

Some Thoughts on Financial System Designs to Enhance Inclusion

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GPII Conference on Standard Setting Bodies & Financial Inclusion

Basel, October 30 – 31, 2014

1. I want to start by thanking the BIS and GPII for inviting me to this important conference and dialogue on standard setting in the landscape of digital financial inclusion. I was also encouraged to learn about India's involvement in these deliberations as Co-Chair of the Committee on Payments and Market Infrastructure and the Standard Setting Body on Regulation and Financial Inclusion. I will focus my remarks on recent developments in the Indian financial sector and some implications of this on the broader theme of design and regulation of the banking system.
2. As many of you may be aware; despite both historic and ongoing efforts to redress this, India still has very low levels of both financial inclusion and financial depth with severe regional inequities. In many parts of the country, absence of financial access is a key bottleneck to growth and poverty reduction. In order to effectively address this issue, it is clear that India needs to significantly improve the extent and quality of financial intermediation. One potential direction for India to pursue is to license a larger number of new full-service banks and to propel existing banks to grow rapidly. However, it is neither possible nor desirable to immediately issue a large number of full-service bank licenses or to have existing banks grow far too rapidly. For

example, in the last round of bank licensing in India, only two candidates qualified from a pool of twenty-six applicants. Given this reality, India will need to identify strategies which, while successfully and quickly addressing the financial inclusion and deepening challenges, do not exacerbate systemic risk. Additionally, the approaches that are adopted will need to bear in mind that India is a large and a diverse country and that no one strategy, however well designed, can ever hope to serve the entire country. Therefore, instead of going in the direction of one strategy or one big idea, a better approach may instead be to articulate a clear vision; establish a set of design principles; and then to carefully create an environment which permits all strategies to flourish to the full extent of their potential.

3. We already know that a well-functioning and resilient financial system needs a good mix of institutions that collectively meet the financial intermediation needs of the country, while simultaneously enhancing the stability of the system as a whole. Fortunately, in India, there are already many of these elements present along with a deep experience of multiple kinds of banking system designs, which have been developed over the years. India has significant experience of both the National Bank as well as the Regional Bank designs – two types of horizontal or full-service banking designs. There are also a robust set of well-capitalised and well-regulated Non-Banking Financial Companies or Credit Institutions; and several Prepaid Instrument issuers (PPIs) which operate with far narrower mandates than do the full-service banks. These maybe thought of as examples of vertical banking designs. This already represents a sufficiently wide set of financial institutions. Perhaps instead of

looking for answers in entirely new structures, what is required is to eliminate the constraints on each type of existing design to fully realise its potential; address stability concerns, wherever they may exist within any design; encourage specialisation instead of requiring everyone to acquire the character of a universal bank; and finally, enable significant, arms-length partnerships between various institutional types that leverage each of their strengths. This will allow the complete development of the kind of financial institutions and financial system that is needed for a country of the size, diversity, and complexity of India.

4. The credit and payments strategy need to evolve differently within the broader financial inclusion strategy. While progress on credit would necessarily have to be much more measured and prudent given the inherent risks and customer protection concerns, there is an urgent need to make access to payments ubiquitous. In addition, there is also a pressing need to create an architecture that allows information relating to customer behaviour, in particular, transactions histories with financial institutions, telecommunications companies, and utilities, to be captured and transmitted with high integrity, while simultaneously maintaining the highest standards of customer privacy. The development of these payments and information architectures will not only have enormous inherent value but could also be thought of as “highways” on which a more diverse credit intermediation system can be built. Fortunately, India already possesses the necessary tools to build these. She has a 700 million strong Unique Identification project and electronic KYC database; a rapidly growing telecommunication network in rural

areas with over a billion mobile phone users; expanding broadband connectivity which is expected to cover every village in the next 12 to 24 months; and multiple credit bureaus which are all very active. If these improvements in supply-side infrastructure can be strengthened and adequately leveraged by both existing and new financial institutions, India could deliver on universal access to basic payment services and be well prepared for a rapid but high quality growth in the penetration of credit to all customer segments and regions of the country.

5. There are over 2,000 universal banks in India, both national and regional, and while they clearly have an important role to play in servicing significant parts of the market, as mentioned earlier, there are limits to how quickly their size and number can grow. Furthermore, it is clear that this design does not have all of the inherent strengths needed to service all parts of this market. In the absence of viable alternatives, the ability of these universal banks to play to their strengths has been constrained both by attempts to push them to serve customers and markets that they are not well suited to do, and the absence of supportive risk-transmission infrastructure which allows them to hedge regional and sectoral risks. This has resulted in low levels of profitability combined with high levels of risk in most of these universal banks, particularly the regional banks. Non-bank entities such as the Non-Banking Finance Companies (NBFC) and Pre-Paid Instrument providers (PPIs) offer strong additionalities in terms of cost structure, customer access, and risk management capacity. There are also companies with large distribution networks such as consumer goods and telecommunications companies which

possess strong business model adjacencies vis-à-vis payments relative to universal banks. While a good beginning has been made, through the NBFC and the PPI structures, their strengths have not been fully leveraged because of the strong preference for universal banking designs.

6. There has been a great deal of debate in India about the best path to grow these non-bank entities – whether as “shadow” entities, that are outside the ambit of the banking system, or as an integral part of it. This debate is also of wider relevance from a financial systems design perspective. For a number of reasons, it appears strongly desirable to have a single banking regulation framework to govern the entire system instead of separate ones for full-service banks, pre-paid instrument operators, and non-bank finance companies. A full-service banking license combined with the suspension of specific permissions such those relating to lending or retail deposit taking could allow for the development of an elegant, internally consistent and arbitrage free banking systems design, and simultaneously allow for the level of variety in providers that is essential for the full penetration of financial services in the remotest corners of India.
7. An integrated banking regulation framework that permits differentiated banking models would be desirable for a number of reasons:
 - i. There would be flexibility to approach payments, savings, and credit both independently (in a Vertically Differentiated Banking Design) and to bring them together (in a Horizontally Differentiated Banking Design) when the

efficiency gains are high and the other costs are low. Concerns relating to finding fit-and-proper candidates in the case of vertically differentiated institutions would be far fewer and licensing a relatively large number of them would, consequently, be far easier. These, over time, could also provide a pipeline for future universal banks should they express a desire and the demonstrated capability to be eligible for such a transition.

- ii. The current fragmented regulatory structure creates far too many arbitrage and lobbying opportunities, and in the absence of a single unifying framework, measures are continually being taken to respond to them in a somewhat ad-hoc manner (such as higher capital adequacy norms for NBFCs combined with an easier Non Performing Assets recognition norms and 100% risk weights and no capital adequacy requirements even for operational risk but escrow accounts for pre-paid issuers combined with no cash-out capability).
- iii. If these institutions are formally licensed as Banks, some of the specific constraints such as cash-out restrictions and “pancaking” of accounts for PPIs and dual regulation for NBFCs can be swiftly and elegantly addressed.
- iv. There is also the concern about the safety of funds being held by the PPIs that arises from contagion risk. Since these institutions are “nested” within a sponsor bank, if the sponsor bank fails for some reason, then since the amounts held by the PPI with the sponsor bank are at risk, the amounts held by individuals with the PPI are also at risk and do not enjoy the benefit of

deposit protection unlike the direct depositors of the sponsor bank itself. And, if the size of the total balances held by the sponsor bank grows to be large relative to its own balance sheet size, the failure of the PPI could threaten the survival of the sponsor bank itself. These entities could assume sizes that are significantly larger than some of the existing banks and as shadow banks would constantly pose a potential threat to systemic stability if not equally well regulated. Thus, nested approaches potentially create opacity in the system by screening the build-up of risk in the system.

8. Finally, no matter what shape it takes, the financial system needs to ensure the Right to Suitability of the customer by maintaining the principle that the provider is responsible for sale of suitable financial services, and not restrict customer protection merely to financial literacy and disclosure measures.
9. In conclusion, I would re-emphasise that India already has all the elements for success in place – a wide range of institutional types, well-developed financial markets, a good regulatory framework, and large scale and high quality authentication and transaction platforms. With a concerted effort it should be possible to ensure the achievement of several key goals such as universal access to a bank account; a ubiquitous payments infrastructure; and a base level access to all the other financial products such as credit and insurance within the next two to five years. Thank you.