

By P N Vasudevan, Managing Director, Equitas

Editorial Note: The Reserve Bank of India released a Discussion Paper on “[Entry of New Banks in the Private Sector](#)” last month. The paper invited views/comments of banks, non-banking financial institutions, industrial houses, other institutions and the public at large. Suggestions and comments are invited on the following aspects delineated in the Discussion Paper

- *Minimum capital requirements for new banks and promoters contribution*
- *Minimum and maximum caps on promoter shareholding and other shareholders*
- *Foreign shareholding in the new banks*
- *Whether industrial and business houses could be allowed to promote banks*
- *Should Non-Banking Financial Companies be allowed conversion into banks or to promote a bank*
- *Business model for the new banks*

In response to the discussion paper Mr. P N Vasudevan, Managing Director, Equitas Micro Finance India has made certain suggestions and an outline of new Micro Bank framework.

[Microfinance Focus](#), Sept 8, 2010: The purpose for which RBI is now mulling issue of new banking licenses is spelt out in their objects clause in Section 2 of their discussion paper which is reproduced here for easy reference:

2.4 Though the Indian financial system has made impressive strides in resource mobilization, geographical and functional reach, financial viability, profitability and competitiveness, vast segments of the population, especially the underprivileged sections of the society, have still no access to formal banking services.

2.5 The Reserve Bank is therefore considering providing licenses to a limited number of new banks. A larger number of banks would foster greater competition, and thereby reduce costs, and improve the quality of service. More importantly, it would promote [financial inclusion](#), and ultimately support inclusive economic growth, which is a key focus of public policy.

Please note the words: ‘vast segments of the population, especially the under privileged sections of the society has still no access to formal banking services. The Reserve Bank is therefore, considering providing licenses to a limited number of new banks.’ It is clear from this that the only reason RBI is looking to allow more banks is to foster financial inclusion of the masses that are currently not able to avail of banking services.

Clearly it is not the intent of RBI to create more banks of the kind we have today in the country. On the other hand, there is a clamor for merger of existing banks to create banks of larger sizes rather than creating more banks of small sizes. Hence we conclude that the sole purpose of creating new banks is to foster financial inclusion for the underprivileged than to serve the already served segment of population

Why is 'vast segments of the population' not able to avail of banking services?

There are various reports on poverty levels in India including the Tendulkar report. If we take \$1.25 per person per day as the criteria, about 32% of the population are poor but if we move it to \$1.35 then it moves to 61% of the population. This effectively means about 2/3rd of the population of the country (i.e about 650 million people) are economically weak. This means that the amount of money they have for saving is extremely small, the amount of loan they can avail of and service is also extremely small and the kind of remittance requirements they have is also for very small amounts.

The Banks which are in existence today, including even all the PSU banks, are not at all built for handling such small value transactions. The banks, including PSU banks compete on a variety of indicators and such peer pressure ensures that the banks are focused on only those corporate and individual accounts which supports high profitable operation. The banks consequently ignore the 'low value' masses completely because they don't want to be left behind in the race with other banks.

Expecting these banks to focus on financial inclusion for the masses is like expecting the Five Star hotels to serve the poor ... it will never happen. There have to be hotels and restaurants which are built with different cost structures, different range of offerings etc to meet people with different affordability. Just like this, a different type of bank needs to be created which is built on a different cost structure, offers a lower range of services and hence is operationally less costlier which can then be in a position to service the unbanked masses for their low value transactions.

Can banks be 'directed' and 'compelled' to serve the poor? RBI's every effort like 'no frills' accounts and BC banking are not reaching their full potential. Reason is again not far to seek. Going back to the hotel example, if all Five Star hotels are directed to ensure they also service the poor. The hotels would then say that they cannot be serviced through the main entrance, lobby or main restaurants or rooms and hence they would be required to come through a back door reeking in filth and be made to wait an inordinate time for any service and be treated as dirt so much that the poor person will never walk into the hotel again but go to the nearest road side restaurant, get treated like a proper client, eat to his heart content and pay to his abilities and leave a happy man. The hotel would also proudly display to his 'regulators' that it has complied with its direction since it has set up a separate channel of service for the poor. So everyone becomes happy except that the poor man continues to use his previous unorganized sources of servicing

Inverting the approach of the Discussion Paper

The objective of the discussion paper is to see how to license new banks which would foster financial inclusion of the masses. But immediately thereafter, instead of approaching it from the demand side, the entire paper discusses issues only from the supply side which I believe is not going to lead to achieving the objective set out in the beginning. The question is not about whether corporate, NBFCs, professionals, foreigners should be given licenses but who would offer banking for the masses. The

answer to this question depends on first understanding what it takes to offer banking to the masses and then figure out who is the right candidates for this service

Demand side approach

Assuming about 650 million Indians who are the underprivileged and unbanked. Dividing it by 4.5 (which is the average family size) gives us about 145 million families. Given below is the typical banking needs of this 145 million families:

Type of service	Requirement per family	Total for 145 million families
Savings account(@)	2	290 million accounts
Small short term consumption loans	Rs. 10,000 p.a	Rs. 1,45,000 Crores
Micro / Small enterprise loans (*)	Rs. 25000 p.a	Rs. 2,17,500 Crores
Medium enterprise loans (**)	Rs. 1,00,000 p.a	Rs. 72,500 Crores
Total loans required		Rs. 4,35,000 Crores
Housing loans (***)	Rs. 2,50,000	Rs. 14,50,000 Crores
Remittance (\$)	Rs. 25,000 p.a	Rs.1,45,000 Crores

(@): Savings accounts are likely to have average balance of between Rs. 50 to Rs. 1000 and per transaction value may be around Rs. 50 to 200 on an average

(*): Assuming about 60% of the poor live off self-employment activities

(**): Assuming about 5% of the people are either running or capable of running larger enterprises

(***): Assuming about 40% of these people would be able to afford and absorb housing loans

(\$): Assuming, in about 40% of these families, the main wage earner stays away from the village and remits back home

This, in brass tacks is what inclusion is all about. If RBI's real objective for licensing 'New' banks is to be achieved, such banks must do the above banking, and not be for the purpose of offering portfolio management services to HNIs, facilitating cross border acquisitions, offering derivatives and swaps etc.

Characteristics of 'Micro Banks' – The Business Model for Micro Banks

Let us christen these 'New' banks as 'Micro Banks' for the moment. The following should be the characteristics of such a Micro Bank to ensure that these banks stay true to the objectives with which they are set up:

a. Savings:

- KYC norms as applicable to 'No Frills' account with a maximum cumulative deposit not exceeding Rs. 2 lacs p.a and a balance not exceeding Rs. 3 lacs at any point in time

- For accounts opened with normal KYC compliance, maximum cumulative deposits not exceeding Rs. 3 lacs p.a and a balance not exceeding Rs. 5 lacs at any point in time
- The Micro Bank should compulsorily issue ATM cards to all savings account holders and it must be usable at all bank ATMs with one such other-bank ATM transaction per month being free

b. Loans:

- Maximum loan while giving it either under SHG or JLG not to exceed Rs. 50,000 per client
- Maximum loan for individuals unsecured in nature not to exceed Rs. 50,000 per client
- Maximum loan for individuals / firms for enterprise loan, fully secured not to exceed Rs. 5 lacs
- Maximum loan for housing loan purpose not to exceed Rs. 10 lacs per person
- No loans against shares / securities and no loans to real estate developers

c. Technology:

- All branches must be necessarily connected through Core Banking solution and clients must be offered any branch banking
- Door step banking by way of hand held devices or through mobile vans, linked to main server must be offered to all clients which they should be able to access close to their house (within 1 km of their residence) atleast once a week
- [Mobile banking](#) option must be made available to all clients

d. Branches

- 56% of the poor in the country reside in urban locations. Exclusion from banking services happens to people principally due to the uneconomical cost of servicing them rather than only because of distances. Hence large percentage of even urban population remain unbanked. Hence Micro Banks to be allowed to open branches anywhere in the country based on internal Board approvals and details of all branches opened to be submitted to RBI quarterly

Number of Micro Banks required

The demand for loans from this segment is about Rs. 4,35,000 Crores. Assuming that on an average these Micro Banks would be able to reach a level of about Rs. 10,000 Crores of advances over a period of time, we need about 45 such Micro Banks to be operational. This would mean that on an average they would also handle savings account of about 6 million clients.

Just as in the mainstream banking sector, what is likely to emerge is that a few Micro Banks would grow to a larger size of about Rs. 50,000 to 100,000 Crores while the rest would be small in the range of Rs. 5000 to Rs. 8000 Cr.

Capital required

For an average loan book of about Rs. 10,000 Crores, assuming a Capital Adequacy of 9%, the networth required is about Rs. 1000 Crores. Such banks can be mandated to bring in an initial capital of Rs. 300 Crores and be required to raise it to Rs. 500 Crores within 3 years and to Rs. 1000 Crores within 5 years of commencement of operations. This would ensure that these banks remain focused on large scale financial inclusion and don't 'waste' the license.

Ownership structure

Being a financial intermediation player, the normal rules of diversified ownership structure is recommended with no one owning more than 15% of the capital. While in the initial stages, promoters may be allowed upto about 40%, it should be progressively brought down to 15% within 5 years of operations

Whether Corporates / NBFCs / Foreign investors can be allowed to start Micro Banks

Once we define the structure of Micro Banks as above and ensure that through regulatory definition of business and per client exposures, these Micro Banks remain exclusively focused on the financially excluded segment of the society, it really makes no difference who is allowed to start Micro Banks. Hence the regulators can be immune to the person/s who want to start such Micro Banks subject to the promoters complying with the 'Fit and Proper' criteria that RBI normally uses for promoters of any financial intermediation entities.

In Conclusion

It may be argued, as indeed it is, in the discussion paper, that if such new Banks are forced, by their business model to focus exclusively on financial inclusion of the low income categories, they may be unfairly positioned vis a vis the other existing banks and their survival may be threatened. I believe this is singularly a wrong assumption and worry. The Micro Finance companies have proved adequately that micro loans to the poor can be done in a sustainable manner. The question really is the motive of the promoter wanting to promote Micro Banks. If they have the abilities and stay focused on the under-privileged segment of the population there is no reason why they cannot create sustainable and profitable operations which can truly take financial inclusion beyond the buzz word it is today, into realms of reality. The solution can be uniquely Indian and be a global benchmark for other developing economies to follow.

A Separate Regulator: Financial Inclusion Regulatory and Development Authority (FIRDA)

A final point for RBI to consider would be whether they have the bandwidth, given their preoccupation with the macroeconomic policies, to focus on and create 45 to 50 such Micro Banks and support them as well as closely regulate them to ensure that regulatory licenses are not misused to the detriment of the poor. I believe RBI should look to create a separate subsidiary regulator called FIRDA (a la NHB), whose full time job is only to focus on financial inclusion. This FIRDA can then not just license and monitor such Micro Banks but also play a very positive and supportive role which would be required early on to make this whole dream a reality. And since FIRDA would also be a subsidiary of RBI, policy continuities between the macro economy and the micro economy is properly managed.

Entrepreneurship is not the exclusive preserve of the rich only. Adequate access to private equity including start up risk capital has ensured that across sectors, young Indians have come up with outstanding ideas and great execution skills and are creating a network of enterprises creating hitherto expected value to clients. I am fully confident that if RBI takes the plunge and creates these Micro Banks, many entrepreneurs would step in and take the lead in achieving the dream of the Government and RBI of complete financial inclusion and placing India in the unique position of high growth economy with inclusive growth opportunities for its entire populace.

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