Differentiated Banking

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Manifest Pedagogy

Banking and Types of Banking – role, functions and type of services they provides for beneficiaries along with their impact on inclusive growth and financial inclusion ae focus areas not only for prelims but also for mains. Functions along with regulatory framework governing them are of equal importance.

In news

Banking in India

Placing it in the syllabus

Economy: Banking, Inclusive growth

Static dimensions

- What are differentiated banks?
- Payments Banks in India
- Small Finance Banks

Current dimensions

- Challenges and opportunities for Payments Banks in India
- Challenges and opportunities for Small Financial Banks

Content

What is differentiated banking?

Differentiated banks are banking institutions licensed by the RBI to provide specific banking services and products.

It is a system refers to the system of different licenses for different subcomponents of the banking sector such as Limited Banking License, Commercial Banking License, etc. A differentiated license will allow a bank to offer products only in select areas.

The main aim of giving license to differentiated banks is to promote financial inclusion and payments. The term differentiated banks indicate that they are different from the usual universal banks. The universal banks like SBI, Canara Bank, etc. can give almost all products and services. On the other hand, the differentiated banks can give only selected products like credit, payments, deposit, etc., with RBI regulations.

Differentiated banks licensing was launched in 2015. **The differentiated banks are of two types-payment banks and small finance banks.**

Payments Banks in India

Based on the recommendations of Dr. Nachiket mor committee RBI granted license for the commencement of banking business under the Banking Regulation Act 1949 and registered as a private company under Companies Act.

The main Objective of setting up Payment banks for the purpose of financial inclusion by providing:

- Small saving account
- Payment services

Key features of Payment banks

1. Non-finance company entities and existing non-bank prepaid instruments issuer may apply for the payments bank
2. **Minimum capital** required for the payment banks is Rs. **100 crore**

3. Foreign shareholding is allowed to these banks but as per the regulations of FDI (Foreign Direct Investment)
4. Payment Banks **cannot provide lending services** but allowed to distribute financial product such as mutual funds and insurance products.
5. The bank must use the term payment bank in its name to differentiate it from other banks.
6. 25% of the bank branches of the payment banks must be in unbanked rural areas.

Services provided under these banks

- Acceptance of deposits (initially restricted to Rs 100,000)
- Payment Banks can provide services like ATM, net banking, debit cards, and net banking
- Current and savings accounts can be operated through this bank.

Key challenges to Payment banks

- **The payments-only model: A payments-only offering is an incomplete proposition and relies highly on low ticket account balances (capped at ₹1 lakh) for profitability. It's akin to any high volume-low margin commoditized business, driven by convenience and pricing, with little customer stickiness.**
- Cross-sell fee: Selling of insurance and mutual fund products is closely regulated by sectoral regulators (IRDA and SEBI). Not only are the distribution and sales commissions capped, but there are also strict requirements to prevent miss-selling. Both require certified and trained manpower to sell the products, which implies hiring better quality manpower, expense on training them and longer gestation before the resource is productive. In simple words – higher costs and limited upside on income. Cross-selling credit products like loans from NBFCs or Banks is not easy either.

Building competence for a basic credit evaluation to target the right customers has a learning curve for both individuals and organizations.

- Restriction on fund deployment: Payments banks are required to invest 75% of their CASA(current account and savings account) balances in Statutory Liquidity Ratio (SLR) eligible government bonds or T-Bills. For the balance 25%, the option is deposits with other SCBs. While this is considered as a safety net for depositors, it restricts their ability to optimize treasury operations.
- No lending. No NII (Net Interest Income) or IRR (Internal Rate of Return): Unlike Scheduled Commercial Banks (SCB) and Small Finance Banks (SFB) Payments banks are not permitted to lend. Their investment in stipulated government securities and bank FDs would yield 2-4% net of the cost of funds (or negative if they try to aggressively mobilize balances at higher rates like Airtel). Adjusted for other operating costs, the net return may fall to sub 1% levels, again corroborating the high volume-low margin nature of this business.
- Over-competition: With existing SCBs upping their focus, multiple payments banks and SFBs vying for the customer attention and even the FinTech startups disrupting the existing models, the segment is already too hot to handle. While some of the players like Airtel or Vodafone, with the existing distribution network and large customer base, have an advantage, the nature of the relationship they are now trying to build with the customer is different from a duopolistic market we normally see in telecom where top two players become market makers. India Post may be an outlier with distinct advantages of large physical distribution; however, for others, it’s a long haul to acquire critical mass.

The Opportunities:

- **The sheer size of the market:** India's unbanked population stands at 233 million. Even those who can be considered 'included' through Pradhan Mantri Jan Dhan Yojana (PMJDY), are still new to banking products. Importantly, the sheer size of the market can accommodate multiple players, offering their services to various segments of society.
- **Simplification: With the government initiative on JAM (Jan Dhan-Aadhar-mobile) and more recently demonetization, there is a push for digitization. The initial traction of wallets was primarily driven by the proposition of a 'free' and 'more convenient' payment method. There is still an opportunity to bring cost-effective and simplified technology interfaces for real-time payments. Payments banks can utilize the payments infrastructure of National Payments Corporation of India (NPCI), where the SCBs may have some lag due to their legacy systems.**
- **Offer Financial Advisory:** Unless you count the insurance pitch from your bank's relationship manager, 99% of the people in India have little access to any form of financial advisory. This inefficiency opens a huge white space for payments banks to offer real advisory services to rural and BOP.
- **Bank as a Platform: Payment banks can be the financial services gateways or platforms to re-bundle a host of innovative services. One such wholesome combination could be a tie-up with MFIs.**

Small Finance Banks

Small Finance Banks are registered as a public limited company under the Companies Act 2013. These are registered under the Banking Regulations act 1949. Financial inclusion is the main aim for setting up of these banks.

Small Finance Banks (SFBs) shall primarily undertake basic banking activities including acceptance of deposits and lending credit to unserved and underserved sections. SFBs shall be subject to all prudential norms and regulations applicable to commercial banks, including maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).

The key features of these Banks

1. Existing NBFCs (Non-Banking Finance Companies), Micro-finance Companies and Local Area Banks may apply for the small finance banks in India.
2. Small Finance Banks are established as a public limited company in the private sector.
3. **Minimum paid-up capital** for the small finance banks is **Rs 100 crore**
4. Small Finance Banks are required to establish its 25% branches in unbanked areas.
5. These entities **must add the term small finance bank with its name to differentiate** it from other banks.
6. Foreign Shareholding is allowed as per the FDI (Foreign Direct Investment) policy.

Services provided under these banks

- **These banks provide basic banking facilities such as deposit and lending of funds(to farmers, Unorganized workers and small business units.**
- They can also undertake non-risk sharing simple financial services such as distribution of mutual funds, insurance products, and pension products.
- **Key Challenges to Small Finance Banks**
- Restructuring of capital to comply with the strict RBI guidelines.
- Mobilizing deposits in a highly competitive environment.
- Re-engineering front- and back-end systems.
- Another challenge is the SFBs will require comprehensive and efficient change management processes.

- SFBs will also need to approach their **technology requirements** with a different lens compared to the traditional banks as the former will be serving a customer base that is markedly different from that of a typical commercial bank. Hence, there is a need for cost-effective mobile-based technology deployments that are better suited to reach underserved areas.
- With additional scrutiny by the RBI, the SFBs will also **require to strengthen their governance structures.**
- **Opportunities to small Finance Banks**
- Focused efforts by SFBs to carve a niche for themselves will help them cut the clutter and occupy the elusive mind-space of their target customers. It can be achieved by following initiatives they include;
    - Developing customer-centric products that reflect the mental-models and suit the cash flow of the target segment.
    - Riding on the agent network infrastructure propelled by the proliferation of PMJDY programme and Payments Banks.
    - Creating convenient avenues to trigger customers to save regularly; complementing savings with payments, and
    - Most importantly making significant investments to develop and upgrade human capital.