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Differentiated Banking in India: The Road Ahead

Akshay Kumar Mishra
Assistant Professor, Birla Global University, Bhubaneswar

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ABSTRACT

The healthy Banking sector is one the important pillars for the development of every economy in the world. The financial sector can strengthen by improving its participant and product and services to be offered by adopting innovation and new methods. The banking sector has witnessed many phases of development in India. Many intuitions in India has received banking license as payment and small bank to target banking niche from the Reserve Bank of India, recently. The differentiated bank licensing will enable these banks to grab opportunities and untapped markets of the banking sector. This paper will discuss the concept of differentiated banking and prospect from an Indian perspective.

Keywords: Banking Sector, Payment Banks, Differentiated Banking, Financial Inclusion.

1. INTRODUCTION

Post banking sector reforms, commendable progress has been witnessed in the Indian banking industry by the entry of competition and private sector banks, using technology, utilization of resources etc. Banks are permitted to facilitate a range of services under a uniform universal banking model which is used to leverage banks' resources as well as emphasize their operation with synergy. The journey of the banking industry witnessed from class banking in the 19th century to mass banking in the present time, comprises many distinct phases which include social control and the nationalization of banks, followed by banking sector reforms in 1991. The differentiated banking model aims to achieve a new high in terms of banking penetration as well as financial inclusion by providing specialized services. Objectives of socio-economic growth require being acquainted with the process of financial broadening and deepening to widen the financial institutions and financial services. To adhere to a dynamic growth-oriented economy, the banking sector needs to keep pace with various crucial factors such as competition and demand. The banking industry is one of the important channels to foster the growth of any economy. The Reserve Bank of India (RBI) has taken many important measures to spread the banking services and banking habits by the nationalization of banks, liberalizing the guidelines, opening bank branches in unbanked areas etc. Despite this a major chunk of the population is unbanked as per the census report 2011 and RBI is very much clear that financial inclusion is a massive requirement and the financial institution has to pursue consistent efforts in this direction. The concept of differentiated banking was first discussed in 2007 and then in the paper "Banking structure in India- The way forward" brought out by RBI in 2013. This is complemented by setting up a committee on 'Comprehensive Financial Services for Small Business and Low–Income Households headed by 'Shri Nachiket Mor' and came up with two broad designs for the banking structure based on functional building blocks of payments, deposits and credit. These are the horizontally differentiated banking system (HDBS) and vertically differentiated banking system (VDBS) (Gandhi, 2015). Differentiated banking refers to the banking model which facilitates products and services in select verticals for example payment services and project financing etc. Under this banking model, the product and services are offered as specialized banks such as retail banks, wholesale banks, infrastructure banks, payment banks etc. Differentiated banking aims to encourage niche banking by offering specialized service which can focus on specific customer segment and thus improves the effective use of its resources.

In differentiated banking, the differentiation might be taken place in the form of capital conditions, area of operations and core competencies and services to be offered. One of the most important benefits of differentiated banking licensing is in terms of capital requirements and core competency as compared to full-fledged banks which need more capital and operational competency for various products and services.

2. LITERATURE REVIEW

This concept is not new as differentiated banking licensing practices exist in developed countries like Singapore, London and Hong Kong (The Economic Times, 2007). In India, RRBs and Local area banks have not achieved their objectives for differentiated banking licenses issued by the authority and thus larger banks are asked to go for rapid financial inclusion (Jain, 2014). Banking in India should meet the new challenges of technological change along with other external and internal factors (Manikyam, 2014). Payment Banks and Small Banks are niches or differentiated banks with the common objective of furthering financial inclusion, and the impetus to license niche banks arises out of the need to spread such inclusion in the country (The Hindu, 2014).

3. FUTURE PROSPECT

Due to the lack of financial literacy, and awareness, the substantial weaker section of the society doesn't have access to the formal financial sector and has to be dependent on the informal financial sector, thus the existing system needs to be redesigned to meet the requirement (Chauhan, 2014). The government has put forward various measures to improve financial inclusion in the country. Although the penetration of banking services in India is low, less than 59% of the adult population has access to a bank account and less than 14% to a loan account (Jain, 2014). The differentiated banking model can unlock many diversified opportunities along with the targeting unbanked population who do not possess access to the formal financial sector. Recently, RBI has given licenses to payment banks and small banks which can expand their reach to rural and semi-urban areas. 'India Post' received a license from the authority as a payment bank which has the most widely distributed postal network in the world with 154882 offices as of 31.03.2014 (www.indiapost.gov.in). Thus 'India Post' has the opportunity to leverage its vast network to expand its reach to unbanked and rural areas as per the objective.

Though a single banking license was issued for both domestic and foreign banks, having full access to payment and settlement systems the introduction of differentiated bank licensing the newer dimension would emerge (Jain, 2014). Some of the merits and challenges of differentiated banking models are shown in the following table.

Table 1. Merits and Challenges of Differentiated Banking

Merits	Challenges
flexibility to serve diverse opportunities	Impact on Priority sector lending
Focus on specialized core competency	Difficulty to cross-subsidize the product
Gaps can be filled in different niche segments	Risk due to focus on a particular segment
Helpful to furthering financial inclusion	Safety of interest of depositors
Improve savings and thus supply of credit	Liquidity risk
Can operate across India	Limited avenues for income generation

Indian experience shows that the small banks with geographical limitations play an important role in the supply of credit to agriculture and small enterprise. Risk management, capital requirements, exposure norms and governance etc. have been the key challenges for these banks. Furthermore, the sectoral focused institution also plays a significant role, where the ability to manage funding and concentration risk would be the key to their success (CAFRAL, 2014). With these opportunities and challenge the differentiated banking model will help to achieve the objective of financial inclusion as well as banking habits. Furthermore, the payment bank and small bank licensed under this banking structure could emerge with a new dimension by utilizing their resource and expertise.

4. CONCLUSION

The RBI's concern over financial inclusion and development of rural and unbanked masses could achieve a new high with licensing payment and small banks under a differentiated banking model. The banks under this approach will be able to reduce misuse of their funds as well as new differentiated banks will grab diverse opportunities and untapped markets. The differentiated bank will differentiate from other banks for example the payment banks will be looking for payment but not for credit. For the development of the financial sector as well as the economy the depth can be increased by increasing the number of participants and services in the financial sector. This can be achieved with innovation at both the front of participants and products and services to be offered. This mechanism is inevitable and significant for development. It will emerge as a great challenge for the regulators and participants in terms of supervising and risk management.

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