

ILLUSTRATION: AJAYA KUMAR MOHANTY



# Intent and outcome

## The experience with local area banks and RNBFCs should have offered some lessons

With the decision of the Reserve Bank of India (RBI) to cancel the licence of Paytm Payments Bank, it is necessary for us to look at the multiple initiatives of the RBI, the intent of the initiative, and how it was designed. This will give us an idea of why there could be a slip between the proverbial cup and the lip. One never gets what one intends to unless the design favours the intent. Let us discuss three initiatives for now.

In the mid-1990s, as banking opened up for the private sector, the RBI came up with guidelines to open local area banks (LABs). These LABs were expected to have three contiguous districts as the area of operations, could open only one branch in each of the district headquarters, and all other branches were to be in villages and semi-urban areas. It had lower capital requirements. LABs were an alternative to the private sector in competing with regional rural banks (RRBs), which started in 1975. The objectives of both RRBs and LABs were primarily market development, commercial returns being the secondary objective.

The result was familiar. There were multiple applicants. Of the 10 in-principle licences given, only six started operations. Of the six, two continue today. The question, therefore, is whether the design of LABs (with restrictions in the area of operations) appropriate? The data till then did not indicate that RRBs, operating in a similar format, had cracked the code and were profitable enough to attract private-sector investment. Even now, the experiment of having a restricted area is successful

only in places where economic activity is vibrant. Such a format is squarely in the arena of the state. The state can recapitalise these banks and keep them going even if they are not achieving commercial returns because of the objective of "market development".



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At the same time, the market does not operate on development principles. This would be evident from how eager the market would be to seek licences for new banks. While the RBI did not issue any further licences for LABs, the two fledgling banks continue as a separate category, adding to the regulatory burden. It is time the RBI acknowledged that the LAB experiment failed, and merged these banks with an interested party. In this case, the design flaw was in putting a profit-maximising model in a market that is constrained: Geographical constraints in growth, high concentration, and co-variance risks.

The state can absorb such risks, but the markets cannot. With the consolidation of the RRBs and moving to one state-one RRB, we see that even the state is unwilling to absorb the costs of market development, and would prefer cross-subsidising it by giving it a larger area of operations.

The second model is payments banks. These do not have a clear revenue model. They can collect deposits from the public but cannot lend. They have to make money by investing. In one sense they are like mutual funds but without the flexibility of playing the markets because they are "banks". The

only fee income they could get is from remittances, which have been killed by Unified Payments Interface (UPI). Therefore, why did 42 entities submit an application for the banking licence? Possibly the underlying idea was that the transaction data could be used to generate leads for others to lend. The revenue model was "data" rather than "pure-play banking".

This is complex, with evolving norms on data use, predatory lending, and data privacy. No wonder even as 11 licences were issued, three players soon withdrew. Of the remaining eight, we have five players continuing, with one trying to convert itself into a small finance bank (SFB). The others are deeply embedded in their other conglomerate businesses and cannot even hope to become an SFB. The only standalone player is trying to be an SFB.

In the case of payments banks, it was evident that the business model was never core transactions with the customer. This model was bound to be under stress and eventually fail. While it was termed a solution for payments, it offered no better service than that of any payment aggregator and there were better and safer places for public deposits.

After having residuary non-banking financial companies (RNBFCs; Sahara being the most prominent among them) for decades before shutting them down, the RBI should have gained from that experience. Payments banks were no different from RNBFCs on one side of the business — taking deposits. But in the case of RNBFCs, the rules required them to invest 80 per cent of the deposits collected in safe government paper, thus giving six months' float and 20 per cent of the deposits to lend and earn. Organisations like Sahara also depended on poor clients forfeiting their deposits for non-compliance with rules, which gave them additional buffer. Payments banks did not even have the advantage of this grey zone!

The third business where the RBI showed agility to regulate was the peer-to-peer (P2P) lending model. Again, there is no business sense in a P2P platform unless it is used as a data base. P2P platforms are supposed to be clearing houses between lenders (savers) and borrowers and the intermediation is purely data and assessment. That means an individual investor is taking a call on lending to someone she does not know, based on the information provided by an intermediary, who is passing on the risk of default to the lender (saver) for a fee. How does this model make sense at scale?

While experimentation is welcome and we should try interesting new models. As regulator, the RBI should possibly go back to an old-fashioned question: How does it work? Is it simple enough for a large number of people to understand? Is the revenue model obvious, or is it shrouded in something else? With the announcement of Saksham, a new initiative to increase the capacities of cooperative banks, the fear is that the RBI might also open up fresh licences for new cooperative banks. We will review this a decade later! Sometimes it is possibly better to be old-fashioned.

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