

11 August 2014

Dr Raghuram Rajan
Governor,
Reserve Bank of India
Fort, Mumbai.

**Sub: Setting up of Differentiated banks – Suggestions submitted
for consideration of RBI in response to their draft guidelines**

Dear Dr Rajan,

This Memorandum from Moneylife Foundation is in response to the draft guidelines inviting suggestions with regard to issue of licence for setting up of Payments banks and Small Banks, announced by the Hon'ble Finance Minister in the Union Budget 2014-15.

While the idea of expanding banking facilities in the country by granting new banking licences, albeit of a different type than what is existing at present, is basically a progressive step in the direction of giving a thrust to financial inclusion, there is a need to make it more flexible, more customer friendly and most importantly safe and secure banking to create trust and confidence of the banking public in this novel experiment of spreading banking in to unbanked and under-banked areas of our country. Towards this objective, following suggestions are made for the kind consideration of RBI in the interest of serving the cause of financial inclusion coupled with spreading financial literacy for the larger good of our people.

These suggestions are divided into four parts, first part covers suggestions with regard to Payments banks, second part relating to Small banks, the third part covers suggestions to expand the scope of differentiated banks to other areas of economic activity and the fourth part covers the general suggestions applicable to all types of differentiated banks proposed to be set up under these guidelines.

1. Payments Banks:

- a. The guidelines stipulate that the Payments Banks can accept only demand deposits up to Rs.1,00,000/- per customer This restriction to accept only demand deposits to the exclusion of time deposits is neither in the interest of the proposed bank nor its customers. Restricting these banks to accept only demand deposits would force the customer to look for another commercial bank to invest any part of his surplus funds in fixed deposits, which would virtually negate the benefits of setting up these banks, as this may result in the first bank losing the customer completely once he goes to another bank.

- b. We, therefore, suggest that these Payments banks must be permitted to accept time deposits also as permitted to other commercial banks, but with a limit of say Rs.5,00,000/- per customer. This limit can be stipulated for deposits kept with all the branches of the same bank by the same customer. This limit can be reviewed as and when the banks grow bigger and depending on their satisfactory performance.
- c. In order to encourage financial inclusion of those who are outside the banking net, it is desirable that RBI should persuade the government and get the present legal requirement of mandatorily deducting tax at source if the interest paid to an individual in excess of Rs.10000/- per year by a bank should be got amended to permit all banks not to deduct tax on interest paid on deposits to a customer up to the limit of Rs.50,000 per year per customer. This would synchronize with the limit of Rs.5 lakhs proposed above for time deposits that can be placed with these Payments Banks, which will also relieve these banks from the tedious paper work of having to issue TDS certificates every quarter.
- d. Such a step of increasing the limit for TDS by banks will obviate the need for deducting tax at source which has been the bone of contention for people in the rural areas to invest their surplus cash with banks for fear of getting notices from the income tax and the rigmarole of having to file tax returns to get a refund if they are not liable to pay tax.
- e. When these banks are allowed to accept time deposits, as a natural corollary, it will be necessary to permit these banks to lend against the pledge of these deposits also; through they may be prohibited from other normal lending operations.
- f. The added advantage of permitting these banks to accept time deposits for different periods will be that it will help the banks in ensuring that the mismatch in their assets and liabilities is kept to the minimum, if not completely eliminated.
- g. In addition to accepting demand and time deposits, these banks may also be allowed to provide safe deposit lockers to their customers, depending upon the need for such services in rural areas.

2. Small Banks:

The guidelines stipulate that the small banks shall primarily undertake basic banking activities of acceptance of deposits and lending to small farmers, small businesses, micro and small industries and unorganized sector entities. It can also undertake other simple financial services activities with the prior approval of the RBI.

The RBI should, however, ensure that these small banks do not dabble in speculative activities nor should they be allowed to market exotic products not easily understood by their customers, who are mainly from the rural and the semi-urban areas of our country. Besides, these banks should be completely barred from selling third party products like mutual funds and insurance products etc. as they cater mainly to the illiterate and semi-literate population who can be easily taken for a ride. These conditions should be made amply clear in the final guidelines when formulated so as not to give raise to any misgivings in this regard.

RBI has stated that the objectives of setting up of small banks will be for furthering financial inclusion by provision of savings vehicles to underserved and unserved sections of the population. RBI has also stipulated a condition that these small banks' operations should be technology driven from the beginning. In order to protect the customers of these banks, who are mostly not tech-savvy and financially not literate, from the risks involved in dealing with the technology driven banks, RBI should come out with clear guidelines to limit the liability of the banks' customers, who use the technology driven products and services, to near zero, unless the bank is able to establish total negligence on the part of the customers.

3. Need for differentiated banks in the housing finance sector:

RBI has proposed only two types of differentiated banks, namely Payments Banks and Small Banks in the draft guidelines announced so far. There is a need for differentiated banks in the field of housing finance, which is of paramount importance to a large part of our population who do not have a roof over their head. Therefore, dedicated Housing Finance Banks (HFBs) for exclusively lending to home buyers is a desideratum for the following reasons:

- a. President Pranab Mukherjee while addressing a joint sitting of Parliament, laying the roadmap of the new government headed by Prime Minister Narendra Modi. on 9th June, 2014 had said that by the time the nation completes 75 years of its Independence, every family in our country will have a pucca house with water connection, toilet facilities, 24x7 electricity supply and access.
- b. Following this promise, Mr. M. Venkaiah Naidu, the Urban Development, Housing and Urban Poverty Alleviation Minister announced that his priority will be to ensure housing for all by 2020 and to cut interest rate on home loans. While this is a laudable objective, this requires strategies on different fronts and providing finance to people to own houses is the most important part of this initiative.
- c. Therefore, providing institutional finance to the common man at reasonable rates of interest should be the priority to achieve the objective. Today, scheduled commercial banks (SCBs) are the largest lenders to home buyers, but they have not been able to make an impact in this area as this is a low priority business for them. Their focus is more on lending to trade, commerce and industry, where the banks have opportunity to earn extra fee income, due to which banks are more inclined to go for lending to business ventures rather than home buyers.
- d. As is well known, housing is a basic need of every human being next only to food and clothing. "Roti, kapada our Makan" form the three pillars of human existence. Besides, development of housing has its ramifications in many other economic activities resulting in overall improvement in the well-being of people. But the need for housing is very large and the money required to finance such a huge demand will also be humongous.
- e. According to a report of National Housing Bank, mortgage to GDP ratio stands at 9 per cent in India in 2012-13, significantly lower than the levels achieved in most of the advanced economies where the mortgage markets average is around 60% of GDP. Even the economies in the Emerging Asian region have figures going up to 31% in Malaysia,

19% in Thailand and 17% in China. It shows the extent of opportunity available to the lending institutions for deeper penetration into this untapped market in India. So there is a need for concerted efforts to create suitable institutional framework to supplement the existing institutions to bridge the resource gap that exists between supply and demand in this vital economic activity.

- f. Then there are the housing finance companies (HFCs) who specialise in lending to home buyers, and they have been able to do a reasonably good job of expanding their home loan portfolio within the limited resources they have and the restricted reach due to limited branch network in metros and urban areas of the country. They need to go a long way even to catch up with banks, which they will be able to do if their hands are strengthened by giving them the status of a bank dedicated to the job of lending only to home buyers and other activities incidental to housing.
- g. The current financing mechanism prevalent in the country mostly targets middle and high income sections of the society while the households falling under low income and economically weaker sections category especially from the unorganized work force have no or limited access to housing finance. This can be attributed to the reluctance of the formal housing finance providers like commercial banks to cater to these segments due to lack of appreciation of the needs of the unorganized sector which have remained outside the banking fold so far. It is only by having dedicated housing finance banks that the housing needs of unorganized sector can be taken care of.
- h. Though housing loans are disbursed today by both the commercial banks and housing finance companies, it has hardly met a fraction of the needs of our large population who are struggling to have a shelter of their own. The commercial banks being engaged in a wide variety of activities could give very little attention and focus to this important area of finance so far. The housing finance companies operating in our country could hardly meet the needs of our growing population, who need innovative housing finance schemes which can be provided only by dedicated banking institutions that could devote undivided attention to this class of borrowers.
- i. At present there are as many as 57 housing finance companies authorised by the National Housing Bank in our country, but their contribution by way of lending to this sector is totally inadequate.

The following table will illustrate this point:

(Figures in Rs. crores)	Total Outstanding <u>As on 31.3.2012</u>	Housing Loans. <u>As on 31.3. 2013.</u>	Growth %
Public Sector banks:	2,73,012	3,11,982	14.27
Private sector banks:	1,30,388	1,50,218	15.21

Total: Scheduled com. Banks:	4,03,400	4,62,200	14.60
Housing Fin. Companies:	2,22,225	2,90,427	30.69

Total:	6,25,625	7,52,627	20.30

Source: National Housing Bank report on trend and progress of housing in India 2013

- j. The RBI has recently issued guidelines for issuance of long term bonds by banks for financing affordable housing with exemption from regulatory pre-emptions, such as CRR, SLR and PSL (Priority sector lending) requirements on such bonds. While this is a good augury to encourage housing finance, it would gather steam if such a facility is made available to the specialised Housing Finance Banks to be set up, as these specialized banks would be able to do full justice to the proposal, as lending to home buyers is their only area of business activity.
- k. The Housing Finance Banks when set up should be allowed to accept all types of deposits like any other commercial bank, as this facility will help these specialized banks to bring down their cost of funds, which in turn will help them to reduce their lending rates to the home buyers.
- l. At present, the housing finance companies are not able to compete with banks mainly because they have no access to cheap funds and consequently they are forced to lend at higher rates than banks, which puts them at a disadvantage vis-a-vis the banks.
- m. As per the media reports, the Finance Minister informed the Lok Sabha on 8th August, 2014, that the government plans to ensure availability of loans at lower interest rate for low cost housing for seven crore families under the Mission of Low-Cost Affordable Housing. Achieving this objective would be easier if licences are granted to set up a few specialized banks exclusively for housing finance under the differentiated category of banks now proposed by RBI.
- n. In this year's budget the government has provided tax benefits for principal repayment of housing loans up to Rs.1.5 lakhs (raised from Rs.1 lakh) and interest payment on housing loans up to Rs.2 lakhs (increased from Rs.1.5 lakhs), which will result in greater demand for housing loans in the country.
- o. The Building Societies of U.K are the best examples of how specialized institutions with banking status can create a revolution in housing finance in the country. Though their constitution is a mutual society, they have been able to play a very crucial role in

spreading home loan concept among a large number of citizens in that country by their innovative offerings and novel home loan structures, which banks were not willing to do. This is due to their getting a status of a bank, accepting both demand and time deposits from their customers, who are mainly home buyers, and providing much better personalized services to this class of bank customers. As per the media report, the Building Societies in U.K now control more than 60% of the mortgage lending market which is the result of their concentrated attention to one business activity and winning over customers through better customer service. This has resulted in mortgage to GDP ratio of U.K reaching a high level of 80% which is a commendable.

- p. In India too, we can develop such specialized institutions by upgrading some of the housing finance companies into housing banks, and permitting new entrants also into this field, as the demand for housing loans is expected to grow exponentially with much greater gusto in the years to come.
- q. There are 57 housing finance companies (HFCs) at present registered with National Housing Bank, but only about eight companies have been listed in the stock exchanges. If some of these companies meet the fit and proper criteria of RBI, they can certainly be considered for up-gradation into full-fledged Housing Finance Banks, which can create a remarkable improvement in the home loan market in our country.
- r. However, RBI as a regulator should come out with appropriate checks and balances for all the housing finance banks, if and when licensed, to ensure that they work on sound lines and do not go the way of Freddie Mac and Fannie Mae of U.S.A, and meet the expectations of a large majority of our people who aspire to own homes by availing loans at reasonable rates of interest.
- s. The happiness of people is directly co-related to the home ownership enjoyed by the people. By making available housing finance easily and as cheaply as possible, people of our country will surely be happier than before. In the global happiness ranking list of last year, India stands at rank No. 111, much after Pakistan (rank:81) and Bangladesh (108). Providing housing to our people as promised by our government should help our country to climb a few steps in the ladder of global happiness index in the coming years.

4. General Suggestions applicable to all type of differentiated banks:

A. All types of differentiated banks to be licensed now or in the future should be barred from selling all types of third party products like mutual funds, insurance etc. as they may be tempted to mis-sell these products to increase their non-interest income. But this will be at a very heavy cost to their customers, who being illiterate and semi-literate can be easily taken for a ride and this will cause untold misery and grief to these hapless bank customers with no recourse to redress their grievances.

B. To develop trust and confidence in these new but small banks, there is a need to increase the deposit insurance cover to at least Rs. Five lakhs per customer from the present Rs. One lakh, as this will serve to give a boost to these banks during the initial period of their operations.

C. The higher deposit insurance cover stated above can be made available only to the customers of these specialized banks, till they continue in this bracket, to help them to compete with bigger banks and attract customers into their fold. This incentive will be the only tool to make this novel experiment of differentiated banks a success.

D. There is a need for RBI to come out with stringent guidelines to ensure that these banks provide the services expected of them with utmost diligence and in a satisfactory manner. Otherwise they will promise everything under the sun but fail to deliver not only what is promised, but may even take advantage of the ignorance and helplessness of their customers, who will be left high and dry, thereby undermining the very purpose of setting up these institutions.

E. In early April this year, RBI had announced that it would come out with comprehensive customer protection guidelines in the banking industry to ensure that banks do not take advantage of the customer's difficulty or inattention etc. But these guidelines are yet to see the light of the day even after a lapse of four months. There is an urgent need for ensuring that these customer protection guidelines are put in place well before dispensing these licences for new banks, so as to ensure that only the serious players with full knowledge of the risks and rewards enter this field for a long haul in this business.

Yours sincerely,



Sucheta Dalal,
Trustee, Moneylife Foundation
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