

Review of Local Area Banks and Policy Implications for Narrow Banks in India

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In the recent past there has been renewed discussion on the possibility of setting up narrow banks to focus on including the population left out of the formal financial sector. Reviewing the experience of local area banks and the landscape of financial inclusion, this paper identifies internal contradictions in the approach to narrow banks — primary objectives, structures, limitation of size and geography, mainstream banking standards, evaluation of performance. Despite these issues, the existing banks are indeed performing (under severe constraints), and do not give cause for anxiety on solvency and stability.

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Financial inclusion has been a priority for the Indian state. The objective of the state in opening new narrow banks was to deepen financial services available from the formal sector. Providing financial services to the poor, especially in rural areas, is difficult. The policy on financial inclusion had to be tempered with profitability, sustainability and growth.

Review of Past Efforts

The approach of the state was through national-level integrated institutions, through quotas, allocations, and incentive/disincentive schemes. These schemes penetrated to an extent. The inclusion achievements of the banks since nationalisation are in Table 2 (p 53). The share of rural credit from non-institutional sources fell from 92.8% in 1951 to 36% in 1991. The branch network spread since the first round of bank nationalisation in 1969. The average population per branch fell from 65,000 in 1969 to 13,756 in 1990 due to opening of branches. The share of urban and metropolitan branches to the total branches fell from 45.6% to 22.9% even as the absolute number of branches expanded (see Table 1).

After economic liberalisation was rolled out in 1991, the share of informal credit, particularly from agricultural and professional moneylenders has increased (see Table 2).

Table 1: Branch Network of Commercial Banks

As at End	Rural Centres	Semi-Urban Centres	Urban Centres	Metropolitan Centres/Port Towns	Total	Population Per Bank Office
1	2	3	4	5	6	7
June 1969	1,443 (17.6)	3,337 (40.8)	1,911 (23.3)	1,496 (18.3)	8,187 (100.0)	65,000
December 1975	6,807 (36.3)	5,598 (29.9)	3,489 (18.6)	2,836 (15.1)	18,730 (100.0)	31,660
December 1980	15,105 (46.6)	8,122 (25.1)	5,178 (16.0)	4,014 (12.4)	32,419 (100.0)	20,481
December 1985	30,185 (58.7)	9,816 (19.1)	6,578 (12.8)	4,806 (9.4)	51,385 (100.0)	14,381
December 1990	34,791 (58.2)	11,324 (19.0)	8,042 (13.5)	5,595 (9.4)	59,752 (100.0)	13,756
March 2000	32,734 (50.0)	14,407 (22.0)	10,052 (15.4%)	8,219 (12.6)	65,412 (100.0)	15,725
March 2010	32,624 (38.2)	20,740 (24.3)	17,003 (19.9)	15,026 (17.6)	85,393 (100.0)	13,800

Figures within parentheses are percentage shares in total.

Source: Data up to December 1990 — *Report of the Currency and Finance, 2008*, Chapter 3. Mumbai: RBI, p 98.

Data for March 2000: *Basic Statistical Returns of Scheduled Commercial Banks in India: Summary Tables March 2000*, Mumbai: RBI, p 1.

Data for March 2010: *Basic Statistical Returns of Scheduled Commercial Banks in India*, Volume 39, Mumbai: RBI, p 1.

Table 2: Break-up of Institutional and Non-Institutional Rural Credit (%)

	1951	1961	1971	1981	1991	2002
Institutional agencies	7.2	14.8	29.2	61.2	64.0	57.1
Government	3.3	5.3	6.7	4.0	5.7	2.3
Coop society/bank	3.1	9.1	20.1	28.6	18.6	27.3
Commercial bank including RRBs	0.8	0.4	2.2	28.0	29.0	24.5
Insurance	—	—	0.1	0.3	0.5	0.3
Provident fund	—	—	0.1	0.3	0.9	0.3
Other institutional agencies*	—	—	—	—	9.3	2.4
Non institutional agencies	92.8	85.2	70.8	38.8	36.0	42.9
Landlord	1.5	0.9	8.6	4.0	4.0	1.0
Agricultural moneylender	24.9	45.9	23.1	8.6	6.3	10.0
Professional moneylender	44.8	14.9	13.8	8.3	9.4	19.6
Traders and commission agents	5.5	7.7	8.7	3.4	7.1	2.6
Relatives and friends	14.2	6.8	13.8	9.0	6.7	7.1
Others	1.9	8.9	2.8	4.9	2.5	2.6
Total	100	100	100	100	100	100

* Includes financial corporation/institution, financial company and other institutional agencies.

Percentage of share of different credit agencies to outstanding cash dues of the households as on 30 June.

— Denotes not available.

Source: *All India Rural Credit Survey* (RBI 1954); *All India Debt and Investment Survey*, various issues.

The physical presence of rural branches after 1991 has seen a setback. By 2001, the average population covered by a branch increased — reflected by the increase in population without a concomitant increase in branch outreach. The aggressive growth of branches during 2001–10 was skewed in favour of urban/metro centres, which represented 75% of the new branches. As against a pre-liberalisation policy of one licence in an urban/metro location in return for opening four branches in unbanked locations, the new policy required 25% branches in rural locations and that was reflected in the spread of branches.

The state should be concerned about the shrinking share of formal sector, relative shrinkage of physical presence of rural branches and residual financial exclusion.

The targets for physical location of branches even in the pre-liberalisation era did not address regional imbalances. The southern region always had a greater penetration; north-east, central, and eastern regions were always underbanked. So, the problem or residual inclusion was as much about reaching poorer customers as reaching difficult regions.

The regional imbalance was initially addressed through decentralised solutions. The first decentralised solution came from the All India Rural Credit Survey (AIRCS) report which advocated state partnership with primary rural cooperatives. The second phase of decentralised solution was establishing regional rural banks (RRB).

Cooperatives worked for three decades and started failing. A detailed review of performance of the credit cooperatives could be found in the Vaidyanathan Committee report (GoI 2005). The story of RRBs was no different. There were multiple efforts in consolidation, recapitalisation and rethinking the design of RRBs. While the performance of RRBs is the subject of another paper, we recognise the role of RRBs in the vexed question of regional imbalances. Table 3 shows that the north-east, east, and the central regions were disproportionately underserved in 1975. The skew became lesser by 2009. In these three underserved

Table 3: Population Per Bank Branch

Branch Statistics as on	Census Year	Region					Total	
		Northern	North-Eastern	Eastern	Central	Western Southern		
December–1975	1971	19.5	71.2	56.1	46.5	20.2	21.7	29.5
December–1980	1981	15.0	35.2	31.6	29.2	16.9	16.3	21.1
December–1991	1991	11.0	16.9	16.4	15.8	12.8	11.9	13.7
March–2001	2001	12.6	20.4	19.5	19.0	14.5	12.5	15.6
March–2009	2011	11.6	21.1	20.3	19.4	14.2	11.3	15.2

Source: Data on region-wise spread of branches from Banking Statistical Returns (various years) and Branch Banking Statistics (various years). Mumbai: RBI.

Population data from Census of India (various years). New Delhi: Registrar General and Census Commissioner, Government of India.

regions the lessened skew is explained by a larger proportion of RRB branches (Table 4), a localised effort was helpful in spreading banking deeper. The large banks helped the cause of penetration but not of regional imbalance. Narrow banks are significant from this perspective.

If we were to achieve the coverage of residual population, in difficult regions, we need decentralised solutions that could penetrate deep as evidenced by RRBs. We examine local area banks (LAB) in this context.

Table 4: Region-wise Share of Branches between RRBs and Commercial Banks, 2009

Region	Share of RRB Branches (%)	Share of Commercial Bank Branches (%)
Northern	15	85
North-Eastern	31	69
Eastern	27	73
Central	29	71
Western	8	92
Southern	14	86
Total	19	81

Source: *Branch Banking Statistics* (Volume 4), March 2009, Mumbai: RBI, September 2010.

Local Area Banks

LABs as an idea were conceived in 1996. The finance minister in his budget speech on 22 July 1996 said:

...[I]t has been agreed with RBI (Reserve Bank of India) to promote the setting up of new private local area banks with jurisdiction over two or three contiguous districts. This would enable the mobilisation of rural savings by local institutions and, at the same time, make them available for investments in the local areas (Chidambaram 1996).

Following this, RBI released guidelines for new LABs (RBI 1996). The objectives articulated in the budget were reiterated: “(LABs are) expected to bridge the gaps in credit availability and enhance the institutional credit framework in the rural and semi-urban areas.”

The LABs would focus on the local customers, adhere to the priority sector, and weaker-section deployment targets applicable to all banks. The capital stipulated for a LAB was Rs 5 crore. The licensing conditions mandated that the promoters' contribution had to be at least 40% of the equity, with a road map to reduce concentration in shareholding. The area of operation was three contiguous districts.

All other requirements of capital adequacy, income recognition, asset classification, and provisioning were the same as commercial banks. The guidelines stipulated that branch licensing would be governed by “existing” policy. However, when the branch licensing policy for commercial banks changed in 1996, they were not applicable to LABs. The change effected in 1996 allowed commercial banks to open branches without specific permission as long as 25% of the new branches were in Tier v and Tier vi locations.

RBI initially received more than 50 applications (RBI 1997) and eventually 227 applications for LAB licences were received over a period of four and a half years (RBI 2002). Of these, 10 were considered for issue of in-principle approvals, but four were withdrawn before the LABs were set up. Six applicants were issued LAB licences. The licences of two LABs were cancelled due to problems. Four LABs continue to function.

Ever since LABs were set up, there were discussions on the desirability of LABs. Literature indicates that RBI was uncomfortable with small banks, and the government was keen. In 2013, there was a convergence of views between RBI and the government.

Ramachandran Committee 2002

A review group set up by the RBI, the Ramachandran Committee, reviewed the performance of four LABs. It recommended that no further LAB licences be issued till there was stability with the existing LABs.

While the RBI did not issue licences following the recommendations of the Ramachandran Committee, the discussion continued. The annual Trend and Progress of Banking in India report (T&P) 2003 said that RBI revised the policy for licensing LABs “considering the poor inherent financial strength of LABs” (RBI 2003). The T&P continued to articulate its concerns in 2004:

...the two existing smaller banks, viz, The Subhadra Local Area Bank Ltd, which suffered net losses in the very first year of its operation and Krishna Bhima Samruddhi Local Area Bank Ltd, whose profits remained low and virtually stagnant during 2003–04, raise concerns about their sustainability (RBI 2004).

The subsequent T&P reports reported the performance of the LABs without any comment. Till 2010 the T&P reported performance, without comments. In 2010, the report raised concerns, and invoked the Ramachandran Committee to point out that except one bank, the others failed to reach net worth of Rs 25 crore — as recommended by the committee (RBI 2010). This was in the light of the recommendations of the Rangarajan Committee (discussed subsequently), which recommended allowing new LABs, while RBI was still not comfortable with the idea.

Rangarajan Committee

The Report of the Committee on Financial Inclusion (Rangarajan Committee) (GoI 2008) said that LABs were a part of its strategy for building an inclusive financial sector. The committee thought that LABs could integrate with local financial markets and “offer a host of financial services including savings, credit, remittances, insurance.” It suggested that RBI could allow LABs, in regions with high levels of exclusion. News reports at that time said that the finance ministry would take up with RBI the issue of resuming licensing of LABs (*Indian Express* 2014). However, neither the recommendation of Rangarajan nor the articulation by the finance ministry resonated with the RBI.

Raghuram Rajan Committee

The report of the Committee on Financial Sector Reforms (Raghuram Rajan Committee), (GoI 2009) laid faith on small banks and blamed their “not-so-stellar” performance on poor governance structures, excessive government and political interference, and unwillingness/inability of the regulator to undertake prompt corrective action. It said that instead of “large-bank-led, public-sector-dominated, mandate-ridden, branch-expansion-focused strategy for inclusion;” LABs with low cost, efficient structures would work better. They said that the LAB initiative was prematurely discontinued. They suggested exploring the possibility of setting up privately-owned, well-governed, deposit-taking, small-finance banks similar to LABs but with a difference. These banks were to

...bring local knowledge to bear on the products that are needed locally, and would have the locus of decision making close to the banker who is in touch with the client, so that decisions can be taken immediately’. These banks were expected to be entry points ‘into the banking system, which some entities can use to eventually grow into large banks (GoI 2009: 7).

The union government wanted to take these recommendations forward. In 2009 it was reported that the finance ministry and RBI were planning to “allow more LABs...to provide an impetus to the government’s financial inclusion drive.” Unbanked revenue blocks, 120 of them, were identified and the new banks were to be allowed to “perform all functions of a scheduled commercial bank,” in a limited geographical area (Anto 2009). The reports in January 2010 said that RBI had “granted an in-principle approval for a proposal that will allow private sector players to promote small local banks” (Kuber 2010). However, this was refuted by minister of state for finance in a written reply to the Rajya Sabha (*Economic Times* 2010). The Raghuram Rajan Committee renewed the debate on LABs, and also suggested that institutions operating at local level — microfinance institutions (MFI) and community-based lending organisations — could choose to become small banks and raise their own deposits. In 2011 the Ministry of Rural Development, in the wake of the MFI sector crisis suggested that MFIs could be converted to LABs and brought under a regulatory framework (Money-control 2011).

Banking Structure in India: The Way Forward

In spite of these discussions, RBI was either silent or critical of LABs. A change in RBI’s approach was seen in a discussion paper on the future of banking structure in India (RBI 2013a). Here, RBI accepted the possibility of having different forms of banks, including small banks. It argued that small banks (LABs and Urban Cooperative Banks) played an important role in providing credit to small enterprises and agriculture and had potential for financial inclusion. The paper noted that performance of LABs suffered because of high costs. The paper envisaged LABs to be in the fourth tier of banking to “specifically cater to the credit requirements of small borrowers in the unorganised sector in unbanked and under banked areas” (RBI 2013a: 7).

Reflecting this, the report of T&P made a positive statement:

Notwithstanding these constraints, these institutions show promise of small-scale banking institutions that can be experimented with on a larger scale in future. ...Such banks pose less threat to systemic stability given their limited-area operations with little financial interconnectedness (RBI 2013b).

Nachiket Mor Committee

The committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Nachiket Mor Committee) (RBI 2014) made recommendations on the banking structure, going beyond the issues raised in the discussion paper. It offered options including specialised banking structures like payment banks and wholesale banks. It also suggested that a “gradual transition of eligible and interested NBFC to Wholesale Consumer Banks or National Banks” (RBI 2014: 13) could be considered.

There were divergent views on small banks at a conceptual level. This paper revisits these views by examining the performance of LABs; and by engaging with policymakers who were for and against the idea of LABs.

Key Covenants of LABs

LABs were set up with the intention that they would be like RRBS in their structure having these features:

(a) The area of operation was restricted. While they were called local area banks, they were local area rural banks with only one urban branch in a district. While the Ramachandran Committee suggested that one urban branch be licensed for every 10 rural branches, the policy statement that considered the report was silent on this (RBI 2002a). The regulatory constraints on LABs prevented adoption of innovative outreach models.

(b) The initial equity contribution was set at Rs 2 crore. The structure was no different from mainstream banks. The promoters were expected to contribute a minimum of 40% of the capital (or a minimum of Rs 2 crore). If the equity holding was not diversified, they had to diversify to reduce promoter holding to 40% over a reasonable period. For expansion of capital, the promoters could not contribute disproportionate amounts; had to get investors to maintain the diversified holding. There were restrictions on the concentration of non-promoter holdings which were capped at 10% of the share capital for each block of investors.

(c) The capital adequacy norm for LABs was 8% of the capital-to-risk weighted assets ratio (CRAR). For RRBS, these norms were first specified in 2007 (RBI 2007), and mandated to be followed in 2013 (RBI 2013c). Following recommendations of the Ramachandran Committee (RBI 2002, 2002a) RBI increased CRAR for LABs from 8% to 15% and the minimum net worth requirement was raised to Rs 25 crore. Except Capital LAB, others did not achieve the net worth criteria in the stipulated time (RBI 2013b: 88).

A high capital adequacy implied a lower leverage. Low-cost deposits come from the ability to leverage. Policies that restrict leverage reduce the bank's ability to attract deposits. Higher

capital results in high return on assets (higher profits because of lower interest payouts) but low return on equity (a higher capital base had to be serviced with these profits). Banking was not attractive, unless the leverage was fully exploited. A high CRAR made it unattractive for equity investment.

(d) All the covenants applicable to the new private banks were applicable to LABs. These included a cap on voting rights at 10% irrespective of shareholding; compulsory diversification of shareholding through disinvestment; appointments to the board and the chief executive officer positions had to go through a fit-and-proper test and be approved by the RBI.

(e) It was expected that the LABs would recruit locally. This was an advantage, as borne out by the cost-to-income ratio and other financials (discussed later).

(f) RRBS and rural cooperative structures were inspected and supervised by National Bank for Agriculture and Rural Development. The urban cooperative banks were inspected and supervised by the urban banks division of RBI. For LABs, the supervision was with the Department of Banking Supervision — a department that supervised commercial and foreign banks. The functions of LABs were similar to the RRBS, but the supervision was that of the commercial banks. The regulation of the LABs initially vested with the Rural Planning and Credit Department, was also shifted to the Department of Banking Operations and Development.

(g) LABs had limited growth due to geographical restrictions, and more concentration risk. The only way LABs could grow was through the infusion of promoter capital. Diversification of capital through external investments or through a public issue was difficult. There was no special dispensation for operating in areas that were difficult. LABs could be as profitable by charging a risk premium on their loan book.

Regulation: Discontinuing Licence Issuance

The Ramachandran Committee had misgivings on the feasibility of LABs much before it was given a chance. Though it said: “At the outset, it needs to be emphasised that these banks have been in existence only for a short period thus ruling out a definitive pronouncement on their success or failure,” the committee made some fundamental recommendations, without recognising the performance or their feasibility. All LABs were profitable at the time of the report and did not have concerns of solvency then or later. However, the committee articulated major concerns:

(a) Branches of the banks were not located in unbanked centres;

(b) bulk of the business emanated out of the head office;

(c) they were not significant players in their area;

(d) they had concentration risks, their deepening had to happen in agriculture leading to stressed assets. The capital and the small size did not give it cushion to absorb losses — when they occurred;

(e) there were fundamental weaknesses in their business model;

(f) they were dealing in securities and bonds, which were risky;

(g) they were achieving their outreach through agents and quasi agents.

While the committee suggested stiff norms on capital (discussed earlier), it offered some sweeteners: access to refinance, freedom to open branches, one urban branch licence for every 10 rural/semi-urban branches. While the recommendations on capital were accepted and notified, the sweeteners were never implemented.

The committee report was internally contradictory, not borne by performance. The LABs continued to be viable. The contradiction was between the design, the intended objective, the regulatory framework and the evaluation framework.

(a) The design principles applied to LABs were similar to a commercial bank, except for restricted area of operation, freedom to open branches and lower capital. LABs were to follow all the other requirements on provisioning, priority sector and weaker sections deployment targets. There was restriction on opening urban branches — dictating LABs to work in centres that had lower populations. They did not have the ability to cross-subsidise between bulk loans in diversified sectors and small loans to weaker sections. The geographic restriction also had implications on the types of deposits that these banks attracted.

LABs had geographical concentration risks; there were also risks at the portfolio level because of the underlying activity (agriculture). These risks could be managed by having branches in locations where the business was lucrative and wait for that success to spill over to remote areas. If there was portfolio concentration risks, the de-risking happened by diversification. The committee examined risks from a liabilities perspective, focusing on depositor interest, without examining business viability. A high capital reduced the exposure to depositors and increased the equity holder's stake. It did not reduce the weakness of the portfolio.

The operating costs of LABs were high because of the ticket size. The design had to be flexible to share costs across multiple activities. An agent outreach model with exclusivity in financial services and non-exclusivity in other activities could have addressed this problem. The committee believed that this was risky. Even if it were, the risks could be addressed by charging a premium. A part of the premium could be passed on to a corporation that offered risk coverage (RBI 2014: 9).

LABs could not diversify their portfolio locally because of (i) lack of alternative opportunities; (ii) inability to offer some products due to mismatch of assets and liabilities; (iii) lack of human resource capability to assess risks; and (iv) complexity and technical nature of the project.

To address these, LABs could invest in a basket of instruments that financed such activities. Investing in such a diversified portfolio would fetch risk-adjusted returns lower than what they would have earned if it was direct finance. Criticising LABs for getting income from securities was unfounded. In fact the policy had to encourage LABs to find alternative income sources — subject to prudential norms and good internal management systems. If design of LABs was like a commercial bank with diversified portfolio, the balance sheet had to mimic that.

(b) The policy (Ramachandran Committee, RBI guidelines and notifications) showed that the intended objective of LABs was to serve the unserved segments, and take up financial inclusion. These objectives contradicted the design of a good bank, taking it towards risky activities, geographies and customers. If the markets had discovered mechanisms to address these customers, there was no need for a policy or institutional intervention; it just needed a regulatory framework. However, decades of experience showed that there were no institutional mechanism that addressed risky activities, risky geographies and risky customers all at one go.

Let us examine the 10 in-principle licences issued for LABs. These covered three districts each, in diverse parts of the country. The area of operation for eight licensees are available. Of these, only two applicants (Priyadarshini and Vinayak) wanted to operate in areas where the banking density was significantly lower than the national average (Table 5). Both these did not survive. Of the four that are continuing, one was in an area where banking density was marginally lower than the national average. The other three operate in well-banked areas. Capital LAB, the most successful, operated where the banking penetration almost double the national average.

Table 5: Details of Applicants Issued In-Principle Approval for LAB Licences, Area Covered and Banking Spread

SlNo	Applicant	Districts Opted	Total Commercial Bank Branches	Population	Population Per Branch	Average All for Districts
1	Priyadarshini	Jalgaon	183	36,82,690	20,124	
		Jalna	75	16,12,980	21,506	
		Aurangabad	159	28,97,013	18,220	19,647
2	Manipal	DK	306	18,97,730	6,202	
		UK	166	13,53,644	8,154	
		Shimoga	157	16,42,545	10,462	7,780
3	Kongunadu-Salem	Salem	164	30,16,346	18,392	
4	Central Gujarat-Dabhoi	Vadodara	335	36,41,802	10,871	
5	KBS	Mahabubnagar	197	35,13,934	17,837	
		Raichur	96	16,69,762	17,393	
		Gulbarga	177	21,74,742	12,287	15,656
6	Coastal LAB	Krishna	342	41,87,841	12,245	
		Guntur	332	44,65,144	13,449	
		WG	277	38,03,517	13,731	13,098
7	Subhadra	Sangli	185	25,83,524	13,965	
		Kolhapur	230	35,23,162	15,318	
		Belgaum	321	42,14,505	13,129	14,023
8	Vinayak	Sikar	112	22,87,788	20,427	
		Jhunjhunu	93	19,13,689	20,577	
		Churu	115	19,23,878	16,729	19,142
9	Capital	Jalandhar	329	19,53,508	5,938	
		Kapurthala	115	7,54,521	6,561	
		Hoshiarpur	152	1,4,80,736	9,742	7,028
10	South Gujarat	Navsari	142	12,29,463	8,658	
		Surat	304	42,75,540	14,064	
		Bharuch	121	13,70,656	11,328	12,126
All-India figures			66,195	1,02,70,15,247	15,515	

Figures in bold indicate districts where the banking density is lesser than the national average. Shaded cells indicate LABs that are in operation currently. Source: Data on Banking outlets Branch Banking Statistics, 2002. Population figures: Census of India 2001.

If the objective was to penetrate deeper; reach the poorer segments and undertake financial inclusion, then districts chosen for issue of licences were not the priority districts.

(c) The regulatory framework was not synchronous with the articulated objectives. For greater financial inclusion, the regulation had to provide concessions on capital structure, and rules applicable to ownership and governance. The two major players engaged in the inclusion agenda — the cooperative banks and RRBS did not have capital adequacy and prudential norms imposed on them for a long time. LABs on the other hand were expected to maintain the same levels of performance as the large banks; were hamstrung on expansion; and were required to maintain a higher CRAR. They were set in a regulatory and governance framework that did not further the agenda of inclusion.

Getting “fit and proper” board members for a small bank was a challenge given the size and location of the bank. These directors had to stand up to possible conflicts of interest, ensure the solvency of the bank, and safeguard depositor interests. This also had to be seen in conjunction with the issue of professional management (discussed later).

(d) The evaluation framework showed contradictions. The design and regulatory framework expected LABs to work like a large bank. The objectives expected the bank to be pro-poor, pro-agriculture, pro-small accounts, operate in remote areas and undertake difficult business. The evaluation framework expected achievements on both profitability and outreach parameters. The primary expectation of the committee was on outreach parameters and their fear was that concentrating on the outreach parameters would affect profitability and solvency. If LABs achieved profits, they were criticised on other operational aspects: making loans from head office, not being relevant to the communities and being small compared to commercial banks in the district. If mainstream design and regulation parameters were applied, then inclusion and deepening variables had to be a by-product than a basic evaluation variable.

Financial and Operational Performance

Misplaced Concerns on Stability and Solvency: From the performance of four LABs it showed that the concerns on stability and solvency were unfounded. While Capital LAB was the leader from inception, the other banks did not cause concern, except that they were unable to scale rapidly and were unable to attract more investment to take their individual net worth to Rs 25 crore. But they did not pose a systemic risk, were not failing and did not suffer from the apprehensions of concentration and covariance risks. Table 6 shows the financial performance of LABs. The numbers show LABs in good light on most parameters.

With a history of more than a decade, with consistent performance, they did not raise issues of solvency. Two banks that were operational have been shut down. The first to be shut down was the Vinayak LAB that was set up in Sikar, Rajasthan. The licence for this bank was withdrawn in less than 15 months of the bank being set up, as the RBI found

major irregularities in the functioning of the bank. The reason for withdrawal of licence was not pertaining to the business model, but due to failed governance. The second bank to be shut down was the South Gujarat LAB, which was operating from October 2000 till May 2004, when moratorium orders were issued. News reports during that time indicate that the reason for withdrawal was again related to mismanagement and fraud rather than losses and continuing sickness due to the inherent deficiency in the business model. When the Ramachandran Committee examined the question of LABs in 2002, the South Gujarat LAB was discussed as a bank that was delivering marginal profits and had a deposit base comparable to the Coastal LAB and higher than KBS LAB. At the time of the announcement of moratorium it was indicated that the two main promoters of the LAB were named defaulters to the bank leading to its collapse (Ray 2004). In both cases of closure it was evident that there were irregularities that led to failure and nothing indicated that the failure was due to inherent weaknesses in the business model.

Considering that of the nine bank licences issued when the banking sector was opened up to the private sector in 1991, four (Centurion Bank, Bank of Punjab, Global Trust Bank and Times Bank) were closed for various reasons, the failure rate of LABs appears in line with the mainstream banks and LABs have not created any systemic risk in the process.

Performance of LABs Cannot Be Seen Out of Context

The performance of LABs should be examined in the context where RBI believed that they were flawed institutions. After the Ramachandran Committee, the only positive discourse on

Table 6: Financial Performance of LABs (amounts in Rs crore)

Indicator	2008–09	2009–10	2010–11	2011–12	2012–13
Income	90.6	104	124	150	180
Interest income	74.9	86	107	140	160
Other income	15.8	18	17	20	20
Expenditure	76.5	91	105	130	160
Interest expended	41.7	51	55	80	100
Provisions and contingencies	7.8	8	13	10	10
Operating expenses	27	32	37	40	50
of which: wage bill	12.2	14	17	20	30
Profit					
Operating profit/loss	21.9	20	32	30	40
Net profit/loss	14.1	13	19	20	20
Spread (net interest income)	33.2	34	52	60	70
Total assets	786.6	946	1107	1360	1580
Financial ratios@					
Operating profit/loss	2.8	2.4	3.1	2.6	2.4
Net profit	1.8	1.4	1.9	1.5	1.6
Income	11.5	12	12.1	12.3	12.3
Interest income	9.5	9.9	10.4	11	11.1
Other income	2	2.1	1.7	1.3	1.2
Expenditure	9.7	10.5	10.2	10.8	10.7
Interest expended	5.3	5.9	5.4	6.2	6.5
Operating expenses	3.4	3.7	3.6	3.6	3.5
Wage bill	1.5	1.6	1.7	1.7	1.7
Provisions and contingencies	1	0.9	1.3	1.1	0.8
Spread (net interest income)	4.2	4	5.1	4.9	4.6

@ Ratio to total assets.

Source: *Trend and Progress of Banking in India*, various years. Mumbai: RBI.

small banks came in 2013, when there was a favourable mention in the discussion paper on new banking architecture. Till then, RBI was indifferent to LABs. Even the few positive recommendations made by the committee (refinance facilities and benevolent branch licensing) were not acted upon.

Given the conditions, it was not possible for LABs to be super-profitable. RBI did not consider requests of these banks to expand until they were in touching distance of a net worth of Rs 25 crore. Capital LAB grew because it was able to meet this criterion quickly. They started with a larger capital base ab initio, and garnered enough business and ploughed back profits. The other banks were not able to achieve this feat.

On one hand, LABs were not growing fast, making it unattractive for investors. On the other, RBI was not giving approvals to open branches. This approach did not give opportunities for the LABs to prove the model. The RBI's apparent "even handed" regulation was helping prove the model wrong.

Operational Issues

In order to understand the operational issues of LABs, we examine both sides of the balance sheet. The liabilities side provided insights on resources and assets side provided insights into how these were deployed to generate meaningful returns.

The Liabilities Side: The resources consisted of capital, quasi-capital and borrowings. In banking, higher leverage and higher deployment lead to greater profitability if margins and overheads are reasonable. However, a higher leverage would raise concerns on the safety of deposits. People put money in the bank on the assumption of safety. The regulatory approach was to increase the equity as and when the assets became risky. This approach has disproportionate concern on deposit protection. If a licence to run a bank was granted, the challenge on the liabilities side was not as great as a challenge on the assets side. However, for LABs raising equity — which formed the base for leverage — was itself a challenge.

The Assets Side: A challenge for LABs came from managing the portfolio. They could overcome the small ticket size and concentration risk issues by charging a premium. They could also diversify the portfolio as much as possible by widening the activity engagement. Capital LAB achieved client and product diversification even within the limited geography.

Need for a Portfolio Mix: In managing resources there had to be a good mix of advances and investment portfolio. Several experts believed that LABs should not be participating in the treasury and money markets. We would like to differ. The LABs could overcome concentration risk by investing in assets that were outside their area, in markets. The received wisdom was that LABs would not have the systems and resources to manage the portfolio effectively. We question this wisdom.

The resources available for loans was a function of the statutory (SLR, CRR) and voluntary investments (Treasury). LABs

did not come out in flying colours in deployment of resources towards building a loan book. The credit–deposit (CD) ratios of the LABs were no different than the other banks, and in many years lower than the other category banks. Deposits as a proportion of total resources were smaller in proportion because of high capital requirements. Credit as a proportion of this low deposit base indicated that a large part of resources available were not deployed as investments. This showed a need for deeper penetration and diversification across activities — agriculture, off-farm, non-farm, small industries, consumer, and other retail finance. Agriculture had its cycles and therefore it was important to restrict the exposure to agriculture to ensure uniform liquidity. It was unlikely that there would be significant opportunities for term finance. Understanding the levers of the local economy and moving beyond agriculture was imperative.

Costs and Localisation: LABs could cut operational costs by having innate knowledge about customers and the geography, making transactions relationship based, and removing anonymity. Localisation reduced the risk of adverse choice of borrowers and the resultant wilful default. While the transaction costs for both the bank and the borrower would be low due to localisation, the bank could monetise it by a price premium and lower loan losses.

Governance and Management

On governance, there was a challenge in finding truly "independent" directors who kept the depositors' interest above the shareholders' interest and focused on reputation and solvency. The two failures discussed earlier related to misgovernance, and in case of South Gujarat LAB, one of the promoter had a prior history of being involved in a scam pertaining to a cooperative bank. Therefore the most crucial test for granting a licence for a LAB had to be due diligence on the antecedents of the promoters. Even in case of some of the existing LABs we find that there are other financial services organisations within the group, promoted by the same set of promoters, which is risky from the regulators' standpoint vis-à-vis mainstream banks. Those principles have to apply to the LABs as well. Technology and computerisation helped these banks be transparent, but the size and location made it difficult for external oversight.

We have established the inherent viability of the LABs. However, if RBI wants to have several small banks, to accelerate financial inclusion, there is bound to be a risk of failure. Even with the early LABs there were two failures. Therefore we address the following questions:

(a) What is the institutional architecture for depositor protection, considering that they came from vulnerable sections of society?

(b) What was the tolerance level for failure? A failed LAB may not cause systemic ripples because of its insularity. The policy did not allow LABs to embed themselves into the banking system very deeply. However, a few failing LABs meant a reputational risk for LABs as a category and a reputational risk for all banks in general.

LABs have not been tested under diverse conditions, particularly in areas where banking penetration, monetisation, and population density were low; the road connectivity was bad; and commercial activities were low. The assumption of viability of LABs based on the performance of the existing LABs is not appropriate. Areas like West Champanar, Shri Ganganagar, Kendujhar, Jagdalpur, Sidhi, have to be tested for viability.

Concerns on the Approach to New Narrow Banks

Policy Approach: If we were to look at the task of covering the residual population of the country with regulated financial services, we find the task to be daunting. A single approach would achieve impact, but has left elements uncovered. The Nachiket Mor Committee observed that a centralised single idea approach was energetic, but “its key weakness as well, because it has propelled highly engaged regulators and policymakers to move from one big idea to another, each time convinced that they have finally found the key to financial inclusion” (RBI 2014: 4). The time has come to try out multiple institutional forms — particularly narrow banks.

In case of MFIs, the regulator learnt the hard way about the effects of a weak regulatory architecture. If RBI had specialised institutions, the required ecosystem would need information to monitor the customer base; a system that enables informed policy decisions and reasonably good supervisory and regulatory apparatus. Above all, we need tolerance for failure. The database can be built through credit bureaus. The regulatory apparatus would be in place if RBI wanted to focus on this by enabling a regulatory architecture. The most difficult part is to develop a tolerance for failure given the fact that poorer segments of the population would be involved, and this would have political sensitivities.

LABs would work in appropriate policy architecture. We address the concerns of policymakers of the past and the critics of policy.

Approach to Licensing?: While the guidelines for setting up LABs (RBI 1996) indicated anybody, a society, trust, a corporate body, or a set of individuals could promote a LAB. On review of the performance and organisation of LABs it is evident that they operate on a model that is different from mainstream banks. Their advantage comes from the promoters being “located” and having roots in the area. The policy dichotomy would be between deepening banking in well-banked districts as in the case of capital LAB in Punjab and addressing the issue of regional imbalances. Achieving a regional balance must be an overarching consideration in granting a licence from the public policy perspective, but those are areas where the business model would appear shaky. However, the policy approach needs to take the due diligence on board first, and then prioritise districts that have low banking penetration on grant of licences.

The Conditions of Issue of Licence: The policy objective should translate to the terms of licence. The growth path for the niche bank had to be articulated to ensure that there is no incremental dilution of the objectives for the sake of profits. Also it was better to have an ownership architecture that reduced conflicts of interest. Should Non-Banking Financial Companies convert themselves into LABs? Should promoters having extant interests in the financial sector be allowed to promote LABs? The answer was available in the guidelines (and clarifications) for next bank licences (RBI 2013d).

Dealing with Concentration Risks: We can pick lessons from successful primary cooperative societies. Cooperatives that survived for decades in spite of concentration risks did so because of diversification. To start with, most primary cooperatives had a “B” component of a crop loan, which got them some fertiliser business that fetched commissions. Several cooperatives operated multiple activities which helped them cross-subsidise their inherently risky agricultural portfolio. We do not advocate LABs get into trading, but they need to obsess on diversification.

The corollary to cooperatives was RRBs. RRBs functioned better when they had treasury income. However, whenever RRBs consolidated their average loan size moved up and became more profitable. But consolidation and size takes the institutions away from the last mile.

The policy approach — to achieve inclusion — is to restrict the area of operation, so that they realise the growth within the area, rather than spread wider and thinner. Offering new districts to existing LABs and consolidation of RRBs has the same effect — it dilutes the inclusion agenda. Having restricted the area, then giving operational autonomy subject to the conditions of priority sector and other obligations is of prime importance. The risk management practices applicable to large banks had to be applicable to narrow banks as well. The branch licensing policy had to be on par with the other banks with freedom to open branches anywhere in the area of operation.

Should the policy allow for spreading outside licensed area? If the policy objective was to achieve inclusion, then an expansion should be allowed only after the inclusion objective was met through saturation. An agreed index could be used to benchmark levels of inclusion. Expansion into newer areas had to be calibrated to ensure that the expansion happened in districts that had a lower inclusion index than the existing area. These restrictions provide an architecture for narrow banks. The policy had to keep away from dictating anything specific to the narrow banks that made them uncompetitive against the other players in the same area.

Dealing with Failure: The larger political situation made dealing with failure difficult because a large part of the customer base was poor. However, we need to examine the institutional architecture dealing with failure — deposit insurance, institutional arrangements to settle claims, the quickness of settlements and minimising the contagion.

Conclusions

It is evident from the above discussion and the examination of the data, the concept of the LAB or a narrow bank is not a failed idea. It is an idea which has not been tested in diverse conditions. The two failures in the new banks that were set up after 1996 have been due to a failure of governance and possible misallocation of licences in the first place. The performance of state-owned RRBs would also give some indication that while there have been regional failures in terms of overall solvency,

by and large they have worked. The guidelines for new narrow banks should be welcomed and the final guidelines should be informed by the experience of the LABs, and should also take into consideration the possible difficulty in rolling out the model viable in certain difficult regions. However, if we were to look at it from a larger public policy framework, the cause of inclusion would be achieved much more by narrow banks deepening their business in a limited area than new banks spreading their business far and wide across the country.

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