RBI Report on Financial Inclusion: A Review

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It is debatable if the report of the Reserve Bank of India's committee on comprehensive financial services – the Nachiket Mor Committee – offers practical solutions for extending banking services to the poorer sections of society and small businesses. The committee's recommendations are largely conceptual, and some of them could even have serious negative consequences. It is to be hoped that the RBI will examine all the recommendations in depth before implementing them.

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The report of the Reserve Bank of India's (RBI) committee on comprehensive financial services for small businesses and low-income households has exhaustively dealt with various facets of providing financial services by different agencies in India. Spread over 265 pages, it has 104 recommendations, some of which are repetitions. One would not be far wrong in concluding that quantity and extensive treatment of the subject was the focus instead of quality and in-depth examination with a practical bias. Further, the only two Indian commercial bankers on the committee, Shikha Sharma (chief executive officer, Axis Bank) and S S Mundra (chairman and managing director, Bank of Baroda) have given strong dissenting views couched, of course, in diplomatic language, which would indicate that the recommendations were not possibly examined by all the members of the committee. The report would thus seem to be the result of the strenuous efforts of its chairman, Nachiket Mor. He deserves to be complimented on the work, but it is debatable whether the report offers practical solutions for extending banking services – both deposits and advances – to the poorer sections of society and small businesses. An attempt is made to examine the report in this article.

The report extensively quotes practical examples from countries as varied as Australia, Brazil, Egypt, Indonesia, South Africa, the UK and the US. As for substance, a few recommendations merit serious consideration, some would bring back the "control and command" system of the past, a few others are of dubious quality, and some others border on the risky and dangerous.

1 For Serious Consideration

The following recommendations about priority sector lending (PSL) in Chapter 4.8 are worthy of adoption: (a) all loans to landless labourers and small/marginal farmers should be counted as part of PSL; (b) investment by banks in bonds of institutions must qualify for PSL, where wholesale lending to the same institutions already qualify for PSL; (c) non-fund based (NFB) limits to priority sector should be included under PSL, subject to the total credit of a bank, also including NFB. This would reckon exposure levels instead of amounts lent; (d) PSL targets should be computed on a quarterly basis; (e) banks should purchase bank-wide portfolio insurance to guard against natural calamities affecting a region/nation.

Recommendations in Chapter 6.2 regarding customer protection deserve further consideration by the RBI. Here the committee has quoted examples from Australia and the UK. The dissenting note mentions that this should not result in vicarious responsibility even

where the customer is culpably negligent/cheating. In the Australian example, even where the customer was telling a lie, the bank had to bear some responsibility. The dissenting note rightly stresses "that there should be adequate safeguards for action of banks based on inaccurate/misleading information".

The urgent need to protect unwary customers from the predatory practices of banks cannot be overemphasised. A few months ago, an incident was reported in the media where an elderly customer was induced by a bank to convert his fixed deposit into a mutual fund product with an alleged assurance from the bank officials that the mutual fund was as safe as a bank deposit. In a few years, the mutual fund lost considerably and the customer suffered a big loss. To the customer's objections, the bank retorted that he had signed a closely printed document confirming that he understood the risks, despite the oral assertions of bank officials earlier. After repeated protests and vigorous sponsoring by a media outlet, the bank relented and restored the principal amount of the original deposit to the customer. One suggestion is that in such cases the RBI should take up the matter and give the benefit of doubt to the customer and not the predatory bank.

2 Control and Command System

In Chapter 4.8, the report recommends that "each district of the country should achieve at least a 50% credit to GDP ratio" with sector and sub-sector level ratios. More particularly, the vision statement states that each district and every significant sector (and sub-sector) should have a credit to gross domestic product (GDP) ratio of at least 10% by 1 January 2016, which should increase every year by 10% to reach 50% by 2020. The RBI and/or government are expected to monitor the compliance of banks. Practically, the burden of giving credit in each district in relation to GDP (largely reflected by bank deposits) would fall primarily on public sector banks (PSBs). And, monitoring would be done by junior government officers who would take pleasure in hectoring senior bank officials to lend more, irrespective of risk.

There is already a mechanism of district-level credit plans. Extending it to the credit deposit ratio for a district and sector/sub-sector is fraught with risks. While working in a rural area of a developing state, this writer saw a bank extending loans to a number of poor women for making dried and stitched leaf plates, only to see many of the loans turn bad. The place did not have the capacity to absorb the product. Basically, the committee seems to consider institutional credit as the driving force for industrial/agricultural development, whereas it is well recognised that lack of proper infrastructure in the form of roads, power, water, storage facilities, and so on act as barriers to growth. To reiterate, PSBs would be commanded to lend and later blamed for poor quality lending.

In Chapter 4.2, it is recommended that the regulator provide specific guidance on differential provisioning norms for different customer segments and asset classes. The dissenting note has justifiably argued that the basic object could be achieved by an advanced internal-rating-based approach under Basel II norms, to which banks in India are moving.

3 Dubious Quality

(i) Universal Electronic Bank Accounts: The committee wants each resident above 18 years to "have an individual, full-service, safe and secure electronic bank account" by 1 January 2016. The dissenting note deems it to be an aspirational goal and January 2018 to be more realistic. The presumption is that all citizens would have a felt need for banking services. It is hard to conceive that a person who earns less than Rs 1,000 per month (as per the government's definition of below the poverty line – BPL) would be able to use a bank account. BPL families constitute more than 25% of the population. Thus, not less than 150 million (60% of BPL) people aged above 18 might need any banking services. It looks as if the chorus from various authorities is that a bank account is an end in itself, instead of being a means to an end. If the banks are forced to open such accounts, virtually automatically, from the Aadhaar card, most of them are likely to be dormant.

There is another aspect to be considered here. The committee wants banks to not insist on a local address while opening an account, suggesting that a "national" address should suffice. Banks are required to complete know-your-customer (KYC) verification for two purposes – to ensure against money laundering and to comply with the laws of the land. The first could possibly be met to some extent by the Aadhaar card. The second relates to the provisions of the Negotiable Instruments Act, in terms of which banks are relieved of responsibility if they collect cheques on behalf of customers in "good faith and without negligence". Banks have, therefore, to be cautious in their dealings with customers. The committee considers that banks could safeguard themselves by examining the transactions in an account with the help of technology. For this, personal monitoring is also essential. It is irrelevant if such monitoring is feasible when one considers the very large number of bank accounts to be opened in a short time.

(ii) Disclosure of Stress Tests: The committee has recommended that all banks should be required to disclose the results of their stress tests both at an overall balance sheet and segmental level, at least annually. The dissenting note is against this view. It rightly says that "public disclosure of the results may lead to unintended consequences". Such breast-beating in public by banks is best avoided. Gone are the days when Indian banks were allowed to stash away profits as "secret reserves" to provide for a rainy day. Banks exist because of the faith and trust reposed in them by the public. If such trust is even momentarily shaken due to partial and subjective information, the very edifice of the banking system would be at peril.

(iii) Universal Accessibility: The committee wants the number of distribution and electronic payment access points to be expanded so that every single person is within 15-minutes walking distance from such a point by 1 January 2016. The distribution channel would include bank branches, agents, non-bank financial companies (NBFCs), business correspondents

(BCs), ATMs, mobile phone networks, and the like. It is estimated that this would require three million access points in the country. While urban areas are saturated with such points, the task of establishing links in remote rural areas will be daunting. Bank branches and the BC/agent network might not reach such areas in the time frame envisaged by the committee. Possibly, ATMs have to be used extensively. A recent experience in Bangalore, where a woman drawing cash from an ATM was criminally assaulted in the morning hours, indicates how protection in ATMs is urgently needed. It would be next to impossible to provide security guards in remote rural areas.

(iv) Payments Bank: Chapter 3.6 waxes eloquent on the concept of a payments bank to be licensed by the RBI. Broadly, they will be similar to "narrow banks" and would invest only in risk-free government paper with less than three months duration. (The concept of narrow banks was examined by the authorities about a decade ago and given up as impractical.) They will serve small depositors with a cap on deposits of Rs 50,000 per customer. Their minimum entry capital requirement should be reduced to Rs 50 crore compared to Rs 500 crore for a full-service scheduled commercial bank. Further, the vision statement of the committee states that "at least one of the deposit products… would offer a positive real rate of return over the consumer price index" (CPI). Considering that rarely, if ever, government paper (that too of very short duration) yields any real rate of return over the CPI, it is impossible for these payment banks to offer the return enjoined on them by the committee. Further, given the proposed structure, the authorities would invariably order PSBs to open such banks as subsidiaries. Naturally, these payment banks would incur losses from day one and would then be blamed by all and sundry as inefficient. Surely, this should not be the objective of the RBI.

The dissenting note argues against the concept of a payments bank. One alternative that could be considered is to serve the financial needs of people in remote areas by adopting a hub-and-spoke approach of access points. National and regional banks could station some staff in a district headquarters or big city and send them in secure vans to various outlying areas. Each cluster in remote areas could be visited twice or thrice a week on fixed days to enable people to transact banking business. In this manner, the committee's objective of universal accessibility could be achieved and the concerns of bank staff (housing, schools, and so on) could be met.

(v) Equity Investments of Banks in Rural Infrastructure Companies: The committee considers that banks should facilitate creation of rural infrastructure by investing in the equity of companies setting them up. The dissenting note has stressed that banks should not be asked to invest in equities, as their role is to provide debt capital. This is a valid objection.

Besides the above, there is another aspect to be considered. The infra companies would all be small by capital market standards and their shares are unlikely to be listed and traded in the market. With no exit route through stock markets, the equity investments of banks would have to be necessarily repaid by the promoters over the years. Some years ago, the concept of "venture" capital investment in small industries was actively pursued by banks but it was found that banks were unable to exit even when the customer prospered. This was because the promoter had to buy back the shares from the profits earned by the business after tax. As opposed to this, debt capital could be returned by the business (and not the promoter) from even the depreciation provision of the business. Therefore, the better idea would be to approve of a higher debt-equity ratio and a longer repayment period for loans to companies engaged in rural infrastructure such as warehouses, cold storages, market yards, and so on.

4 Risky and Dangerous Terrain

The committee seems to have implicit faith in the self-correcting mechanism of markets to ensure fair play in financial markets. Such a faith had been rudely shaken in the sub-prime tsunami witnessed in the advanced markets in 2008. Subsequently the shenanigans of dishonest commercial bankers in modifying London interbank offered rate (LIBOR) interest rates and the foreign exchange rates have shattered the concept that bankers will abide by truth and fair play when they are not under watch by the authorities. In this regard, the following areas need to be thoroughly examined.

(i) Loans against Warehouse Receipts: Recommendation 4.36 states that the "Food Corporation of India and State Governments should be required to originate warehouse receipts and raise low cost funds from the market against the receipts instead of being reliant only on bank credit." Obviously the warehouse receipts should be backed by money market instruments such as banker's receipts (BRs). Two issues need to be considered. First, mutual funds would be the main investors in such short-term instruments. They would in turn get the money from banks. Thus it would only be round tripping bank money, yielding a cut to the mutual funds.

Second and most important, such BRs evoke painful memories of the early 1990s when these instruments played havoc in the market – the total BRs backed by units of Unit Trust of India (UTI) far exceeded the total corpus of UTI. And a gigantic fraud was perpetrated by some share brokers in 1992. If BRs backed by warehouse receipts are introduced, another scam would be waiting to happen.

(ii) Securitisation of Loans: The committee endorses the concept of banks churning their portfolio of PSL through pass through certificates (PTCs) and similar instruments. It is also proposed that the special purpose vehicles (SPVs) that issue PTCs should get income tax exemption. A major component of PTCs would be short-term working capital/crop loans. A PTC is suited for longer- and medium-term loans. Further, the RBI has justifiably frowned on the practice of the originator passing through an entire loan to another party and has insisted on the originator retaining some portion of the credit in its own books. If PTCs were to be issued for longer-term loans such as housing and education, there is a distinct possibility of the sub-prime crisis of 2008 being played out in India.

(iii) Wholesale Banks: Wholesale banks are supposed to be intermediaries between commercial banks and money markets on the lines of investment banks abroad. They should have, according to the committee, a lower capital requirement of Rs 50 crore (instead of Rs 500 crore). They should not accept retail deposits (less than Rs 5 crore). They should be exempted from the reserve requirements applicable to commercial banks. The dissenting note has expressed the view that these wholesale banks should also be subject to the same capital and reserve stipulations as commercial banks.

There is a serious risk/danger in the above concept. Consider the following prescriptions of the committee on such wholesale banks – (a) there should be no cap on the all-inclusive interest charged on a PSL against the present stipulation of base rate of the purchasing bank (of a securitised loan) plus 8% per annum; and (b) governmental agencies such as the National Bank for Agriculture and Rural Development (NABARD), the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), the Small Industries Development Bank of India (SIDBI), and the National Housing Bank (NHB) should be market makers and providers of risk-based credit enhancements rather than mere providers of direct finance.

The parallel to the events of the 2008 collapse of financial markets in the US cannot be starker. Substitute the NABARD and others by Fannie Mae and Freddie Mac of the US government, with a supporting role by the American International Group (AIG), the insurer. Instead of sub-prime loans, in India there would be PSL attracting a very high interest, otherwise known as sub-prime in the US. Compound the whole matter with the low capital base of the wholesale bank (Lehman Brothers, Bear Stearns, and the like). One would then have a full-blown financial catastrophe.

One shudders to think of the ways in which a western marauding bank could swindle with gay abandon if the committee's above recommendation is accepted. The scenario could emerge thus. An investment bank from abroad opens a subsidiary wholesale bank with a capital of say, Rs 100 crore. It could have a leverage of 32 as indicated by the Basel norms and the committee wants even the reserve requirements to be waived. Thus, it could pile up assets worth 33 times its capital. The assets would comprise PTC and other securitised loans yielding high interest (therefore sub-prime category loans). Because the mark-up would be around 10% or more over its base rate, and even after paying hefty salaries to its employees, its return on capital could easily be at least 200% since gross return would be 320%. It could then blithely throw in the towel after a couple of years and withdraw from India. Money lent by Indian banks in the call money market to that investment bank would be totally irrecoverable. Do we need such wholesale banks in India?

To conclude, the committee's recommendations are largely conceptual, many of them not lending themselves to practical application. Some recommendations such as those on wholesale banks and creation of money market instruments for warehouse receipts could have devastating consequences. It is hoped that the RBI will examine all the recommendations in depth, considering all the downstream consequences before implementing any of them.