Realignment & Reforms:
Increasing the Outreach of Indian Financial Services

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Message from Chairman, CII Northern Region

Confederation of Indian Industry (CII) believes that to boost the economic growth, the Financial Services sector needs to play a critical role in mobilizing the savings and channelising the investments in the growth sectors of the domestic economy. Hon'ble Finance Minister's in his Union Budget 2014-15 address presented a roadmap for sustained GDP growth of 7 – 8 per cent or above within the next 3 – 4 years.

The Northern region of the country comprising of eight states and one union territory occupies a significant position in the national economy contributing more than a quarter to national GDP. Some of the fastest growing states in the country are from this region.

We at CII Northern Region are emphasising on building a conducive eco-system for accelerating economic growth which facilitates investments in the region, critical for generation of employment opportunities, besides ensuring sustainable development and inclusive growth in the region and in the country at large. With this thought, CII Northern Region adopted the theme of 'Accelerating Growth in North : Facilitating Investments ….. Creating Employment' for the year 2014-15. The financial services sector has an critical role to play towards this aspect.
In this context, the theme of the 4th CII Finance & Investment Summit, 'Realignment & Reforms : Increasing the Outreach of Indian Financial Services' is very appropriate. Enhancing the outreach of Indian Financial Services sector amongst all the concerned stakeholders is the need of the hour.

In the recent past, regulatory bodies have undertaken multiple initiatives that are focused towards making financial services available, accessible, and affordable to people. For instance, RBI is considering differentiated licenses for specialist banking players which could be for wholesale, payment, asset-light, small banks, etc. This will further drive competition in the industry where new players would be eager to make a mark and grab market share, and the old stalwarts would have re-organize and restructure their business model in order to become agile and keep pace.
This flagship Summit will foster deliberations on the key challenges, the need and nature of resources required for enhancing the outreach of the Financial Services sector, banking sector reforms, wholesale finance to boost MSMEs, infrastructure financing, distribution model of financial products, differentiated banking and banking amalgamation, alternate payment channels etc.

Zubin Irani
Chairman, CII Northern Region &
President – Building & Industrial Systems (India), United Technologies Corporation India Pvt Ltd

Introduction by Summit Chairman

I am very pleased to be chairing the 4th Annual Summit on Finance & Investment. When we started conceptualizing the Summit in 2011, we had decided to have a different approach by focusing on the most relevant contemporary theme within the overarching domain of "finance and investment" which could help the Northern Region in particular. We were committed to inviting the best moderators and speakers to bring a rich content to the audience. We also decided to raise the bar for the audience as well, where we could have more quality interactions. I am happy that the event has gone from strength to strength each year. The feedback from the audience and the speakers has made us improve on the form and substance of the Summit each year.

The year 2014 has been an exciting one for the Indian Financial Services industry. This year witnessed a string of new policy moves ranging from banking licenses to two entities, focus on differentiated banking like payment banks, increasing the FDI cap on Insurance to 49 per cent and renewed emphasis on achieving financial inclusion, improving asset quality, capital management to meet Basel III norms, measures to improve the access of finances to MSMEs and for availability of finances to the infrastructure sector initiatives such as Banks to be permitted to raise long term funds to lend to the sector and modified REITS type structure for infrastructure projects . All these initiatives point towards exciting outlook for the Financial Services sector.

Accordingly, we have designed a focused agenda. The theme of one of the important Panels revolves around channelising of funds for infrastructure sector to bridge the critical gaps in the various sub-sectors of infrastructure. We believe that growth of MSME sector is imperative for 'Make in India' mission of Hon'ble Prime Minister and Northern Region is hub of the MSMEs. It is true that poor access to finance to this important sector of the Indian economy has adversely impacted its growth and hence, our discussion will focus on role of formal banking system to meet the credit requirements of MSMEs.

I look forward to an invigorating Summit.

Rajesh Srivastava
Chairman, CII Finance & Investment Summit, 2014 and
Chairman & Managing Director, Rabo Equity Advisors

Preface by Deloitte

The Indian Economy has entered a resurgent phase with the GDP growth having touched its highest point in the past two-and-a-half years. A spurt in growth, aided by a number of economic reforms and forward looking policies, waning inflation levels, steady foreign investments and an increasingly stable currency exchange, the economy is at its prime as compared to the last few years. Pulsating capital markets with the benchmark indices breaching their lifetime highs are evidence of the growth wave that's starting to grip the economy.

While the new government's efforts to boost the economy are in the right direction, there still remain many areas of concern within sectors such as MSME, Infrastructure, Insurance, etc.

The SME sector which serves as the backbone of manufacturing industry faces acute shortage of capital and a consequent crunch in technology and production capacity. Being a key source of employment for semi-urban and rural populace, the industry needs significant turnaround to prevent a major impact on the economy. The Prime Minister's recent 'Make in India' campaign is a shot in the arm for this sector. Aimed at making India a manufacturing hub, the government has started pulling out all the stops for ensuring a smooth sailing for investors, by setting up a dedicated cell to answer queries of business entities within 72 hours. It has also promised to closely monitor all regulatory processes to make them simple and reduce the burden of compliance.

In this report, Realignment & Reforms: Increasing the Outreach of Indian Financial Services, we look at some key challenges more closely to assess their potential impact, the plausible constructive steps and policy reforms. We will delve deeper on the key challenges, the need and nature of resources required for enhancing the outreach of the Financial Services sector, banking sector reforms, wholesale financing to boost MSMEs, increasing insurance outreach, distribution model of financial products, differential banking and banking amalgamation, alternate payment channels etc.

The above mentioned topics form the core of the report apart from some novel ideas, which are equally thought-provoking. These have been discussed in greater detail in this report.

We hope you find this worthwhile.

Monish Shah
Senior Director
Deloitte Touche Tohmatsu India Private Limited

Summit theme

The Summit aims at examining the core issues, challenges and opportunities that will act as catalysts in driving the reach of financial services in the country, with special focus on Infrastructure and SME financing. The Summit provides a platform for recognized Industry Leaders and policy makers to discuss and present their vision around this theme. The Sessions have been carefully chosen to dissect relevant topical issues leveraging the experience of the expert panel of speakers. The format is designed to provide for the panellists and participants to discuss, deliberate and recommend on the perspectives of the said areas that will be covered in the Summit.

Special Plenary: 'Realignment & Reforms' – Increasing the Outreach of Indian Financial Services'

This session would dwell upon the need for realignment of policies to expand the outreach of the Indian Financial Sector. It would deliberate on the implications of recent banking license reforms and the presumptive consolidation of banks, for the end consumer and the banking sector. This panel would also discuss about the Insurance Industry in the country, which has been facing a lot of challenges in recent times and the necessary reforms to revive the sector. Some of these could be to enhance the coverage of non-life insurance products, which at present do not compare to the traditional life insurance products in terms of popularity and reach. Last but not the least, this panel would also debate on the need for greater retail participation in the Capital and Money markets. This has been one of the major mandates of market regulators and keeping in view the current buoyancy in the capital markets, could result in a significant easing of the liquidity crunch being faced by many businesses

Panel Discussion I: Channelizing Funds for Infrastructure: New Models of PPP & Promoting Centre – State Partnership

Infrastructure development has always been a top priority for India, and in the current scenario, it has emerged as one of the single largest imperatives which could drive the economic growth. A well-planned revival policy, aided by a seemingly recovering macro-economic climate will steer the economy back on track. One of the key concerns which remain persistent is the capital crunch which stifles the industry. This session will dwell upon the need for innovative models in infrastructure financing to support the envisaged economic growth through infrastructure development, with special focus on the Union Budget announcements with regards to novel models to attract long term finance from foreign and domestic sources. Leveraging the capital market and sourcing long term funds from Sovereign and Pension Funds would form part of this discussion. The panel would also debate on the need for greater coordination between the Central and State Government and also between the States to facilitate efficient execution of projects.

Panel Discussion II: Access to Finance for MSMEs – Role of Financial Institutions and Banks

For decades, the MSME sector has accounted for over 40% of the country's industrial output, exports & employment. Over 90% of the country's manufacturing enterprises belong to this category and consequently any fundamental weakness in this sector is bound to adversely impact the growth prospects of the country. The sector's declining share in the manufacturing output only serves as evidence of the challenges that it faces. Apart from the conventional problem of inadequate institutional support, the sector faces severe liquidity crunch due to lack of access to Financial Institutions, Banks and Capital Markets. This has further compounded the problems for the sector as technology obsoleteness, low production capacity, modernization and expansion constraints, etc are widespread. This session is dedicated towards discussing sustainable solutions to boost their growth. Steps enabling SMEs to raise capital through organized channel of capital markets, initiating micro-investments from rural and semi-urban investors, budgetary reforms (such as the recent initiative of setting up of a corpus fund) and alternate financing channels would be discussed.


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Understanding Northern Region: - Increasing the outreach of Financial Institutions

Introduction

Northern India, accounting for approximately 31% of the population and 30.7% of the land area, plays a pivotal role in the economy of the country. Northern India constitutes of Jammu and Kashmir, Himachal Pradesh, Haryana, Uttarakhand, Delhi, Uttar Pradesh, Rajasthan and Punjab and UT of Chandigarh. Each of these states differs in its climate, geography, population density, level of development and culture. In terms of the climate and topography, the northernmost states (Jammu and Kashmir, Uttarakhand, and Himachal Pradesh) are mountainous and have a cold weather, Rajasthan is hot and arid and has deserts, and Uttar Pradesh has large plains and plateaus. In terms of the population, some states / U.T. such as Chandigarh, Delhi and UP are densely populated as compared to the states with hilly terrain such as Himachal Pradesh, Jammu and Kashmir and Uttarakhand. These hilly states have traditionally been agrarian economies with a recent shift to the manufacturing and service industry.

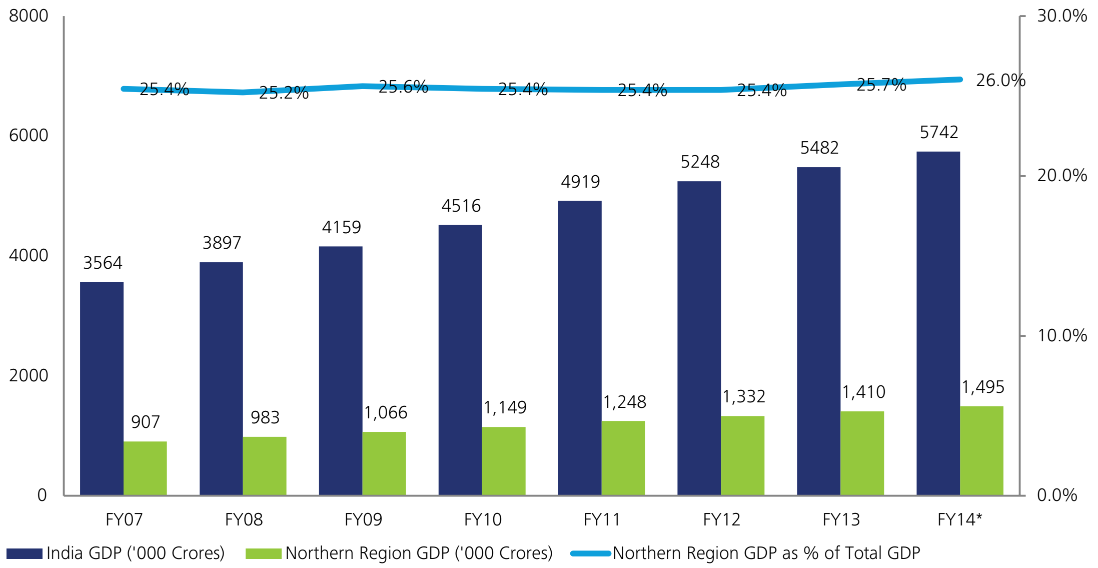
Northern India also plays an important role in the politics of the country. Delhi is the capital and the political center of India. Almost 28% of the total seats in the Lok Sabha are from Northern India with UP contributing the most number of seats.

In this section, we provide our perspectives on the overall state of economy of the Northern Region, the level of financial inclusion and various initiatives that have been taken to enhance the level of financial access and reach in this region. As we will learn later, Northern region has a significant impact on the economy of India. It also has some of the fastest growing states in the country along with a major portion of the demographic value in terms of number of youth.

Economic Growth in Northern India

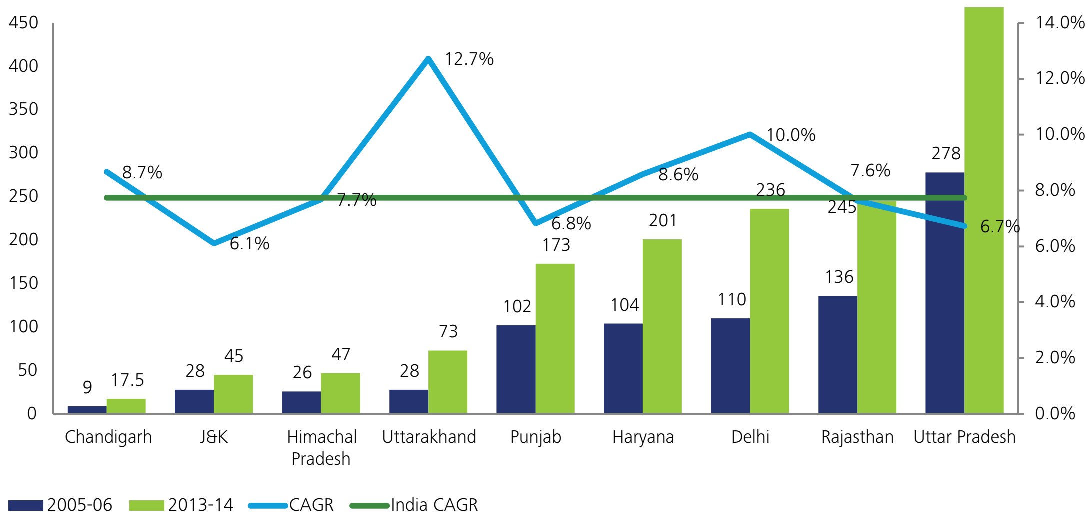
Northern region contributed INR 14.95 trillion (approximately US$ 245 billion, considering the current exchange rate of 1 US$ = ` 61) to the Indian GDP, which is 26% of the India's GDP. Being a significant contributor to the country's economy, it is evident that this region has shadowed the country's growth rate. As the region accounts for more than 30% of the area and population of the country, its economic contribution is therefore a slight mismatch. This might well be covered as the country moves out of a persistent period of slowing growth and enters into an increasingly conducive economic environment.

Exhibit: Comparison of India's GDP with Northern Region (` '000s at constant prices 2004-05)



Source: Data Tables, Planning Commission, May 2014

Exhibit: GSDP of Northern States (` '000s at constant prices 2004-05) and CAGR

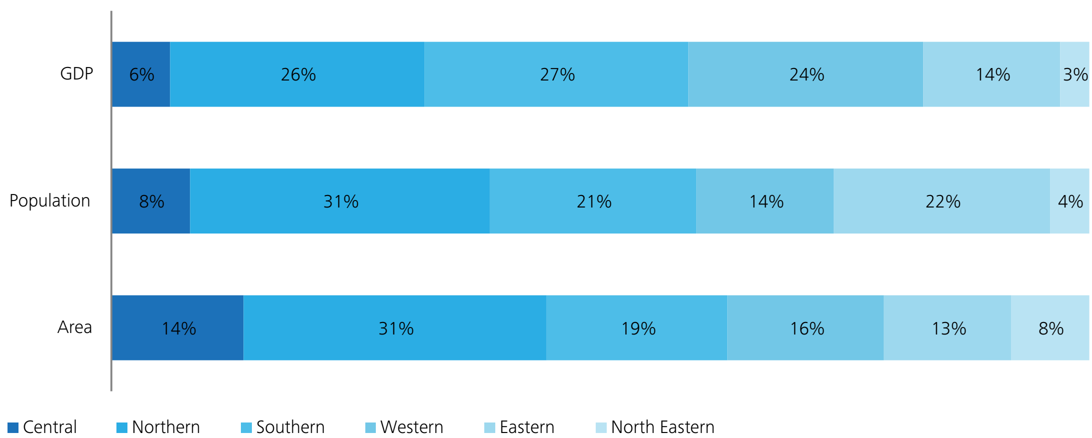


Source: Data Tables, Planning Commission, May 2014

The Northern Region had been showing a stable growth rate till 2010-11 when it grew at 8.6%, post which it has started tapering off gradually to approximately 6.0% for 2013-14. Though this is still higher than the average GDP growth for the country, it has followed a similar trend of decelerating growth. The disparity of growth across northern states is also apparent from the exhibit below. This is justified as states such as Uttarakhand are relatively new and have a smaller base to be compared with. All Northern states except Rajasthan have grown at rates faster than India's GDP.

With promising forecasts for the growth of the overall Indian economy in the coming years, the northern region will also gain momentum in growth and ride the current wave of economic progress. Northern region does have significant advantages as compared to the other regions of the country. It has a demographic advantage as more than fifty percent of the under-15 population resides in five states in India, of which two, viz. Uttar Pradesh and Rajasthan, are in the Northern region. This provides it with a prospective pool of young workers which would be a significant requirement for the manufacturing industries. These factors do foster a positive outlook for the northern region in future.

Exhibit: Comparison of Shares of GDP (2013-14), Population & Area for all regions



Source: Planning Commission; Census 2011, Ministry of Statistics & Programme Implementation, India

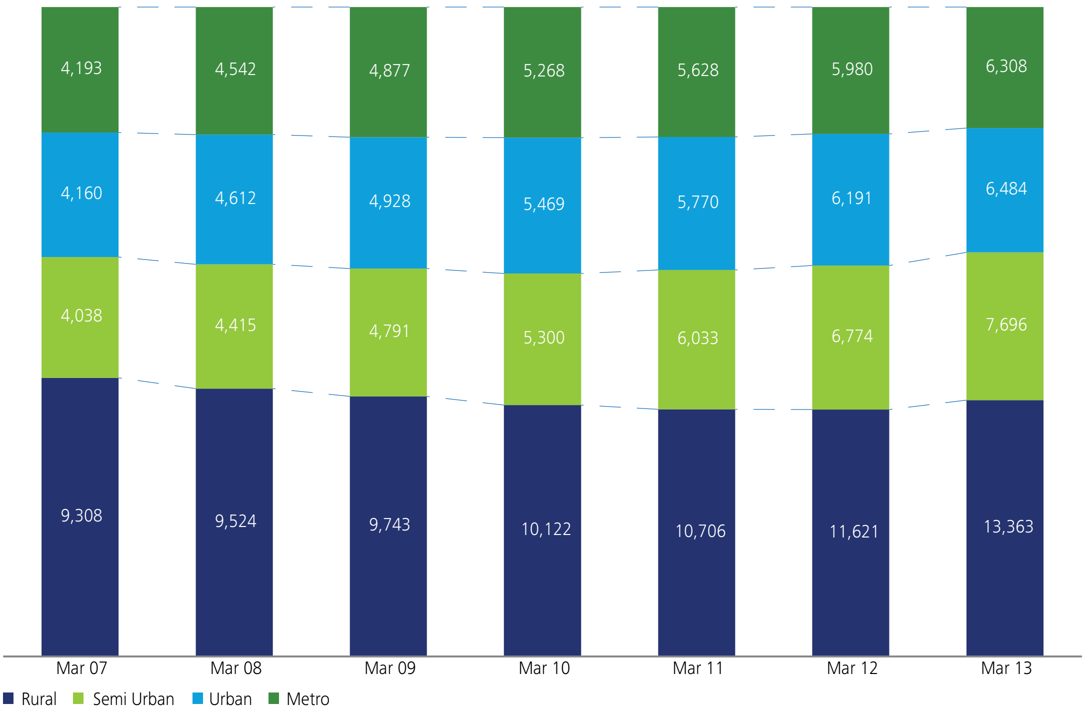
Financial Access in Northern India

The RBI has always played an instrumental role in the bank-led financial inclusion model - relying primarily on expanding branch network (rural branch mandates), setting up special purpose government sponsored institutions (such as regional rural banks (RRBs) and cooperative credit institutions), setting priority sector targets for the banks, promoting Self-Help group (SHG) linkages, launching Kisan Credit Cards (KCCs), etc . However, such steps have seen mixed success in promoting financial inclusion and have been providing diminishing returns over the last few years and still over 50% of the total population in the country remains unbanked. Currently, close to 40% of the branches are in rural areas. This percentage has remained the same for the last six years. With more than 70% of the population in rural areas, rural banking penetration stands at a dismal 7% [1].

Besides, banks have also been criticized for not extending financial assistance to the micro, small and medium size enterprises (MSMEs). This has severely affected their growth. Lenders have been advised to consider the working dynamics of this sector while extending credit, and proposals are being designed to incentivise banks for the same.

Evolution in modes of transaction; cash based to digital, is also gradually getting a hold within the banking industry. With advanced use of technology, high penetration, low cost of services, aided with an adoption rate which is exponential, alternate banking channels are gaining pace.

Exhibit: Commercial Bank Branches in Northern Region



Source: Database on Indian Economy, RBI, 2013

1.Financial Inclusion: Overview of Efforts – Department of Financial Services, Ministry of Finance

Initiatives for Financial Inclusion

Considering the low level of overall financial inclusion and the disparities among different regions, the regulator has encouraged multiple initiatives that are focused towards making financial services available, accessible, and affordable to people. Some of the initiatives that are expected to enhance the level of financial inclusion and access are discussed below. These include steps taken by both the RBI and some other regional banks.

New Banking License – Focus on financial inclusion

Reserve Bank of India has been very active in pushing the agenda of financial inclusion across the country and has consistently emphasized on financial inclusion in the un-/ under-included regions of the country. As a part of this vision, the RBI has recently awarded in-principle banking licenses to two players, one of which is a microfinance company providing microcredit to more than 55 lakh customers. It has also proposed guidelines for issuing banking licenses 'on-tap', which essentially means that the license window would be open throughout the year. This is in line with RBI's mandate for setting up niche banks in the country catering to diverse sectors of the economy, with special focus on Financial Inclusion and Micro-credit.

Proposed licenses for small and payments banks

To enhance financial inclusion, the RBI has recently issued draft guidelines for two new categories of banks – small banks and payments banks. The primary objective of setting up these banks is to extend financial inclusion across the country. Small banks would be limited in size and operations compared to the scheduled commercial banks and would offer only basic savings products and small loans. These banks would cover only limited geographic areas and are expected to rely heavily on technology to reduce operational costs. These small banks are expected to serve as saving vehicles for the un-/ under-banked sections of the society. Though the payments banks would not be able to offer credit products, these banks are expected to extend financial inclusion by providing small savings accounts and payment or remittance services to migrant labourers, low-income households, small businesses and unorganized sector entities. Payments banks are allowed to leverage other players' network in addition to their own that would help them in providing a large number of access points in particularly remote areas, thereby including the people of these areas into the formal financial system.

"Jan Dhan Yojana" – Prime Minister's financial inclusion drive

Financial inclusion has been a key policy focus of the new government and the Hon'ble Prime Minister has recently launched the Jan Dhan Yojana, one of the biggest financial inclusion programmes in the world with the objective to end "financial untouchability". Under this scheme, 7.5 crore accounts are to be opened by January 2015 and each account holder is expected to get a RuPay debit card, a INR 1 lakh accident insurance policy as well as a INR 30,000 life insurance cover. It is expected that the banking sector would need to set up an additional 50,000 business correspondents, more than 7,000 branches and more than 20,000 new ATMs in the first phase alone (from 15 August 2014 to 14 August 2015). The government's long-term mission is to have a full-fledged brick and mortar branch for all villages with population above 2,000 and each bank to have at least one fixed point banking outlet for every 1,000 to 1,500 households. These initiatives are expected to improve the lives of millions of unbanked Indians by bringing them into the mainstream financial sector and freeing them from the clutches of usurious moneylenders and fraudulent chit funds.

Financial Inclusion – Uttarakhand Gramin Bank

Geographically challenged regions have always posed difficulties for banking services to reach people living in remote areas. To overcome this problem, Uttarakhand Gramin Bank has developed a fully computerized network of 260 branches spread over 13 districts, and appointed 286 Business Correspondents. This alternative initiative has freed people from the clutches of moneylenders and has increased formal banking penetration in the state. The bank has also financed 48,000 KCCs (Kisan Credit Cards) amounting to Rs 238 crore thus enabling the farmers to perform better. For empowering people and enhancing financial literacy, the bank has also organised 218 financial literacy awareness camps till date.

Grassroots Empowerment – Kashi Gomti Samyut Gramin Bank

Partaking at the grassroots is one of the key drivers for sustainability of micro entrepreneurship. In this case, Kashi Gomti Samyut Gramin Bank along with TERI approached village entrepreneurs to invest in and operate the solar micro-grids. In the process, these local entrepreneurs were assessed for the task at their own localities. They were extended micro-credit based on individual credit assessment and effective deployment of funds was overseen by the Bank staff. The initiative resulted in substantial savings in kerosene cost and also helped prevent exposure to pollutants. Productivity of handloom workers has improved, there are additional income generation opportunities and skills of local electricians have improved.

Other RBI initiatives

RBI has launched a few other initiatives to encourage banks to include greater number of people in the financial system. Some of the key initiatives include relaxed and simplified KYC norms to facilitate easy opening of bank accounts and simplified branch authorization policy where scheduled commercial banks are permitted to freely open branches in Tier 2 to Tier 6 centres subject to prescribed reporting to the regulator.

In addition, all the banks have been mandated to open at least 25 per cent of their branches in unbanked rural centres (population up to 9,999 as per latest census). All these initiatives are expected to enable spreading of banking services in the previously un-/under-served regions.

Conclusion

Over the next decade, there will be a huge thrust on financial services in India. As the government envisions inclusive growth, the next wave of growth can be achieved by including the unbanked population in the formal financial system and empowering them so that there is a significant increase in the average per capita income. Also for the industries, especially in sectors where there is a significant financial crunch, enabling financial access is imperative for re-invigorating their growth and steady contribution to development. Government policies coupled with the efforts of the financial services industry, both public and private, to look for growth will help enhance financial inclusion and access.

Small Bank & Payments Bank – the new game changers?

The banking sector in India is the lifeline of the Indian financial system with banking flows accounting for over half of the total financial flows [2] in the country. In India, the sector is not only responsible for financial intermediation but also facilitates the process of social and economic inclusion by bringing 'excluded' population in the mainstream of financial services While several directives and reforms have been introduced in the sector in order to increase the outreach of financial services, based on the following statistics, it would be an exaggeration to say that these efforts have resulted in an unqualified success story.

- As per census 2011, only 58.7% of the total households are availing banking services in the country.
- As per the NSSO 59th Round Survey results [3] :
  - 51.4% of farmer households are financially excluded from both formal and informal sources [4].
  - Of the total farmer households, only 27% access formal sources of credit; one third of this group also borrowed from non-formal sources.
  - Overall, 73% of farmer households have no access to formal sources of credit.

With a new government taking the centre stage amidst heightened expectations, reaching the 'bottom of the pyramid' is set to remain a cornerstone of the expected new wave of economic growth. To ensure that benefits are equitably shared, 'inclusive' participation from all corners and all social groups of India is critical – especially from the un-/ under-included regions that have continued to remain on the periphery of the financial mainstream even after two decades of liberalization and globalization

The RBI has been very active in pushing the financial inclusion reforms across the country and has adopted a bank-led model where banks have typically acted as the nodal point for introducing various initiatives centred on improving the financial inclusion situation in India. Further, the RBI has attempted to create conducive regulatory environment and provide institutional support for these banks in accelerating their financial inclusion efforts. Some of these initiatives include:

- Basic Saving Bank Deposit (BSBD) accounts with minimum common facilities
- Relaxed and simplified KYC norms to facilitate easy opening of bank accounts
- Simplified branch authorization policy to address the issue of uneven spread of bank branches
- Compulsory requirement of opening branches in un-banked (Tier 5 & 6) centres
- Intermediate brick-and-mortar structure for cash management, documentation, redressal of customer grievances and close supervision of Business Correspondent (BC)operations with minimum infrastructure
- Submission of board approved three year Financial Inclusion Plan (FIP) (RBI has been monitoring these plans on a monthly basis)
- Revised guidelines on Financial Literacy Centres (FLCs) to facilitate financial inclusion through provision of two essentials i.e. 'Financial Literacy' and easy 'Financial Access'.

While these initiatives are important steps towards realizing the mission of achieving complete financial inclusion in India, these initiatives have had a measurable, yet limited impact on the overall financial inclusion situation in India, indicating a more or less incremental nature of these initiatives.

The new banking licenses

Realizing the need, the RBI has taken significant steps over the last year towards its vision of achieving complete financial inclusion and has awarded in-principle banking licenses to two private players, one of which is a microfinance company and the other is a pan-India infrastructure finance company. The one thing that stood out in the process for issuing guidelines and seeking applications was the regulators' thrust on financial inclusion to be the central theme for any applicant seeking a banking license, underlining its continued push towards achieving financial inclusion. The primary intention behind the guidelines was to promote banks which focus on serving the financially excluded strata of the society and at the same time, have a sustainable business model along with a sound capital and robust governance structure.

It should be noted that the last time when RBI had awarded new banking licenses in 1994 (10 in number) and 2003 (2 in number), there were far-reaching consequences for the entire sector. The new private sector banks focused on 'customer service' and leveraged 'technology' in a big way and pushed the public sector and old private sector banks to embrace new ideas and explore newer opportunities, and led to an overall improvement in efficiency for the sector.

Therefore, it may come as no surprise that the two new licensees bring about the same effect once again, ushering in a new wave of technological innovation

2.Report on Trend and Progress of Banking In India 2012-13 - estimate based on the Flow of Funds Accounts for the Indian Economy

3.All India Debt and Investment Survey, NSSO 59th Round

4.Formal sources include credit from SCBs (including RRBs) and credit from Co-op society/bank and informal sources include credit from agricultural and professional money lenders.

and customer centricity, balancing business viability with deepened access, that are currently missing in the established order.

While preparing these guidelines for awarding universal banking licenses, the RBI recognized the need for an explicit policy on banking structure and found merit in considering alternate banking structures serving niche interests to meet credit, deposit and remittance needs of small businesses, unorganized sector, low income households, farmers and migrant work force. These differentiated banks could be created based on a regional/ sectoral focus (Horizontally Differentiated Banking System) as well as based on the portfolio of offerings i.e., credit, deposit and payments (Vertically Differentiated Banking System).

Continuing with this theme, recently issued Draft Guidelines for Licensing of two new categories of banks in India on July 17, 2014:

- "Small Banks" in the Private Sector
- "Payments Banks"

Proposed licenses for "Small Banks"

The new mandate

RBI envisages the role of a Small Bank as a bank with has a "local feel" and culture embedded in its operations which are normally restricted to contiguous districts in a homogenous cluster of States/Union Territories. This would be a design where there would be several small banks functioning in the rural hinterlands, working as full-service banks catering to the basic banking needs of the catchment area. In the initial few years of operations, a small bank shall focus its efforts primarily on undertaking basic banking activities of acceptance of deposits and lending to small farmers, small businesses, micro and small industries and unorganized sector entities in their limited areas of operations, through high technology-low cost operations. However, if considered necessary, the bank would be allowed to expand its area of operations beyond contiguous districts in one or more States with reasonable geographical proximity.

While the RBI has restricted the small banks to be set-up in the private sector alone, the guidelines indicate a preference for Non-Banking Financial Companies (NBFCs), Micro-Finance Institutions (MFIs) and Local Area Banks (LABs) which have "local" focus and the ability to serve smaller customers, to set up or convert into the new small bank structure. Further, the RBI has mandated the small banks to open at least 25 per cent of its branches in unbanked rural centres in the first three years of its operations. With the bank operating at a smaller level with basic banking offerings, the RBI has kept the minimum paid up voting equity capital at Rs. 100 crore and minimum Capital Adequacy Ratio (CAR) of 15 per cent computed under simplified Basel I standards.

In view of concentration of its area of operations, RBI has advocated for maintaining a well-diversified portfolio of loans and advances spread over its area of operations. The maximum loan size and investment limit exposure to single/ group borrowers/ issuers would be restricted to 15 per cent of the capital funds. In addition, the guidelines state that at least 50 per cent of the loan portfolio should constitute loans and advances of size up to Rs. 25 lakh in order to extend loans primarily to micro enterprises.

The previous experience

The idea of small banks being a new channel to reach out to the un-/ under-included regions holds a significant appeal at the first instance. However, it may be noted that this is not an entirely new concept in Indian banking sector. In the past, the RBI has experimented with similar idea when the LABs were conceived as low cost structures and expected to provide efficient and competitive financial intermediation services in a limited area of operation, i.e., primarily in rural and semi-urban areas, albeit at a much smaller scale. Similarly, the co-operative banks with their network of Primary Agricultural Co-operative Society (PACs), and Regional Rural Banks (RRBs) have employed business models that focus on the local catchment area.

One of the many benefits that arise out of the "local" nature of these banks is the easy availability of "soft"‖ information related to the local community that these banks typically use and rely on while offering their various products, especially lending products. This makes these banks distinct in functioning compared to the larger national banks that base their offerings on hard, standardized information collected from their customer base irrespective of the region and location. These banks have developed a thorough understanding of the catchment area and the community and this helps these banks to connect with the community in a better and more meaningful way – in terms of understanding the unmet needs of the customer base, offering customized products and services, using suitable and more effective channels to expand financial outreach, and using local personnel to communicate better and provide a personal touch in the bank dealings. This provided trust and confidence to the previously excluded population in joining the financial mainstream, enhancing the overall outreach of these banks.

Though the financial performance of these institutions has been less than commendable owing to multiple operational and governance-related issues, there is no denying the fact that these "local" banks have made laudable efforts in enhancing the level of financial inclusion.

The challenges and the road ahead

While being a "local" bank has its benefits, their local nature may make them more prone to "capture" by local political interests leading to persistent governance issues as well as creating a systemic risk due to the smaller catchment area of operations exposing the bank to local factors such as weather, crop prices, and regional economic performance. This may make these banks more likely to pay a higher rate to their depositors which in turn, might create the need to make riskier loans resulting in a vicious cycle of rising non-performing assets. Further, a localized event such as a natural disaster affecting the catchment area may even prove fatal to the existence of these banks. Therefore, equipped with the learnings from the previous experience, it is expected that the RBI would put suitable mechanisms in place and introduce a design that balances the benefits from the "local" nature of operations and the regulatory/ supervision demands without compromising the stability of the small banks.

Proposed licenses for "Payments Banks"

The new mandate

For a Payments Bank, RBI envisages a bank which would offer payments and remittance services through various channels including branches, BCs and mobile banking along with small deposit products (current deposits, and savings bank deposits) and prepaid instruments to migrant labor workforce, low income households, small businesses, other unorganized sector entities and other users, by enabling high volume-low value transactions in a secured technology driven environment. This category of bank would not be able to offer credit products. While there is a need for transactions and savings accounts for underserved population and remittances have both macro-economic benefits for the region receiving them as well as micro-economic benefits to the recipients, higher transaction costs diminish these benefits. In this regard, a Payment bank would be allowed to leverage other players' network in addition to their own that would help them in providing a large number of access points in particularly remote areas, thereby lowering the cost of operations and transactions. At the same time, a Payments Bank may choose to become a BC of another bank for credit and other services which it cannot offer.

While in the case of Small Banks, the space was restricted for private players alone, the RBI has enlarged the applicant pool to include the public sector companies as well for Payments Bank license. The eligible entities that may choose to set-up or transform their current operations into a Payments Bank include existing non-bank Prepaid Instruments (PPI) issuers authorized under the Payment and Settlement Systems Act, (PSS Act) 2007) and other entities such as NBFCs, corporate BCs, mobile telephone companies, super-market chains, cooperatives and public sector entities. The current banks can also take equity stake in a Payments Bank. As per the RBI mandate, preference would be given to applicants who propose to set up Payments Banks with access points primarily in the under-banked States/ districts in the North-East, East and Central regions of the country.

Due to the nature of business, the Payments Banks would not be allowed to assume any credit risk and there may not be any need of capital for market risk. However, the Payments Bank would be exposed to operational risk and would be required to invest heavily in technological infrastructure for its operations. The minimum paid up voting equity capital shall be Rs. 100 crore and minimum capital adequacy ratio of 15 per cent computed under simplified Basel I standards. As the Payments Bank would have almost zero or negligible RWAs, a minimum CAR of 15 per cent would not reflect the true risk. Therefore, the RBI has mandated the Payments Bank to maintain a leverage ratio of not less than 5 per cent in the guidelines. With a focus on including the "excluded", a Payments Bank would be required to have at least 25 per cent of access points in rural centres where the access points may include their own network in addition to other players' network.

The previous experience

While the concept of a Payments Bank represents a new structure that may accelerate the financial inclusion process, the basic design is functionally equivalent to a pre-paid instrument provider (PPI) that has been permitted to receive cash deposits from customers, store them in a digital wallet, and allow customers to pay for goods and services from their digital wallets. There are currently 27 PPIs authorized by the RBI under the PSS Act. These players have enabled significant expansion of low-value payments services among individuals who hitherto have never used banking services. These PPIs are currently permitted to accept a maximum amount of Rs.50,000 from their customers in their wallets and are required to maintain an escrow account with a bank.

However, this model has been plagued with certain challenges that have prevented the proliferation of their services – the current model (a) limited the cash-outs on the wallet at the banking outlets, (b) gave rise to KYC/ CFT/ AML issues due to relaxed KYC requirements and issues around identification and authentication, (c) prevented the PPIs from earning interest on their escrow account balances and passing on the benefits to its customers in the form of interest payments, and (d) introduced contagion risk in the system as PPIs are exposed to the riskiness of their sponsor bank that holds their deposit balances.

The challenges and the road ahead

While introducing the concept of Payments Bank, the RBI has taken measures in the Draft Guidelines to do away with the aforementioned challenges in the PPI model. However, there may be times where other issues may crop up with the Payments Banks – a licensee such as a mobile telephone company or a super-market chain partnered with banks prior to operating as an independent Payments Bank may now face a conflict of interest in serving its partner bank vis-à-vis its own Payments Bank.

In addition, there is demonstrated customer preference for a combination of differentiated channels to access payments and credit. In this respect, a Payments Bank may come up short in meeting expectations of its customer base. However, with the guidelines suggesting that a Payments Bank may become a BC to another bank, they may expand their offerings portfolio to include credit products and others, and become a one-stop solution provider to a customer. Further, with the Payments Banks exposed to operational risk, the RBI has mandated these banks to establish a robust operational risk management system and to follow its guidelines on liquidity risk management to minimize liquidity risk to the extent applicable.

Way Forward

While conventional banks have been in existence for past several decades, introduction of new differentiated banking participants in the banking system in India may prove to be a master stroke in tackling the problem of financial exclusion. Along with the "local" knowledge and personalized touch, these "niche" banks would be well equipped with latest technology and employ a low cost operating model. These new licenses, due to the nature of their businesses and smaller size, would effectively work "bottom-up" rather than "top-down" approach followed by the conventional banks, where they would target the financially excluded population in the un-/under-served regions of India to serve them with customized products and services at more affordable rates.

This would make the business model viable as well as sustainable and would bring a new perspective and inject a new vigor and energy in the RBI's efforts to include the "excluded". With the two new universal banking licensees set to enter the financial inclusion play along with the current incumbents' consistent efforts to improve the outreach, it would not be an exaggeration that the new "niche" licensees would provide an extra impetus that may lead to far-reaching consequences for the Indian banking sector.

General Insurance market in India

General insurance industry in India has grown manifolds in the last decade and has reached ~Rs 70,000 crores of premiums. The reasons for growth of general insurance sector were rising demand for general insurance, liberalization of insurance sector and Detariffication of general insurance products (fire, engineering and Auto(own damage)) . The market was historically dominated by public sector insurers; however private players such as ICICI Lombard, Iffco Tokio, Bajaj Allianz have seen significant growth in their business in the last few years. Despite the presence of more than 20 players, the current low penetration levels at <1% augur well for the growth ahead

Among the product segments of general insurance, which constitute of fire, marine, motor, health and others, motor has ~50% of the share. Health insurance has been the fastest growing segment and has doubled its premium contribution to ~25% in the last few years. Fire and Engineering portfolio have seen drastic reduction in growth rates after de-tariffing and contribute ~16% of the premium share

Urban India has been the primary contributor to the general insurance market in India, but this is changing with the rural population now bringing great opportunities for the insurers to tap the unmet demand. Several insurers have tailored their strategies by leveraging technology to improve their distribution levels and access points and using rural institutions to deepen their presence

Health insurance portfolio is expected to grow in excess of 25-30% over the next 5 years. Government's proposal to scale up the foreign direct investment (FDI) in the insurance sector from 26% to 49% is expected to boost the health insurance business. A move towards a customer centric approach in the areas of product development, sales, servicing and claims settlement is called for to achieve these growth aspirations

Health Insurance market in India is largely underpenetrated

Health insurance spending across the globe is influenced primarily by the healthcare spending patterns. In India, healthcare expenditure has been on the lower side. ~86% of the healthcare expenditure in India is paid through patient's own expenses; this figure is significantly higher as compared to other countries such as UK, Brazil. Families meet ~70 % of their health expenses out of their own pockets, placing considerable financial burden on poor households, often pushing them deeper into poverty.

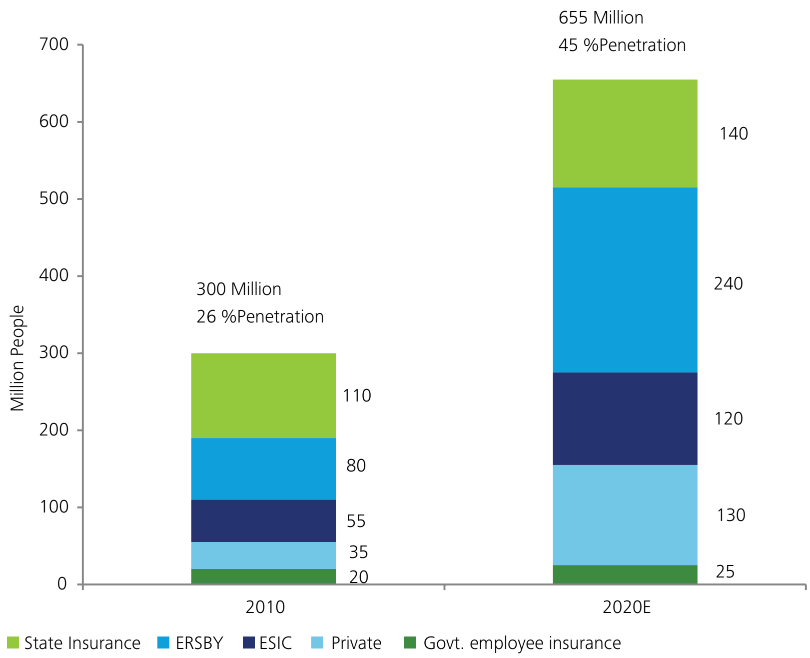
The lower spending on health care has impacted the penetration of health insurance in India. The contribution of private health insurance to the per-capita healthcare spending in India is very low compared to the global average. Currently less than 30% of the population is enrolled for some kind of health insurance as compared to 85% in the United States. This can be attributed to the lack of awareness on the importance of buying health insurance and the unaffordability of the standard health insurance policies for a major proportion of the Indian population

Regional imbalances are seen in health insurance penetration in India, with the southern states having insurance penetration of >50% for Andhra Pradesh, Karnataka and Tamil Nadu. On the other hand, the numbers are very low for some of the Northern states such as Rajasthan, Punjab, UP. The East and North Eastern states of India present a worse picture in line with the low level of financial inclusion in these regions. The penetrations are as low as 3% for Assam and 6% for Orissa. The central state of Madhya Pradesh has the lowest penetration among all states at 2%.

Government has been trying to improve the healthcare scenario in the country by launching several schemes targeting the BPL population. Some of the prominent schemes are: Health Insurance Scheme for Handloom Weavers and Rajiv Gandhi Shilpi Swasthya Yojana for handicraft artisans under the occupational group schemes; and Rashtriya Swasthya Bima Yojana (RSBY) and Universal Health Insurance Scheme (UHIS) for the masses. Schemes for occupational groups are operated by ICICI Lombard; UHIS is operated by the four public sector insurance companies and RSBY by both private and public sector insurance companies across the country. These schemes give patients the choice to visit any public or private provider empanelled by the government. Transactions are mostly cashless and this schemes leverage information and communication technology, and use pre-agreed package rates for payment .Andhra Pradesh (85% coverage through Rajiv Aarogyasri) and Tamil Nadu (62% coverage) are two states where state sponsored health insurance are the strongest in their outreach. Overall, Government-sponsored schemes have helped cover over 300 million people, with ~180 million belonging to the BPL category, with some form of insurance, but there is a major chunk of the population which is still excluded.

Several factors, on the demand and supply side, are expected to bring a change in the currently underpenetrated health care insurance market While the numbers are disappointing, they indicate the untapped potential of the health insurance market in India, as both the healthcare spends and the insurance penetration are on a rise. Market dywnamics has evolved since liberalization of the insurance industry. Expansion of health care provision and increased medical inflation, changing demographic environment, entry of standalone insurers in the Indian market, improved distribution strategies adopted by the insurers, product innovation to cater to all segments of the population, growth of managed healthcare market, push from the government and conducive regulatory environment aiding growth are expected to provide the required boost for the health insurance penetration in India

Health Insurance is likely to reach a penetration level of 45% by 2020



Supply Side Factors

Entry of Standalone Health Insurance Providers

Contribution of standalone health insurers is on a rise and the premium contribution has gone up from 8% in 2009 to greater than 15%. These include players such as Star Health, Apollo Munich, CIGNA, Max Bupa and Religare Health. These companies have grown faster than public and private insurers in recent years due to their better services and innovative product offerings e.g. Star Netplus provides health insurance covering HIV patients. Few others such as Aetna and Fortis, have also expressed their interest in joining the bandwagon of standalone health insurers

Growth of Managed Health Care Market

TPAs have been playing key role in extending Health Insurance services. TPAs have gained importance in recent past due to facilitation of payment for healthcare services and direct claim settlement between service provider and insurance company. between service provider and insurance company

TPAs have also started providing value added services such as wellness management/ preventive cure education and medical assistance information to insured individuals

Insurance companies are increasingly looking for 'In-sourcing' of TPA for improved customer service, streamline claims settlement and to control costs. Bajaj Allianz, ICICI Lombard, Star Health, Max BUPA Life, Future Generali, have already setup captive TPAs

Regulatory boost for promoting health insurance

In addition, the regulator has been trying to create a conducive environment for expansion of health insurance. IRDA has mandated that all insurance companies operating in India have to generate certain percentage (e.g. 2% in 1st year, 7% in 9th year) of total gross premium income from rural or social sector. IRDA has also made a special waiver for pure play health insurance companies to leverage existing agents of both life and non-life companies. IRDA has classified health insurance as a separate category and has permitted the insurers to tie-up with banks. This allows exclusive health insurers to tie up with banks across the country to improve their reach. This has encouraged many pure play health insurers to enter this market. Some key examples include CIGNA and Religare Health

Health insurers are increasingly tied up with NGOs in order to expand their presence in rural areas

Government Push for increasing health insurance penetration has seen some success and is expected to contribute largely to the growth of health insurance in the future

Other than the existing health insurance schemes which exist to cover the poor sections of the society, The new Prime Minister has been contemplating introducing health insurance policies with nominal premium that would cover treatment for widespread ailments like diabetes, cardiac and cancer. In the recently introduced Jan Dhan Yojana by the new Prime Minister, an accident cover of Rs 1 lakh is provided with every Rupay debit card for every account holder

Demand Side Factors

Changing Demographic environment

Increased urbanization and rise in income levels has increased the presence of lifestyle diseases. In addition to this, improving life spans has also led to the need to have a health care coverage. Per capital spend on health care is on a rise and indicates that the demand for health care insurance is increasing

Expansion of Health Care provisions resulting in higher costs of treatment

There has been an expansion of health care provisions and several private hospitals have come up in both urban and semi urban areas. Along with this there have been significant investments in developing medi-cities and other specialized treatment facilities. This private players have resulted in higher treatment costs, which further increases the need to have health insurance cover

Health Insurers shall be required to tailor their strategy to win in health insurance business

Specialized Products	• Apart from normal Mediclaim policies, offer specialized products to cover emerging demands of customers • ICICI Lombard offers critical care plans covering 9 major critical diseases; Star Health Insurance has introduced Star Netplus policy for HIV patients. Many companies now offer schemes for senior citizens with part payments being offered by the insurer for some cases • Some insurance companies have started offering individual products for coverage of Ayurvedic treatments • Bajaj Allianz has a specialized critical illness plan for women covering major illnesses such as breast cancer, fallopian tube cancer, ovarian cancer etc. • 'Star Care' a rural healthcare policy with an annual premium of less than Rs 2,000 for a sum insured of Rs 1 lakh a year is being rolled out by Star Health • Apollo Munich offers a "Restore" feature in which the cover amount gets restored in case it gets exhausted in a particular year
Product bundling	• Product bundling strategy would be useful to target customers in low income category (urban as well as rural) • Companies can consider bundling of products such as micro -savings, micro insurance and micro credit to target low income financially excluded population. The recent Jan Dhan Yojana is an example of this
Channel Alliances	• Insurers need to develop innovative distribution strategies to expand the reach. Apart from traditional branches, insurers should focus on developing new channels such as Bancassurance . In rural areas, existing ecosystem of NGOs, cooperatives can be used • Cigna TTK Health Insurance is planning to utilize 400 distribution stores of TTK Prestige, 1.6 lakh pharmacies of TTK Healthcare as well as 20,000 Direct Dealers for distribution of its products
After Sales Service	• The claim settlement record of the insurer is key for the customer to choose an insurer or renew his policy • Value added services would be the key to achieve product differentiation. Customers are increasingly giving preference to cashless hospitalization facilitating direct payment between insurance company and healthcare service provider • ICICI Lombard is offering value added services such as health risk assessment of the employees of its corporate clients to increase health and wellness awareness

Conclusion

Unlike, other lines of business, Health insurers are spread across the price spectrum and don't necessarily play the price-sensitive game to gain market shares. This has resulted in players trying innovative strategies which has and will benefit the consumer in the future. Investments made by players, the government, the regulator, and the providers will aid in expanding the reach of health insurance to the larger population and can be potential game changers for insurers, the customers and the economy as a whole.

MSME Financing

Overview

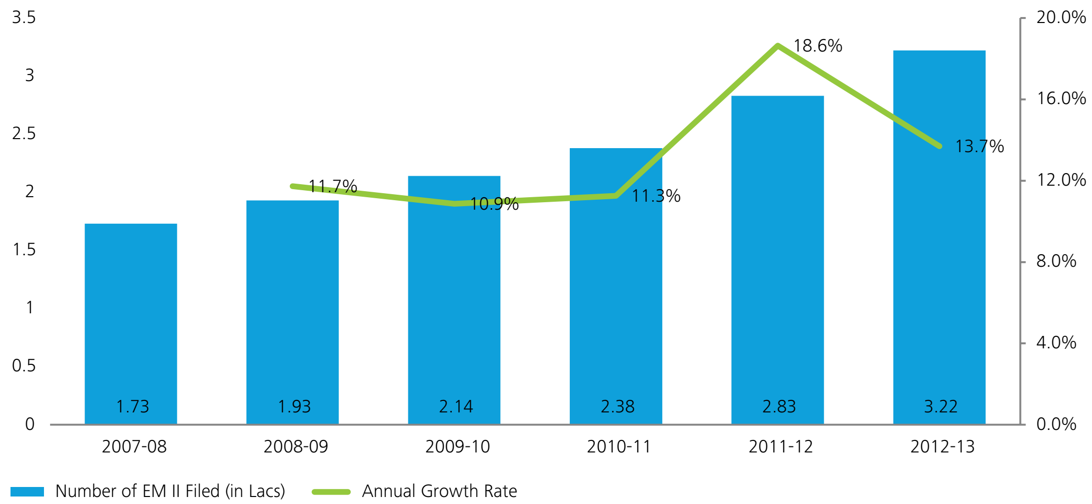
The role of Micro, Small and Medium Enterprises (MSMEs) in shaping the economic landscape of the country needs no elucidation. Its contribution in growth, employment and inclusion in the economy and society has been unprecedented. These small business entities are next only to agriculture. With micro businesses traditionally known as village and cottage industries, Indian MSMEs also boast of ancient heritage. Apart from playing a crucial role in providing employment opportunities at a lower capital cost than larger industries, MSMEs also complement larger industries as ancillary units.

Classified into three categories based on the capital investment (as can be seen from the table below), this sector has seen as impressive growth over the last 5-6 years.

Enterprise (Type)	Investment in Plant & Machinery (Manufacturing)	Investment in Equipment (Service)
Micro	Up to INR 25 Lacs	Up to INR 10 Lacs
Small	Between INR 25 Lacs - 5 Crores	Between INR 10 Lacs - 2 Crores
Medium	Between INR 5 - 10 Crores	Between INR 2 - 5 Crores

Consistent growth in terms of number of Entrepreneurs Memorandum (Part II) / [EM-II] filed every year at the District Industries Centres (DICs) across the country, which was 1.73 lakh in 2007-08 and increased to 3.22 lakh during 2012-13, apart from the healthy year-on-year growth rate of 18.6% in 2011-12 and 13.7% in 2012-13, also show a promising picture for the sector.

Exhibit: Growth of MSMEs since 2007-08



Source: Entrepreneurs Memorandum Data on MSME Sector 2013, Ministry of Micro, Medium & Small Enterprises

MSMEs in India account for more than 80%[6] of the total number of industrial enterprises and produce over 8000[1] value-added products. In terms of value, this sector accounts for 45%[1] of the manufacturing output, 40%[1] of the total exports of India and provides employment for 60 million[1] people. Also, the labour intensity of MSME is estimated to be 4[1] times that of the large enterprises.

Challenges

Despite showing a robust double digit growth for the past five years, MSMEs in India are affected by problems such as outdated technology, increasing domestic and global competition, suboptimal scale of operations, supply chain inefficiencies, etc. Of these, the major bottleneck is shortage of funds for the sector, which has been stifling the industry for quite some time. Lack of

6 MSMEs in India – Overview; MSMEMentor.in (Joint Initiative of SIDBI, NSE & Prime Database)

adequate financing has led MSMEs to underutilize their resources and depend on obsolete technology, thereby hampering the sector's competitiveness in the global and domestic markets. They are also unable to retune their manufacturing and operating strategies to meet the contemporary standards.

Financing of MSMEs

MSMEs require timely and adequate funding like any other industry throughout their early and growth stages. According to an RBI report,[7] MSMEs have relied on family capital, personal savings, loans from unregulated money-lenders (which entail high interest rates and caveats), asset sales etc, apart from financing by scheduled commercial banks and seed funds. The latter being relatively less accessible as it requires multiple layers of documentation and assessment.

Conventional financing options for MSMEs primarily comprise of:

Financial Assistance from Scheduled Commercial Banks (SCBs)

a. RBI has mandated SCBs to achieve 20% year-on-year growth in credit extended to MSMEs
b. Many State Level Bankers' Committees (SLBCs) have been instituted for resolving credit related problems for MSMEs
c. Many bank schemes such as SME Credit Cards, Standby Line of Credit, Artisan Credit Card, SME Construction Equipment Loans, Open Term Loan, SME Collateral Free Loans, etc. have been instituted for extending credit facilities for the sector

Support Schemes of Government

a. Central schemes have been set up for providing financial assistance to MSMEs apart from tertiary support in form of marketing and training assistance
b. Schemes such as Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), Credit Linked Capital Subsidy Scheme (CLCSS), Scheme of Fund for Regeneration of Traditional Industries (SFURTI), Cluster Development Schemes, and many more have been initiated to help finance both fixed costs and working capital requirements by MSMEs
c. Centrally sponsored institutes such as Small Industries Development Agency (SIDA), National Small Industries Corporation (NSIC), Small Industry Development Bank of India (SIDBI), National Bank of Agriculture & Rural Development (NABARD), etc have also been instrumental in extending credit and training facilities to MSMEs

Venture Capital (VC) Funding

a. VCs generally provide equity funding to rapidly growing MSMEs, though after careful scrutiny of their operations, with an aim to earn higher returns on their investments
b. They also bring in their management expertise and help the company in key areas such as technology and strategic advice, personnel recruitment, networking in international markets, introductions to strategic partners, and with additional rounds of financing
c. Some of the major players in the country in this category are IFCI Venture Capital Funds Limited (IVCF), Accel India Venture Fund/ SeedFund, Aavishkaar India Micro Venture Capital Fund (AIMVCF), SIDBI Venture Capital Limited (SVCL), SBI Capital Markets Limited, SEAF India Investment and Growth Fund, etc.

Though these traditional financing options have helped evolve the MSMEs over a period of time, there still are many gaps that need to be filled. Lack of awareness and low access of financing options for MSMEs often result in a financial crunch for the bulk of industry participants. Issues such as lack of documentation, low levels of information with banks for appropriate assessment and high cost of financing have resulted in under-utilization, incapacity and archaic technology, etc. Furthermore, VCs are extremely cautious in their approach and are therefore less accessible.

New Initiatives for MSME Financing

Access to Capital Markets for Equity Funding

MSMEs generally lack awareness about stock markets and equity funding options, other than banks. So far debt-financing options have dominated their industry. A novel initiative in this direction has been the introduction of small and medium exchanges for SMEs with listing norms much simpler than regular listing, on a SME platform through an IPO. Designed for MSMEs with a paid-up capital of less than INR 250 million, this allows them to use capital market funds by getting listed on the exchange without an IPO.

Apart from creating a sustainable ecosystem for MSME financing, this will also help in easing the liquidity crisis haunting the industry with the regulator mandating market making in the SME exchange platform.

7 Strengthening SMEs Capabilities for Global Competitiveness (Address by Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India at the interactive session on 8 October 2012 at Mumbai) http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?id=739

Fund of Funds

The Union Government in the recent budget of 2014 has announced setting up of a corpus of INR 100 billion for providing equity through venture capital funds, quasi equity, soft loans and other risk capital specially to encourage new startups by youth and MSMEs. Along with reviewing the definition of MSMEs for higher capital ceiling, a programme to facilitate forward and backward linkages with multiple value chain of manufacturing and service delivery, and an INR 2 billion corpus fund for a Technology Centre Network has also been planned.

Securitization

Creating loan pools of MSME credit and sale of such securitized assets to investors could also lead to more liquidity in the MSME credit market. This sort of financial structure would be of immense interest to leveraged investors thereby creating a system of easy financing for MSMEs and along with adequate safeguards in place, the quality of the securitized asset can also be enhanced.

Conclusion

Irrespective of the various measures instituted to enhance financial assistance to MSMEs and the growth in the credit exposures of banks, MSMEs still face stiff challenges while accessing timely credit at an equitable cost. As mentioned earlier, small businesses rely on multiple sources of financing ranging from personal funds and funds from friends, to external sources, both formal and informal, which include financing from banks, NBFCs, venture capital funds, etc.

As demand increases and MSMEs continue their double digit growth, alternate channels of financing will have to be developed to cater to the increasing need for liquidity. Such channels might as well create an ecosystem for nurturing a sustainable industry which provides an indispensable support to our nation’s economy.

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