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Topic- Explain the mode obtaining the licence from Reserve Bank of India for establishment of new Bank.

Mode obtaining the licence from Reserve Bank of India for establishment of new Bank

On July 1, 2013 the list of 26 applicants for new banking licenses to be issued by the Reserve Bank of India (RBI) was announced – marking the end of the first phase of a process that played out in the 2010-2011 time frame. During that period, RBI posted a discussion paper on its Web site – inviting comments and feedback on the proposal to offer new banking licenses to private sector players. Among other things, RBI sought views/ comments on the minimum capital required for new banks; the promoter's contribution; foreign shareholding in the new banks, and the business model for the new banks. 1 Based on responses – from banks, the general public and non-banking financial companies (NBFCs), as well as microfinance institutions (MFIs), analyses opinion pieces in the media and discussions with relevant stakeholders – the RBI issued specific guidelines, "Licensing of New Banks in the Private Sector," in February, 2013. The guidelines take into account the existing economic environment, RBI's objective regarding banking sector reforms, and its past experience with banking licenses issued in 1993 and 2003.

Apart from stringent entry-level guidelines, RBI expects new banks to take the lead in achieving greater financial inclusion, enhancing rural bank - ing facilities, reaching priority-sector lending tar - gets, and ushering in technology innovations in the banking industry. Applicants that were issued licenses in the earlier two stages have reached a certain degree of success in some, but not all, of the above. It will be a tough task for the beneficiaries of the new banking licenses to meet RBI's expectations while ensuring they establish and run a financially strong entity. This paper looks at why applicants find it desir - able to apply for a banking license, and what they can expect from its allotment. Among other benefits, the new banks will have access to a vast unbanked/underbanked populace, lowcost funds, as well as opportunities in credit and investment products. We will analyze the cur - rent position of banks that were issued licenses earlier, and attempt to interpret RBI's guidelines. This paper will also cover the challenges that new banks are likely to face, such as compliance with RBI guidelines on financial inclusion, rural banking and priority-sector lending, plus the significant capital expenditures and competition from existing banks. Inherent advantages that some applicants possess, such as an infrastructure for a Public Sector Undertaking (PSU), or a client base from an NBFC/MFI (Non Banking Financial Company/Microfinance Company), will be analyzed as well. Finally, we will examine business opportunities for consulting firms in areas like business process modeling, core banking product selection, core banking implementation, governance, risk and compliance. Background Following the nationalization of banks in the 1960s and 1980s, the Reserve Bank of India began issuing banking licenses to 10 private sector banks between 1993 and 1994, and to another two between 2003 and 2004. The first set of licenses led to the emergence of private banks such as ICICI Bank Ltd., HDFC Bank Ltd., and Axis Bank Ltd. Promoted by various financial institutions, these went on to become the biggest private sector banks in India. A few other banks that had come into existence at the same time as these “Big Three” either collapsed or were merged with one of the three. Times Bank merged with HDFC Bank, while Bank of Punjab was acquired by Centurion Bank to form Centurion Bank of Punjab, which in turn was acquired by HDFC Bank. Global Trust Bank failed – subsequently merging with the Oriental Bank of Commerce. Only two licenses were issued between 2003 and 2004, creating Kotak Mahindra Bank and Yes Bank. The issuing of banking licenses between 1993 and 1994 (and to a lesser extent during 2003 and 2004) was probably the outcome of economic liberalization initiated by the then-government. The current licensing cycle seems to be prompted by RBI’s objectives of financial inclusion and taking banking to the unbanked and underbanked areas. New Banking Licenses — Why Now? Economic conditions during 1993 and 1994 demanded new banking licenses. Economic liberalization was underway, and the role of banks and other financial sector intermediaries was becoming prominent. PSU banks held 91% of the total bank branches in India, and collectively accounted for 85% of the total banking business in the country.2 New banking licenses were issued to move financial sector reforms forward, upgrade technology in the financial services sector, and avoid placing economic power in the hands of a few.

Those objectives were probably met to a large extent by newer entrants, since RBI proceeded with issuing another round of banking licenses during 2003 and 2004. RBI’s intent can be broadly attributed to three objectives:3 Financial inclusion — Providing affordable banking services to the lowest strata of the population is one of the primary goals. RBI has mandated that commercial banks achieve financial inclusion by offering “no-frills” savings-bank accounts and easy access to credit facilities through general-purpose credit cards (GCCs). KYC (Know Your Customer) norms have also been relaxed to achieve greater financial inclusion. Additionally, CRISIL Inclusix provides a comprehensive index for measuring financial inclusion in the country (see Figure 1). Source: www.crisil.com Figure 1 CRISIL Inclusix Score CRISIL Inclusix Score 33 35 37 39 41 2009 2010 2011 CRISIL Inclusix measures financial inclusion on three parameters: branch penetration, deposit penetration and credit penetration. As seen in Figure 1, financial inclusion has improved from 2009 (score of 35.4) to 2011 (score of 40.1) but is still low, and reflects under-penetration of banking services in the country. Other findings from the index also indicate significant room for improving this score (see Figure 2, next page).

Significant Room for Improvement To rectify this situation, RBI has mandated that new banks would have to open at least 25% of their branches in unbanked rural areas. This would result in: A wider reach of financial services — For banking to be truly inclusive, banking and financial services must reach a large section of the general population. Consumers can then benefit from access to a wide variety of banking products and services; banks win by bringing more people into the banking fold, which reduces the cost of offering such services. Penetration of banking services also achieves the greater good of financial inclusion. The percentage of growth in rural and urban households availing themselves of banking services (see Figure 3) can be attributed to the increasing reach of such services in rural centers. Rural banking — Penetration of banking services in rural areas is RBI's third objective regarding issuing new banking licenses. During 1993 and 1994, new banks were obligated to open branches in rural areas; between 2003 and 2004 they were required to have 25% of their branches in rural and semi-urban centers. This time around, RBI has specified that new banks must set up 25% of their branches in unbanked rural centers (having a population of up to 9,999). This guideline emphasizes RBI's focus on rural banking.

"Average Population per Bank Branch" (APBB) for rural and semi—urban areas (see Figure 4, next page) fell from 17,200 in 2005 to 12,100 in 2013. The APBB is likely to continue to decline as the number of branches increases. Out of a total of 102,343 branches of scheduled commercial banks in India (as of March 31, 2013), 37,953 (37%) are located in rural areas. Of these, private sector banks account for just 1,937 (only 5.1%).4 As Figure 5 (next page) indicates, private sector banks and foreign banks have the least number of rural branches. Clearly, private sector banks have lagged behind in terms of providing banking services to rural Findings from the Index Interpretation Number of savings bank accounts is close to four times the number of loan accounts. 1 Access to credit facilities is restricted to a small section of the population, possibly due to the stringent regulations that are in place. 2 There is significant opportunity for banks/other financial intermediaries. 3 Banks are looking to mobilize low-cost funds and focus less on extending credit to every category of depositors. India's six largest cities have 11% of the total bank branches. 1 Banks have largely ignored smaller cities and rural areas. 2 Indian cities may be overbanked. There are four districts in the Northeast with only one bank branch among them. 1 Some regions in the country are highly underbanked, in spite of RBI-mandated financial inclusion measures. Source: www.crisil.com Figure 2 Source: financialservices.gov.in Figure 3 0 20 40 60 80 2001 2011 A Wider Reach of Financial Services Rural Households Urban areas. By issuing guidelines for setting up branches in those parts of the country, the RBI hopes to correct this situation. What is in it for Applicants? The number of applicants for new banking licenses has come down – from 113 in the 1993- 1994 time frame to 100 between 2003 and 2004, to just 26 in the current cycle.5 This can be attributed to the stringent guidelines issued by RBI and an uncertain operating environment. However, the fact that 26 applicants across NBFCs, PSUs and large business houses have applied for a banking license indicates that these entities see business and other opportunities in this sector. A few reasons why new applicants could succeed can be attributed to: An underbanked population — For the financial year ending March 31, 2012, there were 26 nationalized banks, 40 foreign banks and 21 private sector banks (including both old and new-generation private sector banks).6 In addition to these, there were 86 regional rural banks, 1,721 urban cooperatives, 31 state cooperatives and 371 district central cooperative banks.7 However, as Figure 6 (next page) indicates,8 India has a lot of ground to cover compared to other emerging economies and developed economies. This represents a significant opportunity for newer entrants, since they have access to this vast and probably underbanked population. Access to low-cost funds — Most of the 26 applicants already have a presence in the financial services sector, with a significant portion of their existing business coming from rural areas (see Figure 5). Therefore, they are likely to have better access to low-cost funds in the form of current and savings deposits. Deposit holders in the rural and semi-urban areas are not as financially literate as their urban counterparts; hence, they are largely unaware of alternative financial and investment products. They are more apt to keep surplus funds in the bank rather than invest in other instruments. Low credit penetration — As we mentioned earlier, the number of deposit accounts in India is almost four times the number of loan accounts. The reasons could range from stringent credit checks to the Indian mindset of not turning to loans. However, this also indicates that credit penetration still has ample room to grow, and that newer and more aggressive entrants can take advantage of this opportunity. Low penetration of financial products and services — Nowadays, distribution of thirdparty products (TPPs) such as mutual funds and insurance, and services such as portfolio management, form a sizable portion of a bank's income. However, in spite of aggressive marketing by banks, mutual fund penetration in India stands at 4.7%, while insurance penetration is at 5.1%.9 The new banking license applicants will be looking to tap into this market. Dissatisfaction with existing banks — Newer entrants will seek to leverage customer dissatisfaction with existing banks due to Source: financialservices.gov.in Figure 5 Percentage Distribution of Rural and Other Branches 0 20 40 60 80 100 Public Sector Banks Private Sector Banks Foreign Banks Regional Rural Ban declining standards in customer service, lack of technological innovations and limitations in geographical reach, for example. Use of existing infrastructure and experience — The list of 26 applicants for banking licenses comprises entities such as Bajaj Finserv Ltd., JM Financial Ltd., LIC Housing Finance Ltd. and Reliance Capital Ltd., which have ample experience in dealing in financial products and services. Apart from experience, these entities also possess the infrastructure and client base necessary to support their foray into banking. Success stories of earlier entrants — Licenses issued in the earlier phases resulted in the formation of banks such as ICICI Bank Ltd., HDFC Bank Ltd., Axis Bank Ltd., Kotak Mahindra Bank Ltd. and Yes Bank Ltd. These institutions have grown in size, income and geographical reach, and now wield considerable influence in the Indian financial markets. Along the way, these entities also got listed on major stock exchanges in India, such as the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE), as well as overseas (The New York Stock Exchange [NYSE] and the London Stock Exchange [LSE]) – creating more value for shareholders. New applicants will be looking to emulate the business model of such banks. Licenses Issued Earlier — Successes and Failures Banks that came into existence post the 1993- 1994 time period are referred to as New Generation Private Sector Banks (as opposed to the Old Generation Private Sector Banks, such as South Indian Bank, Federal Bank and Karnataka Bank, for example). Most of the banks that came into existence as a result of banking licenses issued in the 1990s and early 2000s have done well. The new private sector banks, such as ICICI Bank, HDFC Bank and Axis Bank, which were set up post-1991, compare favorably (see Figure 7, previous page) to the PSU Banks such as PNB (founded in 1895), Bank of Baroda (founded in 1908), Canara Bank (founded in 1906) and Bank of India (founded in 1906) (See Figure 8, below). These banks have also been able to create and enhance value for their shareholders in the comparatively short period of time they have been listed. However, not all banks that came into existence post-1991 have managed to survive and prosper. Global Trust Bank had to be merged with the Oriental Bank of Commerce; Centurion Bank and Bank of Punjab merged with HDFC Bank, largely due to lack of financial strength. Times Bank voluntarily merged with HDFC Bank. The banks that did well were those promoted by financial institutions. They had adequate experience in the financial services field, financial resources, and a sound business model, and were well equipped in every way to run a bank. Banks that were promoted by individuals with banking experience either collapsed or merged with other banks; for example, Global Trust Bank and Centurion Bank. Development Credit Bank, which was earlier a cooperative bank, and IndusInd Bank, which was promoted by an individual, continue to function.10 Guidelines for Licensing New Banks in the Private Sector — An Analysis Guidelines for licensing new banks are formulated by the Reserve Bank of India, based on Market Capitalization.

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