned below has

the potential to be individually large to sustain significant balance sheets and specialised entities can play a major role in all of them.

- ii) Very large ticket, long term infrastructure lending requires risk management expertise that goes beyond traditional credit appraisals at banks. There is significant space for specialized entities in risk assessment and structuring of infrastructure finance.
- iii) Very low ticket unsecured credit requires risk management methodology and cost control that is not easy in business model of conventional banks.
- iv) Gaps in SME finance can be filled with asset based lending, operating leases, and factoring.
- v) Issues of conflict of interest when a bank performs multiple functions would not arise, where differentiated licences are issued.
- vi) Risk management systems and structure for regulatory compliance could be customised according to the banking type.
- vii) Customised application of supervisory resources according to the banking type could result in greater optimisation of such scarce resources.
- viii) Core competency could be better harnessed leading to enhanced productivity in terms of reduced intermediation cost, better price discovery and improved allocative efficiency.

Cons

- i) Given the extent of financial exclusion in India, such a regime would be a path away from carrying banking to masses particularly if large number of banks were to opt for this.
- ii) Priority sector lending could be impacted as specialised institutions may not have to meet the extant targets for such lending, which is otherwise applicable to all commercial banks. In fact, recently, with a view to streamline priority sector lending, norms for such lending were revamped in the light of the recommendations of the Nair Committee.
- iii) Many niche-banking models typically depend on inter-bank liquidity, and whole sale funding which is a potential source of risk and vulnerability in a crunch situation.
- iv) Unlike specialised banks, banks engaging in various kinds of activities will find it easier to cross subsidise across various sectors and optimum utilization of resources and therefore ensure better profitability of banks.
- v) Specialized banks may be prone to high concentration risk as their business would be focused on a particular area.

5.38 On balance it would appear that differentiated licensing would be a desirable step particularly for infrastructure financing, whole sale banking and retail banking (focussed on

SME financing). The small banks (discussed in Chapter 4) could also be under differentiated licensing regime with restrictions on their area of operation, size and range of activities. These banks will have to be under differentiated prudential regimes depending on their risk profile. For example, the reserve requirements and capital adequacy and exposure norms etc. could be different from that of universal banks. Similarly, there could be restrictions on some of them accessing retail deposits or wholesale deposits or deposits altogether.

5.39 As regards the attendant conditions laid down in RBI's discussion paper of October 2007 for considering differentiated licence, it may be stated that banks have shown significant progress in financial inclusion and in improving the quality of risk management though a lot more needs to be done.

Continuous Authorisation- An Alternative Approach

5.40 A wide range of licensing approaches has been adopted around the world. One among them is a trend towards the use of general authorisations and open entry regimes in some economies, consistent with the general liberalisation of financial markets. Individual and continuous authorisations are in place in a number of countries⁵. In view of the need to stimulate and foster competition, there is merit in considering liberalising the entry process through introduction of continuous authorisations of new banks. Stringent entry norms, especially regarding capital and related buffers, to be prescribed by the regulator will ensure that only eligible and deserving entities will be able to enter the fray.

5.41 'Stop and go' licensing policy inevitably leads to a frenzied response from large number of competing aspirants, whenever the licensing process is opened up in an *ad hoc* manner. It also promotes rent seeking. The suggestion of 'continuous authorisations' to open new banks in India needs to be viewed from the perspective that it is not entirely new. Such continuous authorisations are permitted already in the case of foreign banks, which

⁵ In addition to a number of advanced countries, Malaysia, Thailand, Hungary, Brazil and Russia have a system of continuous authorisations of bank entry.

want to enter the Indian banking system but not the domestic banks. As CFSR (Chairman: Shri Raghuram G. Rajan) suggested, there is a strong case for making the entry into banking more liberal. Rajan stressed that the purpose of this entry is not primarily to increase the level of competition, but to also bring new ideas and variety into the system through entry. As India grows, it is hard to imagine that all the valuable financial ideas will only originate in existing institutions.

5.42 A proposal to liberalise the bank licensing policy can well pave the way for the next round of reforms in the banking sector. The objectives of financial inclusion and broadening the geographical reach of banking can be achieved only when the entry process is not a restricted one. A competitive financial market does not necessarily require a large number of institutions, nor exclude the presence of institutions with substantial market share; however, the market must be contestable in that market shares and prices are market-driven competitive outcomes and there is liberal entry and exit. In particular, entry should be open to entities that meet the necessary requirements regarding the competence of owners, capital and the adequacy of management and other systems.

5.43 The pros and cons of ‘on tap’ licensing policy are summarised below:

Pros:

- i) Bank licences available on tap would put competitive pressure on the existing banks and improve performance and efficiency.
- ii) Bank licences available on tap would bring new technology and new ideas into banking on a continuous basis.
- iii) Gradual increase in the number of banks spread over a long period of time would be efficient and would not strain the existing banking system. On the other hand, sudden increase in the number of banks during a particular period of time would strain the existing banking system in terms of business and human resources.
- iv) It would ease undue pressure on the regulatory resources during a short period of time and enable allocation of regulatory resources evenly.
- v) If applicants have ample time to prepare the application and their business model, it would be qualitatively superior and genuine and the cost of setting up/transition to a banking model would be more manageable.

Cons:

- i) It does not allow proper assessment of the needs of the economy based on which a licensing policy could be prepared at the opportune time.
- ii) It does not give an opportunity to the regulator to reorient the licensing policy each time the guidelines for licensing of banks are issued.

5.44 Viewed against this setting, there is merit in considering ‘continuous authorisations’ for opening new banks in India as opposed to the present system of periodical review for the entry of new banks. A licensing policy may be announced to have a shelf life of say 3 to 5 years. This would ensure that the aspirants know for certain the policy regime under which they have to set up a bank and the regulator will also be able to periodically modulate the licensing policy based on the needs of the economy and the banking sector. However, it is important that the entry norms should be stringent. Of particular importance for preserving appropriate incentives are standards governing the entry of financial firms together with bankruptcy codes and other provisions relating to exit. Authorities should seek to facilitate and encourage entry by well-qualified entities in order to improve the quality of the banking system and promote competition.

Chapter 6

Consolidation and Emergence of Large Banks and Legal Framework for Banks

6.1 The debate about consolidation in the Indian banking structure is not new. Starting from the age of Presidency Banks, the Indian banking sector has witnessed consolidation to enhance competitiveness. In fact, India's largest bank, the State Bank of India, is a product of mergers of the Presidency Banks. There are, however, arguments both in favour and against consolidation. Consolidation can have several positivities but gives rise to certain concerns too.

The pros and cons of consolidation are discussed below.

Pros

- i) Larger banks may be more efficient and profitable than smaller ones and generate economies of scale and scope. Furthermore, the reorganisation of the merged bank can have a positive impact on its managerial efficiency. The efficiency gains may lead to lower cost of providing services and higher quality as the range of products and services provided by larger banks is supposedly wider than what is offered by smaller banks. Experience in some countries indicates cost efficiency could improve if more efficient banks acquire less efficient ones.
- ii) Consolidation may facilitate geographical diversification and penetration towards new markets.
- iii) Big banks are usually expected to create standardised mass-market financial products. The merging banks may try and extend marketing reach and enhance their customer-base (Dymski, 2005).
- iv) The common criticism against consolidation is that it will have an adverse effect on supply of credit to small businesses, particularly, those which depend on bank credit, as consolidated big banks would deviate from practising relationship banking. But, there is recent evidence that reduced credit supply by the consolidating banks could be offset by increased credit supply by other incumbent banks in the same local market (Oxford Handbook, 2010b).

- v) The transaction costs and risks associated with financing of small businesses may be high for small banks. Large and consolidated banks can mitigate the costs better and penetrate through lending into these sectors.
- vi) One of the arguments cited against consolidation is that it may result in rationalization of branch network and retrenchment of staff. However, rationalization may lead to closure of branches in over banked centers and opening of new branches in under banked centers where staff can be redeployed.

Cons

- i) Consolidation may increase the market power of merged institutions and could result in neglect of local needs leading to reduction in credit supply to some category of borrowers, particularly small firms. The consolidated bank may rather cater to big ticket business, in the process adversely affecting financial inclusion.
- ii) Not all customers are treated in the same way by the big banks. There is empirical evidence [Dymski (1999)] that one consequence of the merger wave in US banking in 1990s has been that loan approvals for racial minorities and low income applicants have fallen and the extent of this decline was more severe for large banks.
- iii) The consolidating institutions are found to shift their portfolios towards higher risk-return investment (RCF, 2008).
- iv) Consolidation could also result in less competition through structure-conduct-performance-hypothesis giving fewer choices to the customer and arbitrary pricing of products.
- v) Empirical evidence suggests that financial consolidation led to higher concentration in countries such as US and Japan, though they continue to have much more competitive banking systems as compared with other countries. However, in several other countries, the process of consolidation led to decline in banking concentration, reflecting increase in competition (Prasad, A. and Ghosh. 2005).

6.2 Ever since the introduction of financial sector reforms in early nineties, the issue of consolidation of banking sector has consistently found a detailed mention in various reports of the committees looking into the Indian financial sector and these included Narasimham Committee - I (1991), S. H. Khan Committee (1997), Narasimham Committee -II (1998), Committee on Fuller Capital Account Convertibility (2006), Raghuram G. Rajan

Committee (2009) and Committee on Financial Sector Assessment (CFSA) (2009) . In his inaugural address on the annual day of the Competition Commission of India on May 20, 2013, Shri P.Chidambaram, Finance Minister, Government of India alluded, *inter alia*, to the need for restructuring of banks through mergers. To quote “ ... some banks, including some public sector banks among the 26 public sector banks that we have, may be better off merging. The need for two or three world-size banks in an economy that is poised to become one among the five largest in the world is rather obvious”.

6.3 Since 1961 till date, under the provisions of the Banking Regulation Act, there have been as many as 81 bank amalgamations in the Indian banking system, of which 47 amalgamations took place before the first phase of nationalisation in July 1969. Out of the remaining 34 mergers, in 26 cases, the private sector banks were merged with public sector banks and in the remaining 8 cases, both the banks were private sector banks.

6.4 Since the onset of reforms in 1990, there have been 31 bank mergers/amalgamations. Further, prior to 1999, amalgamations of banks under Section 45 of the Banking Regulation Act, 1949 were primarily resorted to in response to the weak financials of the banks being merged. In the post-1999 period, however, the business and commercial considerations also prompted voluntary mergers between healthy banks under Section 44A of the Act. Merger of the New Bank of India with the PNB in 1993 and the acquisition of State Bank of Saurashtra in 2008 and State Bank of Indore in 2010 by the SBI are the only instances of consolidation among the government owned banks through mergers and amalgamations.

Whether Indian banks can aim to become global in size and become global players?

6.5 The need for having Indian banks among the top global banks is debated recently. The desire to find a place in the global list for Indian banks probably emerges as we increasingly integrate with the global economy and progress to fuller capital account convertibility.

6.6 How do Indian banks fare globally? The global league table for 2013 based on the size of assets reveals that Wells Fargo, Chase, HSBC, Bank of America, Citi, Santander,

ICBC, American Express, BNP Paribas and China Construction Bank are amongst the top ten. The ranking of Indian banks is presented in the table below:

Ranking of Indian banks in the global league

| Name of Indian bank | Ranking |
|----------------------------|----------------|
| SBI | 38 |
| ICICI Bank | 99 |
| HDFC Bank | 126 |
| Axis Bank | 175 |
| PNB | 189 |
| BoB | 206 |

(Source: http://brandirectory.com/league_tables/table/banking-500-2013)

6.7 State Bank of India (SBI), at the 38th position, and ICICI Bank at 99th position, are the only banks from India appearing in the top 100 banks (Brand Directory League Tables 2013). It is, therefore, unlikely that any of our banks will leap into the top ten of the global league even after reasonable consolidation (Subbarao, 2011a).

6.8 In the international banking arena, size, innovation, efficiency and best standards of customer service alone matter. There is no substitute for innovation to survive and lead in the new-age banking. India continues to face the more fundamental challenge of financial inclusion. According to the World Bank, India has around 3.5 ATMs and less than 7 bank branches per 100,000 people as compared with OECD countries, where there are nearly 30 branches and 90 ATMs per 100,000 people.

6.9 With regard to globalisation, there is an opposing view that instead of looking outwards, Indian banks should look inwards by scaling financial deepening. In this context, it needs to be noted that looking outwards for global presence and looking inwards for deeper financial penetration are not mutually exclusive. It should be possible to aim for both. Therefore, it will be opportune for larger Indian banks to be looking out for opportunities for both organic and inorganic growth (Subbarao, 2011a).

6.10 Nonetheless, it is worth bearing in mind that pursuing becoming global in size is not a totally benign option. On the positive side are a higher exposure threshold, international

acceptance and recognition, improved risk management and improvement in financials due to economies of scale and scope and technological innovations. This can be achieved both through organic and inorganic growth. On the negative side, we need to be wary of the fact that there are apprehensions that the creation of 'too big to fail banks' may entail fiscal costs to the Government during a crisis. Recent crisis proved this point. Further, experience shows that globalisation would fail if there are no synergies in the business models and there is no compatibility in the business cultures and technology platforms of the merging banks (Subbarao, 2011b).

6.11 Globalisation of Indian banks would further integrate Indian economy with the vicissitudes of global finance, exposing it thereby to higher degrees of contagion and external sources of systemic risk. Globalised Indian banks would be subjected to more stringent regulatory norms under the framework for global systemically important banks (G-SIBs).

6.12 It may be inferred based on the above mentioned facts that Indian banks even with consolidation would not be able to make to the top league of global banks. Besides the issue of size, there are other aspects involved for being in the top league- sophistication in risk management, dealing in a vast range of financial products and in several economies, modern technology and skill, etc. Nevertheless, a measured approach is to be taken both on consolidation and global presence (strategy for global presence is discussed in Chapter 7) even if attaining global size is not imminent.

6.13 On balance, voluntary consolidation of commercial banks with established synergies, and based on economic logic is welcome. Consolidation in the banking sector may pave the way for stronger financial institutions with the capacity to meet corporate and infrastructure funding needs. There is evidence, as measured by Herfindahl-Hirschmann Index (HHI) for 2002-03 and 2011-12, of increasing fragmentation among PSBs and private sector banks as the value of the index fell, while foreign sector banks are relatively better consolidated.

6.14 At present, the Government is the owner of about three-fourths of the total assets in the banking system. It needs to build the consensus required to bring consolidation. Initiative for the exercise at least at the preliminary stage should come from the Government. Consensus has to be built at the employee and management levels. It also requires the integration of the heterogeneous work cultures and alignment of technology in the merged entities. One should not ignore the fact that beyond a point, size may not increase efficiency. Banks, however, cannot be coerced to go for consolidation. An informed debate among all stakeholders will help to arrive at a rational decision in this regard.

Way forward for consolidation - Managing the trade-off

6.15 The structure of the banking system as recommended by the Narasimham Committee consisting, along with medium sized and smaller banks, of three or four large international banks, would not only meet the financing needs of infrastructure and large projects and provide the economies of scale and scope but also leverage the country's image as a financial destination and enable Indian banks to compete globally in terms of fund mobilisation, credit disbursal, investment and rendering of financial services. This could be attained through consolidation.

6.16 However, while encouraging / promoting the consolidation route, the need for competition within the domestic banking sector should not be overlooked nor the risks and challenges that emanate from the presence and operations of large systemically important financial institutions be ignored.

6.17 While nobody knows what the optimum size in terms of largeness is, one thing which is very clear is that banks should refrain from, and regulatory dispensation should not permit, building complex structures (Sinha, 2012).

6.18 To contain the negative externalities, the Basel Committee's Domestic – Systemically Important Bank (D-SIB) framework should be implemented at the earliest.

6.19 Consolidation among the banks may reduce competition in certain segments or geographies substantially and may alter competition between banks and non-banks. These potential consequences will have to be evaluated diligently (Chidambaram 2013). Therefore, at every stage of this process, special attention would have to be paid to the implications for financial inclusion. The areas of synergies are to be properly identified encompassing, *inter alia*, compatibility of businesses, culture, treasury and IT and locational advantage.

Urban Cooperative Banks

6.20 Urban Cooperative Banks (UCBs) are organised based on the principles of cooperation. UCBs are perceived as banks for people of small means. They cater to the financial needs of local communities and serve the lower and middle strata of population in urban and semi-urban areas, within a limited geographical boundary.

6.21 Multi-State Urban Cooperative Banks (MS-UCBs) are cooperative societies registered under the Multi-State Cooperative Societies Act, 2002 (MSCS Act), and licensed to carry out banking business under Section 22 of the Banking Regulation Act, 1949 (As Applicable to Cooperative Societies)[BR Act (AACS)]. By virtue of their registration under MSCS Act, they can have membership (shareholders)/carry out business in more than one State. This is in contrast to other UCBs registered under the Cooperative Societies Act of a particular State, whose area of operation is limited to the State of registration.

6.22 The UCB sector emerged financially stronger ever since RBI conceived a Vision Document for the sector in 2005. The Vision Document envisaged a multilayered regulatory and supervisory approach, revival of potentially viable UCBs and non-disruptive exit of non-viable ones. The sector witnessed a process of rehabilitation and consolidation with the signing of Memorandum of Understanding (MOU) by the Reserve Bank with the Central Government and State Governments and setting up of Task Force for Urban Cooperative Banks (TAFUCBs) at the State level and at the Centre. There has been a

continued reduction in the number of UCBs from 1872 as at the end of March 2005 to 1606 as at the end of March 2013, *inter alia*, due to amalgamation of UCBs.

6.23 UCBs are local banks. Out of the total 1606 UCBs, as at the end of March, 2013, as many as 1563 UCBs had their area of operations within a single State. Only 43 UCBs had presence in more than one State. The cooperative character of UCBs constrains their growth. Therefore, in the overall context of the proposed banking structure, a question arises, should UCBs be permitted to convert into Local Area Banks (LABs) small banks or full-fledged commercial banks to provide them avenues for growth.

Conversion of Multi State UCBs into commercial banks

6.24 As regards the Multi-state cooperative banks, there is a case for their conversion into commercial banks. As UCBs become larger and spread into more states, the familiarity and bonding amongst their members diminishes and commercial interests of the members overshadow the collective welfare objective of the organisation. The UCBs lose their cooperative character. In the process, some of them become ‘too big to be a cooperative’. The collective ownership and democratic management no longer suit their size, and competition and complexities in the business force them to explore alternate form of ownership and governance structure to grow further. Corporatisation could be the best alternative for multi-State UCBs. UCBs enjoy arbitrage in terms of both statutory and prudential regulations. Only some provisions of Banking Regulation Act, 1949 are applicable to them. UCBs continue to be under Basel I capital framework. Though, these may not cause serious concerns when UCBs are small and their operations are limited, regulatory arbitrage may create incentives for large multi-State UCBs to have greater leverage. Their remaining under lighter regulation is a risk. Larger multi-State UCBs, having presence in more than one State, dealing in forex and participating in the money market and payment systems, could be systemically important. Their failure may have contagion effect and unsettle the UCB sector. The systemic risk could be minimized, by subjecting them to prudential regulations applied to commercial banks. Another supportive reason would be that larger multi-state UCBs having more restrictions in some respects in

their functioning than commercial banks, may be at a competitive disadvantage and may lag behind their competitor commercial banks as they are unable to provide a wider range of facilities to their customers. Conversion into commercial banks would give more business opportunities to such UCBs.

6.25 However, while considering the option for conversion of multistate UCBs into commercial banks, it will have to be rigorously examined whether they would be able to compete with the peer group and remain viable when subjected to much more stringent statutory and regulatory requirements applied to commercial banks. It will also have to be kept in view that the large sized financially strong multi-State UCBs have been taking over several weak UCBs by way of merger and conversion of such UCBs into commercial banks may slow down the pace of mergers in the UCB sector. Also UCB sector has a market share of about 3 per cent and if some major multi-State UCBs convert themselves into commercial banks, the cooperative sector may lose its presence.

6.26 The existing laws governing cooperatives do not specifically provide for conversion of UCBs into (banking) companies. Therefore, necessary amendments to the Cooperative Societies Acts/ Multi-State Cooperative Societies Act and Companies Act, 1956 may be required for facilitating conversion of UCBs into commercial banks.

Conversion of Urban Cooperative Banks into LABs or small banks

6.27 While the UCBs are organized based on the principles of cooperation and are members driven institutions, the LABs/small banks are set up as corporate entities. The merits of conversion of UCBs into LABs/small banks are as under:

- i)** The members (shareholders) of UCBs are debtors who manage the affairs of the bank and exercise control. The depositors do not have control over UCBs and hence their interests are at stake. Conversion of UCBs into corporate entities like LABs would serve the interest of the depositors better.
- ii)** Only some provisions of the Banking Regulation Act, 1949 are applicable to UCBs, whereas all provisions of the Act apply to LABs and being incorporated as companies, they are also governed by the provisions of Companies Act, 1956. Therefore, conversion of UCBs into LABs would free them from the dual

control of the State/Central Government and the Reserve Bank and mitigate conflict of interests.

- iii) The only source of capital for a UCB is its members which severely constrains the growth and soundness of UCBs. LABs would not have such problems as they can raise capital from the market and issue shares at premium.
- iv) Small banks would have the feel of the local credit needs and would lend to small business, agriculture and meet micro credit needs of the local population. These banks can play an important role in furthering financial inclusion by meeting the basic banking requirements of the local population.

6.28 It could also, however, be argued that the conversion of UCBs into LABs might dilute the founding principle based on which they were created. Firstly, the UCBs are organised on the cooperative principles. These principles would be lost in conversion into a LAB. Moreover, a financial system needs a variety of institutions which enhances stability. Easy conversion of UCBs into LABs or small banks would adversely affect the spirit of cooperation and reduce the diversity in the financial system. Secondly, the LAB would work on more commercial consideration and would tend to overlook people of small means and lend on more commercial lines to achieve economies of scale. The focus of lending of the UCBs, therefore, faces the risk of shifting away from the present clientele of small traders, small businesses to retail loans for vehicle, housing loans and personal loans.

6.29 On the whole, setting up stronger UCBs, with good net worth and strong corporate governance, would facilitate extension of banking services in the regions characterized by poor banking outreach. Some UCBs could convert into LABs/small banks if they meet the required prudential requirements. Such banks, freed from dual control and with better ability to raise capital, may be able to further extend the reach of banking services. .

Legal Framework for Banking

6.30 At present, commercial banks are governed by the following six statutes viz., the Banking Regulation Act, 1949, viz., Banking Companies (Acquisition & Transfer of Undertaking) Act, 1970/1980, State Bank of India Act 1955, State Bank of India (Subsidiary Banks) Act, 1959, Industrial Development Bank (Transfer of Undertaking and

Repeal) Act, 2003 and the Companies Act, 1956. These statutes have embedded provisions which, *inter alia*, hinder consolidation.

6.31 A Report of the Working Group set up by Indian Banks' Association (IBA) in 2004 titled *Consolidation in Indian Banking System: Legal, Regulatory and Other issues* recommended, among others, bringing all commercial banks under the Companies Act (corporatisation of banks) so as to ensure that legal dispensation for mergers and amalgamations in the banking sector is akin to that of the corporate mergers. . In fact, Report of the Committee on Fuller Capital Account Convertibility (Chairman: Shri S.S. Tarapore) called for registration of all commercial banks under a single Act, *viz.*, Companies Act and their regulation under the Banking Regulation Act for providing a level playing field. In view of the foregoing, it is worth consideration, whether irrespective of the nature of incorporation, all banks can be brought under the provisions of the Banking Regulation Act, 1949 and the Companies Act, 1956.

6.32 The report of the Financial Sector Legislative Reforms Commission (FSLRC) (Chairman: Shri B.N.Srikrishna: 2013) has recommended a draft Indian Financial Code, a single unified and internally consistent draft law, that replaces a large part of the existing Indian legal framework governing finance. Further, the Commission also recommends ownership neutrality and competition in the regulatory framework where governance standards for regulated entities will not depend on the organizational form of the financial firm or its ownership.

Chapter 7

Cross-Border Banking Presence

7.1 This chapter examines the issues relating to the presence of foreign banks in India and the Indian banks presence abroad.

Presence of foreign banks in India

7.2 The significance and need for foreign banks' participation in India arises primarily to increase competition, promote efficiency of the local banking system and also for bringing in sophisticated financial services and risk management methodologies which can be adopted by the domestic banks. Based on cross-country experience, there are four main drivers of foreign bank participation, *viz.*, (i) the desire of banks to follow their home customers abroad; (ii) the attractiveness of local profit; (iii) opportunities in the host countries, the absence or elimination of barriers to foreign bank entry; and (iv) the presence of mechanisms to mitigate information costs of doing business in foreign markets.

7.3 The share of foreign banks in total assets of the banking sector in India is just 7 per cent which is less as compared to other jurisdictions. Moreover, the operations of foreign banks are mainly concentrated in urban and metropolitan areas. Out of the total of 333 foreign bank branches, 331 are in urban and metropolitan areas (out of which 44 branches are in underbanked districts). Thus, going by the geographical dispersion, the operations of foreign banks are skewed. In addition, foreign banks account for less than one per cent of total branches of commercial banks in India. In view of the inherent potential for sustained growth in the economy and also growing integration into the global economy there needs to be commensurate expansion in the presence of foreign banks. As major foreign banks specialise in the provision of menu of sophisticated financial products and also facilitate in the flow of foreign capital, their larger presence would meet the requirements of a growing and vibrant economy.

Mode of presence

7.4 Currently, foreign banks presence in India is in the form of branches or representative offices. Reserve Bank of India issues a single class of banking licence for conducting all type of banking business, ranging from retail, wholesale, forex, and derivative products, credit cards, etc. There is no restriction as to the type of business to be conducted through branches unlike in some other countries where restrictions are placed on acceptance of retail deposits, conducting business in local currency, types of clientele, region, availability of deposit insurance, access to clearing and settlement systems etc. Once established, the regulation is non-discriminatory in India, as foreign banks enjoy near national treatment in the matter of conduct of business. As on May 31, 2013, there are 43 foreign banks in India operating through a network of 333 branches. Also, 47 foreign banks have presence in India in the form of representative offices.

Evolving Roadmap for Global Presence

7.5 The experience of the recent global financial crisis suggests that (i) complex structures (ii) too big to fail (TBTF) and (iii) too connected to fail (TCTF) structures could exacerbate the crisis. During the crisis, jurisdictions hosting foreign banks realised that they were exposed to risks generated in the home countries of these banks. Foreign banks significantly withdrew from the credit market in several jurisdictions and more so where they had branch presence. This was the experience in India too where the growth in foreign banks' lending fell to 4 per cent and (-) 1 per cent during the years 2008-09 and 2009-10, respectively. Accordingly, the support for domestic incorporation of foreign banks i.e. subsidiarisation has acquired importance. The other trend in the wake of the crisis has been a move towards more decentralised model – not only in terms of subsidiarisation but also in terms of local funding and risk management, *i.e.*, a move towards 'multinational banking' model over 'international banking' model. It is often argued that such a model leads to suboptimal use of 'capital' and 'liquidity' as they get trapped in various legal entities. However, this is considered to be a tradeoff between efficient use of capital and liquidity

and financial stability. In fact, quite a few host jurisdictions now insist on parental guarantee for support, particularly, for liquidity for branches operating in their jurisdiction.

7.6 Experience from Latin America and Eastern Europe suggests that banks prefer subsidiary model over branches where they intend to undertake large retail operations. From financial stability perspective also a move towards subsidiarisation of foreign banks would be welcome.

Indian Perspective

7.7 As a sequel to the “Roadmap for Presence of Foreign Banks in India” (released in February 2005) and pursuant to the announcement made in the Annual Policy Statement for 2010-11, a *Discussion Paper on Presence of Foreign banks in India* was released on the RBI’s website on January 21, 2011. The Discussion Paper proposed to incentivise the existing foreign banks to convert into an alternative form of presence in the form of Wholly Owned Subsidiaries (WOS) of their parent banks. While deciding the approach towards conversion of existing foreign bank branches, India’s commitments to WTO will have to be kept in mind. It may not, therefore, be possible to mandate conversion of existing branches into subsidiaries. However, the regulatory expectation would be that those foreign banks which meet the conditions and thresholds mandated for subsidiary presence for new entrants or which become systemically important by virtue of their balance sheet size would voluntarily opt for converting their branches into WOS. As regards new entrants, WOS form of presence would be mandatory under certain set of conditions. The other new entrants could opt for a branch mode but subject to an obligation to mandatorily convert to WOS on reaching a certain size.

7.8 The Discussion Paper envisaged a less restrictive branch expansion policy, almost on par with domestic banks with a view to creating an environment favourable to foreign banks being encouraged to set up WOS. With this liberal branch expansion policy, WOS would have access to the hinterland, which hitherto remained unexplored by foreign banks

in India. Thus, there are ample growth opportunities for foreign banks under the WOS set up.

7.9 After resolution of certain issues, comprehensive guidelines on the mode of presence of foreign banks in India would be formulated factoring in the views/comments on the Discussion Paper received from all the stakeholders.

Mode of presence of Indian banks abroad

7.10 Indian banks have overseas presence abroad in the form of branches, subsidiaries, joint ventures and representative offices. As on May 31, 2013, 18 public sector banks and 6 private sector Indian banks have overseas presence. As on March 31, 2012, the aggregate share of overseas branches in the global assets of Indian banks was 11.37% and the share of net profit of overseas branches in the overall profit was 13.02%. State Bank of India accounted for the largest share (27.71%) in the total assets of the overseas branches of Indian banks as on March 31, 2012 followed by Bank of Baroda with 19.53%, Bank of India with 14.08% and ICICI Bank with 13.47%. Indian banks had 24 overseas subsidiaries spread across 17 countries.

7.11 These operations in the local overseas markets are small, are focussed largely on Indian diaspora and have large India exposure. Indian banks have not been able to make significant inroads in the local overseas markets.

Policy stance

7.12 Indian banks are allowed to expand overseas under a policy framework of Reserve Bank of India and Government of India. In February 2005, RBI had come out with a press release stating that the applications from Indian banks for setting up representative offices / branches / subsidiary(ies) outside India as well as applications received from foreign banks for their branch presence in India would be considered for expeditious disposal, based on a liberalised policy and a simplified procedure.

7.13 While examining the applications made by Indian banks for opening overseas offices, the RBI considers, *inter alia*, supervisory comfort, banks' sustainable financial and competitive strength, robustness of their systems for Know Your Customer (KYC)/Anti

Money Laundering (AML), concentration of Indian banks in a particular jurisdiction and approval/ consent from the host country regulator, etc. Likewise, applications from Indian banks for acquisition of banks outside India are examined by the RBI keeping, additionally in view, other factors, such as, due diligence on investee bank and degree of management control.

7.14 In consonance with the above policy framework, while giving approval for opening offices, the critical aspect that is considered, amongst other factors, is the capacity of the bank to survive in a competitive market and remain resilient in the event of adverse market conditions. Needless to add that size and scale of operations would be among the predominant criteria in assessing the strength of the bank to sustain in such a business environment.

Challenges faced by Indian banks in overseas expansion and the Way forward

7.15 Due to a highly competitive environment, enhanced regulation, more intensive supervision and growing emphasis on ring fencing of operations in host jurisdictions in the wake of the crisis, the cost of foreign operations and compliance is on the rise. Moreover, branches in many jurisdictions are subjected to several restrictions unlike in India, viz., restrictions on businesses, restrictions on currencies they can deal in and restriction on taking retail deposits, etc. Thus, Indian banks may find it difficult to sustain competition and grow in certain jurisdictions. A business plan which factors in an appropriate strategic response by Indian bank managements would be the way forward. Some of the plausible responses to meet such challenges could be as follows:

- i) The large Indian banks identified for international presence in accordance with the Narasimham Committee recommendations would continue to have liberalised regime for setting up branch presence abroad. However, they should be encouraged to set up locally incorporated entities either individually or in Joint Venture (JV) mode with other banks or overseas banks with the object of offering a wider range of products rather than just 'trade finance' in which margins are beginning to get stretched. Local incorporation will allow the Indian banks to engage in a much wider range of activities and the potential for growth and facilitate global reach eventually. These banks could endeavour to

widen their range of products and clientele by shifting away from excessive Indian exposure.

- ii) Medium sized banking entities which have to be essentially domestic entities in the context of the Narasimham Committee recommendations could be allowed branch presence on a selective basis. These banks could also be permitted to participate in the overseas subsidiaries or JVs of the large Indian banks. This would enable medium sized Indian banks, who would find it difficult to enter certain competitive jurisdictions all by themselves, to have access to lucrative markets.
- iii) Smaller banks may be allowed presence only by way of Representative office and a branch presence on a very selective basis based on some specific considerations like linkage with Indian diaspora, etc.

Chapter 8

Ownership of Indian Banks - Issues

8.1 At the time of independence in 1947, banks were owned by the private sector and as such there was large concentration of resources in the hands of a few business families. The objectives of social control introduced was to achieve a wider spread of bank credit, prevent its misuse, direct a larger volume of credit flow to priority sectors and to make it an effective instrument of economic development. Nationalisation of banks was resorted to in 1969 (14 banks) and subsequently in 1980 (6 banks).

8.2 Reflecting large-scale expansion of branch network by the PSBs over the years, population per branch fell significantly from 1,36,000 in 1951 to 12,500 in 2012, a big leap towards inclusive banking.

8.3 There is, however, a debate about the private sector banks being more profitable and efficient than the public sector banks. Those who favour private sector ownership of banks advocate that Government should reduce its ownership stake in the public sector banks. In the context of this debate, it is essential to look at the comparative performance of the PSBs and the private sector banks.

Comparative Analysis: Public vs. Private

8.4 Profits per branch and profits per employee of PSBs are much lower than that of the private sector banks. Given the fact that PSBs have more number of branches and more number of employees than the private sector peers, profit per-branch and profit per-employee would invariably be lower for PSBs.

8.5 A better way to gauge the performance of PSBs is to examine their share in total assets and profits of all scheduled commercial banks (SCBs) since the on-set of banking sector reforms. The share of PSBs in total assets of all scheduled commercial banks (SCBs) fell from over 85 per cent in 1995-96 to about 73 per cent in 2011-12. However, the share

of PSBs in the overall profits of the banking sector rose from over -39 per cent (negative profits) to about 61 per cent during the same period. As indicated by the two main indicators of profitability, *i.e.*, return on assets (RoA) and return on equity (RoE), the private sector banks showed relatively better performance as compared with the public sector banks. This is reflected in higher RoA of private sector banks for almost all the years during 2000-2012. In addition, RoE of private sector banks exhibited an increasing trend from 2007 onwards, as compared with a more stable trend in case of public sector banks during the same period. In 2011-12, RoA of PSBs was placed at 0.9 per cent against 1.5 per cent for the private sector banks. The corresponding figures for RoE were 15.3 and 15.2 per cent respectively. Before 2008, the NIM of public sector banks was higher than private sector banks. However, there is a reversal of this trend after 2008. This implies an increased profitability of private sector banks during recent times.

8.6 The Report on Currency and Finance (RCF) 2006-08 made an assessment of among others, efficiency and productivity of banking sector in India using different dimensions, one of them being ownership (public *vs.* private). The efficiency and productivity of the banking system was measured in terms of certain parameters. These included ratio of operating cost to total assets, cost to income ratio, labour cost per unit of earning assets, non-labour cost per unit of earning assets, Net Interest Margin (NIM) to total assets ratio, business per employee and business per branch.

8.7 PSBs posted divergent performance standards when measured by different yardsticks. The performance of the PSBs was better than that of the other two bank groups (private sector banks and foreign banks) in terms of measures such as operating cost to total assets and non-labour cost per unit of earning assets, while it was poorest when measured in terms of business per employee and business per branch. On the other hand, performance of the PSBs was placed between that of the other two groups *vis-à-vis* labour cost per unit of earning assets, cost to income ratio and net interest margin to total assets ratio.

8.8 Clearly, the evidence here is not conclusive, because comparisons are beset with several difficulties. Given the size and variety of PSBs, it is possible to find banks that

could equal the good private sector banks as well as the not so good ones. In addition, PSBs had to reckon with 'legacy' problems, such as many of the non-performing assets that they have been saddled with. Recent trends in NPAs, however, clearly indicate that the stress on asset quality in the PSBs is significantly higher than that in the private sector and foreign banks. This could be due to several reasons: PSBs' larger presence in infrastructure and other big projects which have suffered due to delays in various clearances, some PSBs operating in relatively backward areas with limited discretion to pull out from such areas and also due to credit appraisal and risk management issues.

8.9 Notwithstanding the above, broadly over the years, the performance of public sector banks has converged with that of new private sector and foreign banks. Even, more importantly, contrary to popular perception, there is also no significant relationship between ownership and efficiency - the most efficient banks straddle all three segments - public sector banks, private sector banks and foreign banks (Subbarao, 2011b).

8.10 In fact, many studies in the Indian context have not found any significant difference between the performance indicators of Public Sector Banks (PSBs) *vis-à-vis* private sector banks in the post-reform period. This suggests that, with operational flexibility, public sector banks are competing relatively effectively with private sector and foreign banks. The 'market discipline' imposed by the listing of public sector banks has also probably contributed to this improved performance. Public sector bank managements are now more attuned to the market consequences of their activities. Another factor that seems to have played a role is that PSBs enjoy a huge first mover advantage in terms of scale of operations over private sector banks and these advantages perhaps offset any inefficiency that could be ascribed to the Government ownership.

Financial stability

8.11 The predominance of government owned banks in India has contributed to financial stability in the country. Experience has shown that even the deterioration in bank financials does not lead to erosion of consumer confidence in such banks. This kind of consumer confidence does not extend to private sector banks (Mohan, 2006).

8.12 Further, as demonstrated in the recent global financial crisis, public-ownership has positive implications for financial stability as deposits migrated from the private sector banks to public sector banks. Thus, even at the height of the recent global financial crisis, retail deposits in India did not desert banks. This was in contrast to the banks in advanced economies where there was a liquidity crisis due to deposit run, as a result of which there was a need for blanket extension of deposit insurance across Europe. Further, banks in the advanced economies were bailed out by their sovereigns through bank recapitalization, asset purchases, etc. For example, the US government invested about \$200 billion in various banks – including US \$ 25 billion into the Citigroup Inc - through its Capital Purchase Program in an effort to prop up capital. Nationalisation of failed large private banks engaging in casino banking in these economies during the recent crisis was criticised as characterising private gains and public losses.

Optimal ownership mix

8.13 Ideally, the ownership status of banks should promote a balance between efficiency, equity and financial stability, which the current approach to banking sector reforms in India aims at with a comprehensive reorientation of competition, regulation and ownership in a non-disruptive and cost-effective manner. In particular, it enables use of instrumentality of public ownership to further certain identified broader objectives of public policy. Therefore, going forward, there is a better payoff in enabling PSBs to improve their performance while promoting private sector banks.

Recapitalisation of banks

8.14 Of late, yet another dimension that has been added to the ownership debate : Adoption of Basel III framework by banks requires large-scale mobilisation of capital and given the limited fiscal space for the Government – the owners - to bring in more capital, there is a requirement of diluting public-ownership to allow for private capital to come in. In 2012-13, there was a capital infusion of the order of ₹.125 billion in select public sector banks in India. In this context, it needs to be noted that as per RBI calculations, the amount of additional capital required to be infused by the Government in the wake of adoption of

Basel III framework is ₹. 900 billion over a period of 5 years, if the Government opts to maintain its shareholding at the current level. Clearly, providing equity capital of this size in the face of fiscal constraints poses significant challenges. The Narasimham Committee had recommended reducing the government ownership in public sector banks to 33 per cent. The contention is that it will help the government to reduce its allocation of scarce funds to recapitalize the banks from time to time. So, it is argued that as a prudent economic decision, there is a case for government to reduce its ownership stake in the PSBs. Reduction in fiscal burden on account on recapitalization of the PSBs can also be achieved by considering issue of non-voting equity shares or differential voting equity shares. Government could also consider diluting its stake below 51 per cent in conjunction with certain protective rights to the government by amending the statutes governing the Public Sector banks. Government also has the option of considering setting up Financial Holding Companies as recommended by the Report of the Working Group on Introduction of Financial Holding Company structure in India.

8.15 In order to achieve the objectives of adequacy of credit and financial inclusion, it may be necessary to expand the number of banks and the size of the banking sector. However, such expansion is unlikely to come about from public banks given the fiscal costs involved in providing continuous capital support to these institutions. Hence, there is a need to boost the presence of private banks, while consolidating the existing public banking system.

Chapter 9

Resolution Mechanisms and Deposit Insurance

Need for an Effective Resolution Mechanism

9.1 Fundamentally, banks suffer from maturity mismatch on account of their business model, wherein they borrow short (traditionally in the form of demand deposits) and lend long. Banks are therefore particularly susceptible to runs, which can lead to the failure of even an otherwise healthy institution. Given the central role banks play in a well-functioning economy, safety nets were established to prevent or-if necessary-contain the failure of individual banks. This safety net typically consists of temporary liquidity support (lender of last resort), prudential supervision, orderly resolution and deposit insurance. Working together, these “circuit breakers” are generally able to prevent widespread banking failures during normal times.

9.2 The recent crisis, however, saw breakdowns at virtually every level of the safety net. In particular, capital standards (a crucial component of prudential supervision) proved completely inadequate, as most of the high-profile failing banks-including Lehman Brothers and Bear Stearns-had capital levels well in excess of the standards for a “well capitalised” bank. This calls for a well defined resolution mechanism to address the bank failures, especially those that are too-big-to-fail.

9.3 Special bank resolution regime protects certain critical stakeholders and functions, such as depositors and payment systems, and maintains them as operational, while other parts, which are not considered key to financial stability, may be allowed to fail in the normal way. In order to avoid moral hazard and use of taxpayers’ money to support failing banks, shareholder and debt holders need to know that they will bear an appropriate share of the losses in the event of a failure and attribute a suitable price to this risk. Special bank resolution regime also ensures that decisions are taken rapidly in order to avoid contagion. An effective resolution framework should not only provide the tools and the financial means to act decisively, but it should also empower an independent authority (the

resolution authority) to orderly resolve any bank in difficulties without exposing the taxpayers to loss, while ensuring continuation of critical and important functions.

Deposit Insurance and resolution

9.4 Deposit insurance system is a component of the financial system safety net that promotes financial stability in the economy. Increasingly, deposit insurance and resolution functions are being combined in one agency. The combination allows for swift decision-making and efficient resolution. In situations when liquidation of the bank is the only possible way to resolve the bank, deposit insurance comes into play. In certain jurisdictions like Belgium, Hong Kong, India, Singapore, Sweden and Switzerland, deposit protection schemes are not used to fund resolution measures, but only fund the repayment of deposits up to a certain limit.

9.5 There are some basic principles for an appropriate safety net viz. desirability of private sector solutions, resolution mechanism involving least cost criteria, use of private funds for resolution, availability of fiscal backstop, swift and effective decision-making, good governance and accountability of the resolution mechanism.

International experience

9.6 Post- crisis, many jurisdictions initiated major reforms in their resolution regimes; the most important are Canada (2009), UK- the Banking Act (2009), USA-Dodd-Frank Act (2010), Germany – The Law on Bank Restructuring (2011), Switzerland (2011), and recently the draft framework for crisis management in the financial sector issued by European Union in June 2012.

9.7 The Financial Stability Board has proposed a set of twelve core elements viz. ‘the Key Attributes’, as essential components of an effective resolution regime for financial institutions⁶. Key Attributes envisage a full-fledged resolution authority that would have a

⁶ The key attributes are: (i) Scope of resolution regime (ii) Dedicated resolution authority (iii) Resolution tools and powers effecting orderly resolution (iv) Legal framework governing set-off rights, contractual netting and collateralization agreements and the segregation of client assets, and power to stay temporarily such rights (v) Safeguards regarding

broad range of powers/ tools and options to resolve a firm that is no longer viable and has no reasonable prospect of becoming so.

USA

9.8 The U.S. has the longest established bank resolution regime. The Federal Deposit Insurance Corporation (FDIC), plays three critical roles in relation to bank resolution, namely (i) acting as an insurer of bank depositors; (ii) acting as a statutory receiver for failing banks and administering the resolution regime; and (iii) acting as a prudential supervisor and regulator of banks generally, including triggering the prompt corrective action (PCA). The Orderly Liquidation Authority (OLA) established under the Dodd-Frank Act of 2010 further expands the resolution authority of FDIC assigning resolution powers for large banks including investment banks in addition to the existing FDIC powers for smaller banks.

UK

9.9 UK has overhauled its system drastically and put in place a Special Resolution Regime in time for the latter stages of the financial crisis. The UK Special Resolution Regime (SRR), established under the Banking Act (2009), provides the authorities such as the HM Treasury, Bank of England (BOE) and Financial Services Authority (FSA), with four key tools to carry out two specific objectives: stabilisation and orderly resolution. The tools available for stabilization include power to enable the BOE to either sell a failing bank's business to a private sector purchaser; transfer the bank to a bridge bank (owned and controlled by the BOE) or put the bank into temporary public ownership (nationalisation). The tools available for orderly resolution of bank include modification of procedures to

respecting creditor hierarchy and "no creditor worse off" principle in resolution;(vi) Resolution funding arrangements (vii) Legal framework for cross-border cooperation and information sharing; (viii) Constitution of crisis management groups (CMGs) for all G-SIFIs (ix) Institution-specific cross-border agreements (x) Resolvability assessments of financial institutions (xi) Formulation of recovery and resolution plans (RRPs) (xii) Information sharing arrangements

expedite depositors' claims payment and facilitate transfer of deposits to another bank. In allowing for a partial as well as a whole transfer, the regime applies the principle of a good bank-bad bank model, as the transfer of assets would leave a "residual bank" which may remain a functioning entity. The resolution tools under the SRR are supplemented by the bail-in powers recommended by the Vickers' Report of 2011 which would enable the resolution authority to impose losses on all unsecured debt of a failing bank.

European Union (EU)

9.10 Under the proposed EU Crisis Management and Bank Resolution Framework published on June 6, 2012, the European Commission outlines four key resolution tools resolution authorities should have in carrying out two objectives: stabilisation and orderly resolution. For the stabilization objective, the resolution authorities should have the power to either sell the failing entity through an open and transparent process, transfer the entity to a bridge bank (wholly-owned by the authority) for a specified period or transfer the entity to an asset management vehicle (wholly-owned by public authorities). The orderly resolution tools include power to require conversion of debt instruments of the failing entity into equity or write down the claims of unsecured creditors (bail-in).

Resolution triggers

9.11 Resolution triggers vary across countries and depend on the type of financial institution being dealt with and (in some countries) the nature of the powers being exercised. In general, they are pre-insolvency, based on qualitative regulatory criteria – e.g., breach of Resolution policies and frameworks, prudential or regulatory thresholds, or supervisory orders (e.g., - Australia, Brazil, France, Hong Kong, Italy, Japan, Mexico, Singapore, the United Kingdom and the United States), conduct of business in a manner not consistent with the interests of depositors (e.g., Brazil, China, Singapore and the United States), or a threat to the stability of the financial system (e.g., Australia, Belgium, Germany, Sweden and the United States) - to avoid the risk of regulatory over-shooting (i.e., that the authorities would act mechanically although the real situation might differ from the model).

9.12 The triggers are generally exercised at the discretion of the authorities, which permits the authorities to respond “rapidly” and “flexibly” to a “wide variety of circumstances”, as stated in the Basel Committee on Banking Supervision’s (2002), six categories of bank resolution methods:

- Bank closure and deposit payout (Deposit reimbursement),
- Radical restructuring,
- Purchase and assumption (P&A),
- Mergers and Amalgamations (M&A),
- Bridge bank, and
- Open bank assistance.

9.13 Each method embodies advantages and disadvantages and could be more or less appropriate depending on circumstances. The above six categories are illustrations of the alternatives for handling failing banks, even though these do not represent a mutually exclusive typology. In other words, a combination of some of the methods can be implemented in a sequence or in tandem to address problems at a given failing bank. Countries typically adopt a least cost criteria in order to decide which resolution method to apply.

Indian Experience

9.14 Deposit Insurance and Credit Guarantee Corporation of India (DICGC), a wholly owned subsidiary of the Reserve Bank, has operated as a ‘pay box’ for paying the small depositors of the failing banks. But in making payments to depositors, it is handicapped by inadequate information regarding depositors. The delay in settlement of claims of depositors can be attributed to reasons such as pending court cases, improper maintenance of books, delay in appointment of the liquidators, etc. With a view to reducing hardship to small depositors of failed banks, the Corporation has been taking various steps to ensure quicker settlement of deposit insurance claims. However, the average time taken for settlement of claims has remained around one year in the absence of an accountability regime for liquidators.

9.15 The deposit insurance in other countries is substantial [e.g., USA - USD 2,50,000, France – EUR 1,00,000, Germany - EUR 1,00,000, Canada - Canadian \$ 1,00,000, Hong Kong - HK\$ 5,00,000 (approx USD 64,000), UK - GBP 85,000, Australia – AUD 2,50,000 (approx USD 2,55,000), Indonesia – 2 billion rupiah (approx USD 2,07,000), Japan – JPY 10,000,000 (approx USD 1,05,000), Singapore – SGD 50,000 (approx USD 40,000), etc]. DICGC in India covers the depositors to the extent of ₹.1,00,000/- (approx USD 1,582). At this level, DICGC provides full protection to 94 per cent of accounts and in value terms, 33 per cent of deposits are covered.

9.16 In India, failures of commercial banks have been rare, and the beneficiaries of the deposit insurance system have mainly been the urban co-operative banks. As far as the resolution mechanism is concerned, India does not have a special resolution regime or comprehensive policy or law on bankruptcy exclusively for the financial institutions as a whole. The typical resolution methods used in India are assisting the troubled bank in restructuring, or merging it with a strong institution, or closure (Saran, P and Gopinath Tulasi, 2010). In case of smaller urban cooperative banks, the general approach has been to encourage voluntary amalgamation with large-sized, well-managed and financially sound banks or to liquidate the bank with reimbursement made to small depositors by the DICGC.

9.17 For the purpose of resolution, there are provisions contained in various Acts which empower either the RBI or the central government to resolve different types of banks and other financial institutions in India. The provisions relating to resolution of banking companies, i.e. private sector banks and foreign banks having offices in India, are contained in the Banking Regulation Act, 1949 and Companies Act, 1956. However, the resolution of public sector banks (i.e. State Bank of India and its Associate Banks, and nationalized banks) and Regional Rural Banks (RRBs) are governed by the respective statutes, viz., State Bank of India Act, 1955, State Bank of India (Subsidiary Banks) Act, 1959, Banking Companies (Acquisition & Transfer of Undertakings) Act, 1970/1980 and Regional Rural Banks Act, 1976 respectively.

9.18 The resolution of co-operative banks (state co-operative banks, central co-operative banks and primary co-operative banks) is governed by the provisions of the Banking Regulation Act, 1949 (As Applicable to Co-operative Societies), respective State Co-operative Societies Acts and the Multi-State Co-operative Societies Act, 2002.

9.19 For resolving a troubled bank, Reserve Bank has powers to supersede the Board of Directors of a banking company, impose moratorium in consultation with the Government, prepare a scheme of reconstruction or amalgamation and make an application to the High Court for winding up of the banking company.

9.20 The extant legal framework, however, does not specify or provide powers to the Reserve Bank or the Central Government to ensure continuity of essential services and functions of the failing private sector banks. In case of public sector banks, the existing legal framework does not provide any specific powers to the Reserve Bank or the Central Government to exercise any resolution tool, except for liquidation.

9.21 The existing resolution regime for banks in India is deficient. The extent of gaps is so huge that implementation of the FSB Key Attributes in the Indian context would require complete revamp of the existing legislation and arrangements for effective resolution of banks and financial institutions. Such an exercise with alignment of resolution powers and tools would be a huge task. There are also difficulties in bringing the co-operative banks within the scope of the special resolution regime, without a separate legal framework that overrides all other Acts, as these are under the dual control of the RBI and concerned State/Central Governments.

9.22 The existence of an effective resolution regime is essential for any type of banking structure India may pursue. For example, if small banks are preferred to large banks, as has been discussed earlier, these banks would be more prone to failures and their effective and quick resolution is essential. Similarly, if the option of large and global banks is preferred,

there would be a need for resolution of the complex structure that they would create on the lines suggested by the Key Attributes. Therefore, the issues to be debated are:

- i) What should be the resolution regime for India - should it essentially cover all financial institutions (*including holding companies of a firm; non-regulated operational entities within a financial group or conglomerate that are significant to the business of the group or conglomerate; and branches of foreign firms*) that could be systemically significant or critical if it fails or cover financial institutions of all sizes.
- ii) The FSB key attribute provides that each jurisdiction should have a designated administrative authority / authorities responsible for resolving the financial institutions. Where there are different resolution authorities for resolving entities of the same group within a single jurisdiction, a 'Lead Authority' should be identified for coordinating the resolution of the legal entities within that jurisdiction. The sectoral regulators have the expertise, resources and the operational capacity and the know-how of the respective financial institutions they regulate and would, therefore, be the suitable authorities for exercising the resolution measures and actions in respect of the respective financial institutions. Considering that RBI is the regulatory authority for banks and NBFCs which have dominant financial assets in the system and major portion of the financial market infrastructure also comes under the regulatory jurisdiction of the RBI, the RBI could be designated as the Lead Authority for coordinating the resolution of such entities. However, the FSLRC has suggested setting up of a new Resolution Corporation.
- iii) A key attribute of an effective resolution regime is the existence of a legal framework governing set-off rights, contractual netting and collateralisation agreements and the segregation of client assets, and power to stay temporarily such rights. Safeguards regarding respecting creditor hierarchy and "no creditor worse off" principle in resolution is also essential. The legal framework in India in this regard is very weak. A robust legal framework may be needed for an effective resolution regime.
- iv) A FSB key attribute provides that jurisdictions should put in place an ongoing process for recovery and resolution planning, covering at minimum domestically incorporated financial institutions that could be systemically significant or critical if they fail. The key attributes provides that the supervisors and resolution authorities should ensure that the financial institutions, that are considered to be so systemically important that could affect the financial stability, should maintain a "recovery plan" that gives a detailed presentation of options that the firm would take to restore its financial strength and viability when it comes under a severe stress. On the other hand, the

resolution authorities are required to prepare a “resolution plan” for all such firms detailing the resolution strategy for the failure of the firm so as to manage its demise in a controlled manner. The above requirement would become essential if India pursues the path of encouraging a few large and global banks whose corporate structures could be relatively complex.

9.23 Another FSB key attribute, *inter alia*, provides that the jurisdictions should have statutory or other policies in place so that the resolution authorities are not constrained to rely on public ownership tool or bail-out funds as a means of resolving failing financial institutions. The principle underlying this key attribute is to avoid the exposure of taxpayers to loss in resolving a failing financial institution. This also means that the resolution regime of a jurisdiction has a statutory mandate that restricts the resolution authority from relying on public ownership or bail-out as a means of resolving firms; or permits it only if specified conditions are met, or only in limited and defined circumstances (for example, where only public ownership or bail-out of the firm and no other measures could address a serious threat to financial stability or meet public policy objectives). With a view to avoiding the exposure of taxpayers to loss in resolving a failing firm, the FSB key attribute provides that the jurisdictions should have in place privately-financed deposit insurance or resolution funds, or a funding mechanism for *ex post* recovery from the industry of the costs of providing temporary financing to facilitate orderly resolution of a firm. As mentioned earlier, India has a deposit insurance scheme under the DICGC. But it is not a resolution fund. It may be synergistic to have a resolution fund with the DICGC if DICGC evolves into a resolution agency or as recommended by the FSLRC, a new Resolution Corporation could be set up which would have the fund.

Way forward

9.24 An internal Working Group (Chairman: Shri B. Mahapatra) looked into the current gaps, vis-a-vis the FSB “key attributes” in the Indian resolution regime for the banking system in particular and the required legislative and regulatory changes to address such gaps.

9.25 Under the aegis of the Sub-Committee of the Financial Stability and Development Council (FSDC) a Working Group (Co-chairman: Shri A.Sinha, Deputy Governor, RBI and Shri Arvind Mayaram, Secretary, Ministry of Finance, Government of India) comprising of members from RBI, Government of India, SEBI, IRDA, PFDR and DICGC was set up. The Group is examining issues involved with regard to a comprehensive resolution regime for all types of financial institutions in India.

Chapter 10

The Way Forward

10.1 The approach in the Discussion Paper has been to introspect and contemplate changes in the banking structure in the light of the need for the banking system to serve the requirements of a growing and globalizing economy as well as the need to further financial inclusion, factoring in the lessons from the crisis, particularly, on structural issues, to analytically assess and put forth pros and cons of the proposed changes and suggest a direction for further debate.

10.2 The analysis made in the Discussion Paper brings to the fore, the fact that there is a case for reorienting the existing banking structure to make it more dynamic and amenable to meet the needs of the economy. Since 1991, the Indian economy has grown manifold and there has been progressive liberalization and globalisation of the economy. During this period the number of new commercial banks licensed is only 12 and none of the Indian banks has acquired the size and reach on a global scale. The percentage of population without access to formal financial services is still significant. It is, therefore, imperative that the expansion in the banking sector keeps pace with the dynamism and competitive nature of the real economy. Further, there is a need to relook the structure of the banking system keeping in view the international experience and the current debate on banking structure so as to evolve a structure most suited to our needs while enhancing financial stability. In this context, this Paper sets out logic for aiming for a more dynamic banking system on the basis of following considerations:

- Scope for increasing the size and capacity of the banking structure
- Imperative need for increasing the outreach of the banking structure
- Requirement of banks with large international presence
- Gaps in providing credit to some sectors
- Liberal entry process of banks on a 'continuous basis'
- A differentiated licensing system for providing special or niche services
- Scope for enhancing foreign banks presence and a more nuanced policy for Indian banks' presence abroad

- Scope for encouraging well-performing multi state urban cooperative banks to convert themselves into commercial banks and other UCBs into LABs/small banks
- Significant capitalisation needs of banks in future to conform to Basel III norms
- Pre-dominance of Government ownership
- Banking structure to enhance financial stability
- Strengthening deposit insurance and resolution mechanism

10.3 There is a case for encouraging new entrants into the banking system. In a dynamic setting of emerging and evolving needs, it would be utopian to think that there would be a static class of small banks serving local needs and will continue to do so for all time to come. Banks would either grow to become big or would merge, or, fail. Since mergers and inorganic growth are natural phenomena, the number of small institutions which would be at the grass-root level will likely shrink over a period of time even as the population needing basic financial services increases. It follows that there would be a need for a steady stream of new entrants which comply with stringent entry norms, into the banking system.

10.4 While the objective of the review is to address various issues such as enhancing competition, financing higher growth, providing specialised services and furthering financial inclusion, the concerns arising out of such changes need to be carefully considered. For example, encouraging the emergence of big banks does help fund big-ticket investments. However, large banks do pose moral hazard problems of too-big-to fail with adverse implications for financial stability, as demonstrated by the recent global financial crisis. Similarly, while competition and efficiency improve price discovery and efficient allocation of scarce financial resources across competing productive sectors of the economy, financial stability concerns arising out of such an endeavour should not be lost sight of. As regards financial inclusion, while encouraging small banks could be one of the preferred institutional choices for financial inclusion endeavor, such an approach may increase cost of capital, as small banks may lack the scale needed for cost-effective resource mobilization. The trade-offs, therefore, need to be judiciously managed.

10.5 The Discussion Paper examines various issues of policy relevance from the stand point of reforming the banking structure elaborating both pros and cons, reflecting the trade-offs therein, drawing upon international/cross-country experience, wherever appropriate. In the process, the building blocks for such a reorientation have tentatively been identified and examined in the Paper. This involved an in-depth analysis of the constituents of the Indian banking structure and the well-laid down policy framework on which it rests. The Paper examines various policy options encompassing commercial banks including foreign banks and co-operative banks that would alter the contours of the existing banking structure.

10.6 The Discussion Paper while examining the pros and cons of various options suggests that the objectives of enhancing competition, promoting higher growth and furthering financial inclusion could be achieved possibly, by measures such as putting in place a continuous entry process, creating space for more mid-sized private banks, allowing setting up niche banks through differential licensing and small-sized local banks, encouraging the presence of more foreign banks, rationalizing the policy regarding presence of Indian banks abroad, allowing conversion of UCBs into commercial banks or LABs/small banks and facilitating consolidation of large and mid-sized commercial banks on voluntary basis. However, there should be no let up in the rigorous prudential requirements at any stage to ensure that banks at various tiers of the envisaged structure are financially sound and resilient.

10.7 Reorientation of the Indian banking sector is not a discreet onetime event, but a continuous and endogenous process matching the structural changes taking place in the Indian economy. Therefore, the policy environment should impart flexibility to allow this to happen endogenously and in normal course. The spirit and the thrust of the reorientation exercise is to tweak the existing policy regime in a dynamic way, so as to create enabling conditions that may pave way endogenously to the emergence of a more dynamic banking structure.

10.8 Suggested basic building blocks of the reorientation exercise

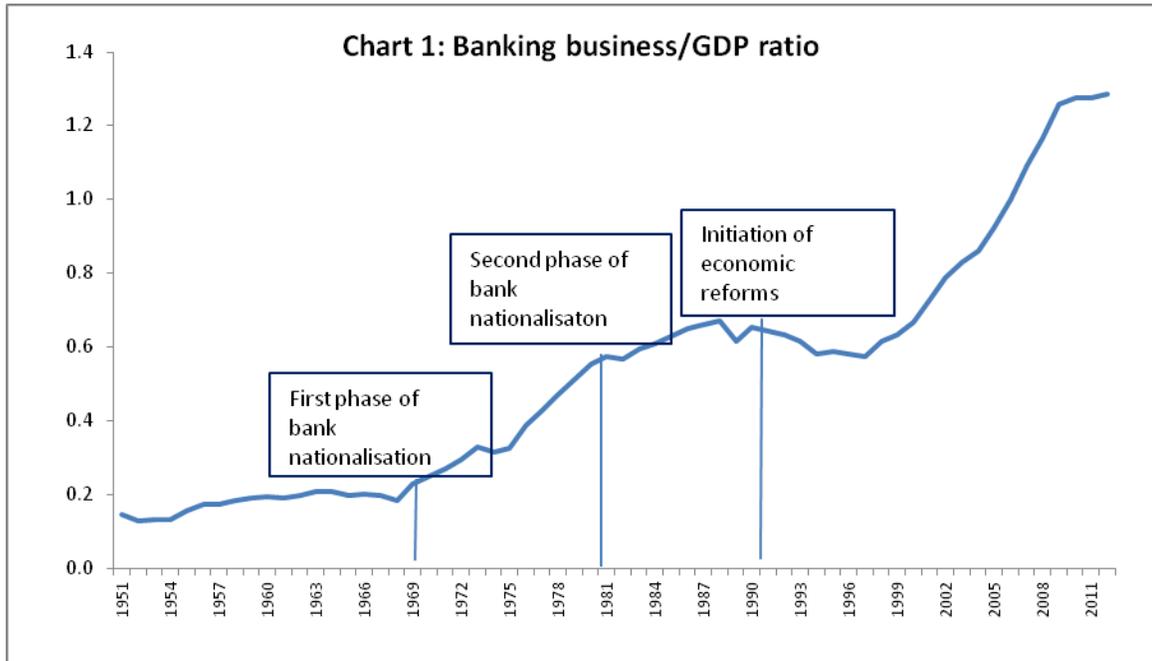
- i) Expanding capacity for banking services with suitable structures which enhances the degree and efficiency of financial intermediation process.
- ii) Creation of three or four global sized banks to have global presence through consolidation among large public sector banks and private sector banks, keeping in view the need for competition within the domestic banking sector and avoiding complex structures
- iii) Implementing domestic systemically important Bank framework to deal with negative externalities of large banks
- iv) Transiting from bank led universal banking model which is the dominant form in India to a financial holding company structure
- v) Encouraging investment banks/investment banking activities
- vi) Allowing banks for niche segments for taking care of specialized banking needs through differentiated licensing.
- vii) Enhancing presence of foreign banks to stimulate competition and their subsidiarisation from the perspective of financial stability
- viii) Reorienting the policy regarding the presence of Indian banks abroad.
- ix) Encouraging inclusion to reach out to the excluded and underbanked regions. Small banks at the bottom of the tiered structure may be the preferred vehicle for these objectives to facilitate financial inclusion.
- x) Conversion of UCBs which meet the necessary criteria into commercial banks or LABS/small banks.
- xi) On tap licensing as compared to block licensing approach to enhance competition and bring in new ideas and variety into the system.
- xii) Enhancing the regulatory and supervisory regimes with increased intensity of supervision for the systemically important banks.
- xiii) Evolving an efficient deposit insurance and resolution mechanism to support the envisaged tiered structure.

10.9 Most of these building blocks as stated earlier have both strengths and weaknesses as discussed in this Paper. Therefore, while devising a structure these trade-offs will have to be suitably balanced for promoting financial stability.

10.10 Once the relevant policies are appropriately liberalised, possibly, a reoriented banking system with distinct tiers of banking institutions may emerge. The first tier may consist of three or four large Indian banks with domestic and international presence along with branches of foreign banks in India. The second tier is likely to comprise several mid-

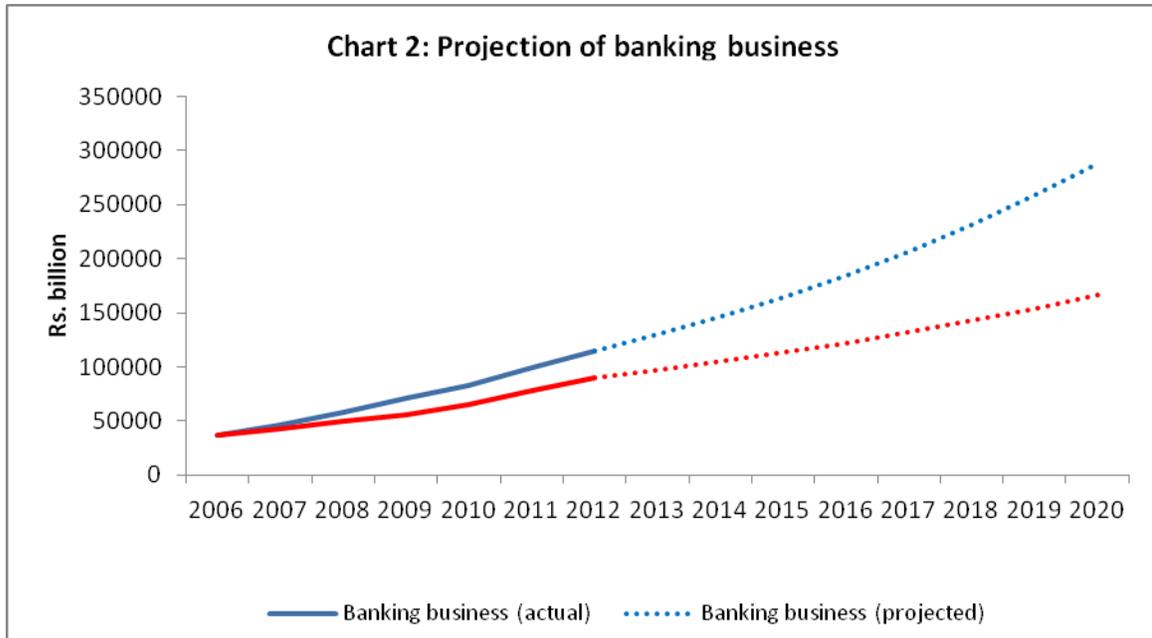
sized banking institutions including niche banks with economy-wide presence. These are capable of offering a broad range of banking products and services to the domestic economy such as investment banking, wholesale banking and funding large infrastructure projects. The third tier may encompass old private sector banks, Regional Rural Banks, and multi state Urban Cooperative Banks. The fourth tier may embrace many small privately owned local banks and cooperative banks, which may specifically cater to the credit requirements of small borrowers in the unorganised sector in unbanked and under banked areas. The present and the indicative profiles of the reoriented banking system after the envisaged restructuring are given in *Annex III*.

10.11 In short, the reoriented structure will be dynamic, with the emergence of well capitalised banks, which are prudently regulated and rigourously supervised. The task of restructuring the Indian banking system is a complex exercise and poses a number of challenges and would require wading through several cumbersome and conflicting processes and execute a plan of action.



The structural breaks were estimated using the Bai-Perron Test

Source: Handbook of Statistics on Indian Economy.



Note: GDP is projected assuming the rate of growth of 8 per cent per annum till 2020. The ratio of banking business to GDP is worked out assuming that the trend witnessed in the latest break period of 1999-2012 would continue during the projected period.

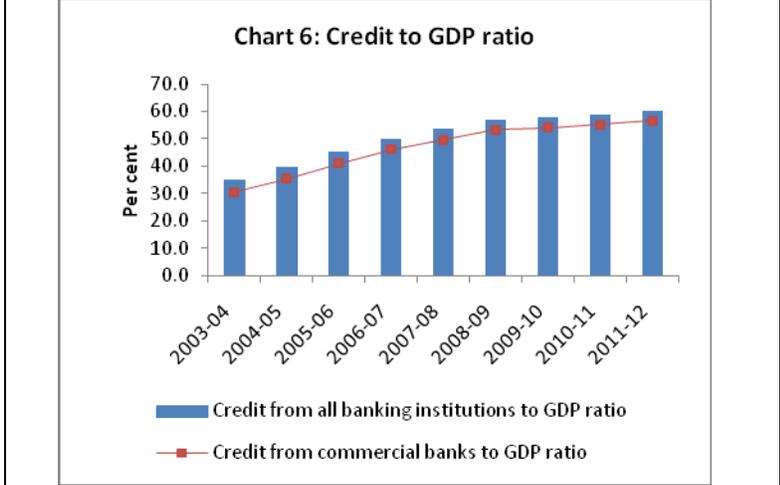
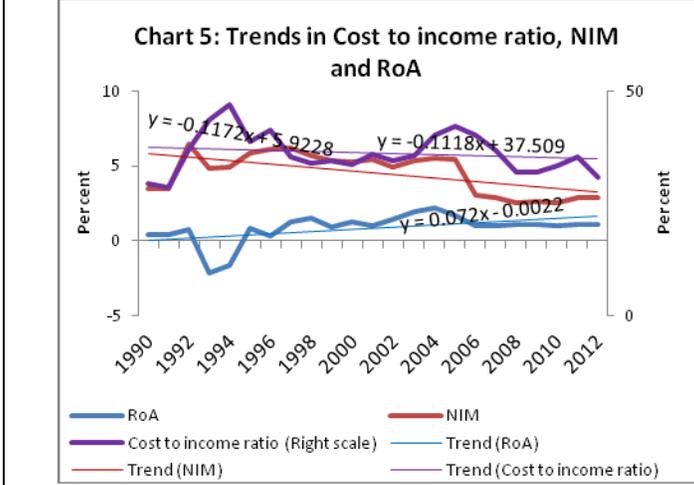
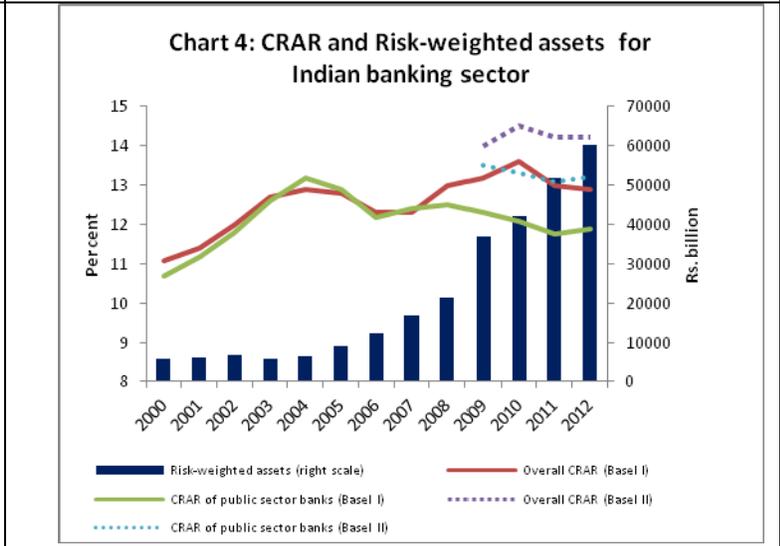
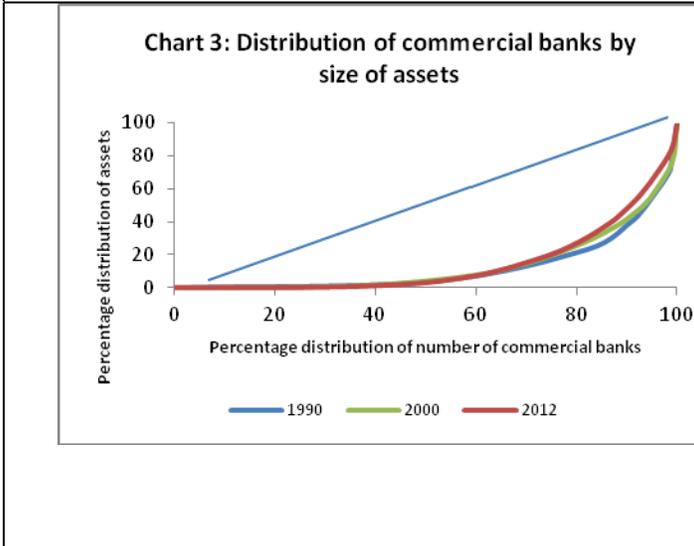
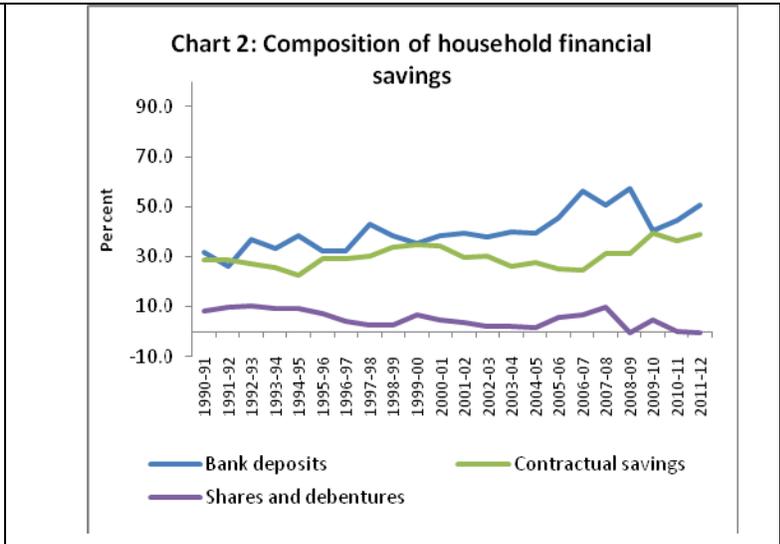
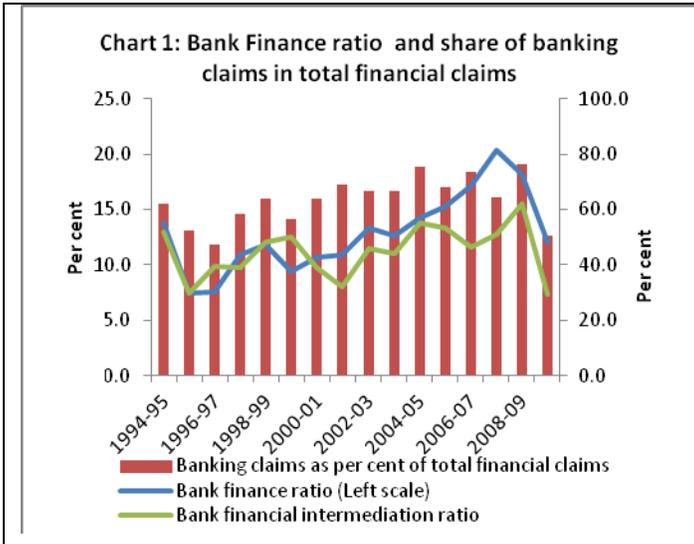
| Table 1: Break-up of Institutional and Non-Institutional Rural Credit (Per cent) | | | | | | |
|---|-------------|-------------|-------------|-------------|-------------|-------------|
| | 1951 | 1961 | 1971 | 1981 | 1991 | 2002 |
| <i>Institutional Agencies</i> | 7.2 | 14.8 | 29.2 | 61.2 | 64.0 | 57.1 |
| Government | 3.3 | 5.3 | 6.7 | 4.0 | 5.7 | 2.3 |
| Co-op. Society/bank | 3.1 | 9.1 | 20.1 | 28.6 | 18.6 | 27.3 |
| Commercial bank incl. RRBs | 0.8 | 0.4 | 2.2 | 28.0 | 29.0 | 24.5 |
| Insurance | -- | -- | 0.1 | 0.3 | 0.5 | 0.3 |
| Provident Fund | -- | -- | 0.1 | 0.3 | 0.9 | 0.3 |
| Others institutional agencies* | -- | -- | -- | -- | 9.3 | 2.4 |
| <i>Non-Institutional Agencies</i> | 92.8 | 85.2 | 70.8 | 38.8 | 36.0 | 42.9 |
| Landlord | 1.5 | 0.9 | 8.6 | 4.0 | 4.0 | 1.0 |
| Agricultural Moneylender | 24.9 | 45.9 | 23.1 | 8.6 | 6.3 | 10.0 |
| Professional Moneylender | 44.8 | 14.9 | 13.8 | 8.3 | 9.4 | 19.6 |
| Traders and Commission Agents | 5.5 | 7.7 | 8.7 | 3.4 | 7.1 | 2.6 |
| Relatives and Friends | 14.2 | 6.8 | 13.8 | 9.0 | 6.7 | 7.1 |
| Others | 1.9 | 8.9 | 2.8 | 4.9 | 2.5 | 2.6 |
| <i>Total</i> | <i>100</i> | <i>100</i> | <i>100</i> | <i>100</i> | <i>100</i> | <i>100</i> |

* includes financial corporation/institution, financial company and other institutional agencies.

Note Percentage share of different credit agencies to the outstanding cash dues of the households as on 30th June.

-- denotes not available.

Source: All India Debt and Investment Survey, Various Issues.



Annex III

| Existing Banking Structure in India* | | |
|--|------------------------------------|---|
| Commercial Banks | Public Sector Banks (26) | State Bank of India |
| | | Associate Banks(5) |
| | | Nationalized Banks(19) |
| | | Other Public Sector Bank(1) |
| | Private Sector Banks (20) | Old Private Sector Banks(13) |
| | | New Private Sector Banks(7) |
| | Foreign Banks (43) | Branch mode of presence (331 branches) |
| Regional Rural Banks (64) | Limited area of operation | |
| Local Area Banks (4) | Limited area of operation | |
| Cooperative Banks | Urban Cooperative Banks (1,606) | Multi-State Urban Cooperative Banks(43) |
| | | Single State Urban Cooperative Banks(1563) |
| | Rural Cooperatives (93,551) | Short Term (92,834) |
| | | State Cooperative Banks(31) |
| | | District Central Cooperative Banks(371) |
| | | Primary Agricultural Cooperative Societies(92,432) |
| | | Long Term (717) |
| | | State Cooperative Agriculture and Rural Development Banks(20) |
| Primary Cooperative Agriculture and Rural Development Banks(697) | | |

*Position as on March 31, 2013

| Indicative Re-orientation of Banking Structure in India | | |
|--|---|---|
| <i>First Tier</i> International Banks | i) Three or four very large banks ii) Foreign Banks in India | <ul style="list-style-type: none"> • Possible mergers of Associate Banks with SBI. • Voluntary merger of a few large Public Sector Banks having significant overseas presence. • Organic and in-organic growth of one or two large Private Sector Banks. <p><i>Note:</i> These will lead to formation of large banks. The issue of competition among them in particular and in the banking system in general will have to be kept in view.</p> <ul style="list-style-type: none"> • Branches of Foreign Banks in India. |
| <i>Second Tier</i> National Banks | i) Public Sector Banks ii) New Private Sector Banks iii) Subsidiaries of Foreign Banks incorporated in India iv) Specialized banks | <ul style="list-style-type: none"> • Voluntary merger of banks both in the Public and Private Sector. • To encourage foreign banks to have subsidiary mode of presence in India. • To grant differentiated licences for specialized banks. |
| <i>Third Tier</i> Regional Banks | i) Old Private Sector Banks ii) Regional Rural Banks iii) Multi-State Urban Cooperative Banks | <ul style="list-style-type: none"> • To carry forward the process of consolidation of the Regional Rural Banks. • Conversion of a few well managed, financially sound Multi-State Urban Cooperative Banks into commercial banks |
| <i>Fourth Tier</i> Local Banks | i) Local Area Banks/small banks ii) Single-State Urban Cooperative Banks State Cooperative Banks iii) District Central Cooperative Banks | <ul style="list-style-type: none"> • Well managed and financially sound UCBs would have opportunities to convert into commercial banks • Well managed and financially sound LABs/small banks would have opportunities to expand their area of operations. • Rural cooperatives to be made financially sound to serve the local needs. |

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