Licensing new private sector banks: RBI provides new opportunities!

Introduction

The economic growth of a country is quantified based on the stability, soundness and depth of its financial system and India is not an exception to this. The Reserve Bank of India (**"RBI"**) has made several efforts to improve regulation to the best global standards in the banking sector to provide a well systematic banking system, so that it is easily accessible and satisfies the needs of the modern economy, and also to act as a major cause for the economic growth in the country. Over the last two decades, RBI has licensed twelve banks in the private sector and out of them; ten banks were licensed on the basis of guidelines issued in January 1993.[1] The guidelines were revised in January 2001 based on the functioning of these banks and it was further decided by RBI that more licenses will be issued for licensing new banks in private sector. On August 29, 2011 RBI released draft guidelines (**"Guidelines"**) for licensing of new banks by the private sector players and Non Banking Financial Companies (**"NBFC"**).

This newsletter focuses primarily on the proposed Guidelines of the RBI, the changes intended to bring in the norms and regulations in the banking sector and a comparison of the Guidelines with the previous guidelines issued in 1993 and 2001. The various parameters of discussion shall be the eligibility criteria, capital requirement, foreign shareholding, corporate governance, and further amendments as required in the Banking Regulation Act, 1949 (**"Banking Act"**).

1. Eligibility Criteria

The eligibility conditions in the Guidelines provide that any private sector company **(i)** having a successful track record of the past 10 years, **(ii)** which is controlled by residents, **(iii)** have diversified ownership, sound credentials and integrity, are eligible to promote banks. However, the entities engaged in real estate and broking activity are not considered suitable for licensing by RBI as their business activity is riskier and differs from the business culture and model of the banking sector. The attempts at licensing new private banks by RBI through previous guidelines of 1993 and 2001 offered little help while issuing the Guidelines. The RBI insistence on "sound credentials", "integrity", "diversified ownership" and a 10-year track record is an attempt to cover the gaps in the existing guidelines.

If eligible, the new private banks can be set up only through a wholly owned Non-Operative Holding Company (**"NOHC"**) which has to be registered with the RBI as a NBFC. RBI shall have control on the regulated financial services and activities of the NOHC, including the new bank. Further, only the non-financial services companies or entities and

[1] See draft guidelines for licensing of new banks in the private sector available in http://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=2414 (as viewed on September 12, 2011)

individuals belonging to the promoter would be held by the NOHC without any direct or indirect shareholding in it. If considered eligible for a bank license by RBI, the promoter/promoter group with an existing NBFC will have two options:

(a) If some or all the activities undertaken by it are not permitted to be undertaken by banks departmentally, the activities undertaken by the NBFC which banks are allowed to undertake departmentally, will have to be transferred to the new bank; or

(b) Convert itself into a bank, if all the activities undertaken by it are allowed to be undertaken by a bank departmentally.

Under both options, the promoters will have to first set up a NOHC. RBI will consider allowing the new bank to take over and convert the existing NBFC branches into bank branches subject to the existing rules applicable to opening of branches and also subject to maintaining 25% of the bank branches in unbanked rural centers.

Promoters have to forward their business plan for the new banks along with their applications to RBI. The models will have to address how the bank proposes to achieve financial inclusion which should cover all sections of the society in India. The business model submitted by the promoter should be realistic and viable. In case of deviation from the stated business plan after issue of license, RBI may consider restricting the bank's expansion, effecting change in management and imposing other penal measures as may be necessary. This strict approach of RBI is only to make sure the banking system runs in a smooth way by restricting the promoters to concentrate their business not only in the metropolitan cities but also in rural and semi-urban areas in the country.

2. Minimum Capital Requirement

The proposed minimum paid-up capital required to start a private bank has been kept at INR 5,000 million over three years from commencement of business. This is a substantial increase from the INR 3,000 million requirements as per the guidelines of 2001. This will enable private players willing to focus on financial inclusion[2] and sophisticated commercial banking to seek a banking license and will increase the access to financial services needed by all sections of the society in general at an affordable cost in a fair manner by introducing new banks especially by the private players. The NOHC shall hold a minimum of 40% of the paid-up capital of the bank which shall be locked in for a period of five years from the date of licensing of the bank. Shareholding by NOHC in excess of 40% of the total paid-up capital shall be brought down to 40% within two years from the date of licensing of the bank. In the event of the bank raising further capital during the first five years from the date of licensing, NOHC should continue to hold 40% of the enhanced capital of the bank for a period of five years from the date of licensing of the bank. In respect of promoter groups having 40% or

[2] Financial Inclusion is a process of ensuring access to appropriate services needed by all sections of society in general and vulnerable groups at an affordable cost in a fair and transparent manner by mainstream institutional players

more assets/income from non financial business, the following additional requirements will be applicable:

(a) Board of the bank should have a majority of independent Directors.

(b) The exposure of the bank to any entity in the promoter group, their business associates, major suppliers and customers shall not exceed 10% and aggregate exposure to such entities shall not exceed 20% of the paid up capital and reserves of the bank, subject to compliance with the provisions of Section 20 of the Banking Act.

(c) The bank will have to file a return, certified by statutory auditors, on quarterly basis of all exposures including credit facilities extended to the entities in the promoter group, their business associates, and major suppliers and customers for amounts in excess of INR 10 million.

(d) Banks would be required to seek prior approval of RBI for raising paid-up capital beyond INR 10,000 million for every block of INR 5,000 million. This is done to check whether the corporate governance standards are adequate, whether information from promoter group has been forthcoming to facilitate consolidated supervision and whether the Board members remain 'Fit and Proper.'

The shareholding by NOHC shall be brought down to 20% of the paid up capital of the bank within a period of 10 years and to 15% within 12 years from the date of licensing of the bank and retained at that level thereafter.

3. Foreign shareholding

The aggregate non-resident shareholding from FDI, Non-resident Indians and FII in the new private sector banks shall not exceed 49% for the first 5 years from the date of licensing of the bank. No non-resident shareholder, directly or indirectly, individually or in groups, will be permitted to hold 5% or more of the paid up capital of the bank. After the expiry of 5 years from the date of licensing of the bank, the foreign shareholding would be as per the extant policy. Currently, foreign shareholding in private sector banks is allowed up to a ceiling of 74% of the paid up capital. The proposed policy is contradictory to the present FDI policy stated supra. But the main objective of the RBI's proposed guideline is to promote more domestic banks and to avail the latest technology in the banking sector. RBI has not excluded the fact that the same can be achieved only by involving the private players and foreign investors in banking sector.

4. Corporate governance

To ensure sound corporate governance, it would be required that at least 50% of the Directors of the NOHC should be totally independent of the promoter/promoter group entities, their business associates, and their customers and suppliers. RBI will have to be satisfied that the corporate structure does not impede the financial services under the NOHC from being ring fenced so that it would be able to supervise the bank and the NOHC on a consolidated basis for smooth running of business. Ownership and management should be separate and distinct in the promoter/promoter group entities that own or control the

NOHC. The management should be professional with adequate corporate governance standards. The source of promoters/promoter group's equity in the NOHC should be transparent and verifiable.

(a) The bank shall get its shares listed on the stock exchanges within two years of licensing of the bank. The bank shall be required to maintain a minimum capital adequacy ratio of 12% for a minimum period of 3 years after the commencement of its operations subject to such higher percentage as may be prescribed by RBI from time to time.

(b) The proposed bank will be under the consolidated supervision by RBI. NOHC shall not be permitted to set up any new financial services entity for at least three years from the date of licensing.

If RBI is not satisfied about compliance with the above provisions i.e. after providing license for the new banks, it would take severe action as per law and licensing conditions. RBI is very clear that the new banks under the private players will be strictly supervised in a way that the public money is safeguarded to the best.

New banks will be governed by the provisions of the Banking Act, RBI Act, 1934, other relevant statutes and the directives, regulations and other guidelines/instructions issued by RBI time to time including the regulations of Securities Exchange Bureau of India (**"SEBI"**) regarding public issues and other guidelines applicable to listed banking companies. It may be pertinent to mention that certain amendments to the Banking Act are under consideration of the Government of India. The vital amendments are removal of restriction of voting rights[3] and concurrently empowering RBI to approve acquisition of shares and/or voting rights of 5% or more in a bank to persons who are 'fit and proper' and empowering RBI to supersede the Board of Directors of a bank so as to protect depositors interest[4] and facilitating consolidated supervision.

Conclusion

The Guidelines of RBI for the private players to set up banks in India is highly welcomed and there will be a serious impact in this sector as it will improve the banking system in India to meet the needs of the modern economy and the intention is not only to improvise the financial system but also to ensure that new technology reaches the rural and sun-urban areas in India too. The Guidelines by RBI was issued with utmost caution as it considered that public money will be involved in it and the promoters are kept away from the risk prone areas of the working structure of the banks which might be relaxed in future to attract more foreign investors in this sector. The Guidelines should be analyzed and confirmed without any delay by RBI in a way that it satisfies every common man in India, and have to assure that banking sector in India achieve its level to the International standards.

Authored by:
S. Aravindan

[3] See Sec.12 of the Banking Act
[4] See Sec.36 (1) (d) of the Banking Act