STUDENTS' ECONOMIC FORUM

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November 2013
Theme 264

BANKING STRUCTURE IN INDIA - THE WAY FORWARD

A monthly publication from South Indian Bank

22nd Year of Publication


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NOVEMBER 2013

THEME NO. 264 : BANKING STRUCTURE IN INDIA - THE WAY FORWARD

A well informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "Forum". RBI has proposed a comprehensive overhaul of the country's banking structure, to increase competition and growth, and for further financial inclusion. In a discussion paper issued recently, titled 'Banking Structure in India — the way forward', the regulator has provided a road map for the reorientation. It proposes a four-tier structure. The first tier may consist of three or four large Indian banks with domestic and international presence along with branches of foreign banks in India. The second tier is likely to comprise several mid-sized banking institutions including niche banks with economy-wide presence. These are capable of offering a broad range of banking products and services to the domestic economy such as investment banking, wholesale banking and funding large infrastructure projects. The third tier may encompass old private sector banks, Regional Rural Banks, and Multi State Urban Cooperative Banks. The fourth tier may embrace many small privately owned local banks and cooperative banks, which may specifically cater to the credit requirements of small borrowers in the unorganised sector in unbanked and under banked areas.

What do you know of the present banking structure in India?

At present, only a universal banking structure is allowed; there is no separate licensing for niche activities as in developed nations. The central bank still thinks the universal model is the preferred model, particularly in the aftermath of the global financial crisis. However, it acknowledges the need for differentiated banking licenses - for infrastructure financing, retail banking, wholesale banking and investment banking. There is a need to address the concerns and consider the issues arising out of any proposal for a new structure.

What are the major challenges in the way of structural reforms?

Small banks vs. large banks: Small local banks with geographical limitations play an important role in the supply of credit to small enterprises and agriculture and have the potential for financial inclusion. If small banks are to be preferred, the issues relating to their size, numbers, capital requirements, exposure norms, regulatory prescriptions and corporate governance need to be suitably addressed.

Universal Banking: In India, the universal banking model is followed with banks themselves as holding companies. Under the universal banking model, the Financial

Holding Company (FHC) structure has distinct advantages and may be a preferred model.

Continuous authorisation : Entry of new banks would increase the level of competition, bring new ideas and variety in the system , but the entry norms should be stringent. Authorities should seek to facilitate and encourage entry by only well-qualified entities in order to improve the quality of the banking system and promote competition.

Conversion of UCBs into commercial banks: In the context of extending banking services, there is a case for exploring the possibilities of converting some urban co-operative banks into commercial banks / local area banks or small banks.

Consolidation: The issue of consolidation in the banking sector has assumed significance, considering the need for a few Indian banks to cater to global needs of the economy by becoming global players. Consolidation in the banking sector may pave the way for stronger financial institutions with the capacity to meet corporate and infrastructure funding needs.

Presence of Foreign Banks in India: In view of the inherent potential for sustained growth in the domestic economy and also growing integration into the global economy there needs to be commensurate expansion in the presence of foreign banks in India. The Central bank is now in the process of unveiling new norms for the entry of foreign banks either as a subsidiary with greater freedom or purely as a branch and the final rules are expected to be announced soon.

Indian banks' presence overseas: Indian banks abroad are facing challenges due to a highly competitive environment, enhanced regulation, more intensive supervision and growing emphasis on ring fencing of operations in host jurisdictions in the wake of the crisis.

Government Ownership: On one hand, the predominance of Government owned banks in India has contributed to financial stability, while on the other, meeting their growing capital needs casts a very heavy burden on the Government. What is, therefore, needed is an optimal ownership mix to promote a balance between efficiency, equity and financial stability.

Deposit Insurance and resolution: The crisis has brought into sharp focus the need for effective deposit insurance and resolution regimes to deal with the failing / failed banks with least cost. In India, failures of commercial banks have been rare, and the beneficiaries of the deposit insurance system have mainly been the urban co-operative banks.

Which are the major issues discussed in the paper?

The major points discussed are

- Consolidation of large-sized banks with a view to having a few global banks;
- Desirability and practicality of having small and localised banks as preferred vehicles for financial inclusion;
- The need for having investment banks and other specialised banks through 'differentiated licensing' regime for domestic and foreign banks instead of granting of universal banking license;

- Policy regarding presence of foreign banks in India;
- Feasibility of conversion of urban cooperative banks into commercial banks; and
- Periodicity of licensing the new banks - 'ad hoc issue' or 'continuous licensing'

What are the recent approaches towards reforming existing banking structure?

The Committee on Financial Sector Reforms 1991 & Banking Sector Reforms 1998 , chaired by Shri M. Narasimham; the Committee on Fuller Capital Account Convertibility 2006, chaired by Shri S.S. Tarapore ; and the Report of the Committee on Financial Sector Reforms 2009, chaired by Shri Raghuram G. Rajan have dealt extensively about the need for structural reforms in the Indian banking system. The recommendations of some of these Expert Committees were

- consolidation in the Indian banking structure to create well-capitalised, automated and technology-oriented banks through mergers and acquisitions;
- fostering competition in the banking structure by permitting entry for more private sector banks;
- setting up of small banks with local character to cater to the requirements of rural and unorganised sectors;
- more active foreign banks participation;
- strengthening of the existing structure through enhancing appropriate risk management capabilities;
- Putting in place prudential measures to enable the banking structure to discharge its core functions in an efficient and inclusive manner.

What are the pros and cons in encouraging "small banks" structure?

Small banks have low capital base, with small borrowers, with limited area of operation, with limited infrastructure, staff and lower operational expenses. Small banks would help improve penetration of banking sector to unbanked areas and mobilize resources. Generally their operations are confined to a district or few contiguous districts and hence they would be in a better position to understand the needs and priorities in their area of operation. They would be able to explore business potential more tailored to the socio economic background in the area of operation and extend banking services to the people in that area. Small banks may develop core competence through relationship banking in financing agriculture, SMEs, industries in a particular geographical area, and, thereby, able to serve their credit needs better. Small banks are potentially vulnerable to sector and geographical concentration risk. Small banks are vulnerable to shocks from the local economy and hence require higher level of CRAR. Small banks cannot finance big-ticket investments, including infrastructure. They lack economies of scale and scope. Small banks are prone to be captured by local influence. Small banks generally rely on relationship banking as against lending practices adopted by big banks. A large number of small banks adds to the pressure on the supervisory resources of the central bank.

What are the major advantages of Financial Holding Company over others in a Universal Banking Model?

Universal Banking model still remains the dominant model and has functioned well in India. Broadly there are three different regulatory models such as complete integration, parent bank with non-bank operating subsidiaries and a holding company (FHC) parent with bank and non-bank affiliates. FHC model is better in removing capital constraints and facilitating expansion in other financial services. Since under the FHC, the subsidiaries will not be directly held by the bank, the responsibility to infuse capital in the subsidiaries would rest with the holding company. Management of individual entities in a disaggregated structure is also expected to be easier and more effective. The FHC model may enable a better regulatory oversight of financial groups from a systemic perspective. It would also be in consonance with the emerging post-crisis consensus of having an identified systemic regulator responsible inter alia for oversight of systemically important financial institutions (SIFI).The FHC model would provide requisite differentiation in regulatory approach for the holding company vis-a-vis the individual entities. The FHC model is likely to allow for neater resolution of different entities as compared with BHC model where liquidation of the parent bank may make the liquidation of subsidiaries inevitable. The FHC model broadly on the lines of recommendations of the "Report of the Working Group on Introduction of Financial Holding Company Structure in India" would be suitable both for private and public sector banks on account of several advantages it offers over the currently existing bank holding company (BHC) model. With the broadening and deepening of financial sector, some banks may choose to operate in niche areas. This has certain obvious advantages in terms of managing business and risk management. With the broadening and deepening of financial sector, a need is felt that banks move from the situation where all banks provide all the services to a situation where banks find their specific realm and mainly provide services in their chosen areas.

What are the advantages of a differentiated licensing regime?

On balance it would appear that differentiated licensing would be a desirable step particularly for infrastructure financing, whole sale banking and retail banking (focused on SME financing). The small banks could also be under differentiated licensing regime with restrictions on their area of operation, size and range of activities. These banks will have to be under differentiated prudential regimes depending on their risk profile.

What are the advantages of a continuous authorization approach?

Shri Raghuram G. Rajan in his report on Financial Sector Reforms suggested that there is a strong need for making the entry into banking more liberal. Bank licenses available on tap would put competitive pressure on the existing banks and improve performance and efficiency. Also it would bring new technology and new ideas into banking on a continuous basis. The gradual increase in the number of banks spread over a long period of time would be efficient and would not strain the existing banking system. It would ease undue pressure on the regulatory resources during a short period of time and enable allocation of regulatory resources evenly. The objectives of financial inclusion and broadening the geographical reach of banking can be achieved only when the entry process is not a restricted one. However, it is important that the entry norms should be stringent. Authorities should seek to facilitate and encourage entry by well-qualified entities in order to improve the quality of the banking system and promote competition.

DIFFERENTIATED LICENSING REGIME

- Very large ticket, long term infrastructure lending requires risk management expertise that goes beyond traditional credit appraisals at banks.

- Very low ticket unsecured credit requires risk management methodology and cost control that is not easy in business model of conventional banks.

- Issues of conflict of interest when a bank performs multiple functions would not arise, where differentiated licenses are issued.

- Risk management systems and structure for regulatory compliance could be customised according to the banking type.

- Customised application of supervisory resources according to the banking type could result in greater optimisation of such scarce resources.

- Core competency could be better harnessed leading to enhanced productivity in terms of reduced intermediation cost, better price discovery and improved allocative efficiency.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in


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