

EVOLUTION AND ROLE OF THE DIFFERENTIATED BANKING SECTOR IN INDIA

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Abstract

From the turn of the last century, differentiated banks have been a longstanding and persistent, even if not systemically important, part of the Indian banking system. These banks have been instrumental in financing rural credit needs, agriculture, particularly small farmers and small enterprises, although their growth has not been regionally balanced. The paper finds that the presence of differentiated banks augurs well for financial intermediation and inclusion. However, these banks are on a weaker footing than universal banks in terms of financial viability owing to the operating cost inefficiencies and weaker asset quality. Going forward, consolidation and harmonisation of regulatory framework needed to continue to make differentiated banks well-governed and financially sound, particularly given their deep and focused customer interface. Furthermore, the revival and expansion of these banks, particularly in regions where they have a weak presence, need to be supported in the interest of India's endeavour to financial inclusion.

Keywords: *Differentiated banks, universal banks, financial inclusion, financial viability, credit co-operatives.*

Introduction

Notwithstanding the worldwide innovations in decentralised finance, financial intermediaries,

particularly banks, continue to be the backbone of financial systems in most economies. Even in advanced economies, where market-based sources of financing predominate, bank-based financial intermediation remains relevant for supporting economic growth and inclusion of excluded sections. The bank-based view of financial system is premised on banks (a) enjoying economies of scale in information collection and processing; and (b) reducing information asymmetry and moral hazard embedded in financial relations, through effective monitoring and long-run relationships with their clientele (Boot and Thakore, 1997).

Universal banks are typically banks, which combine the two basic models of banking viz., commercial and investment banking. They offer a wide array of financial services, including lending, deposit-taking, underwriting, brokerage, trading and portfolio management. The experiments with universal banks have varied across countries depending on countries' economic history, banking structures and financial requirements.¹

Like universal banks, there have been varied experiments with differentiated banks – banks involved in financial intermediation focusing on either a sector/region or a specific banking activity (RBI, 2014). Yet, unlike universal banks, the references to differentiated banks are few and far between in the literature. They are also less studied than non-banks

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¹ For instance, Germany's post-war industrialisation greatly benefited from large universal banks, while the US for a major part of the 20th century separated commercial and investment banking through the Glass-Steagall Act of 1933 as a fallout of the Great Depression, until it was repealed in 1999.

or shadow banks. The limited interest in differentiated banks could be due to their niche areas of operation and low systemic importance. However, they play an undeniable role in financial intermediation and inclusion at the ground level. Even if not systemically important, their financial viability is critical given their customer interface.

India offers an interesting case of differentiated banks given (a) its history of co-operative banks since the early 20th century and (b) the subsequent, repeated experiments with newer differentiated banks. Notwithstanding the long history, the term “differentiated banks” has gained currency only in the 21st century (Gandhi, 2015). The paper traces the evolution of differentiated banks in India to answer the following research questions:

- What is the size and role of differentiated banks in banking systems globally and in India?
- How does the presence of differentiated banks in India bode for financial inclusion and viability of the Indian banking system?

The paper is divided into five sections. Section II discusses the evolution of differentiated banks globally. Section III provides an assessment of the Indian experiment. Section IV analyses how far the presence of these banks supports financial inclusion by and financial viability of the Indian banking system. Section V provides the concluding observations.

II. Differentiated Banks – Concept and a Review of Global Evolution

Concept

Based on their areas of operation, differentiated banks can be divided into two categories: (a) horizontally differentiated – these are full-service banks providing all three basic banking services of deposits, payments and credit but focusing on a specific region, size of borrowers or economic sector; and (b) vertically

differentiated - these are not full-service banks but specialise in some of the basic services, noted earlier (RBI, 2014). Differentiated banks can be constituted with a restricted mandate as per statute or licensing policy. They can also acquire a differentiated focus in a *de facto* manner even if they are not restricted from catering to other regions/sectors or banking activities by statute or licensing policy. They can assume different legal forms, such as joint stock companies or mutual-help co-operatives.

Although easy to conceptualise, the real-world identification of a bank as a differentiated bank can be difficult, as any banking institution that is not a universal bank may not necessarily be differentiated. Hence, we employ the following parameters to identify differentiated banks:

Banking institutions: Engaged in financial intermediation of deposits on the liabilities side into credit creation on the assets side and thereby, helping in maturity transformation. Hence, investment banks and development financial institutions that do not mobilise deposits/extend credit but rely on capital markets for raising/investing funds are not included in our definition.

Regulated banking institutions: Thus, semi-regulated or unregulated financial institutions, such as Microfinance Institutions (MFIs), non-Governmental or trust-based financial institutions are not included.

Niche regulated banking institutions: Niche nature of financial intermediation irrespective of (public/private) ownership and (joint stock/co-operative) legal form.

In the Indian context, the differentiated banking sector includes rural co-operative banks (State and district co-operative banks), Urban Co-operative Banks (UCBs), Regional Rural Banks (RRBs) and Small Finance Banks (SFBs) following the above-mentioned parameters.² All these are horizontally differentiated banks, which incidentally form the bulk

² Local Area Banks (LABs) are not assessed separately in the paper given their miniscule share in the differentiated banking sector, see III.1 for details.

of differentiated banking sector globally, as illustrated later.³ In comparison, the universal banks in India include public sector and private sector (domestic and foreign) banks given the single class of banking licence issued by the Reserve Bank of India (RBI) for all types of banking business to these banks.

Global Evolution

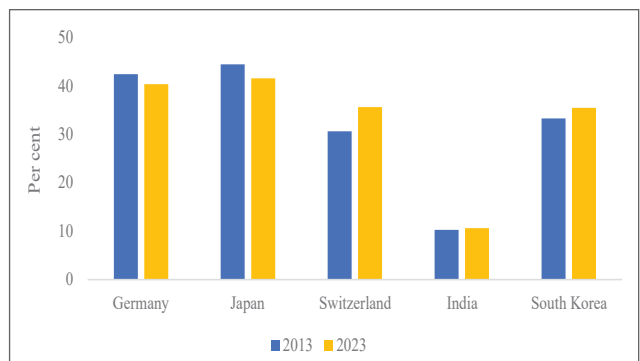
Globally, there have been several experiments with differentiated banks, as per our definition. Following are the major observations from a review of these experiments:

- **Prominent presence in developed economies:** While differentiated banks dot the banking systems in most economies, their presence is more prominent and longer in developed economies of Germany and Japan, where these banks have played an important role in post-war economic reconstruction (Figure 1).
- **A mix of co-operative and joint stock banks:** The differentiated banking sector in developed and developing economies is marked by a mix of co-operative and joint stock banks, with the former predating the latter. Co-operative banks originated in the 19th century Europe following the Industrial Revolution, later expanding to other continents.⁴

Although commercial banks, instituted as joint stock companies, existed even before co-operatives, they were not necessarily differentiated in nature. With capitalism and global trade, differentiated banks lending to specific sectors and regions have been on the rise.⁵

- **Predominance of public banks:** For addressing credit gaps in certain sectors/regions, the Governments in many countries have taken the lead in developing differentiated banks.⁶ Since 1980, there has been a growing trend towards privatisation of the banking sectors in many economies (Kikeri et al., 1992). However, barring sporadic experiments with privately-owned differentiated banks like Small Finance Banks (SFBs) in India, differentiated banks have been predominantly public.
- **Aimed at financial intermediation and inclusion:** These banks have been created primarily for serving the underserved regions/sectors.⁷ Alongside traditional differentiated banks, newer variants have emerged in the 21st century, leveraging on digitalisation.⁸ As these new-generation differentiated banks are in a nascent stage in many economies, their long-term sustainability is yet to be tested.

Figure 1: Share of Differentiated Banks in Total Banking Assets, Select Countries



Source: CEIC database.

Note: Data for Switzerland relate to 2022. For India, differentiated banks include small finance banks, regional rural banks, urban co-operative banks, rural co-operative banks (State and district co-operative banks). Payment Banks and Local Area Banks are excluded given their marginal share but included as part of total banking assets. See Appendix 1 for details on differentiated banks for other countries.

³The examples of vertically differentiated banks are few, such as the South Korean post office bank and payments banks in India, which engage only in deposits/payments. ⁴To illustrate, credit cooperatives were founded in Germany during 1850s which operated in rural areas (as Raiffeisen cooperatives) and urban areas (as Volksbanken) (Ayadi et al 2010). ⁵For instance, Switzerland has seen the growth of regional and savings banks organised as joint-stock companies since the last century. ⁶For instance, in Germany, the Landesbanken (first tier) and savings banks/Sparkassen (second tier) were developed as public banks (Brunner et al 2004). ⁷For instance, German Sparkassen were established for providing tailored finance to low-income communities (Brunner et al 2004). Differentiated banks in France and Italy finance agriculture and local community development (Ayadi et al 2010). The US has geography and sector-specific differentiated banks. Community banks are banks with less than \$10 billion in assets, catering to local communities (FDIC 2020). ⁸These include neobanks and challenger banks providing retail financial services through mobile and online platforms (Zachariadis and Ozcan 2017).

III. India's Experiment with Differentiated Banks – Features and Trends

III.1 Features

a. A long account

India's tryst with differentiated banks has been a long one, going back to credit co-operatives created in 1904 to empower the socio-economically marginalised sections. Although organised originally as societies, with the formation of a three-tier structure, co-operative *banks* became a part of the second and apex tiers of the co-operative system.

Since 1904, there has been a distinction between “rural” and “urban” co-operative societies.⁹ Over time, some of the urban societies have evolved into State or district co-operative banks, others have started functioning as Urban Co-operative Banks (UCBs).¹⁰ The major area of focus of State and district co-operative banks (rural co-operative banks) has been agriculture and rural enterprises, while UCBs have focused on small and medium enterprises and lower- and middle-income groups in urban and semi-urban areas.¹¹ It is the acquired regional and sectoral focus of rural and urban co-operative banks that has made them differentiated. Together, they accounted for two-thirds of India's differentiated banking sector in 2024 (Figure 2).

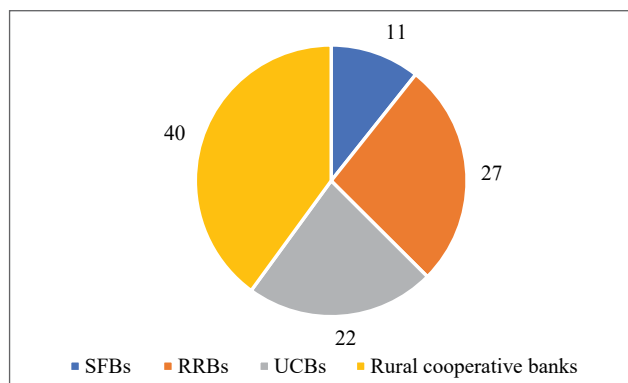
Regional Rural Banks (RRBs) were created in 1975 to support agricultural finance and rural development alongside co-operatives and commercial banks (following their nationalisation) (GoI, 1976). RRBs were differentiated as their area of operation was limited to rural areas and lent mainly to small farmers. Also, as they were constituted with capital support from respective State Governments, there has been a state-specific focus to their evolution and operations, as illustrated later.

Another addition to the differentiated banking sector was of Local Area Banks (LABs) in 1996 for decentralised banking development. Their operations were geographically restricted, targeting rural and semi-urban regions involving three contiguous districts. However, following the recommendations of RBI (2002), no new licenses have been issued to LABs in the subsequent period.¹²

More recently, there has been a renewed interest in differentiated banks with the creation of SFBs and payments banks. The former are horizontally differentiated and the latter vertically differentiated, as noted earlier. Both are guided by the mandate of serving rural and underserved areas (RBI, 2014). Unlike co-operatives, RRBs or LABs, the SFBs are not regionally restricted; their presence can be pan-India. However, they are guided by a size-based mandate, giving them a differentiated character.¹³

With digitalisation, Neobanks have made inroads into India but unlike other countries, they are not licensed as banks. They operate in partnership with regulated institutions, including banks (PWC, 2021).

Figure 2: India's Differentiated Banking Sector, 2024



Source: Statistical Tables Relating to Banks in India (STRBI); and Report on Trend and Progress of Banking in India (RTP). Note: LABs are excluded due to their miniscule size; they accounted for 0.05 per cent of the differentiated banking sector in 2024.

⁹The former catered to agriculturists and latter to artisans and persons of “limited means” (with four-fifth members as non-agriculturists). ¹⁰ For instance, the first urban society in Bombay started functioning as the apex provincial bank in 1924, which later became the Maharashtra State Co-operative Bank. ¹¹ State and district co-operative banks form a part of the short-term cooperative credit structure. There is also a long-term co-operative credit structure, including State and primary agricultural and rural development banks (SCARDBs and PCARDBs). However, these institutions are not registered as banks; see Appendix 2 for an illustration of the present-day co-operative system in India and its portion identified as differentiated banks. Also see https://rbi.org.in/Commonman/English/History/Scripts/Fun_urban.aspx ¹² See Sriram (2015) who noted that geographical restrictions and portfolio risk contributed to limited growth of LABs. Out of four functioning LABs established since 1996, Capital Local Area Bank converted to a small finance bank in 2016 and the licence of Subhadra Local Area Bank was cancelled in 2020. At present, there are two LABs based in Andhra Pradesh and Telangana. ¹³ At least 50 per cent of their loan portfolio should constitute of loans of up to ₹ 25 lakh.

b. A dominant presence of Government-owned or supported banks

Among differentiated banks, rural co-operative banks have been all through supported by State Governments and occasionally recapitalised by the Central Government. Every State has its own legislation for co-operatives, as cooperation is a State subject and most States follow a three-tiered structure of rural co-operatives, with primary co-operative societies being the major shareholders in district co-operative banks and the district banks being major shareholders in their respective State co-operative banks.¹⁴ Apart from its members, however, respective State Governments also contribute to the capital of both State and district co-operative banks. In 2006, the Central Government along with National Bank for Agriculture and Rural Development (NABARD) and respective State Governments initiated a package for rural co-operative banks towards reviving their health, thereby, reaffirming the Governmental stake in these banks (NABARD, 2007).¹⁵

The capital of RRBs is contributed by the Central Government (with a share of 50 per cent), State Government (15 per cent) and a sponsor commercial bank (35 per cent), lending them a public character. Furthermore, the repeated rounds of recapitalisation of RRBs since 2010 have underlined Government's support to these institutions.¹⁶ Together RRBs and rural co-operative banks made up 67 per cent of India's differentiated banking sector in 2024 (Figure 2).

c. Differentiated but increasingly harmonised regulations

In keeping with their specialised operations, the regulation and supervision for differentiated banks have been distinct. For instance, there are differences in either prudential regulations (including capital

adequacy and exposure norms) or developmental regulations (priority sector lending norms) or both these regulations for UCBs, RRBs and SFBs as compared to universal banks.

Over time, there has been an effort to harmonise various regulations of differentiated banks with universal banks to limit regulatory arbitrage and strengthen governance in differentiated banks (Appendix 3). Licensing guidelines have been issued for differentiated banks to shift from one form to another or to convert into universal banks; the possibility of such conversion also underlines a harmonised regulatory view.¹⁷ There is also an effort to bring rural and urban co-operative banks under RBI's regulatory purview through amendments in the Banking Regulation Act, 1949, RBI Act, 1934 and Deposit Insurance and Credit Guarantee Corporation Act, 1961.

d. Focus on financial inclusion and viability

While differentiated banks have been set up with the objective of financial inclusion, their financial viability too has garnered attention in recent decades.¹⁸ The viability of these banks has, in fact, been deemed necessary for their sustained contribution to financial inclusion (Gol, 2008).

To illustrate, priority sector lending target, which was 100 per cent for RRBs, was brought down allowing these banks to lend to other, possibly more profitable sectors. Furthermore, phased consolidation of RRBs has been undertaken for creating financially more viable entities.¹⁹ Capital adequacy, Income Recognition, Asset Classification and Provisioning (IRACP) and liquidity norms have been applied to RRBs and rural co-operative banks towards enhancing their viability (see Appendix 3). Interest rate controls have been liberalised for these banks for commercial pricing of their services.

¹⁴ In north-east and Kerala, there is two-tiered structure, wherein the State-level bank is supported by primary agricultural credit societies at the village level. ¹⁵ 25 States signed a tripartite agreement for this package following the recommendations of Gol (2004), popularly known as the Vaidyanathan Committee. ¹⁶ The first recapitalisation exercise of 1994-95 covered 187 RRBs. In 2011, based on recommendations of RBI (2010), the second round was initiated, when 40 out of 82 RRBs were recapitalised. Since 2021-22, the third round is underway to make RRBs technologically and financially viable. ¹⁷ To illustrate, UCBs with a minimum net worth of ₹ 500 million and CRAR of at least 9 per cent can apply for converting into SFBs; see https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11381&Mode=0#A_2. SFBs can convert into universal banks subject to fulfilment of certain regulatory requirements; see https://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=3797. ¹⁸ See RBI (1991) which provided a roadmap for financial liberalisation in India and suggested measures for restoring the profitability and commercial viability of public sector (universal) banks and RRBs. ¹⁹ The first phase in 2005-06 was between RRBs with their sponsor banks. In the second phase in 2012, RRBs were consolidated across sponsor banks within a State. (Chaudhary and Kaur 2021). After the third phase of consolidation during 2019-21, their number has come down from 196 in 2005 to 43 in 2024. The Government has notified amalgamation of 26 RRBs on the principles of "One State-One RRB" as part of the fourth phase of consolidation; see [https://pib.gov.in/PressReleasePage.aspx?PRID=2120016#:~:text=Department%20of%20Financial%20Services%20\(DFS\),phase%20of%20amalgamation%20of%20RRBs](https://pib.gov.in/PressReleasePage.aspx?PRID=2120016#:~:text=Department%20of%20Financial%20Services%20(DFS),phase%20of%20amalgamation%20of%20RRBs).

III.2 Trends

Credit Growth

There was a divergence in credit growth between differentiated and universal banks during a major part of the 2000s, with the former compensating and providing credit support when the growth of the latter was slackening. Since 2010, the growth trajectory for differentiated banks, however, has been largely in-sync with universal banks, although remaining marginally higher (Figure 3a).

The increased credit growth for differentiated banks in the 2000s was due to (a) a pick-up in the growth for rural co-operative banks following their revival package; (b) consistently high growth for RRBs exceeding 20 per cent per annum, coinciding with their recapitalisation (Figure 3b).

The credit growth for universal banks, however, after peaking by the mid-2000s, posted a steady deceleration. The economic slowdown, increased exposure to infrastructural loans and a prolonged period of regulatory forbearance after the global financial crisis added to the Non-Performing Assets (NPAs) of universal banks, leading to their credit slowdown (RBI, 2018). Their credit growth started to recover only after the Asset Quality Review (AQR) by the RBI in 2015 for a comprehensive recognition of NPAs.

Unlike universal banks, differentiated banks were not exposed to infrastructural loans; they were neither covered by regulatory forbearance nor the AQR. Moreover, by virtue of their differentiated character, their exposure was limited to specific sectors or regions. And yet, the trend of their credit growth since 2012 matched with that of universal banks, possibly due to economic slowdown and their own asset quality pressures (see Section III.3 for an illustration of asset quality of differentiated banks).

Figure 3a: Credit Growth of Differentiated and Universal Banks

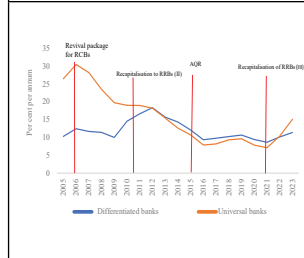
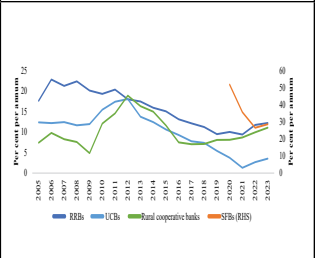


Figure 3b: Credit Growth for Differentiated Banks, Different Segments



Source: Authors' calculations based on Basic Statistical Returns of Scheduled Commercial Banks in India (BSR) using STATA.

Note: Growth rates are three-year moving averages.

Differentiated banks include RRBs, SFBs, UCBs and rural co-operative banks (RCBs).

Regional Distribution

Unlike SFBs and UCBs, which can have a pan-India presence, RRBs and rural co-operative banks have a distinct State-level orientation, as noted earlier.²⁰ Following consolidation, in 2024, there were 43 RRBs in 26 States and three Union Territories (UTs) with some States/UTs having more than one RRB (RBI, 2024).²¹

The branch penetration (defined as population per branch) of RRBs has been generally higher in the southern, central and northern regions than the western, eastern and north-eastern regions (Appendix 4a). In comparison, rural co-operative banks have generally a higher branch penetration in the western and southern regions (Appendix 4b). As we move northwards, their penetration becomes weaker. It is the weakest in the eastern and north-eastern regions.

Thus, broadly speaking, RRBs and rural co-operative bank branches substitute each other with regions under-served by RRB branches are well-served by rural co-operative bank branches. However, there are a few exceptions: most parts of the southern region are well-served by both RRB and rural co-operative

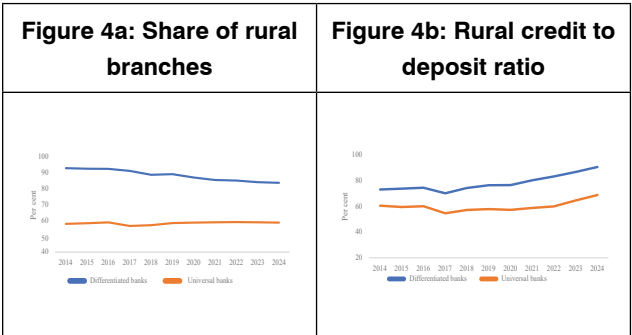
²⁰ UCBs include banks which are not just single-State (operating within a State) but also multi-State (operating across States).

²¹ These include Jammu and Kashmir, Rajasthan, Bihar, Odisha, West Bengal, Uttar Pradesh, Madhya Pradesh, Maharashtra, Gujarat, Andhra Pradesh, Karnataka and Telangana.

bank branches, while the eastern (particularly West Bengal and Jharkhand) and north-eastern regions are most under-served by the branches of both these banks.

Rural-urban Distribution

In keeping with their focus on rural areas, the share of rural branches has been higher for differentiated banks (Figure 4a). The rural credit to deposit ratio for these banks too has been consistently higher (Figure 4b).



Source: Authors' calculations based on Basic Statistical Return ((BSR) using STATA.

Note: Differentiated banks include RRBs and SFBs, as branch-level data for all UCBs and rural co-operative banks are not available. Rural includes rural and semi-urban centres.

Sectoral and Size-wise Distribution

Differentiated banks have a greater presence of agriculture in their credit portfolios (Table 1). Even within agriculture, the share of small farmers, having typically small-sized credit needs, has been higher for these banks.²²

Not just for agriculture but even for other sectors, the average ticket size has been smaller for differentiated banks. This can be discerned from (a) greater presence of small borrowal accounts (accounts with a credit limit of up to Rs. 2 lakh in their credit portfolio; in 2024, such loans accounted for about 39 per cent, while loans of up to Rs. 25 lakh accounted for 87 per

cent of the total credit of differentiated banks (Figure 5); and (b) for industrial and services sectors, the average loan size for differentiated banks has been smaller; it ranged between 4 per cent and 6 per cent of the size for universal banks in 2024 (Table 2).

Table 1: Share of Agriculture/Small Farmers in Total Credit, Differentiated and Universal Banks

Sector	2014		2024	
	Differentiated Banks	Universal Banks	Differentiated Banks	Universal Banks
Agriculture	66.2	12.0	53.3	11.5
Direct agriculture	64.1	9.9	48.1	10.0
Small farmers	-	-	16.4	8.4

Source: Authors' calculations based on data from NABARD and RTP.

Note: Direct agricultural credit refers to credit given directly to farmers/producers in allied activities.

Table 2: Average Loan Size of Differentiated to Universal Banks, Major Sectors, in per cent

Sector	2014	2024
Agriculture	50.0	63.6
Industry	0.8	4.3
Services	2.0	5.8
All sectors	8.4	15.9

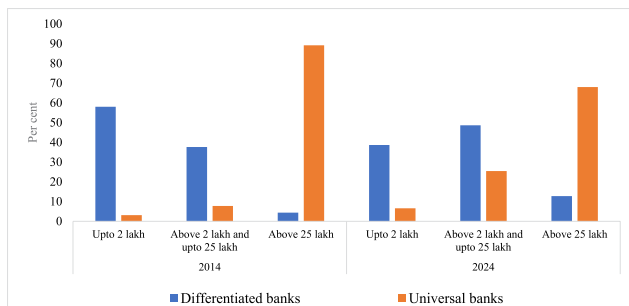
Source: Authors' calculations based on BSR

Note: Services include trade, transport, finance, professional and other services.

Differentiated banks include RRBs and SFBs, as sectoral data for all UCBs and rural co-operative banks are not available.

²² The role of differentiated banks, particularly RRBs, in providing credit to agricultural labourers, small and marginal farmers is well documented in the literature; see Yadav et al (2023).

Figure 5: Distribution by Credit Limit Size, Differentiated and Universal Banks



Source: Authors' calculations based on BSR.

Note: Differentiated banks include RRBs and SFBs, as credit limit data for all UCBs and rural co-operative banks are not available.

Asset Quality and Profitability

The asset quality of universal banks deteriorated significantly following the AQR. After peaking in 2018, however, their Gross Non-Performing Assets (GNPA) ratio has been on a mend. Differentiated banks, though not covered as part of AQR, have toed the trend of universal banks. Their GNPA ratio after peaking by the end of 2010s has been on a decline since. Importantly, this decline in the GNPA ratio can be seen across all types of differentiated banks (Figure 6b).

The poor asset quality affected the profitability of universal banks with their Return on Assets (RoA) turning negative towards the end of the last decade. However, thereafter, it has been on a rising trend (Figure 7a). In comparison, the RoA of differentiated banks was consistently better during the last decade, although on a declining trend. The losses reported by (scheduled) UCBs and RRBs pulled down the RoA of differentiated banks to a negative zone in 2020, but thereafter, it has recovered (Figure 7b). The RoA of SFBs has shown wide fluctuations given the nascent stage of these banks but has been higher than other differentiated banks and even universal banks.²³

²³ Most SFBs were earlier MFIs. Their conversion to SFBs was to benefit from an access to public deposits and consequently, a lower cost of funds. However, their cost of funds has continued to be high due to a lower percentage of Current And Savings Accounts (CASA) (Saraf and Chavan, 2021). Moreover, their return on funds has been higher due to a wider spread. The wide spreads keep their RoAs high.

Figure 6a: GNPA ratio of differentiated and universal banks

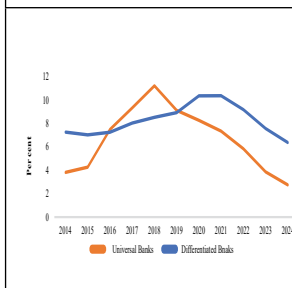
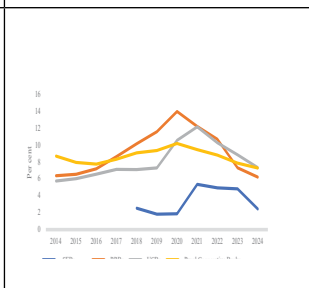


Figure 6b: GNPA ratio of differentiated banks, different bank types



Source: Authors' calculations based on BSR, RTP, Key Statistics and Financial Statements of RRBs.

Note: Differentiated banks include RRBs, SFBs, UCBs and rural co-operative banks.

Figure 7a: RoA of Differentiated and Universal Banks

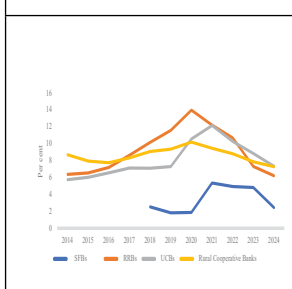
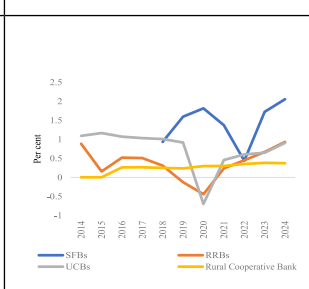


Figure 7b: RoA of Differentiated Banks, Different Bank Types



Source: Authors' calculations based on BSR, RTP, Key Statistics and Financial Statements of RRBs.

Note: Differentiated banks include RRBs, SFBs, UCBs and rural co-operative banks.

In sum, in keeping with their mandate, differentiated banks have been catering to various under-served segments, although their presence is not evenly spread across the country. They lend more to borrowers with smaller credit needs, making them an integral part of the process of financial inclusion. In terms of asset quality and profitability, differentiated banks have been on a weaker footing, but have shown an improvement in recent years.

IV. An Empirical assessment of the Role of Differentiated Banks

IV.1 Data and Methodology

The empirical analysis is based on data from multiple credible data sources, including the Statistical Tables Relating to Banks in India (STRBI), NABARD's Key Statistics and Financial Statements of RRBs and Basic Statistical Returns (BSR) of Scheduled Commercial Banks in India. The period for the empirical assessment is from 2011-12 to 2021-22 owing to the limited availability of bank-level data on RRBs. The data panel is unbalanced owing to the consolidation of public sector banks and RRBs and the introduction of SFBs during the assessment period.

To parse out the role played by differentiated banks, we deploy the time fixed effects model.²⁴

$$Y_{it} = \beta_0 + \beta_1 D + \beta_a X_{it}^a + \gamma_t + \varepsilon_{it} \text{ ----}(1)$$

Where, the dependent variable Y represents various indicators for financial intermediation/inclusion and viability of bank i in year t . X_{it}^a represents the vector of bank-specific and other macroeconomic variables. γ_t represents time fixed effects capturing time-varying bank-independent factors. ε_{it} is error term denoting unobserved changes in dependent variables not captured by the independent variables. D is the variable of interest taking value 1 for a differentiated bank and 0 otherwise.²⁵

We also interact D with the independent variables to gauge the distinctive effect of these variables on the dependent variable for a differentiated bank vis-à-vis a universal bank.²⁶ We use lagged values of independent variables for better interpretation of results, as bank-specific factors may affect financial intermediation or viability over time and not necessarily contemporaneously.²⁷

The selection of bank-specific independent variables, while broadly shaped by data availability, is made keeping in view the likely predictors of financial intermediation/inclusion and viability of banks (see descriptive statistics of all variables in Appendix 5).²⁸

IV.2 Results

Financial Intermediation/Inclusion

The presence of a differentiated bank in the banking system augurs well for financial intermediation, enhancing credit and deposit growth. After accounting for its earnings and profitability and capital and asset quality, the credit growth is about 9 per cent higher, while the deposit growth is about 22 per cent higher for a differentiated bank than a universal bank. (Column 1 and 2, Table 3).²⁹ As expected, better capital positions and asset quality can support higher credit and deposit growth.

If the GNPA ratio increases by 1 percentage point, the credit growth of differentiated banks falls by 0.91 percentage points more than a universal bank, indicating limited credit creating capacity of differentiated banks (Column 1: Specification 4, Table 3).

The presence of differentiated banks also supports banking penetration in rural areas. The share of rural branches is significantly higher for differentiated banks than universal banks during our study period, *ceteris paribus* (Column 3, Table 3).

Table 3: Financial Intermediation and Differentiated Banks

Independent Variable	Credit Growth	Deposit Growth	Share of Rural Branches
	(1)	(2)	(3)
D (Differential bank dummy)	8.619*** (2.543)	21.92*** (7.390)	51.17*** (2.785)
Log of assets	0.516	5.228**	2.543***

²⁴ We run the Hausman test to confirm the usage of the fixed effects model. ²⁵ As the coefficient of interest, β_1 drops out following the inclusion of bank fixed effects, we have accounted only for time fixed effects in our model. ²⁶ While assessing this interaction, we account for both time and bank fixed effect. ²⁷ However, we also run these specifications contemporaneously and observe that the signs and significance of the coefficients are largely unchanged. ²⁸ To address outliers, bank-specific variables were winsorised by 1 per cent at both ends. The correlation between all independent variables is low to moderate, minimising the possibility of multicollinearity in our specification. ²⁹ While we have time fixed effects to address time-varying factors, we also separately interact a dummy for differentiated banks with a time dummy demarcating the introduction of SFBs in 2017 to capture the effect of this introduction. However, the coefficient of the interactive dummy is not statistically significant, indicating limited effect of these banks, possibly given their nascent stage.

Independent Variable	Credit Growth	Deposit Growth	Share of Rural Branches
	(1)	(2)	(3)
<i>Earnings and profitability</i>	(0.690)	(2.016)	(0.617)
Income ratio	0.607 (0.875)	-1.855 (1.511)	-1.351** (0.590)
Cost of funds	-0.138 (1.312)	1.620 (2.695)	-0.864 (0.676)
Cost to income ratio	0.097 (0.136)	0.607 (0.491)	-0.089 (0.070)
Return on Asset (RoA)	0.513 (1.413)	1.235 (2.674)	-0.538 (0.866)
<i>Capital and asset quality</i>			
GNPA ratio	-0.468*** (0.131)	-0.637** (0.266)	0.494*** (0.113)
Capital to assets ratio	0.437*** (0.127)	1.798*** (0.496)	-0.217*** (0.077)
Constant	-4.857 (11.330)	-68.74** (30.730)	8.210 (9.747)
Time fixed effects	Yes	Yes	Yes
Observations	1102	1114	1101
R ²	0.113	0.176	0.811
GNPA ratio (Differentiated: Universal) (4)	-0.910*** (0.182)	-	-

Source: Authors' calculations based on STRBI, BSR and data on RRBs from NABARD.

Note: Robust clustered standard errors are in parentheses.

*** p<0.01, ** p<0.05, * p<0.1

All explanatory variables are taken with a one-year lag.

Differentiated banks include RRBs and SFBs owing to lack of bank-level data on UCBs and rural co-operative banks.

Financial Viability

While the presence of differentiated banks indisputably supports financial intermediation/inclusion, the results are not as straightforward for financial viability. On average, the RoA of a differentiated bank is about 0.2 per cent lower than a universal bank (Column 1, Table 4). In comparison, the Net Interest Margin (NIM), an alternative indicator of financial viability, is 0.8 per cent higher for a differentiated bank (Column 2, Table 4). Thus, while differentiated banks have better interest-earning capability, which possibly follows from greater financial intermediation, their operating cost inefficiencies affect the profit-making capability, rendering a lower RoA.³⁰ Furthermore, if the cost to income ratio increases by 1 percentage point, the ROA of differentiated banks decreases by 0.046 percentage points more than a universal bank, suggesting differentiated banks' profitability being more sensitive to their operating costs (Column 1: Specification 4, Table 4).

The profit-making capability can also be affected by a weaker asset quality of differentiated banks; their GNPA ratio is, in fact, 3.5 per cent higher, *ceteris paribus* (Column 3, Table 4).

Table 4: Financial Viability and Differentiated Banks

Independent variable	RoA	NIM	GNPA
	(1)	(2)	(3)
D (Differential bank dummy)	-0.202* (0.115)	0.768*** (0.187)	3.506** (1.350)
Log of assets	-0.021 (0.030)	0.107* (0.060)	0.781*** (0.297)
<i>Earnings and profitability</i>			
Income ratio	0.175*** (0.029)	0.334*** (0.103)	-0.300 (0.266)

³⁰ See NABARD (2022) for an illustration on the cost inefficiencies of RRBs.

³¹ From 2025-26 onwards, the overall PSL target has been revised to 60 per cent of Adjusted Net Bank Credit (ANBC) or Credit Equivalent of Off-Balance Sheet Exposures (CEOBE), whichever is higher.

Independent variable	RoA	NIM	GNPA
	(1)	(2)	(3)
Cost of funds	-0.282*** (0.040)	-0.266** (0.106)	0.061 (0.408)
Cost to income ratio	-0.024*** (0.004)	-0.001 (0.004)	0.178*** (0.031)
<i>Capital and asset quality</i>			
Capital to assets ratio	0.018*** (0.003)	0.047*** (0.006)	-0.076 (0.049)
Constant	1.147*** (0.370)	-0.482 (0.730)	-2.765 (3.762)
Time fixed effects	Yes	Yes	Yes
Observations	1038	1124	1125
R ²	0.311	0.446	0.150
Cost to income ratio (Differentiated: Universal) (4)	-0.046*** (0.005)	-	-

Source: Authors' calculations based on STRBI, BSR and data from NABARD.

Note: Robust clustered standard errors are in parentheses.

*** p<0.01, ** p<0.05, * p<0.1

All explanatory variables are taken with a one-year lag.

Differentiated banks includes RRBs and SFBs owing to lack of bank-level data on UCBs and rural co-operative banks.

V. Concluding Observations

Although India has experimented with various forms of differentiated banks since the beginning of the last century, the size of the differentiated banking sector has been relatively small in the global context, but stable over time. In 2024, it accounted for about 11 per cent of the total banking assets in India. The sector is marked by a mix of legal forms of banks (co-operatives and joint stock companies) but a predominance of banks either owned or supported by the Government. While these banks are guided

by a primary objective of financial intermediation/inclusion of the under-served regions/sectors, the issue of their viability has gained considerable traction in the period of financial liberalisation to make the process of inclusion, financially sustainable for them. Resultantly, changes have been brought about in the policy framework guiding these banks to enhance their profitability, commercial viability and making them better-governed institutions.

Given its focus on niche and under-served sectors, the differentiated banking sector is akin to the Indian non-banking financial sector. However, it is distinct from the non-banking financial sector, as it relies on deposits as a source of funds, while the non-banking financial companies rely on borrowings from universal banks.

Given their role in deposit mobilisation and credit creation, the presence of differentiated banks bodes well for financial intermediation/inclusion in India. However, despite a better interest-earning capability, the financial viability of these banks has been weaker, owing to their operating cost inefficiencies and weaker asset quality.

Going forward, the regulatory efforts for restoring financial health and ensuring better governance of differentiated banks need to continue. The harmonisation of their regulatory framework too will help in minimising the possibility of regulatory arbitrage. Notwithstanding harmonisation, preserving their identity as differentiated banks is critical given India's emphasis on universal financial inclusion. The process of consolidation cannot lose sight of the regional expansion of these banks, particularly where they currently have a weak presence. Furthermore, cost inefficiencies need to be reduced to enhance profitability for these banks. However, their profitability cannot be accentuated at the cost of affordable finance to their underserved clientele.

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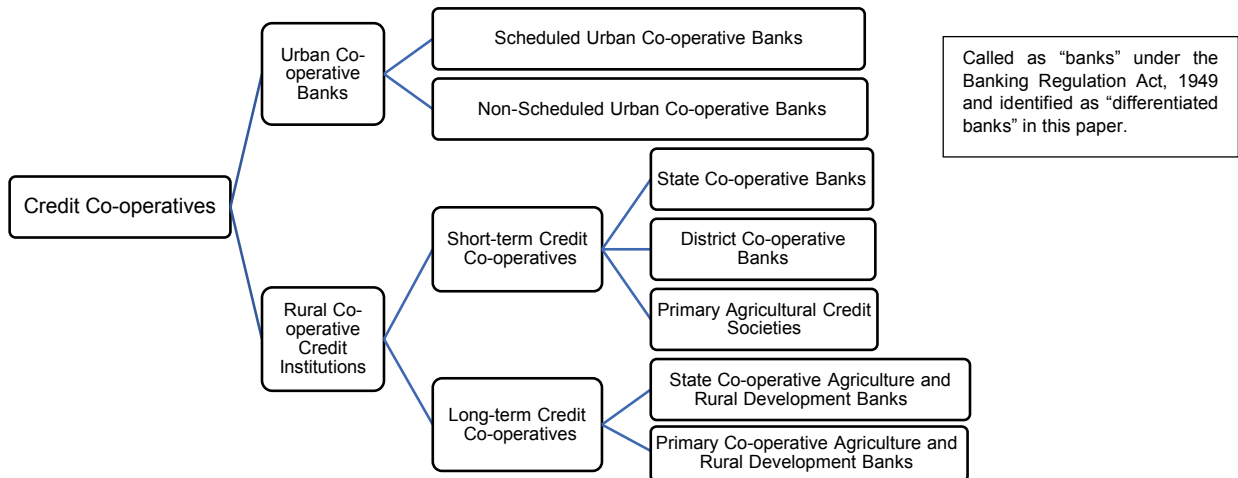
Appendix

Appendix 1: Entities under the Differentiated Banking Sector, Select Countries

Country	Entities	Focus areas
Germany	Sparkassen (Savings Banks) & Volksbanken and Raiffeisenbanken (Co-operative Banks)	Regional banking and community finance
Japan	Regional Banks and Shinkin Banks	Financing for local small and medium enterprises and regional economic development
Switzerland	Cantonal Banks and Regional and Savings Bank	Saving deposits and long-term mortgage lending
South Korea	Specialised Banks	Targeted financial support to various sectors

Source: Authors' compilation.

Appendix 2: Present-day Co-operative Structure in India



Appendix 3: Regulatory Framework for Differentiated and Universal Banks

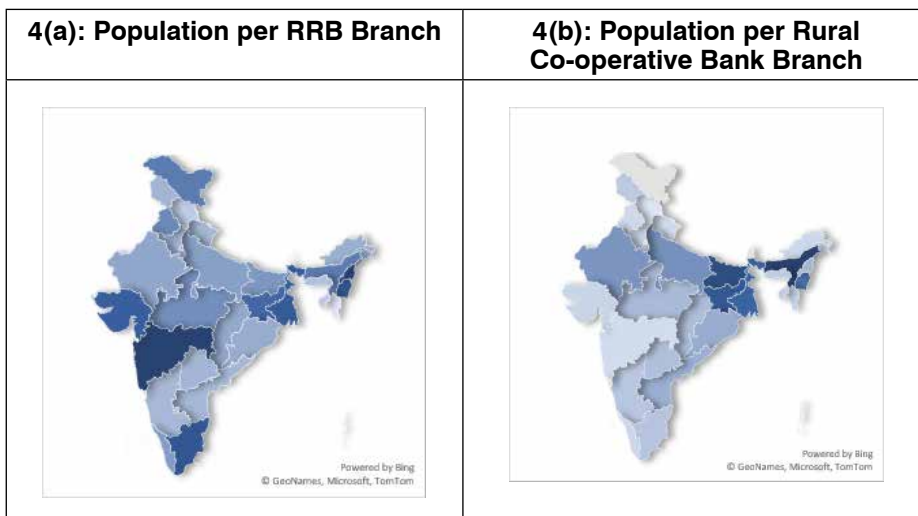
Feature	RRBs	SFBs	UCBs	Rural Co-operative Banks	Universal Banks
Primary area of operation and focus	Rural areas – Agriculture and rural enterprises	Rural and semi-urban areas – underserved population segments including unorganised sector.	Urban areas - Micro and small enterprises and housing and other personal loans	Rural areas – Agriculture and rural enterprises	Pan India presence providing comprehensive range of financial services
Governing statute	Regional Rural Banks Act, 1976	Banking Regulation Act, 1949	Banking Regulation Act, 1949 (as applicable to co-operative societies)	Respective State Co-operative Acts; Banking Regulation Act, 1949 (as applicable to co-operative societies)	Banking Regulation Act, 1949

Feature	RRBs	SFBs	UCBs	Rural Co-operative Banks	Universal Banks
Regulatory domain	Divided between RBI and NABARD RBI – Prudential regulations NABARD – Licensing, supervision, audit-related oversight, liquidation/ supersession of boards	Completely under RBI's domain	Largely under RBI's domain RBI – Licensing, prudential regulations and supervision, audit-related oversight, liquidation/ supersession of boards	Divided between RBI and NABARD RBI – Prudential regulations NABARD – Licensing, supervision, audit-related oversight, liquidation/ supersession of boards	Completely under RBI's domain
Capital adequacy	Applicable Basel I framework – 9 per cent Covering only credit risk and market risk open positions	Applicable Basel II framework Covering only credit risk	Applicable Basel I framework – 9 per cent for Tier 1 and 12 per cent for Tier 2 to 4 UCBs (having large deposit base) Covering credit and market risks	Applicable Basel I framework – 9 per cent Covering only credit risk	Applicable Under Basel III norms Covering credit risk, market risks and operational risks and also other risks under Pillar II
IRACP guidelines	Applicable as universal banks System-based classification of NPAs	Applicable as universal banks	Applicable as universal banks System-based NPA classification Lower standard assets provisioning for Tier 1 UCBs than other UCBs	Applicable as universal banks System-based classification of NPAs	Applicable System-based classification of NPAs
Prompt corrective action framework	Applicable Governed by NABARD	Applicable Governed by RBI	Applicable to all UCBs except Tier 1 Governed by RBI	Applicable Governed by NABARD	Applicable Governed by RBI
Exposure norms	Applicable Lower individual exposure limit than universal banks; comparable group exposure limit (as per cent of owned funds and not Tier 1 capital)	Applicable Lower individual exposure limit than universal banks; comparable group exposure limit (as per cent capital funds)	Applicable Lower individual exposure limit than universal banks; comparable group exposure limit	Applicable Lower individual exposure limit than universal banks; comparable group exposure limit (as per cent of owned funds and not Tier 1 capital)	Applicable as per cent of capital base - Tier 1 capital
Liquidity management	SLR applicable LCR, NSFR not applicable	SLR applicable Same as universal bank	SLR applicable LCR, NSFR not applicable	SLR applicable LCR, NSFR not applicable	SLR applicable LCR and NSFR applicabl

Feature	RRBs	SFBs	UCBs	Rural Co-operative Banks	Universal Banks
Audits – Guidelines and appointments	Guidelines by NABARD – Concurrent audit Internal inspection/audits External/statutory audits Appointment from a panel prepared by NABARD	Same as universal banks	Guidelines by RBI – Concurrent audit Risk-based internal audits for large-sized UCBs External/statutory audits Appointment with prior approval from RBI	Guidelines by NABARD – Concurrent audit Internal inspection/audits External/statutory audits Appointment from a panel prepared by NABARD	Guidelines by RBI – Concurrent audit Internal inspection/audits External/statutory audits Appointment with prior approval from RBI
PSL targets	75 per cent of Adjusted Net Bank Credit (ANBC) <i>Sub-targets:</i> Agriculture - 18 per cent Small and marginal farmers - 10 per cent Micro Enterprises - 7.5 per cent Weaker sections - 15 per cent	75 per cent of ANBC ³¹ <i>Sub-targets:</i> Agriculture – 18 per cent Small and marginal farmers - 10 per cent Micro Enterprises - 7.5 per cent Weaker sections - 12 per cent	60 per cent of ANBC <i>Sub-targets:</i> Micro enterprises - 7.5 per cent Weaker Sections - 12 per cent	Not applicable	40 per cent of ANBC <i>Sub-targets:</i> Agriculture - 18 per cent Small and marginal farmers – 10 per cent Micro enterprises - 7.5 per cent Weaker sections - 12 per cent

Source: Authors' compilation based on various circulars and RBI (2021).

Appendix 4: Regional Penetration of Differentiated Banks



Note: Darker colour = higher population per branch or weaker branch penetration.

Source: Authors' illustration based on BSR and RTP.

Appendix 5: Descriptive Statistics of Variables used for Empirical Exercise

Variable	Description of Variable	Unit	Mean	Standard Deviation
RoA	Net profits/average total assets	Per cent	0.3	1.4
NIM	Net interest income/ average total assets	Per cent	2.8	1.3
Deposit growth	Year-on-year growth rate of deposits	Per cent	22.3	65.3
Credit growth	Year-on-year growth rate of credit	Per cent	11.3	25.3
Assets	Total assets	Log	9.3	2.1
Income ratio	Total income/ total assets	Per cent	8.4	2.1
Cost of funds	Interest expended on deposits and borrowings/deposits and borrowings	Per cent	5.2	1.7
Cost to income ratio	Operating costs/total income	Per cent	30.7	17.2
Capital to asset ratio	Capital/total assets	Per cent	14.7	17.7
GNPA ratio	Gross non-performing assets/ total credit	Per cent	7.2	8.8
Share of rural branches	Rural branches/total branches	Per cent	34.9	30.7

