Differentiated banking

May 3, 2016: Financial sector reforms in 1991 rejuvenated Indian economy and contributed greatly to the progress that India has achieved today. Much later in 2014, a set of recommendations which aimed at financial inclusion were set forth by RBI-constituted NachiketMor committee. The committee recommended establishing differentiated banks meant for providing banking access to the poor and the unbanked. Hence, the foundation stones for differentiated banking were laid.

Similar trends in the banking industry have been observed around the globe. USA, Australia, Singapore, Hong Kong, London and Indonesia, practice differentiated Bank licensing model. In these economies, the purposes of issuing differentiated banking licenses are anchored either to capital conditions or to the activity being financed.

Differentiated banking has existed in India in past, in the form of regional rural banks and local area banks. However, they were not very successful owing to various reasons. The purview of regulations applicable to all these entities have been different. NBFCs, regional rural banks and local area banks have traditionally been under the scope of RBI and Banking regulations act, 1949, while, co-operative banks are disciplined by state co-operative society act.

RBI has been encouraging various financial entities to convert into differentiated banks, thereby increasing financial inclusion and bringing them under the expanse of RBI.

Every entity being established under the differentiated banking umbrella, follow regulations set by RBI. RBI has to adopt a sophisticated approach in drafting regulations. These regulations will have to differentially use the main tools of micro-prudential regulation – capital adequacy and reserve requirements, regulatory audits, reporting and compliance – so as to achieve the desired results, while recognizing differences in business models. RBI will also have to ensure that there is no regulatory arbitrage that is created across different types of banks.

Some leeway in terms of capital required and other regulatory capital is allowed and the rationale behind providing leeway to these banks can be attributed to the fact that these banks are meant for servicing loans of lower ticket sizes and also operate in small geographic areas.

Differentiated banks are signs of government and RBI's efforts towards financial inclusion of masses. In order to induce habit of saving and switching to formal sources of credit among the unbanked population, many of the recently introduced benefit transfer schemes like direct benefit transfer scheme, etc. require mandatory ownership of bank accounts to receive the benefits. Close proximity of differentiated banks like small finance banks, especially in rural areas, would ease the process of transmission of benefits to the unprivileged. Better asset-liability management and stronger regulatory structure under RBI would help differentiated banks fundamentally achieve more success than earlier versions of differentiated banks like co-operative banks.

Differentiated banking licenses have caught the attention of foreign banks as well. Foreign banks have been engaged in specialized banking business, despite having been allotted a universal banking license, due to restrictions in guidelines on sub standardization. Hence, they may decide to opt for a differentiated banking license and maintain focus on their core activity.

Creation of small finance and payment banks is likely to promote better utilization of financial resources, bring depth to core activities, and allow institutions to focus on specific needs and customer segments. Announcing that RBI shall soon provide universal bank licenses on tap is a step furthering the financial inclusion.

The launch of differentiated banking models are part of a revolution in the Indian economy and certainly seems to be a good idea. However, the question that - will India remain receptive and positive to the change, still prevails. The success of the differentiated bank idea will herald a major change in the banking arena.