Relevance of Local Area Banks to Achieve Financial Inclusion

Ramesh Subramanian, Ph.D Research Scholar, SCSVMV University, Enathur, Kanchipuram, Adjunct Faculty, IFMR, Chennai, India

“Overcoming poverty is not a gesture of charity. It is an act of justice. It is the protection of a fundamental human right, the right to dignity and a decent life. While poverty persists, there is no true freedom.” Nelson Mandela

“Poverty is the worst form of violence.” - Mahatma Gandhi.

Bernanke: “Helping people better understand how to borrow and save wisely and how to build personal wealth is one of the best things we can do to improve the well-being of families and communities.” (Shri. P.Vijaya Bhaskar, December 10, 2013)

“The world has seen several episodes of economic growth in many countries and "one clear lesson is that growth is sustainable only if it is inclusive. The inclusive growth process is the one wherein "the poor contribute to growth and the poor benefit from growth” (Dr. Subbarao, 2012)

Abstract
Financial inclusion could be an important instrument in alleviation of poverty. Financial Inclusion would result in even economic growth and lead to regional balanced development. Economic growth would be sustainable only if it is inclusive. Access to finance leads to reduction of disparities in income distribution. Financial Inclusion has been in the top of the agenda of the Central Government and RBI. Financial inclusion broadens the resource base of the financial system by developing a culture of savings among the people. Policy transmission of the central bank could be most effective only when the entire financial system is under the organized sector. 90 per cent of small businesses have no link with the formal financial sector and 60 per cent of the population does not have a functional bank account. The Global Partnership for Financial Inclusion was officially launched on 10 December 2010 in Seoul. India as a member of G20 has rightly put financial inclusion at the top of the agenda of the Central Bank. There are a number of challenges the commercial banks face in their financial inclusion endeavour. Local Area Banks (LABs) have all the advantages of being a commercial bank with a local touch and local feel and are best suited to take forward the financial inclusion agenda of the Government and regulator.

Keywords: Financial Inclusion, Local Area Banks, Reserve Bank of India, Policy transmission, poverty alleviation, resource base, inclusive growth, exploitation of masses, lower cost of funds.

Introduction
Financial Inclusion has been on the top of the agenda of the Reserve Bank of India (RBI) and Government of India for quite sometime. India as a member of G20 forum has taken up the task of taking forward the initiatives of G20 with regard to financial inclusion. The forum has put forth a Financial Inclusion Action Plan. The Global Partnership for Financial Inclusion (GPFI) is an inclusive platform for all G20 countries has come out with a road map for financial inclusion.

Financial inclusion has many pros and can be viewed from different perspectives. Access to finance enables the under-served to uplift themselves from poverty. It also prevents the masses from being economically exploited and protects their wealth. For the regulators financial inclusion enables better policy transmission, increases the resource base, makes the economy less dependent on external finance, leads to better revenue collection, provides audit trail for revenue authorities and furthers economic development. Inclusive growth can be achieved only through financial inclusion.

Financial inclusion represents reliable access to affordable savings, loans, remittances and insurance services and pension.

The essence of financial inclusion is to ensure delivery of financial services which include - bank accounts for savings and transactional purposes, low cost credit for productive, personal and other purposes, financial advisory services, insurance facilities (life and non-life) etc.

The RBI defines “financial inclusion” as the process of ensuring access to appropriate financial products and services needed by all sections of society in general and vulnerable groups, such as weaker sections and low-income groups in particular. This should be at an affordable cost in a fair and transparent manner by regulated,
mainstream institutional players” (Dr. K.C. Chakrabarty, 2013).

The regulatory stand on financial inclusion is perceptible as thrift, credit and funds transfer at an affordable cost and in a transparent manner can be provided only by entities under the purview of RBI. Further other products like insurance (life and non-life) and pension are also distributed by mainstream institutional players either directly or through their subsidiaries/associates.

However, there are a number of challenges the commercial banks face in their financial inclusion endeavour.

Presence of bank branches: The commercial banks basically function through two models brick and mortar or e-banking.

With the low literacy levels in the rural areas E-banking obviously would not take off and financial inclusion cannot be brought about using this model.

Brick and mortar would be most effective in financial inclusion. But this model faces a number of challenges.

"Banks are important financial intermediary, but our problem is that banks access is not there, today out of 600,000 villages only 40,000 villages have bank branch;….. banks penetration is very important” (Dr. K C Chakrabarty DG, 2013)

“In aggregate, there are 105,753 branches across all scheduled commercial banks in India of these. Of these, about 39,336 branches are in rural India” (Mor, 2014).

Capital Requirement: “In its 9th Financial Stability Report, the RBI said the Indian banking system needs to pay urgent and greater attention to the Basel regulations……according to certain rough estimates, Indian banks’ additional capital requirements will be to the tune of Rs.4.95 lakh crore over the period of phasing in of the Basel III capital requirements” (Bureau, Time banks tapped capital market for funds, 2014).

As banks would need a huge amount of capital to adhere to Basel regulations they would in constrained to open another 5 lakh branches.

Cost of Delivery: The cost of delivery of commercial banks is quite high which includes staff compensation (national level), computer systems, core banking solution net working system, security, ATMs and related cost etc. Banks would find serving the mass in remote rural areas impinge their profitability and hence would be reluctant players. However, a localized institution would be in a better position to serve the down trodden with their low cost model, local feel, local touch and localized products. Further the credit decisions are also local as against the centralized decisions of banks.

Customer service and product suitability: “In January 2014 RBI panel led by Nachiket Mor on Financial Services for Small Business and Low-income Households had suggested that banks move from the principle of caveat emptor (let the buyer beware) to caveat vendor (let the seller beware). It proposed a legally-protected right for low-income borrowers to get suitable financial services, suggesting banks can face legal action if found selling unsuitable products to them.

Banks are not willing to ensure that the products they sell to low-income customers are suitable for them, telling the apex bank instead that customers themselves must understand their own financial needs and bear responsibility for the choices they make.

Indian Banks Association (IBA) has communicated to the central bank that the recommendations may create ‘operational limitations’ for banks working with low-income group people and in rural areas, an IBA official, who did not want to be identified confirmed” (Roy, 2014).

Hence commercial banks may not be able offer suitable products to the low-income household and take responsibility for selling the same.

As commercial banks have several challenges in serving the low-income household other models which have been effective in this regard would have to be pursued. Without losing sight of the RBI definition: “RBI defines financial inclusion ……. mainstream institutional players’ it would be appropriate to revisit the Local Area Banks (LAB) model. LABs fit in the bill as these institutions are localized and also under the RBI purview.

Community Development Financial Institutions: Low-income households have always had limited access to finance and financial services. In the United States community development banks (CDBs) are commercial banks that operate with a mission to generate economic development in low to moderate-income geographical areas and serve residents of these communities.

“Organizers wishing to start a new CDB can seek a state or national bank charter. Federally chartered CDBs are regulated primarily by the Office of the Comptroller of the Currency (OCC), like any national bank. According to the OCC Charter Licensing Manual, CDBs are required "to lend, invest, and provide services primarily to low to moderate income individuals or communities in which it is chartered to conduct business. State-chartered community development banks are subject to regula-

“The Committee on Comprehensive Financial Services for Small Businesses and Low Income Households chaired by Nachiket Mor submitted its Report on December 31, 2013. The Report highlights that 90 per cent of small businesses have no link with the formal financial sector and 60 per cent of the population does not have a functional bank account. While the bank credit-GDP ratio is around 70 per cent of GDP, there are wide regional and district-wise disparities which confirms that financial inclusion has a long way to go” (Tarapore, 2014).

Local Area Banks (LABs): Perhaps inspired by the success of the CDBs in United States, the “Local Area Bank Scheme was introduced in August 1996 pursuant to the announcement of the then Finance Minister. He observed that this would enable the mobilization of rural savings by local institutions and make them available for investments in the local areas. The Local Area Banks (LABs) were expected to bridge the gaps in credit availability and strengthen the institutional credit framework in the rural and semi-urban areas and provide efficient and competitive financial intermediation services in their area of operation” (G.Ramachandran, Report of The Review Group on The Working of The Local Area Bank Scheme, 2002)

Capital and applicability of Acts: The minimum start-up capital of a LAB is fixed at Rs.5 crore. The bank would be registered as a public limited company under the Companies Act, 1956 (now Companies Act, 2013). It would be licensed under the Banking Regulation Act, 1949 and would be eligible for inclusion in the Second Schedule of the Reserve Bank of India Act, 1934. The bank would be governed by the provisions of the Reserve Bank of India Act, 1934, the Banking Regulation Act, 1949 and other relevant statutes.

Regulation and Supervision: Rural Planning and Credit Department (RPCD) of the RBI is the Regulator for LABs, while they would be under the Supervision of Department of Banking Supervision (DBS). The commercial banks are regulated by Department of Banking Operations and Development and DBS is the supervisor.

On-site and Off-site supervision: LABs like commercial banks are subjected to detailed financial health checks by RBI through on-site and off-site supervision. On-site supervision of LABs lies with the Department of Banking Supervision (DBS). The LABs are covered under Annual Financial Inspection (AFI) Programme of DBS. A close scrutiny of the management functions, functioning of Board of the bank and constitution of various committees of the Board, internal control system, internal audit and inspection, information system, deposit, advance and investment portfolio, NPAs, profitability, corporate governance, capital adequacy and maintenance of statutory norms such as CRR and SLR etc are covered threadbare. In short – CAMELS pattern of supervision which is observed by the regulator in respect of commercial banks is also undertaken in respect of LABs. The capital adequacy, asset quality, management efficiency, earnings stability, liquidity position (including solvency), systems and control (CAMELS) are assessed by DBS. In addition, DBS undertakes scrutiny books as and when felt necessary.

The functioning of LABs is also closely monitored through off-site returns and other statements required to be submitted at periodic intervals of weekly, monthly, quarterly, half-yearly and annual.

This is to ensure that the affairs of the bank are not being conducted in a manner detrimental to the interests of the depositors.

The rigour of supervision by DBS (RBI) for LABs is the same as it is for commercial banks.

Board of Directors: The composition of the Board of these banks is to be in accordance with the provisions of the Banking Regulation Act, 1949. The appointment of the Board of Directors and Chief Executive Officer requires clearance of the RBI.

Regulatory Norms: Prudential norms, income recognition and asset classification, accounting policies and other policies as prescribed by the regulator have to be scrupulously adhered to by LABs. Further minimum capital adequacy also has to be adhered (8%).

Thus the banking policies as applicable to commercial banks are made applicable to LABs.

Profitability: Given the severe limitations (discussed later) faced by LABs their operations seem to be profitable and have been able to break-even within a short period of establishment.
Established on | Profits March (Rs.lakh) | 2002 | 2014 |
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Coastal Local Area Bank Ltd. | December 27, 1999 | 103.28 | 562.02 |
Capital Local Area Bank Ltd. | January 14, 2000 | 116.32 | 1060.64 |
Krishna Bhima Samrudhi Local Area Bank Ltd. | February 28, 2001 | 15.12 | 403.85 |

“At the outset, it needs to be emphasized that these banks have been in existence only for a short period thus ruling out a definitive pronouncement on their success or failure. LABs have commenced business only recently and more time needs to be given to observe their performance and help given to overcome their weaknesses” (G.Ramachandran, Report of The Review Group on The Working of The Local Area Bank Scheme, 2002)

As can be observed the profitability of these banks have certainly gone up between 2002 and 2014.

Though LABs are being subjected to the rigours of a commercial bank and the regulator maintains a hawkish stance these institutions do not enjoy many of the privileges of a commercial bank.

**Operation and activities:** The area of operation of LABs has been restricted to a maximum of three/four geographically contiguous districts. For eg: Krishna Bhima Samruddhi Local Area Bank operates in 4 districts of Mahabubnagar, Gulbarga, Yadgir and Raichur in Telangana and Karnataka states. They are constricted by their area of operation within the assigned districts.

**Second Schedule status:** The LABs could be included in the Second Schedule of the Reserve Bank of India Act, 1934 subject to the fulfillment of the eligibility criteria laid down in Section 42(6) of the said Act ibid.

The banks included in this schedule list should fulfil two conditions. The paid-up capital and free reserves of the bank is not less than Rs.5 lakh and the activity of the bank does not adversely affect the interests of the depositors.

A Scheduled bank could borrow from the RBI at bank rate and also participate in the payment and settlement system (membership of clearing house).

However, though commercial banks are accorded scheduled status the regulator has not acceded to the request of LABs in this regard.

“Local area banks want the RBI to classify them as scheduled banks so that they can tap deposits from companies and temple trusts. Companies and temple trusts usually place deposits with scheduled banks. This will help diversify the sources of funds and ease the pressure on cost of funds” (Bureau, Local area banks want more leeway to mobilise deposits, 2013)

LABs lend, among others, for agriculture and allied activities, to small-scale industries, agro-industrial units and for trading activities. Lower cost of funds would enable these institutions to reduce the lending rates to the priority sector clientele.

**Refinancing Facility:** “To facilitate the development of the existing LABs into viable commercial units we feel that it will be appropriate to extend them special treatment in certain respects. Access to refinancing facility will be one such avenue. At present LABs are not eligible for drawing refinance from NABARD and SIDBI as they are not scheduled Banks. The absence of refinancing facility places the LABs under a serious handicap in managing maturity mismatch and in their ability to lend at finer rates. We therefore suggest that though an LAB may not be "scheduled," it should not be denied access to refinance for its term lendings from NABARD and SIDBI” (G.Ramachandran, Report of The Review Group on The Working of The Local Area Bank Scheme, 2002)

Recognizing the fact that LABs are permitted to operate in only two or three geographically contiguous districts their ability to mobilize funds would be limited and particularly so since they do not have a scheduled status the committee has rightly recommended refinance facility. However, this has also not been considered by the regulator.

**Committee on Financial Sector Reforms:** “The Local Area Bank Scheme, initiated in August 1996, was set up with the intent of creating new local, private banks with jurisdiction over three contiguous districts that would mobilize rural savings and make them available for investments in the local areas. Only six were approved initially, and four are currently in operation. The LAB scheme was never given a serious try, and this is unfortunate because every proposal for small banks meets the rejoinder ‘the LABs did not work’. This largely inaccurate conclusion stems from over-
interpreting a 2002 RBI internal review group, which examined the operations of the four existing LABs.

The Khan Committee, which examined issues relating to rural credit and microfinance (2005) and the Rangarajan Committee on Financial Inclusion (2008) have supported the revival of the LAB scheme. The latest figures show LABs have profits to assets of about 1.2 per cent, which is about the same as other banks” (Rajan, 2008)

A case for Small Banks: “Experience in Philippines showed that the establishment of small banks has been a critical factor for increasing the provision of financial services to the poor (ADB, 2004). For example, several rural banks in the Philippines that cater to small savers and borrowers were offered incentives in the form of low minimum capital requirements, lower reserve requirement ratio and exemption from various taxes. These incentives enabled these banks to offer higher interest rates on their deposits and lower interest rates on loans and also build-up their capital. By 2004, these banks had a share of over 40 per cent of the total microfinance market in the country”.

“In the UK, the Treasury Committee of the House of Commons noted that localized forms were better able to target financially excluded who tend to have geographic concentrations. New innovations in financial inclusion strategies have often come from credit unions, community banks and non-profit banking institutions (House of Commons, 2006)” (Rajan, 2008)

LABs can involve local leadership in mobilization of local resources for profitable lending in a compact area. It can be an amalgam of local knowledge which cooperatives posses and have a professional management and also using the latest technology for operations.

It is also observed that poor need not necessarily live in rural areas. Concentrations of poor are also found in semi-urban and urban areas. LABs could have a presence in these areas too. Further, LABs with their local feel and local touch would ideally suit the under-served population and further the cause of financial inclusion.

Further, “in its Report on Trend and Progress of Banking in India — 2012-13, the RBI said LABs show promise of small-scale banking institutions that can be experimented with on a larger scale in future. The Reserve Bank’s Discussion Paper ‘Banking Structure in India: The Way Forward’ has recommended the creation of more number of smaller banks in the private sector with the objective of achieving financial inclusion at the local level. Banks, such as LABs, pose less threat to systemic stability given their limited-area operations with little financial interconnectedness” (Bureau N., 2013)

**LABs and Systemic Risks:** LABs are localized institutions and strictly follow the definition of banking as given in Banking Regulation Act, 1949 - ‘accepting deposits for the purpose of lending/investment’. They do not offer exotic derivatives product which was the route cause for the 2008 US economic crisis. As these institutions do not subscribe to such instruments they are unaffected by the contagion. Also from the regulator’s point of view these institutions presence is largely localized and hence would not cause systemic risk. The contagion of the crisis generally spreads through the financial channel – equity markets, money markets, forex markets, and credit markets. To some extent the commodities markets could also contribute to the contagion. LABs hardly have exposure to these channels and hence are unaffected by contagion. Further, they do not contribute to the over-financialisation of the real economy.

**Risks faced by LABs:** Due to several restrictions imposed in their growth and also because of the size and location LABs would face credit concentration risk. LABs have been mandated to lend to agriculture, priority sector and also weaker sections in the rural areas. One way of transferring the risk to institutions which could bear the inherent risk could be larger financial institutions which are away from the geographical area. LABs should be encouraged to securitize their loan portfolio which would not only enable them to transfer the risk but also could improve their cash flow for further financial growth.

**Conclusion:** Commercial banks being regulated mainstream institutions are in an advantageous position to bring about financial inclusion. However, commercial banks have a sub-optimal presence in the country and have challenges in expanding their net work. LABs fill in the regulatory definition of “financial inclusion …… mainstream institutional players’. LABs are mainstream institutional players, licensed and supervised by RBI. They adhere to all the norms stipulated by the regulator. The Committee on Financial Sector Reforms (2008), Trend and Progress of Banking in India 2012-13 (which is a RBI publication) and various other committees are all supportive of the LAB model. The pros in respect of LABs are far too many to reject the model.

There is no discussion by the regulator based on deep analysis about the demerits of LABs. In fact the realities strongly support the LAB model.

Economic growth could be uniform in the economy only if there is financial inclusion. Access to finance can benefit the poor by increasing capital flow to the under-served sections of the economy and increasing efficiency of capital allocation thereby reducing inequality.
Given the geographical restrictions imposed by the regulator LABs are not to be viewed as short term business which would break-even in a short span of time. They are a business model for long-term sustainability and inclusive growth. They also contribute towards financial stability as they do only basic banking and do not indulge in investment banking or trading, thus are not dependent on bulk or wholesale markets for funding.

Countries like Philippines, Indonesia etc have experimented with small banks and have proved to be a great success. Philippines offers incentives in the form of low minimum capital requirements, lower reserve requirement ratio and exemption from various taxes for such institutions.

It would not be right to presume that small institutions would lack corporate governance. History is replete where large institutions have failed investors due the absence of corporate governance. Governance does not depend on the size of the institution.

LABs have all the advantages of being a commercial bank with a local touch and local feel and are best suited to take forward the financial inclusion agenda of the Government and regulator.

Bibliography


