Differentiated Bank Licences : Emergence of a New Bank Structure

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Addressing the 34th Bankers Conference (BANCON 2013), the erstwhile Finance Minister Mr. P. Chidambaram expressed concern about the fact that most of our banks were clones of others rather than having a differentiated identity. Differentiated banking licenses are important as such banks would be innovative in their structure and would lead to better attainment of the financial objectives.

The failure of various companies in not getting a banking license from the RBI and being asked to go back to the drawing board and draft a new application for differentiated permits instead of a full license, is a clear indication from the RBI of its objective of a greater financial inclusion. According to one of the reports, the differentiated banking activity licenses issued to Regional Rural Banks and Local Area Banks (LABs) could not achieve the objectives for which they were set out which prompted authorities to call for larger size banks to go for rapid financial inclusion in a time bound and phased manner. So what exactly are differentiated bank licences? Can they make a difference? Would they be able to get that ultimate objective of attaining financial inclusion?

Unlike a single universal bank license, which are blanket licenses from the RBI allowing banks to offer a range of services , a differentiated license will allow banks to offer specialized services in select verticals like Project Financing, Mortgage Banking, Industrial Financing etc. Though differentiated banks like Cooperative Banks, Agricultural Banks, Foreign Banks, Financial Institutions and NBFCs have been a part of the Indian Financial System for long, only a single class of banking license were issued for both domestic and foreign banks and all of them enjoyed full and equal access to the payment and settlement system and the deposit insurance cover. But with the introduction of Differentiated Bank Licenses, newer dimensions of banking would emerge.

Differentiated licensing refers to the system of different licenses for different sub sectors of the banking sector such as Limited Banking License, Commercial Banking License etc. There are many countries where different licences are issued for Commercial or Saving Banks, Rural Banks or for Credit Unions. In certain countries, no distinction is made between domestic and foreign banks. Thus, there is no widely accepted recommended model available internationally. Advocates of this system say that many banks keep the plain vanilla banking as a small and a necessary adjunct. Banks providing services to retail customers have different skill sets and risk profiles as compared to banks which mainly deal with large corporate clients and hence there should be a system of differentiated licensing. These differentiated banks would specialize only in one area of banking, but at the same time this could lead to higher risk and higher asset-liability mismatches. The Nachiket Mor panel has provided certain recommendations which could be useful.

This differentiated bank structure could help new banks focus on niche lending opportunities and get a regulatory treatment different from other banks. Some countries have differentiated bank licencing regimes where licences are issued specifically outlining the activities the licenced entity could undertake. Singapore has five different kinds of bank licences - Full Bank, Qualifying Full Bank (QFB), Wholesale Bank (WB), Offshore Bank, and Representative Bank - while Hong Kong has a three-tiered structure based on licences, restricted licences, and deposit taking companies. The regulator is further considering making bank licences available on tap to those who fulfill the necessary conditions, rather than grant licenses only for a limited time.

Though the RBI has not yet issued any clear cut guidelines on differentiated banks or 'on-tap' licences , the governor claims it will be done by the end of 2014 . This initiative by the RBI would be able to fulfill the broader objective of financial inclusion and help make India a better banked country.

But, the real challenge before the regulator would be two-fold. One is that of maintaining systemic stability while encouraging the presence of different kinds of banks, and two is to make sure that no bank indulges in regulatory arbitraging. Under the existing norms, every bank is required to keep a fixed percentage of its deposits with RBI in the form of Cash Reserve Ratio on which it does not earn any interest; invest a fixed percentage of its NDTL balances in government bonds / approved securities in the form of Statutory Liquidity Ratio ; and a fixed percentage of its loan book must consist of agriculture and small loans. Once different kinds of banks come into existence, these norms would not be uniformly applicable to all. The banking landscape would change with the coming of these newcomers. Issuing new bank licenses is just one aspect of larger financial sector reforms and both the government and the new RBI Governor Raghuram Rajan are committed to them. There could be significant policy level directions in the areas of consolidation and presence of foreign banks in India and there could also be a complete reorientation of the banking structure.

Under the present situation , in India every bank can carry out every activity permissible under Section 6 of Banking Regulation Act, 1949 (Universal Banking) thereby having the following implications quite relevant to the subject under consideration

- For a wholesale bank dealing with bigger and corporate clients only, it becomes a costly affair to maintain a skeleton retail banking presence. It moreover becomes difficult for such a bank to meet the priority sector obligations and other obligations for inclusive banking.
- Retail banks may have to create risk management and regulatory compliance structures which are more appropriate for the wholesale banks thereby resulting in a significant under-utilisation of resources. Similar resources are devoted to banks with different business profiles resulting in non-optimal use of supervisory resources.
- Some banks find it difficult to provide ' no frills' facility to the economically disadvantaged. For them the more liberal licensing regime causes a different set of problems.

As the penetration of banking services is very low in India and less than 59 % of the adult population have access to a bank account, and less than 14 % to a loan account with a bank, it could be destructive to create a regime where banks are allowed to choose a path away from carrying banking to the masses. Apart from this, the priority sector lending is also equally important for banks. The revised guidelines on priority sector lending have rationalized the components of the priority sector. To enable the banking system to function optimally , and in the interest of financial inclusion, all banks should offer certain minimum services to all the customers while they may be allowed sufficient freedom to function according to their respective business models. There have been a number of issues regarding new bank licences in the recent past, most of which have been resolved but a few of them still remain outstanding like the extent of foreign ownership and the time within which promoters would have to dilute their holding. The issue of new bank licenses is very sensitive as India is an under banked country. The idea behind the licensing regime was that the basic principles of bank ownership and governance, viz. the 'fit and proper' criteria, are not diluted. The industrial licensing has long been scrapped but licensing in the banking industry is still there and the RBI decides who is 'fit and proper' to run a bank. Furthermore, nowhere in the world is banking an unlicensed activity and being fiduciary institutions, they hold deposits of the public on their behalf (public). Any deterioration in their financial health has serious implications not only for the stability of the entire financial system but also for the stability of the economy. The financial crisis of 2008 has brought home quite graphically that banks (and quasi or shadow banks) are quite different from manufacturing companies. The collapse of even a single bank can bring an entire economy to its knees large enough to affect the entire system. While the GOI's concern for rapid financial inclusion is appreciated as it could pave the way for a smoother implementation of rural development and poverty alleviation efforts thereby reducing misuse of critical funds, some other worries have been emerging. But with regulatory disaster staring them in the face if new bank licenses are doled out to powerful business houses, RBI's apprehensions are not ill-found. An 'out-of-the-box' solution will have to be found so that both the concerns are addressed while doling out the new differentiated licenses. Certain axioms for the entire banking industry need an in-depth re-visiting. Indian market is still untapped and there are diverse opportunities in the banking and financial landscape reflecting significant macro-economic growth potential and differentiated licensing could enable the unlocking of this potential as it encourages niche banking by facilitating specialization thereby reducing potential non-optimal use of resources. So if the differentiated bank licence regime is able to bank the country better and help in enhanced financial inclusion, the objective of bringing in this initiative would be achieved and if not, what kind of a banking structure would emerge and what would be its consequences is a matter to be seen. Will the RBI issue the necessary guidelines for the implementation of a differentiated banking model soon? Will India remain receptive and accept the emerging change? Will differentiated banking be good for the country? These are the various questions which would be answered in future which only time can tell.

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