PAYMENT BANKS AND SMALL FINANCE BANKS – A STEP TOWARDS FINANCIAL INCLUSION

The penetration of banking services in India has increased over the past decade but still a large section of the population has no access to formal banking channels. As per the RBI estimates, approximately 90% of small businesses have no links with financial institutions and 60% of the rural and urban population do not even have a functional bank account. In comparison with international branch statistics, India had only seven branches per 100,000 adults in rural areas as compared to over 40 branches in most of the developed and even BRICS economies. Taking cues from the international experience, the US financial system has got big banking institutions along with small community banks. There are about 7,000 such small community banks which account for 46% of small loans to businesses and farms. These banks are well versed with the local credit needs and are able to provide tailor made customized products to the local population. However, these small banks are vulnerable to sector and geographical concentration risks.

In order to improve the penetration of banking services in India, a need was felt for niche banking with specific focus and accordingly differentiated licensing was the need of the hour.

The RBI had released Draft guidelines for both “Payment Banks” as well as “Small Finance Banks” in July, 2014 and based on the feedback received, it has issued the final guidelines on November 27, 2014.

Small Finance Banks would carry out the function of accepting deposits and lending primarily to priority sector. These institutions would help in bringing the unbanked population within the ambit of regulated banking infrastructure and would help in achieving the agenda of financial inclusion.

Payment banks would be providing payment & remittance services and demand deposit products to their customers. However, they won’t be allowed to undertake lending activities.

Presented below are the key features of Small Finance Banks and Payment Banks and CARE's view on these features

Small Finance Banks

<table>
<tr><th>RBI Guidelines</th><th>CARE's view</th></tr>
<tr><td colspan="2">Scope Of activities</td></tr>
<tr><td>• Acceptance of deposits both time and demand
• Lending to small business units, small and marginal farmers, micro and small industries and unorganized sector entities
• Distribution of mutual fund units, insurance products, pension products, etc.
• Category II Authorised Dealer in foreign exchange business</td><td>• Small Finance Banks would provide deposit products to their customers and inculcate the culture of saving funds with a regulated institution among the unbanked population
• Small finance banks will ensure that the credit needs of the unserved and underserved population are met and they don't have to rely on informal sources of credit which charge usurious rates of interest</td></tr>
<tr><td colspan="2">Eligibility Criteria- Promoters</td></tr>
<tr><td>• Resident individuals/ professionals with 10 years of banking and finance experience
• Companies and societies owned and controlled by residents
• Non-Banking Finance Companies (NBFCs), Micro Finance Institutions (MFIs), and Local Area Banks
• JVs by different promoter groups, proposals from large public sector entities, industrial and business houses, including from NBFCs promoted by them, would not be permitted</td><td>• Existing NBFCs, MFIs can convert themselves into Small finance banks. These entities are already serving the credit needs of the unbanked customers, now they can serve them on the deposit side also if they receive the licence.
• Conversion of existing entities may lead to faster roll out of services.</td></tr>
<tr><td colspan="2">Deployment of funds</td></tr>
<tr><td>• Requirement for maintenance of CRR and SLR to be immediate without forbearance.
• A Small Finance Bank is required to extend 75% of its Adjusted Net Bank Credit (ANBC) to sectors eligible for priority sector lending classification. Within overall priority sector lending, 40% should be allocated to different sub-sectors as per the current priority sector norms. The remaining 35% can be allocated to one or more sub sectors under PSL
• The maximum loan size and investment limit exposure to a single and group obligor to be restricted to 10% and 15% of the capital funds.
• At least 50% of the loan portfolio should</td><td>• Maintenance of CRR and SLR since inception would affect the profitability in the short term but will ensure security of depositors' money and make these banks structurally stronger
• High priority sector lending target for Small Finance Banks underlines the very purpose of its incorporation.
• Achieving priority sector requirement won't be difficult for eligible NBFCs and MFIs if they convert into small finance banks as most of their portfolio qualifies for priority sector
• The cap on single and group exposure minimizes concentration risk and the cap on loan size ensures that small borrowers are the ultimate beneficiaries</td></tr>
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RBI Guidelines	CARE's view
constitute loans and advances of up to Rs.25 lakh	
Capital requirement	
• The minimum paid up equity shall be Rs.100 crore. • Minimum capital adequacy ratio is 15% with minimum Tier I capital of 7.5%	• Minimum capital requirement of Rs.100 crore will guarantee that only serious players apply for the licence • Stipulation of minimum capital adequacy ratio will cut down the risk of over leveraging and ensure sufficient capital cushion to absorb various risks • Overall CAR requirement of 15% is in line with the NBFC-SI
Shareholding requirement	
• The promoter's minimum initial contribution shall be at least 40% of the paid-up equity capital which shall be locked in for a period of 5 years from the date of commencement • Further, the promoter's stake should be brought down to 30% within 10 years and to 26% within 12 years from the date of commencement of business	• Minimum promoter holding norm guarantee that the promoter's interest is involved in the entity's operation during the initial phase • Further reduction in the promoter's stake shall ensure diversification in the ownership structure
Other requirements	
• There is no restriction in the area of operations. However since Small Finance Banks are expected to be responsive to the local needs; preference to be given to those applicants who are expected to cater to under-banked regions of the country • The annual expansion plans shall be monitored for the initial five years and should be in compliance with the requirement of opening at least 25% of branches in the unbanked rural centres	• This will help in providing basic banking services to the low income households and people in unbanked areas

Payment Banks

<table>
<tr><th>RBI Guidelines</th><th>CARE's view</th></tr>
<tr><td colspan="2">Scope Of activities</td></tr>
<tr><td>Acceptance of demand deposits (no NRI deposits) covered under the deposit insurance scheme of the DICGC subject to the maximum limit of Rs.100,000 per customer
Issuance of ATM/debit cards (no credit cards)
Payments and remittance services through various channels like ATMs, branches, business correspondents (BC) and mobile banking
Act as BC of another bank
Distribution of mutual fund units, insurance products and pension products
Undertake utility bill payments</td><td>Payment Banks would provide deposit products to their customers and inculcate the culture of saving funds with a regulated institution among the unbanked population
Payment and remittance services would be useful for the migrant worker population and bring them in the domain of formal banking services</td></tr>
<tr><td colspan="2">Eligibility Criteria- Promoters</td></tr>
<tr><td>Existing Pre-paid Payment Instrument (PPI) issuers,
Individuals/professionals,
Non-Banking Finance Companies (NBFCs),
Corporate BCs,
Mobile telephone companies,
super-market chains,
companies,
real sector cooperatives; that are owned and controlled by residents;
Public sector entities
Existing PPI license holders can opt for conversion into payment banks
Promoter/promoter group can have a JV with an existing scheduled commercial bank</td><td>Conversion of PPIs into payment banks will address the limitations/concerns of the PPI model like inability to pay interest on balances and contagion risk</td></tr>
<tr><td colspan="2">Deployment of funds</td></tr>
<tr><td>Maintain CRR with the RBI
Invest minimum 75% of demand deposits in Government securities/Treasury Bills with maturity up to one year
Maximum 25% in current and time / fixed deposits with other scheduled commercial banks</td><td>Mandatory maintenance of CRR and parking of funds in government securities and bank deposits minimize credit and liquidity risk for payment banks</td></tr>
<tr><td colspan="2">Capital requirement</td></tr>
<tr><td>Minimum paid up capital of Rs.100 crore</td><td>Minimum capital requirement of Rs.100 crore</td></tr>
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RBI Guidelines	CARE's view
• A leverage ratio of not less than 3 per cent i.e. outside liabilities should not exceed 33.33 times its net worth	will guarantee that only serious players apply for the licence • Stipulation of minimum leverage ratio will cut down the risk of over leveraging and ensure sufficient capital cushion to absorb various risks
Shareholding requirement	
• Promoters should hold at least 40% of its paid-up equity capital for the first five years • Diversified ownership and listing will be mandatory within three years of reaching a net worth of Rs.500 crore • Maximum 74% foreign shareholding	• Minimum promoter holding norm guarantee that the promoter's interest is involved in the entity's operation during the initial phase
Other requirements	
• At least 25% of physical access points including BCs in rural centres. • Fully networked and technology driven operations from the beginning	• This will help in providing basic banking services to the low income households and people in unbanked areas • Focus on leveraging technology for providing the services would ensure low transaction cost for the customers

Conclusion:

The recent guidelines on Small Finance Banks and Payment Banks are aimed at setting up institutions that further the agenda of financial inclusion. These institutions shall provide the rural and unbanked population access to credit, wealth creation and contingency planning through lending and distribution of third party products such as mutual funds, insurance and pension products. Technology driven low cost model of payment and small finance banks overcome the challenge of high transaction cost faced by scheduled commercial banks in offering banking services in rural / unbanked areas. Further the regulation is a positive development for NBFCs /MFIs which already have operations in rural centres to convert into small finance banks. This would enable them to access low cost deposits to meet their funding needs and can prove to be a launching pad for becoming a universal bank. Also in the final guidelines, RBI has done away with geographical restriction, thus these entities can diversify risk arising from geographical concentration with the increase in size.

Overall, these guidelines are positive for the financial sector and can act as stepping stone for increasing the banking penetration.

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