The fallacy of using outcome based intervention as a yardstick for rule based regulatory intervention in Regional Rural Banks

Key Issues & Recommendations

01-April-2022

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Backdrop

- Combining the reach, familiarity and rural orientation of credit co-operatives and professionalism of commercial banks, regional rural banks (RRBs) are geared to developing the rural economy by providing for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs

- From a modest beginning of 6 RRBs with 17 branches covering 12 districts in December 1975, the number increased to 196 RRBs in 1987 and remained at the same level till 2005

- In FY1995, the Government initiated large-scale reforms that coupled with capital infusion, helped them turn profitable. However, in FY2005, 42% of the RRBs still carried legacy losses. In order to improve their operational viability and to take advantage of economies of scale, the Government initiated a further consolidation programme in FY2006

- As a result, the number of RRBs declined from 196 in 2005 to 43 in FY2021, sponsored by 12 Scheduled Commercial Banks with 21,856 branches catering to 28.3 crore depositors and 2.6 crore borrowers in 26 States and 3 UTs

- Amalgamation drives in RRBs have helped boost their profitability and improved their asset quality while strengthening their capital base. However, RRBs' financial vulnerability remains a significant area of concern due to multiple issues confronting them

Regulation of Regional Rural Banks

- Currently, the Regional Rural Banks are regulated by RBI and supervised by Board of Supervision, NABARD
- Regulation are either rule based or outcome based
  - In a rule based regulatory framework, the regulator sets rules that needs to be adhered to by regulated entities.The rules in themselves aim to "force" a specific outcome
  - In an outcome based regulatory framework, there is a clear move away from adherence to prescriptive rules to high level outcomes that need to be achieved. An outcome-based regulation eliminates one size fits all approach to regulation and enables entities to have a more focused approach
- The RRBs however are subjected to a hybrid regulation: a combination of using specific outcomes to mandate rule-based regulations. This may have queered the pitch for RRBs in terms of performance indicators
- We believe it might thus be better to clearly separate the outcome-based regulation from rule-based regulation
- We also believe that there is a need to have uniformity in regulations across RRBs, Co-operative Banks and even PSBs. Several regulations for RRBs need to keep abreast with changing times and need to be updated
- The RRBs were envisaged with a low-cost structure to make credit available to rural populace at affordable rates. However, a series of interventions like pensions have made the cost structure much higher, making it imperative for RRBs to use and leverage technology to compete with Small Finance Banks, Fintechs and Micro Finance Institutions
- The RRBs also need to partner effectively with state governments to strive for the continued improvement in credit culture and thereby need to adapt to the fast-changing economic landscape and reorient their business model accordingly

Current Financial Health of RRBs shows signs of improvement, reaffirming that the Indian Banking sector outlook looks adequately capitalized, stable and resilient post-pandemic

- Catalysed by capital infusion and bolstered by robust growth in borrowings (24.8%) and deposits (9.7%) on the liabilities side, the balance sheet of RRBs witnessed a healthy growth of 10.8% during FY21 and stood at Rs 6.52 lakh

- After two consecutive years of losses in FY19 & FY20, RRBs, as a whole, reported a consolidated net profit of Rs 1,682 crore during FY21. Even as 30 of the 43 RRBs posted net profit, 17 RRBs carried accumulated losses of Rs 8,264 crore as at end-Mar'21

- Consolidated GNPA of RRBs has declined during FY21 (10.4% to 9.4%). The Net NPA has declined in both absolute and percentage terms during FY21 (5.8% to 4.8%). The PCR has shown a continuous improvement over the previous 3 years and was 51% as on 31 March 2021

- It may be however noted that as per RRB (Employees) Pension scheme 2018, RRBs were required to provide for their pension liability as on March 2019. To offset the significant impact of such a provision, RBI permitted the RRBs to amortise their pension liability over a period of 5 years, beginning FY19 to be provided for fully by FY23. This has impacted the profitability of the RRBs significantly during these years

Financial Health Indicators

	Amount (Rs crore)		YoY growth (%)	
	FY20	FY21	FY20	FY21
Deposits	4,78,737	5,25,226	10.2	9.7
Borrowings	54,393	67,864	1.6	24.8
Investments	2,50,859	2,75,658	10.9	9.9
Loans and Advances (net)	2,80,220	3,15,181	7.0	12.5
Income	49,452	53,858	15.0	8.9
Interest income	43,698	46,803	12.2	7.1
Other income	5,754	7,055	41.8	22.6
Expenditure	51,660	52,176	18.4	1.4
Interest expended	25,985	25,588	9.6	-1.5
Provisions & contingencies	5,599	6,819	-8.5	21.8
Operating expenses	20,076	19,768	45.4	-1.5
Wage bill	14,654	15,101	56.2	3.0
Net profit/Loss	-2,208	1,682	-	
Gross NPA	31,106	31,381		
Net NPA	16,331	15,094		
CRAR (%)	10.3	10.2		
GNPA (%)	10.4	9.4		
Net NPA (%)	5.8	4.8		
Provision Coverage Ratio (%)	47.0	51.0		
Net Interest Margin (%)	3.2	3.4		
Return on Assets (%)	-0.4	0.3		
Cost to Income Ratio (%)	86	70		

Source: SBI Research

Regulatory dispensation for RRBs should be at par with Other Banks

Regulatory Interface that could be synchronised for RRBs	PSBs	Co-operative banks	RRBs
Covered under CRILC	YES	YES	NO
Graduate into SFBs	-	YES	NO
Internet Banking Transaction Rights	YES	YES	YES (but strictly outcome based)
Investment opportunities in mutual funds	YES	YES (higher limit restriction)	YES (lower limit restriction)
Subscription to PDIs issued by other banks	YES	YES (with restriction)	NO
Norms for registration for participating in Government guaranteed schemes for MSME and Mudra units	YES	YES	YES (but strictly outcome based)
Raising Capital through Market	YES	YES	IPO policy yet to be notified
EASE reforms	YES	NO	NO

RBI regulations for RRBs
Separating outcome based and rule based regulation

Internet Banking Transaction Rights are given to RRBs ex-post and not ex-ante : Business Outcomes of RRBs are used to frame Internet Banking Regulations

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- Internet banking has become one of the basic banking requirements for banks' customers in today's digital age and without this, banks face a real challenge in acquiring and retaining customers

- Additionally, RRBs are facing intense competition from multiple fronts including rapidly expanding Fintech companies and SFBs, and hence need all the wherewithal to face it. RRBs are mandated to fulfil a number of conditions such as CRAR, NPA, Profitability etc. for providing transaction rights to their INB customers

- Against this background, RRBs are surprisingly granted Internet Banking Rights purely based on maintaining minimum statutory CRAR at > 10% (out of 43 RRBs, 20 have CRAR of less than 10.0%) and NPA at <7% (25 RRBs have GNPA more than 7.0%)

- In this regard, it will be useful if outcome based regulation is separated from rule based regulation and Internet Banking Transaction Rights are purely made ex-ante and not ex-post for the RRBs

Current Norms for Internet Banking Transaction Rights	
1. CRAR	Not less than 10%
2. Networth	Rs 100 crore or more
3. Gross NPAs	Less than 7%
4. Net NPAs	Not more than 3%
5. Net profit	A net profit in the immediate preceding financial year; & At least in 3 out of the preceding 4 financial years
6. CRR/SLR	Should not have defaulted in maintenance of CRR/SLR during the immediate preceding financial year
Source: RBI; SBI Research	

Current Status of RRBs (FY21)		
Norms		# of RRBs (out of 43)
CRAR (Average: 10.2%)	Less than 10%	20
	More than 10%	23
Gross NPAs (Average: 9.4%)	Less than 7%	18
	More than 7%	25
Net Profit in FY21		30
RRBs with Accrued Losses		17
Source: SBI Research		

RRBs might be incentivised to graduate into Small Finance Banks (SFB) like UCBs were allowed in 2018: This will create a level playing field across RRBs, UCBs & SFB

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- In keeping with the fast paced changes in the banking space and to facilitate growth, a scheme for voluntary transition of Urban Co-operative Banks (UCBs) into Small Finance Bank (SFB) was introduced in Sep'18. RRBs may also be permitted to graduate into SFB in line with Cooperative banks or granted on-tap license to RRBs to become SFBs

- India's largest RRB in terms of size of business - Baroda U.P. Bank (Rs 72,015 crore) is bigger than the largest SFB (AU SMALL FINANCE BANK LIMITED) which has business (deposits + advances) size of Rs 70,588 crore as of Mar'21

Top 5 RRBs and SFBs as per Business size (Rs crore)			
RRB	Business Size	SFB	Business Size
BARODA U.P. BANK	72015	AU SFB Ltd.	70588
KARNATAKA GB	54856	EQUITAS SFB Ltd.	33240
ARYAVART BANK	48649	UJJIVAN SFB Ltd.	27630
ANDHRA PRADESH GVB	43999	JANA SFB Ltd.	23998
KERALA GB	38607	ESAF SFB Ltd.	17167
Source: SBI Research			

Reforms related to BCs may be rationalized for better financial inclusion: Aadhar enabled biometrics should overwrite traditional biometrics

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- Regional rural banks (RRBs) through their local and regional presence usher in greater financial inclusion. RRBs showed a positive growth in number of BCs during the last five-year period. Of the total ~10 lakh BCs, RRBs have share of ~10%. The time has come to rationalise the BC commission charges (in some cases need to increase while in some cases need to reduce). Focus should be on promoting SB account opening through e-KYC, with improved remuneration

- We also believe that CSPs at Urban/Metro centres have to incur higher cost in respect to rentals and other infrastructure. Hence, a separate commission structure may be introduced for CSPs at these locations

- Also, switching of CSP transactions from Kiosk based to android based Micro ATM will not only increase mobility but will reduce operational cost also

- One of the major reforms required at the BC level is the full migration to e-KYC account opening, with Aadhaar enabled biometrics completely replacing the local biometric which is still used by a number of BC's and is prone to frauds

RRBs BC Commission Structure

	Existing	Proposed	
		Rural/Semi Urban	Urban / Metro
SB account Opening	Rs 15-20 per a/c	Rs 15-20 per a/c	Rs 15-25 per a/c
Cash Deposit	Rs 2-12	Rs 2-12	Rs 2-15
Cash Withdrawal	Rs 3-20	Rs 3-20	Rs 3-25
IMPS (Transfer)	Rs 5-50	Rs 5-50	Rs 5-60
Opening of STDR	Max. Rs 50	Max. Rs 50	Max. Rs 60
Opening of RD	Rs 15 per a/c	Rs 10 per a/c	Rs 10 per a/c

Source: SBI Research

Business and Investment rules of RRBs set two and a half decade back, need to be aligned in accordance with best practices and in sync with Cooperative Banks and even PSBs

- The exposure norms of up to 5% of incremental deposit for investment in Mutual Funds under non SLR-securities was set way back in FY97 and has not been revised since. The same may be re-looked into by RBI and relaxed beyond 5%. It is pertinent to mention here that the applicable limit even for Co-operative bank is at 10%

- In Dec'19, Urban Co-operative Banks with assets size of Rs 500 crore were brought under the framework of Central Repository of Information on large Credits (CRILC). RRBs are having assets of Rs 3,34,171 crore as on 31.03.2021 but are strangely not covered under the fold of CRILC. With a view to strengthening offsite supervision, early recognition of financial distress in large accounts, RRBs may be brought under the fold of CRILC

- In Nov'19, with a view to provide additional options for augmenting regulatory capital funds to maintain CRAR, RRBs were allowed to issue Perpetual Debt Instruments (PDIs) eligible for inclusion as Tier 1 capital. But RRBs were not allowed to invest in PDIs of other banks including RRBs. For facilitating synergies and cross subsidization, RRBs may be allowed to subscribe to the PDIs issued by other RRBs

- The account opening bank pays an interchange fee to the operator of the BC/CSP when a customer makes a transaction at micro-ATM that does not belong to the account opening bank (i.e. OFF-US transaction). We recommend a rationalisation in interchange fee as is the custom across PSBs & PVBs as there is currently no level playing field in infrastructure provided by all banks

Government Regulations for RRBs
Creating a level playing field and separating Outcome Based from Rule Based Regulation

Using Outcomes ex-post for recommending registration for CGFMU and CGTMSE

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- RRBs are allowed to register for CGFMU ex-post purely based on maintaining minimum statutory CRAR at > 9% (out of 43 RRBs, 16 have CRAR of less than 9%) and NPA at <10% (33 RRBs have GNPA less than 10%)
- RRBs are allowed to register for CGTMSE ex post purely based on maintaining minimum statutory CRAR at > 9% (out of 43 RRBs, 16 have CRAR of less than 9%) and NPA at <5% (27 RRBs have GNPA less than 5%)
- In this regard, it will be useful if outcome based regulation is separated from rule based regulation and business opportunities are purely made ex-ante and not ex-post for the RRBs. This will enable RRBs to strive for better business penetration and diversify its portfolio

Current Norms for CGFMU Registration	
1. CRAR	Above 9%
2. Networth	Above Rs 50 crore
3. Net NPAs	Equal or less than 10%
4. Net profit	A net profit in the preceding two years
Source: SBI Research	

Current Norms for CGTMSE Registration	
1. CRAR	Above 9%
2. Networth	Positive
3. Net NPAs	Equal or less than 5%
4. Profit	No accumulated loss
5. Regulatory Default	None
Source: SBI Research	

Current Status for CGFMU Registration		
Norms		# of RRBs (out of 43)
CRAR (Average: 10.2%)	Less than 9%	16
	More than 9%	27
Net NPAs (Average: 9.4%)	Less than 10%	33
	More than 10%	10
Net Profit in FY20, FY21		24
Source: SBI Research		

Current Status for CGTMSE Registration		
Norms		# of RRBs (out of 43)
CRAR (Average: 10.2%)	Less than 9%	16
	More than 9%	27
Net NPAs (Average: 9.4%)	Less than 5%	27
	More than 5%	16
No accumulated loss		26
Source: SBI Research		

Government Regulations also need to create a level playing field : routing pension payments through RRBs, opening of PPF accounts & freedom to tap the market, EASE & HR reforms

- Most of the newly opened account holders for RRBs are for Direct Benefit Transfer (DBT) payments with minimal business potential, but it results in huge costs of cash and eat up human resources. Adequate remuneration for RRBs may be allowed for Government Sponsored business (PM Kisan, DBT, etc.)

- Additionally, pension payment should be allowed through RRBs. Also RRBs should be allowed to operate PPF, Sukanya Samriddhi accounts and other Government Businesses to give a boost to their non-interest income

- Amendment was made in RRB Act in FY16 for change in shareholding of RRBs for raising of capital from market. Further in 2019, 3-4 RRBs were identified for IPOs, but IPO policy is yet to be notified. IPO policy for RRBs may be notified for raising capital from market

- EASE (Enhanced Access and Service Excellence) is a common reforms agenda for Public Sector Banks (PSBs). Similar type of reform agenda may be initiated for RRBs to improve their performance and ensure financial stability, improved HR practices, and commercially prudent business practices

- Categorisation of RRBs, staffing norms all need to be relooked amidst changing conditions. The existing norms given by the Mitra Committee recommendations need to be revisited as situation has changed since the committee was formed in 2012 and norms implemented in 2015. Furthermore, lateral recruitment for specialist officers has been permitted in areas like IT, Agri, Treasury, etc. However, promotion policy/norms for these specialist officers has not been specified

- Active Participation of Government nominee in Board Meetings will strengthen the effectiveness of RRB Boards

Refinancing from NABARD needs to be rationalised

Refinance from NABARD at cheaper rates

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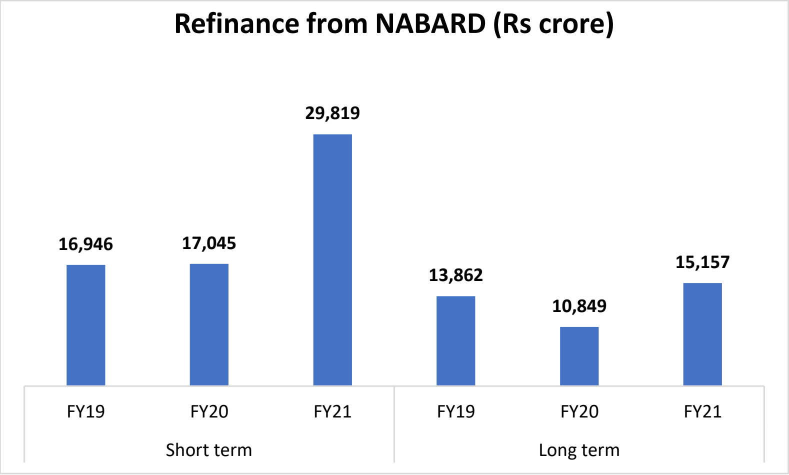
- RRB's financial fragility has suddenly increased due to the introduction of pension regulations at par with other nationalized banks in 2018. Some of the RRBs have availed refinance from NABARD at a high rate with additional prepayment penalty/ charges

- It is pertinent to mention that these refinances were availed for on-lending purpose to create assets in their books by giving more loans and expanding credits to rural areas. The refinance (short + long term) from NABARD has increased from Rs 27,894 crore in FY20 to Rs 44,976 crore in FY21, an increase of 61.2%

- As a result of these high-cost funds, the financial performance of a few RRBs are getting impacted adversely. In this regard, refinance to RRBs may be rationalised at reasonable rates and prepayment should be allowed in case of old loans, wherein the refinance rate is higher, without penalty

Interest charged by NABARD in case of RRBs (%)	
Short Term refinance assistance:	
for financing crop loans	4.50
finance to PACS towards crop loans	4.50
Conversion of Short Term- crop loans into Medium Term loans	8.10
Long Term refinance assistance	
Refinance for 5 years and above	6.40
Refinance for 3 years to less than 5 years	6.00
Refinance for 18 months to less than 3 years	5.50
Source: NABARD (15 Jul'21); SBI Research	



Reforms RRBs need to implement

RRBs need to clearly align business opportunities….Should look beyond KCC

- Of the total demand amount of Rs 2.2 lakh crore as of Jun'20, RRBs have been able to collect only Rs 1.7 lakh crore only. Hence the overall recovery rate for bad assets is 77% (for some RRBs this is less than 65% while for a few this is more than 90% also). We believe that a robust collection mechanism should be put in place to increase the recovery rate of RRBs
- RRBs agriculture outstanding is Rs 2.3 lakh crore as of Mar'21, of which 99.3% of lending went to farm credit only. This indicates RRBs inability or reluctance to lend beyond the farm credit. The share of agriculture infrastructure lending is only 0.3% of total agriculture lending
- RRBs should thus focus more on allied activities in order to diversify their lending portfolio. **RRBs should explore tie-up with Govt. owned Agri/ Allied Agri activities (like dairy etc) and Agri-based fintech Companies. Explore SHG/JLG linkages, where NPA in the portfolio is low**
- This will help RRBs to minimize their Gross NPAs also. Currently agriculture GNPA rate is 8.3%

- RRBs have housing portfolio of worth Rs 21,127 crore as of Mar'21. Its share is only 6% and yearly growth was 7%. The GNPAs in housing is 7.0% as against overall NPA rate of 9.4%. Given the Government's focus on rural housing, RRBs can play a major role in this direction
- RRBs need to have a clearly defined risk appetite in areas of credit, market and operational risk

Agriculture Outstanding Advances by RRBs

Mar-21	Rs crore	Share %
Agriculture, *of which*	233145	100%
Farm Credit, *of which*	231438	99.3%
Short Term Agri Loans	172392	73.9%
Investment Credit	18568	8.0%
Allied Activities	24339	10.4%
Other Agri. Loan	16139	6.9%
Agriculture Infrastructure	607	0.3%
Ancillary Activities	1099	0.5%

Source: SBI Research

Apart from Technology grants/ Interest free IT loans to RRBs, they need to refurbish IT Infrastructure through CRM, Call Centres and Passbook Printing infrastructure

- IT footprint in the RRB is generally poor and is limited to only basic services, which needs additional support
- RRBs may be funded to implement and leverage IT to compete with SFBs. Technology grants/ Interest free loans may be provided to RRBs to develop IT infrastructure
- While all the RRBs have CBS, RTGS/NEFT facilities but only 37 have mobile banking licence. Only 19 RRBs have internet banking facility
- RRBs need to have a separate application dedicated to customer relationship management (CRM). CRM is an effective policy tool to provide a detailed insight into customer needs based on Analysis of Customer preferences. The primary goal of CRM systems is to integrate and automate sales, marketing and customer support
- Setting up a customer service call centre can help RRBs not only in terms of resolving customer issues but also in promoting other products and services. Furthermore, outsourcing also ensures continuity with the level of service and can reduce the burden on the branches who then can focus on more efficient propositions
- Adoption of Debit card (Rupay card) and Aadhaar enabled Payment System (AePS) should be increased
- CSPs should be provided with the infrastructure required for printing of passbooks by the respective sponsor banks. This will lower the burden on the RRBs as passbook printing takes a lot of time and resources of the RRBs that could be utilised better

Status of Technology in RRBs (Jun'21)

Parameters	Number of RRBs	
	YES	NO
CBS	43	0
RTGS/NEFT	43	0
Mobile Banking license	37	6
Internet Banking*	19	24
Merchant acquirer permission	2	41
Completed POS certification	34	9
Live on e-commerce	38	5
On-boarded to PFMS	43	0

Source: SBI Research; * Mar'21

thank you

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We would like to acknowledge the inputs from:

Shri Mihir Narayan Prasad Mishra, CGM (A&S), SBI

Shri Rajeev Kumar Verma, AGM (RRB), SBI

Ms Neelakshi Singh, AGM (RRB), SBI