Chapter: Competition and Regulatory issues in Banking Sector of India with a focus on bank licensing

Introduction

Modern banking, in India, originated during the 18th century and has since, witnessed radical changes. As of 2015, India accounts for 46 domestic commercial banks (26 Public and 23 Private Sector Banks) and 43 foreign Banks, collectively known as Scheduled Commercial Banks (SCBs)[1]. A network of 92,114[2] branches, throughout the country, seeks to provide last mile connectivity of the banking services. The sector provides employment to approximately 1,096,984[3] people in India.

Despite a network this big, banking sector falls short of catering to entire population of India and almost half of the population, till recently, remaining financially excluded. There have been several initiatives taken by the Government, RBI and NABARD over the years to fuel financial inclusion (Annexure I) but the impact have been below expectation. Most recently, the government has shown rigour to bridge this gap by launching the ambitious "Prime Minister Jan Dhan Yojana (PMJDY)" mission. The mission aims to provide at least one bank account to each household, through which basic financial services like credit, remittance, insurance and pension may be provided. PMJDY, since its inception in Aug, 2014[4], has shown tremendous success by opening up 179 million bank accounts[5].

Yet only 55 percent of the population is associated to deposit accounts and only 9 percent have availed credit thorough banks[6]. Approximately 145 million households remain excluded from banking services. Current average of one bank branch catering to 14,000 people[7] when compared to government's mission of at least one branch per 1,000 to 1,500 households (approx. 4,000-5000 people), shows that lot remains to be achieved.

The banking sector may have public and private players now, but since inception till 1960s, the banking industry was dominated by private banks. The established banks then, catered to particular ethnic and religious communities[8] and thus, had limited outreach. In order to swing the focus of banks to national interest, the Government, in 1960s, decided to nationalise a number of private banks.

Nationalisation

Nationalisation meant that private banks were turned public and the government became the majority shareholder. Year 1969 saw 14 banks being nationalised and 6 more were nationalised in 1980[9]. Through nationalisation, the government's overall objective was to achieve a wider spread of bank credit, prevent its misuse, direct larger volume of credit flow to priority sectors (such as agriculture and small industries) and to make banks an effective instrument of economic development[10].

Box 1: Side-effects of Bank Nationalisation
Nationalisation led to increase in bank outreach, controlling private monopolies, directing funds to the needy, et al, it also it resulted in some problems creeping in due to lack of efficient planning and considerations to professionalism and accountability, such as[11]: • Banks lacked professionalism, owing to politicians, bureaucrats and their relatives on the board. • In order to promote agriculture and small industries, banks were forced to lend at unsustainable rates. The rates were even less to cover the cost of loans, which are still

effectively as low as 4 percent.[12]

- Middlemen arose in the system, which borrowed from banks at lower rates (4 percent) and further circulated the money in market (especially to farmers) at multi-fold rates (36 percent).
- The Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) were kept very high (15 and 38.5 percent respectively in 1991), which left banks with very little money for advances.
- Primary focus on agriculture and small industries made it difficult for other businesses to avail loans which adversely impacted business expansion and saw declining exports.

Source: International Journal in Management and Social Science, Vol.03 Issue-02, (February, 2015)

Current scenario highlights the need for strengthening the financial service connectivity in the country. One possible way may be allowing more full-fledged banks or differential banks focussing on ensuring last mile connectivity of financial services. In past, Reserve Bank of India (RBI) had provided licenses to 14 private banks. It has also recently issued in-principle approvals for operations of differentiated banks such as payment banks and small finance banks. Differentiated banks are contemplated to meet credit and remittance needs of small businesses, unorganized sector, low income households, farmers and migrant work force[13].

One of the reasons of low penetration of banking services in India may be attributed to low competition in the sector. A number of studies have indicated that competition drives expansion and efficiency of services. While this may hold true, one of the key factors impeding competition are high entry barriers. Licensing is one form of entry barrier. Added with the inefficiencies of the PSBs, which is clearly reflected from the Rs. 2.67 Trillion[14] of Non-performing Assets (NPA) they contribute, the banking sector needs new private entities to reform it further. It is thus imperative to analyse the impact of the bank licensing regime in India including the entry regulations associated.

Thus, this chapter highlights the concerns of the commercial banking sector, prominent banking reforms over the years, issue of differential treatment of public and private banks and a special attention to new private bank licensing and introduction of differential banking institutions. To understand the competition and the licensing regime, it is necessary to delve into the regulatory architecture of Indian Banking sector and how the banking reforms over the years have influenced the current scenario.

Regulatory Architecture

The Reserve Bank of India (RBI) is responsible for the regulating the banking sector in India. Established on April 1, 1935[15] in accordance with the provisions of the Reserve Bank of India Act, 1934, RBI was originally privately owned. With its nationalisation in 1949, RBI is now fully owned by the Government of India. RBI has 19 regional offices, most of them in state capitals and 9 Sub-offices[16].

Box 2: RBI and its functions
RBI has numerous functions, which are critical to the national development and financial stability. The major functions of RBI are (1) Formulating, implementing and monitoring the monetary policy; (2) Regulating and supervising financial system; (3) Managing Foreign Exchange; (4) Issuing currency; besides a wide range of promotional functions to support national objectives and acting as a banker to the Government and all scheduled banks.
Source: Reserve Bank of India Website (accessed September 2015)

Regulatory Reforms

Over the years there have been a number of committees/commissions constituted to bring reforms to the banking sector. Some of them have been briefly mentioned below:

Narasimham Committee I (1991)

After the Balance of Payment (BoP) crisis in 1991[17], the government had to embrace economic liberalisation. Similar reform was required for the banking sector for inclusive development of the country. An expert committee was thus set up, under the chairmanship of Mr. M. Narasimham, for spearheading financial sector reforms in India. The Narasimham committee recommended many changes to the financial sector of which one was opening of banking sector for private players. The rationale behind this was that private players would infuse competition which shall result in enhancing efficiency in the sector, desperately needed after nationalisation setbacks. This recommendation was accepted and subsequently in 1993, first window of licenses for new private banks was opened.

Narasimham Committee II (1998)

After the earlier committee influenced reforms, the Narasimham committee was again laden with the task to strengthen the financial sector further, in particular the financial institutions. The committee report highlighted the desperate need of providing financial services to underserved and focussed on factors like size of banks and capital adequacy ratio among others. It observed that the new private banks, along with public-sector banks (PSB), had lagged behind on the financial inclusion objectives. Thus the committee, of the many recommendations for financial inclusion, recommended introduction of more private banks which was instigated by RBI in 2003 by opening second window for bank licenses.

Financial Sector Legislative Reforms Commission (2011)

In March 2011, the Ministry of Finance constituted the Financial Sector Legislative Reforms Commission (FSLRC)[18], to clean up and rewrite the financial sector laws according to current requirement of the country. FSLRC assessed that regulatory gaps, overlaps, inconsistencies and arbitrages exist in financial sector because of the presence of multiple regulators.

In March 2013, FSLRC submitted a report[19] to the Ministry which addressed the regulatory issues and a draft Indian Financial Code to supplant numerous existing financial laws. On regulation of banking sector, the FSLRC emphasised on the need of independence and accountability of the regulator i.e. RBI. The code proposed a shift from sector-wise regulation to a differential framework where only RBI would be responsible for regulation of banking and payment system.

FSLRC also commented on the existing legislation on banking and how it impacts ideal competition and operations. In its Eighth Meeting, the Financial Stability and Development Council (FSDC) approved the implementation of the recommendations which would enhance governance, and not require legislative action at present[20].

PJ Nayak Committee (2014)

In January 2014, RBI constituted a committee under the chairmanship of former Axis Bank head P.J. Nayak, to review issues of governance in banks. The issues to be addressed included the assessment of the level of regulatory compliances required, operational framework of different banks, suggesting strategies for growth and risk management, regulatory guidelines on bank ownership, ownership concentration and representation in the board, et al.[21]

Box 3: Recommendations of PJ Nayak committee

Some significant recommendations by the PJ Nayak committee were as follows[22]: 1. State ownership and control impacts PSB's performance. Thus, the committee recommended keeping State only as investor and not exercising any control in PSBs. 2. It recommended repealing the different banking Acts and bringing all banks under Companies Act, and a Bank Investment Company (BIC). 3. It recommended reduction in government stakes in PSBs to just less than 50 percent. This was to reduce burden of vigilance and right to information (RTI) on PSBs while keeping them State Owned. 4. The committee recommended a special vehicle, similar to a holding company, which would have powers to make appointments of whole-time directors and directors that represent State. 5. The committee suggested "**fit and proper**" criteria for governance. 6. The committee suggested a fixed term of 5 years for the chairman/managing director and 3 years for a whole-time director.
Source: "Governance reforms in banks: The Nayak Committee Report", Business Today (May 20, 2014)

Indradhanush Scheme (2015)

In 2015, the Union Government released another banking reform known as "Indradhanush". This reform is intended to revamp the functioning of PSBs through a seven pronged agenda. It is yet to be seen how this reform turns out in improving the state of PSBs but may spur efficiency of the PSBs which have lagged behind their private counterparts and are bearing humongous amount of NPA on their books. The seven points of the agenda were on appointments of top management; setting up Bank Board Bureau, Capitalisation, De-stressing PSBs, Empowerment, establishing a framework of accountability and reforming governance.[23] However, P J Nayak himself has commented on Indradhanush to be insufficient to bring major reforms to the banking sector.[24]

Box 4: Salient features of Indradhanush Scheme
The 7 pronged agenda of the Indradhanush Scheme may be summarised as follow: 1. **Appointment:** Separates post of Chairman and Managing Director in PSBs as Managing Director and Chief Operating Officer (MD & CEO) and a non-Executive Chairman. Announcement of appointment of MD & CEOs and non-Executive Chairmen for various PSBs was also done. 2. **Bank Board Bureau:** The government shall set up Bank Board Bureau which would act as a link between government and bank and shall monitor PSBs performance. 3. **Capitalization:** Infusion of a total of Rs. 25,000 crore of capital into debt-laden PSBs in fiscal 2015-16. Over the next four years, the government plans to inject Rs 70,000 crore. 4. **De-stressing:** Fast processing of projects and clearances to avoid the PSB funding turning into NPAs. 5. **Empowerment:** Providing flexibility to PBS on hiring. 6. **Framework of accountability:** New indicators to measure PSB performance were announced. 7. **Governance reforms:** No State interference in the operations of PSBs.
Source: Department of Financial Services, 2015

There have been other committees as well such as Raghuram Rajan Committee, Malegam Committee, Tarapore Committee, Mor Committee, etc., which provided their recommendations on financial inclusion, microfinance and other financial issues in India. One of the key recommendations of some of the committees, starting from the Narasimham Committees, was the introduction of new private banks in the sector and now the introduction of differential banks such as payment banks and small finance banks in India. Private entities are being rationally given banking licenses by the RBI, which in past has provided the much needed momentum to banking services in India and may even in the future. The next section thus talks about the different licensing windows RBI opened.

Bank Licensing

Bank Licenses: 1st Round (1993)

Pre liberalisation scenario accounted for PSBs holding 91% of total bank branches in number and 85% of total banking business by quantum[25]. Based on the recommendations of Narasimham committee I (1991)[26], the first window for new private bank licenses was opened by RBI in 1993, and applications were invited. Based on the guidelines then, ten private players were granted licenses to operate banks in India in 1993, which subsequently started their operations in 1994-95. Not all banks could survive the competition, which lead to 4 banks merging with others, while 6 others are still operational.

Table 1 – Bank licenses granted in 1993

Still operational	Merged with other banks
1. Industrial Credit and Investment Corporation of India (ICICI)	7. Global Trust Bank
2. Housing Development Finance Corporation (HDFC)	8. Bank of Punjab
3. Unit Trust of India (UTI) (now Axis bank)	9. Centurion bank
4. Industrial Development Bank of India (IDBI)	10. Times Bank
5. Indus Bank	
6. Development Credit Bank (DCB)	

Bank Licenses: 2nd Round (2003)

In 2001, based on Narasimham Committee II recommendations, RBI released guideline for the entry of new private banks and invited applications. Private Banks had shown potential to drive productivity and efficiency in the sector and were looked upon, to drive it further. With focus on ‘customer service’ and ‘technology’, private banks had showed considerable improvements in the economic and financial parameters[27] since their introduction in 1993[28]. This led to improvement in overall efficiency of the sector. However, the collapse of Global Trust Bank made sure that RBI took a more pragmatic approach in granting licenses and thus, granted licenses to only two new banks in 2003 which started their operations in 2003-04 viz.

1) Kotak Mahindra; and 2) Yes Bank

Box 5: Collapse of Global Trust Bank

Global Trust Bank (GTB) was granted license in 1993 in the first licensing window by RBI. GTB went on to become a leading private sector bank in India. Since 2001, GTB's name was associated with scams and controversies, thereby casting shadows over the credibility of the bank and its management.

Due to the over exposure to capital markets and huge NPAs, the bank was in a financial mess. When GTB tried to cover up its monumental NPAs through under provisioning, RBI appointed an independent team to review the finances of the bank. The review revealed various financial discrepancies kept covered by the bank.

RBI imposed a three month moratorium on GTB on the ground of "wrong financial disclosures" and

within two days the bank was merged with Oriental Bank of Commerce (OBC), a public sector bank. With the merger becoming effective, GTB's identity came to an end and it became a part of OBC.
Source: The Rise and Fall of Global Trust Bank, Case Study by ICMR, 2005

Bank Licences: 3rd Round (2013)

In 2011, the then finance minister, Pranab Mukherjee, announced the issuing of new private bank licenses to improve the access to banking services in India. Subsequently, RBI, in 2013, released guidelines for new bank licenses[29]. The new guidelines, surprisingly, allowed large business houses to apply for banking licenses for which RBI, in earlier cases, was reluctant on. However, no business houses were given banking licenses. The licensing attracted 26 applicants of which only two were granted in-principle approval in 2014. These were:

1) IDFC Limited and; 2) Bandhan Financial Services Private Limited

Box 6: Licensing Guidelines of 2013

The key points of the licensing guidelines were:

- Allowed Indian resident owned entities, public sector entities, existing NBFCs as well as large industrial houses to apply.
- A "Fit and proper" criteria to ensure credibility and integrity of applicants. 10 years of operation experience and financial soundness mandated.
- Even if the applicant met the eligibility criteria, RBI could still decide against granting license.
- The new banks could only be set up through a NOFHC (Non-Operating Financial Holding Company), established by the promoters to hold their investments in banks. NOFHC was to be registered as NBFC and no individual, belonging to promoter group, could hold more than 10 percent of total voting equity share in it.
- Initial minimum paid up capital requirement was set as Rs. 5 billion of which NOFHC could hold a minimum of 40 percent of paid-up capital. This capital was to be locked-in for a period of 5 years from the commencement of banking operations.
- If NOFHC's shareholding was more than 40 percent, it is to be brought down to 40 percent within 3 years of commencement of business. Further to be brought down to 20 percent and 15 percent within 10 and 12 years respectively.
- Banks were to maintain a minimum capital adequacy ratio (CAR) of 13 percent of the risk weighted assets (RWA) for a minimum time of 3 years commencement of operations. The banks would also need to go public within 3 years of commencement of operations.
- The foreign shareholding was capped at 49 percent and could not exceed for the initial 5 years from the date of licensing. Post 5 years, the foreign share may follow norms of the existing policy (74 percent).
- The banks couldn't invest or provide credit to promoters or any member of NOFHC. The banks would also not be allowed to invest in capital instruments of other financial entities under NOFHC.
- A single entity or a group (apart than NOFHC) cannot have a shareholding of more than 10 percent of the paid-up voting equity capital of the bank.
- The bank shall need to open 25 percent of its branches in unbanked rural centres.

Source: New banking license in India, Action Financial Service (pvt.) Ltd

The awarding of licence to a microfinance company (Bandhan) and an infrastructure finance company (IDFC) showed the primary intention of RBI to promote banks which focus on serving the financially excluded strata of society along with implementing a sustainable business model to keep the progress going. Bandhan and IDFC have started their banking operations in August and October 2015 respectively.

Comparison of Old and New Private Bank Licensing Guidelines by RBI

The perquisites for the entry of private players, for the banking industry, have been changing over the years. The table below highlights the major differences between the last set of guidelines (2001) and the latest guidelines (2013).

Table 2 – Comparison of 2001 and 2013 new private bank licencing guidelines (Source: RBI Circulars)

Key Features	2001 Guidelines	2013 Guidelines
Eligible Promoters	• The new bank should not be promoted by a large industrial house	• No restriction on large industrial or business houses • Bank may only be set up through a NOFHC
Minimum Equity Capital	Initial: Rs.2 billion Target: Rs.3 billion within 3 years	Initial: Rs. 5 billion
Criteria for selection	**Preference** to promoters with expertise of financing priority areas and financing of rural and agro based industries	"Fit and Proper" Criteria, sound credentials and a 10-year track record of running business successfully
Foreign Share-holding	Maximum Foreign shareholding: 40 per cent	Maximum Foreign shareholding: 49 percent (for initial 5 years, from the date of licensing); and then 74 percent
Promoter's contribution in Paid-up capital	• Minimum Promoter's contribution: 40 per cent of the paid-up capital • Capital locked-in period: 5 years from the date of licensing • Dilution of capital in excess of 40 per cent: after 1 year of the bank's operations.	• NOFHC to hold a minimum of 40 percent of paid-up capital • Capital locked-in period: 5 years from commencement of banking operations • Dilution of NOFHC shareholding in excess of 40 percent: within 3 years of commencement of business. To be brought down to 20 percent and 15 percent within 10 and 12 years respectively.
Minimum CAR	10 percent	13 percent
PSL[30] Targets	25 per cent of its branches in rural and semi-urban areas	25 per cent of its branches in unbanked rural areas
Listing the Bank	No mandatory listing quoted (Option to go public to raise capital)	Within 3 years of commencement of operations.

The new guidelines were more precise as compared to the older one; however, the eligibility criterion for entry of new private banks has now become more stringent and demanding. Higher CAR and minimum capital requirement, strict dilution of promoter's contribution to paid-up capital, limit on foreign shareholding et al, set the bar higher for the entry of new players than ever before. In both rounds, a number of entities applied for banking licenses, however a handful of entities were granted licenses.

The regulator, also, did not specify the reasons for granting bank licenses to some and rejection of other apparently eligible entities. There appears to be no sound rationale for rejection of applications of entities which have qualified the eligible criteria, without providing reasoned decision and opportunity of hearing. Also, there is no redress mechanism to which rejected entities could approach. No fear of potential entrants results in reduced competition.

Looking at the weak performance of PSBs[31], there is a desperate need of allowing more private banks in the arena or privatising the existing PSBs and raising the entry barriers restricts the new entries. However, RBI has also tried to bridge the gap in financial inclusion by introducing differential banking.

Differential Banking Licenses: Payment Banks and Small Banks

Payment Banks

RBI constituted a committee headed by Dr. Nachiket Mor in 2013 to recommend innovative solutions to accelerate financial inclusion in sustainable and cost effective way. One key recommendation in its report, in 2014, was to introduce specialized banks (Payments Banks) to cater to the lower income groups and small businesses. The report also provided high level criteria to assess 'Fit and Proper' status of the Payments bank license aspirants.

RBI, in November 2014, released guidelines on eligibility and licensing of Payment Banks. RBI received 41 applications[32] which included some big business houses as well. In August 2015, RBI granted in-principle approval to 11 applicants to set up payment banks. These are listed in the table below:

Table 3 – Payment Bank applicants getting in-principle approval by RBI

1. Aditya Birla Nuvo Limited 2. Airtel M Commerce Services Limited 3. Cholamandalam Distribution Services Limited 4. Department of Posts 5. Fino PayTech Limited	6. National Securities Depository Limited 7. Reliance Industries Limited 8. Shri Dilip Shantilal Shanghvi 9. Shri Vijay Shekhar Sharma 10. Tech Mahindra Limited 11. Vodafone m-pesa Limited

Payment banks can accept deposits (not exceeding Rs. 1 lac), issue ATM/Pre-Paid Instruments/Debit Cars, offer remittance services and can provide internet banking services to consumers. They can also act as business correspondents to other banks but they cannot provide credit services. Thus, a Payments Bank can not undertake lending activities, issue credit cards, accept NRI deposits or become a "virtual" bank or branchless bank[33].

Box 7: Snapshot of Payment Bank Guidelines

Promoter Eligibility: • NBFCs, Telcos, Corporate BCs, PPI Issuers, super -market chains, companies, real sector co-operatives and public sector entities, individuals, professionals • Partnering with a SCB • Sound track record running businesses for 5 years • Conform to "fit and proper" and any other criteria prescribed by the RBI • Minimum capital contribution: Rs. 400 million • Restriction on aggregate shareholding of FDI, NRIs and FIIs **Credentials:** • Promoter groups should have sound credentials and integrity • Source of promoters' equity should be transparent and verifiable Governance: • The Board should have a majority of independent Directors • Compliance with corporate governance guidelines including 'fit and proper' criteria for Directors **Business Model**: • Business model should compliant with allowed scope of activities provided in the guidelines • Focus to address financial inclusion • Adoption of technology to lower the operational costs and extend reach • Best-in class customer service proposition **Post Licence Requirements:** • Bank should be fully networked and technology driven • Should have well established customer grievance cell • Maintain leverage ratio less than 33.33 • CAR: 15 percent • Maintain CRR and SLR requirements • If net worth reaches Rs. 5 billion, listing and diversification of ownership is mandatory within 3 years
Source: RBI Guidelines for Licensing of Payments Bank: Opportunities and Challenges, Deloitte, December 2014

Small Banks

In 2013, RBI published a policy discussion paper 'Banking Structure in India – The way forward'. The discussion paper highlighted the merit in considering access to bank credit and services through expansion of Small Banks in unbanked and under-banked regions of India. Subsequently in November 2014, RBI published the guidelines for Small Finance Bank and invited applications. RBI received 72 applications[34] and granted in-principle approval to 10 applicants in September, 2015, which were:

Table 4 – Small Bank applicants getting in-principle approval by RBI

1. Au Financiers (India) Limited 2. Capital Local Area Bank Limited 3. Disha Microfin Private Limited 4. Equitas Holdings P Limited 5. ESAF Microfinance and Investments Private Limited	6. Janalakshmi Financial Services Private Limited 7. RGVN (North East) Microfinance Limited 8. Suryoday Micro Finance Private Limited 9. Ujjivan Financial Services Private Limited 10. Utkarsh Micro Finance Private Limited

The objectives of setting up of Small Finance Bank will be for furthering financial inclusion by (i) provision of savings vehicles primarily underserved sections of the population, and (ii) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganized sector entities, through high technology-low cost operations.

A Small Finance Bank can offer basic banking services (acceptance of deposits and lending to underserved sections including small business units, small and marginal farmers, micro and small industries and unorganized sector entities), non-risk sharing simple financial services activities not requiring any fund commitment, such as distribution of MFs, insurance products, pension products, etc. and the Small Finance Bank can also become a Category II Authorized Dealer in foreign exchange business.

Box 8: Snapshot of Small Bank Guidelines
Promoter Eligibility: • 10 years of experience in banking and finance. Successful track record of running business for 5 years • NBFCs, Micro Finance Institution (MFIs),Local Area Banks (LABs) permitted • Conform to "fit and proper" and any other criteria prescribed by RBI • Minimum capital contribution: Rs. 400 million • Restriction on aggregate shareholding of FDI, NRIs and FIIs Credentials: • Promoter groups should have sound credentials and integrity • Source of promoters' equity should be transparent and verifiable • The Board should have a majority of independent Directors • Compliance with corporate governance guidelines including 'fit and proper' criteria for Directors Business Model: • Realistic and financially viable business model • Focus to address financial inclusion • Adoption of technology to lower the operational costs and extend reach Post License Requirements: • Need to have at least 25% of branches in unbanked rural areas • 75% of adjusted net bank credit to priority sector • 50% of loan portfolio should constitute loans and advances of upto Rs. 25 lakh ticket size • CAR: 15 percent • Bank should be fully networked and technology driven • Shareholding by promoters in excess of 40% shall be brought down to 40% within 5 years of commencement • Promoter's stake should be brought down to 30% within a period of 10 years, and to 26% within 12 years from the date of commencement • If net worth reaches Rs. 5 billion, listing is mandatory within 3 years of reaching that net worth
Source: RBI Guidelines for Licensing of Small Bank: Opportunities and Challenges, Deloitte, December 2014

Outlook on Payment Bank and Small Bank guidelines

RBI, like always has stressed on financial institutions to adopt technology and innovative business models to bring the cost of providing services down and increasing outreach of financial services. However, certain clauses in the guidelines may prove restrictive to this purpose.

1. To start from, the guidelines provide the objective of payment banks to further financial inclusion. Payment banks, as envisaged by the Guidelines, enable access to formal savings and payment services but not credit. Access to credit is an essential feature of financial inclusion, and without it inclusion cannot be complete.
2. 5 years (payment banks) and 10 years (small banks) have been set as minimum experience required, to prevent the entry of unscrupulous entities from getting licenses. However, in this world of startups, the key may be held by innovative and technologically sound yet inexperienced entities. Restricting such entries may stifle innovations in business models.
3. Further, the “fit and proper” criterion sets the entry barriers too high for aspirants. The mandatory dilution of ownership by the promoters within 3 years may also repel the potential applicants from applying for licenses as it may go against their interests.
4. The Guidelines provide that payment banks will be required to invest balance funds in government securities/treasury bills with maturity up to one year that are recognised by RBI as eligible securities for maintenance of statutory liquidity ratio. Payment banks must be allowed to deploy funds in corporate bonds of reputed companies (short term AAA rated corporate bonds), in addition to government securities. This would help them to earn reasonable interest, thus making the business model viable. The Nachiket Mor committee made recommendations on similar lines.
5. Lastly, RBI doesn’t provide the rationale behind the number of licenses granted for payments banks (11) and small banks (10). While there is a need to introduce more financial institutions, RBI not keeping the decision process transparent is questionable.

Public vs. Private Sector Banks

It has always been claimed that the public and private banks are treated differentially and thus there exists no level playing ground for all banks combined. This may be attributed to constant change in government’s stance over bank ownership (nationalising and then allowing new private entrants) or the operational factors as different banks governed by different Banking Acts in the country.

Sector Entry

Over the years, the approach of the government on entry of new banking institutions has changed dramatically. From nationalising private banks to allowing new private banks to the sector, the changes have been numerous. Considering the changes, the banking scenario, over the years, may be divided into three phases for independent India:

1947-1959

All the banks, operational then, were private. The only notable public bank during this phase was SBI, which became public through government buying major shareholding in 1955, on recommendation of RBI. During this time, the private banks catered to specific sections of society which left a large population unbanked and underserved. While there was requirement for banks to enhance their outreach for holistic growth of the country, the government was left with limited resources (public sector banks), to drive it.

1960-1990

This phase saw all major private banks being nationalised for national interest. During this phase, Indian Banks were working in a regulated system. Interest rates were regulated by RBI, credit was controlled, and SLR and CRR requirements were high, which adversely affected efficiency and financial stability. Even though there was rapid growth of deposits, profitability of banks was low. Due to constant wearing down of capital, there were questions on the survival of the Indian Banking System.

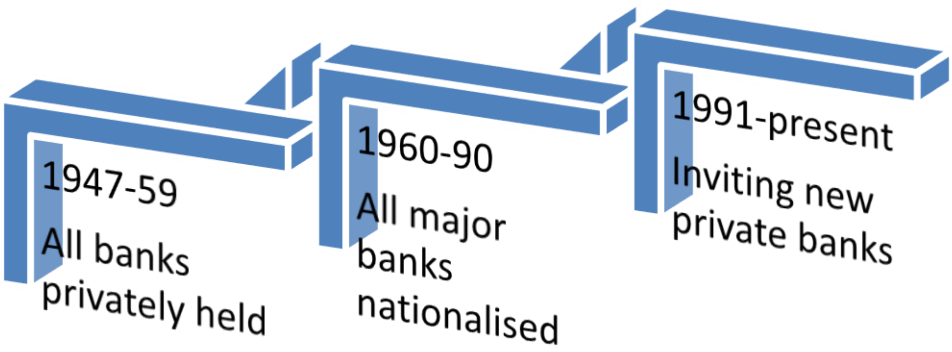

Figure 1 – Confused state of government on bank ownership

1991-present

Post the BoP crisis of 1991, Narasimhan Committee I recommended opening of sector for new private players to infuse competition and efficiency. Thus, in 1993, 2003 and 2013, three different windows were opened for new private banks to step in. The new private banks delivered the much needed competition in the industry and PSBs have been continuously losing their market shares to them.[35] Still, the entry barriers over the years have been raised considerably by RBI. The first window saw collapse of 4 out of 10.

However the FSLRC, in its resolution says, "*Failure of financial firms is an integral part of the regenerative processes of the market economies: weak firms should fail and thus free up labour and capital that would then be utilised by better firms. However, it is important to ensure smooth functioning of the economy, and avoid disruptive firm failure.*"[36]Despite the evident requirement of new private entities in banking, RBI has been constantly raising the entry barriers. Thus, limiting the private players in the sector or restricting their entry, may be deemed questionable.

Box 9: PSBs losing out to Private Banks
The following statistics provide evidences on how PSBs are losing market to their private counterparts: • 2.8% is the share in current account deposits that public sector banks (PSBs) lost in four years, says a Morgan Stanley report • 4.9% is the share in current account deposits that private banks have gained • At a rate of 1-1.5% every year, PSBs are expected to lose market share • 6.1% is market share that private banks have gained in four years • 120 basis points of loan market share is what PSBs have lost to private banks, according to Jefferies
Source Business Standard, "Private banks wrest market share from PSBs". July 2015

Operational Factors

Apart from the change in government strategies for the banking industry, there exist several issues regarding the operations of the banks in India. These might be attributed to regulatory arbitrages, ownerships and the operational frameworks. These issues hinder fair competition between the public and private banks which is negative to consumer interests. While the PSBs enjoy certain leverages and benefits as compared to their private counterparts, they also bear extra burden levied upon them by the government. Thus it is essential that the government ownership should not lead to differential treatment of private and public banks. PSBs should run professionally and compete with private sector counterparts even when they are owned by government.

Regulatory Arbitrages

1. The PSBs are endowed with implicit government guarantee which ensures their insolvency. Thus consumers perceive PSBs safer as compared to private banks.[37]
2. State bank of India (SBI) Act (1955) and SBI (Subsidiary Banks) Act 1959, governs the working of SBI and its associates. The Private Banks are governed by the Banking Regulation Act (1949). The Nationalised Public Sector Banks are governed by The Banking Acquisition (1970), Banking Acquisition (1980) and partially the Banking Regulation (BR) Act (1949). The different acts create an unduly regulatory regime different banks which may be listed as follows[38]:
    a. Voting rights of a shareholder in a private bank is capped at 10%, but voting rights of a shareholder of a PSB is restricted to 1%.
    b. Provisions on restructuring, suspension of business and winding up is also different under different Acts. RBI has powers to intervene when the managing director of a bank, governed under the BR Act, is not a fit and proper person. In case of nationalised banks, RBI does not have such wide powers.
    c. On winding up, RBI may apply to the Central Government for imposing a moratorium for banks governed under BR Act.
    d. For nationalised banks the power to order a dissolution or a merger/ amalgamation vests solely with the Central Government.
3. Riskier PSBs, with high ex-ante systemic risk and low Tier 1 capital, have in the past received greater capital support from the government[39].
4. The Statutory Deposits for government run programmes are parked only at PSBs[40].
5. There is added burden on PSBs for executing the government schemes/social initiatives, for which even the Governor of RBI stated that the PSBs are not compensated sufficiently[41].
6. PSBs cannot appoint Chief Executive and other Directors to the Board themselves[42].
7. Remuneration differences and low decision making independence at public sector.

There exist imbalances in treatment of public and private banks as per existing regulation. The FSLRC and Nayak Committee have recommended key points to eliminate these differences which are however yet to be incorporated by the government/RBI. Based on the discussions in this chapter we can conclude it with few learning and recommendations.

Conclusions & Recommendations

The introduction of differential banks financial services through the likes of new private banks, payment banks and small banks is expected to enhance competition. The likely impact of the competition might be seen on the deposit rates and credit rates, and some players might go on adopting unsustainable rates. It might also result in innovations on products and ways of catering consumers which might bring down the operational costs. Considering the technology upgradations and innovations, to keep up with the competition, would have financial implications on every player and may result in lowering of margins.

This might also be a peephole for un-ethical and other unfair practices between players, for which the regulator, Competition Commission of India (CCI) as well as the consumers would need to stay vigilant. However, to increase the consumer footprint, the new players as well as the old ones, would need to venture into rural setups to hold their market positions. This is likely to impel the financial inclusion drive of India. The other impacts would be the development of a good rural banking network as well as some issues that could crop up regarding corporate governance of new conglomerate-owned banks[43] in case of payment banks and small banks as no business houses were given new private bank licenses.

Box 10: Overlapping of Banking Regulations with Competition
RBI once wrote to the Corporate Affairs Ministry for exclusion of the banking sector from the Competition Act. The request however was declined. There are a number of functions RBI performs which overlap with the operations of the Competition Commission of India (CCI). RBI, through Banking Regulation Act 1949, is the sanctioning authority for banking company's mergers and acquisition. Similarly, there are other regulatory provisions exercised by RBI which overlap with the CCI. Whilst there could be other channels that can be used by the central bank to influence outcomes of the banking sector (e.g., bailouts or directives on mergers), there are generally some specific issues that are covered by specific statutory and administrative regulatory provisions, which include the following: • Restrictions on new entry; • Restrictions on pricing (interest rate controls and other controls on prices or fees); • Line-of-business restrictions and regulations on ownership linkages among financial institutions; • Restrictions on the portfolio of assets that banks can hold (such as requirements to hold certain types of securities or requirements and/or not to hold other securities, including requirements not to hold the control of non-financial companies); • Capital-adequacy requirements, normally enforced through forced or encouraged mergers; • Requirements to direct credit to favoured sectors or enterprises (in the form of either formal rules or informal government pressure), resulting in some needy firms failing to access credit; • Special rules concerning mergers (not always subject to a competition standard) or failing banks (e.g., liquidation, winding up, insolvency, composition or analogous proceedings in the banking sector); • Other rules affecting cooperation within the banking sector (e.g., with respect to payment systems).
Source: ICN, 2005.

However, this would see an increase in pressure on the PSBs for their debt management. The reductions of margins, fresh competition, market aggression, et al shall result in lesser budget left to offset their NPAs. However, the banks may also strategise their debt management through increased efficiency and cost cutting measures, but is highly unlikely to happen given the past experiences. This may result in government infusing more money in PSBs. Even though the Government and RBI have taken many initiatives to make the industry more efficient, there are more reforms needed to ensure this. Some of these are as follows:

Eliminating regulatory arbitrages between private and public sector banks

Different banks in India are governed by different banking legislations. The presences of multiple legislations, creates a non-uniform regulatory scenario for the market players which deeply stifles competition. Ensured insolvency and the benefits enjoyed by SBI and its associates and PSBs must be withdrawn and there should be a standard legislation for all banks in India, irrespective of their ownership type. Tools such as Regulatory Impact Assessment (RIA) and Competition Impact Assessment may help in evaluating the effects of the proposed and existing regulations to formulate the most optimal design.

Ensuring Competitive Neutrality

Other than the regulatory issues, there are several other factors that limit competition in the sector. The PSBs are laden with the responsibilities of government initiatives, which become burdensome in terms of time and costs incurred. There is a requirement for the government to compensate PSBs adequately for these added responsibilities.

Usually, for all government initiatives, significant funds are parked in PSBs only, which provide them additional money to invest or to provide consumers on credit[44]. Private Banks never receive such deposits which dampen the competition in the sector. Moreover the performance meltdown at PSBs may also be associated with the performance of employees. The employees at PSBs have very less incentives to perform well as compared to those in private banks. The salaries for PSB employees are not even comparable to ones at private banks. Thus, there is a need to ensure effective remuneration which shall keep the employees at PSBs competitive to the private employees which shall promote performance.

Ensuring level playing ground for banks and non-banks

With the existing banks struggling for a level playing ground due to presence of different legislation governing different banks, the entry of differential banking institutions might make the situation even more complicated. This may be in terms of the regulations on the differential banks versus the existing full-fledged banks. Just like the regulatory arbitrages exit in case of public versus private banks, to which both entities claim imbalances in regulation, any such regulatory imbalances between differential banking entities shall defeat the purpose of their introduction. The banks (existing and upcoming) may face competition from the differential banks which shall strive hard to expand their consumer base. This would involve fierce fights for existing consumer bases and well as expanding the outreach through modern and more innovative technologies. And this competitive regime may only be ensured by providing a level playing ground for all players irrespective of the type of bank they belong. This needs establishment of a regulatory strategy which is not non-discriminatory between banks and non-banks.

Transparency on licencing by RBI

RBI has come up with in-principle approval to 11 applicants for payment bank licences; 10 for small banks and 2 for new private banks. The rationale behind the number of in-principle approvals has not been provided neither has been the reason for rejection of applications despite meeting the entry requirements. With RBI not providing details about the licensing process highlights the non-transparency. Though, RBI statements suggest the licenses to be provided "on the tap" to show licenses would be providing on rolling basis, but it doesn't provide reason for their actions.

Moreover, RBI deciding on the payment banks to be governed by BR Act rather than the Payment and Settlement Systems Act, 2007, has also not been made clear. Though RBI claims that an external evaluation committee had chosen the 11 successful applicants based on their own procedure and analysis, the evaluation criteria too has been kept opaque.[45] There is a need to make the entire process more transparent which shall make RBI more accountable for its actions and decisions.

Provisions of statutory appeals on RBI decisions

The new bank licensing guidelines make it clear that even if an application checks all boxes of the eligibility criteria, RBI would have the final say on providing the license. This highlights the extent of authority that RBI enjoys in the sector. RBI is not answerable to anybody for its decisions. For all the applications rejected for new banks, payment banks or any other licenses, the applicants can never hope to sort an explanation from the regulator. The non-existence of statutory or regulatory rights makes the scenario even worse for the applicants fearing the closure of doors permanently on them. Considering the control RBI has on banking, it would be rather unwise for the applicants to go against the regulator and better to hope things go favourable on the next opportunity. This sense of fear[46] among applicants is not desirable for a sector which needs new players to achieve the much needed financial inclusion. Thus, there should be a provision for statutory appeals on RBI's decisions. Not only it would bring transparency but this will also imbibe the much needed accountability of RBI on banking reforms.

Annexure I

Measures taken by Government, RBI and NABARD (Source: RBI, Economic Survey, Govt. of India, etc.)

Customer Service Centres

Credit Counselling Centres

Adhaar Scheme

The National Agricultural Insurance Scheme

No-frill Account

Know Your Customer

Project on Processor Cards

Micro Finance Development Fund

Farmers’ Club Program

Rural Volunteers as Book Writers

Role of NGOs, SHGs and MFIs

BF and BC models

Micro Pension Model

Nationwide Electronic Financial Inclusion System

Project Financial Literacy

National Rural Financial Inclusion Plan

Financial Inclusion Fund

Support to Cooperative Banks and RRBs for setting up of Financial Literacy Centres

Financial Inclusion Technology Fund

Separate Plan for Urban Financial Inclusion and Electronic Benefit

Transfer Scheme

Financial Literacy through Audio Visual medium - Doordarshan

SHG-Post Office Linkage

Project on “e-Grama”

General Credit Card

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