CUTS' Comments on RBIs Draft Guidelines for Licensing of New Banks in the Private Sector

Background

In India the origin of discussions on permitting ownership in Indian banks to corporates can be traced to the High Level Investment Commission constituted by the GoI in December 2004. In its report of February 2006, the said Commission, among others, recommended permitting ownership in Indian banks of up to 15 percent by Indian corporates and also to increase limits of holdings by any one foreign bank up to 15 percent in private banks.

Two years later in July 2006 report of the High Level Committee on Fuller Capital Account Convertibility constituted by the RBI also recommended that RBI should evolve policies to allow, on a case to case basis, industrial houses to have a stake in Indian banks or promote new banks. The policy may also encourage NBFCs to convert in to banks and till 2009 foreign banks may be allowed to enhance their presence in the banking system.

The September 2008 report of the High Level Committee on Financial Sector Reforms further recommended entry to private well-governed deposit-taking small finance banks with the stipulation of higher capital adequacy norms.

Shortly thereafter, the world's banking system was severely jolted when it found itself on the edge of a precipice. This triggered a need for revisiting and re-analysing the industry. Much of the effort centred on reversing of the decades of deregulation, indicating among others, mistrust of those who run the banks.

While in the US, it is being examined whether investment banking should be separated from commercial banking, in the UK it is being debated whether the retail sector of banking should be so tightly regulated that it functions as a public utility. Switzerland that was a recipient of massive capital inflows is now downsizing its global banking and investment banking is slated to shrink. Across Europe, bad debts of banks have spoiled their balance sheets raising concerns about their creditworthiness. Some feel that banks in China are growing too quickly.

Even while the banking industry elsewhere in the world was tottering with injury, the RBI came up with a Discussion Paper in August 2010 to invite comments on issuing banking licences to business houses and NBFCs. The Economic Survey 2010-11 was tabled in the Indian Parliament in February 2011 which suggested in favour of industrial houses being given banking licences in order to promote the goal of financial inclusion subject to attendant regulatory robustness.

In this background, the Finance Minister in his Budget speech for the year 2010-11 remarked "The Indian banking system has emerged unscathed from the crisis. We need to ensure that the banking system grows in size and sophistication to meet the needs of a modern economy. Besides there is a need to extend geographical coverage of banks and improve access to banking services. In this context, I am happy to inform the Honourable members that the RBI is considering giving some additional banking licenses to private sector players. Non Banking Financial Companies (NBFCs) could also be considered, if they meet the RBIs eligibility criteria"

The Discussion Paper of the RBI referred to above was debated in October 2010 with associations of stakeholders from the industry, banks, NBFCs, MFIs, CII, ASSOCHAM, FICCI, IBA, etc. Comments on the Discussion Paper were also received by a large number of respondents, including the members of general public. In December 2010, the RBI released 'Gist of the comments' and in August 2011 Draft Guidelines for 'Licensing of new Banks in the private sector' on which comments have been sought. According to these Guidelines, amendments would be necessitated in the Banking Regulation Act.

A brief historical sketch of bank licences in India

Most of the commercial banks were in the private sector till 1969 when a large segment of 14 commercial banks were nationalised with the objective of aligning credit flows with Plan priorities. By the 1980s a set of guidelines for directed lending and regulated interest rates saw outreach of the banking system reach out to remote corners. However, since the onset of reforms in early 1990s with the attendant abolition of industrial licensing, directed lending lost its relevance though priority sector credit targets continued to prevail. Banks came under a free market-based environment, managing credit, interest rates, etc within the prudential framework. In early 1990s, guidelines for licensing of new banks in the private sector were issued in January 1993 and subsequently in 2001. Only 12 banks were licenced under these guidelines.

Key issues in the debate

On the need: The debate questions the need, to start with. According to the Finance Minister we need to have banking services that meet the needs of a modern economy and the need to meet the goal of financial inclusion. The following table is relevant to both:

Number of branches (as of March 31, 2010)

Particulars	**Rural**	**Semi Urban and Urban**	**Metro**	**Total**
SBI+ Associates	5919	9074	3121	18114
Nationalised Banks	13660	19679	9848	43187
Old private sector banks	862	3173	1139	5174
New private sector banks	340	3047	1826	5213
Foreign banks	5	67	238	310
Regional Rural Banks	11742	3902	126	15770
Total	32528	388942	16298	87768

Source: Various and approximate

The above table shows that there is no dearth of numbers. More importantly, the table indicates that private sector and foreign banks have few branches in rural and semi urban areas – which is the thrust to meet financial inclusion targets. Less than 50 percent of Indians have access to formal banking. While those people in metros and urban areas may have more than one bank account, the situation becomes bleak when juxtaposed with rural and semi urban areas – the very areas being cited as justification for a differentiated licensing policy from where private players have divorced themselves.

With most major international banks already working in the country, access to modern banking/technology is available – the challenge is to extend the same to branches in remote areas.

Proponents refer to corporates having the entrepreneurial and management talent in running asset management companies, mutual funds and insurance even in rural areas. However, many banks are also into such services.

On fears for self dealing: The Governor of RBI, Subbarao has candidly admitted that 'if a corporate has an interest in a bank as a promoter or a shareholder, but has no position on the board, then there is no prohibition on the bank lending to the corporate. This opens up opportunities for self dealing.' The Banking Regulation Act prohibits banks from lending to Directors and to entities in which they are interested. Regulations also prohibit lending to relatives of Directors without the prior approval or knowledge of the Board. During the public debate on RBIs Discussion Paper, stakeholders were apprehensive that it would not be easy for supervisors to prevent or detect self dealing as banks could hide related party lending behind the maze of company structures or through lending to suppliers of promoters.

On the need for attracting large capital: Financial inclusion requires a higher scale of operations which the corporates would be able to bring is one of the main arguments of the proponents. Many feel that there is no dearth of capital and that the existing players could also raise the required capital and, as such, no additional benefit would accrue by granting bank licences to corporates.

On concentration of wealth: India already has a concentrated wealth structure which influences political decisions. Allowing corporates to own banks would exacerbate concentration of economic power and political influence.

On regulatory adequacy: International experience shows an extremely tight regulatory watch on functions of corporate-owned banks. The massive Indian banking structure (see table above) is already stretching the capacity of RBI and many have referred to the dubious functioning of the Global Trust Bank (over exposure to capital markets; huge NPAs; under provisioning and other financial discrepancies) and inability of the regulator to detect the same in time. It was eventually merged with the Oriental Bank of Commerce. Similar examples have also been cited for NBFCs such as CRB.

The ownership structure of large corporates may open opportunities for regulatory arbitrage leading to gaps in risk assessment and supervision.

Further, experience of other countries shows that combining banking and commerce implies that there would be a lot of nepotistic lending. India does not have enough experience in supervising a scenario when banks are also owned by diversified corporates.

On financial inclusion:

Over the last couple of years, banks in India have embarked on a financial inclusion drive in under-banked and un-banked villages. No frills or zero balance accounts are being opened at the doorsteps on procurement of basic know-your-customer norms. Facilities such as remittance, micro-credit and micro-insurance are being canvassed to meet financial inclusion targets. There are concerns about associated risks that banks carry as the targeted customers have a low level of literacy and a lower level of financial literacy. The customers, too, could find themselves burdened with products of little use to them.

Banking services towards financial inclusion is not an established and viable business proposition. If it were, existing players would have made deeper forays. Is it another area that calls for subsidisation? Please see our comments at G v d) in the matrix below.

On the international experience:

Internationally, owning of banks by commercial entities is allowed in many countries but there are stringent limits to voting rights and maximum shareholding besides minimum capital requirements and promoters contribution. There are also controls on governance and disclosure based on shareholding levels.

In the US, industrial houses can not own banks under the GLB Act 1999 which authorizes financial holding companies to affiliate only with companies that engage in activities determined to be financial in nature or incidental thereto. In Brazil, corporates can promote banks but ownership beyond a certain percentage requires regulatory approval. Canada allows ownership of small banks by single owners and commercial establishments. UK, too, has allowed some corporate houses in owning banks. Taiwan and Hong Kong do not have restrictions on such ownership, which is however strictly limited on the extent of lending to related parties. While Japan has no restrictions on licences to corporates, the regulator is very strict in issuing the same.

In Korea, subsequent to the Asian crisis, large industrial houses (*chaebol*) are barred from promoting new banks as it is felt best to keep banking and commerce in watertight compartments.

Comments on Guidelines

RBI last issued new licences in 2003 for Yes Bank Ltd. and Kotak Mahindra Bank Ltd. Prior to that, in the mid-1990's, nine new banks opened and a cooperative bank was converted into a commercial bank.

Presuming the need for such new bank licensing and given the above, it must be admitted that the RBI has come up with a set of guidelines that address most of the issues raised during discussions. It separates the wheat from the chaff and provides RBI with teeth on regulating these banks. If anything, the guidelines are very stringent and reflect an extremely cautious approach on the part of RBI leading to speculation that it has been forced to issue the same reluctantly. Even eminent economists such as SS Tarapore, who have been advocating that corporates be allowed to enter the banking field with strong safeguards, feel that granting of licences for banks has serious implications for the overall financial sector and the RBI is justified in taking a 'cautious calibrated' approach.

Amendment to the Banking Regulation Act has been necessitated to accommodate implementation of the guidelines. RBI has reportedly sent the draft thereof to the government. "While the guidelines would be issued shortly, the amendment to the Act is uncertain," mentioned the Governor of RBI a few days prior to announcing the guidelines.

Summarised Important Guidelines	*Comments*
A) Eligible promoters: i) Only those entities and groups in the private sector that are owned and controlled by residents shall be eligible.	It is not clear whether companies/corporations in the public sector could apply for licences. It is reported that Power Finance Corporation (PFC), Rural Electrification Corporation (REC) and IFCI have already approached their administrative ministries for clarification. The thrust of the arguments is based on questioning of the eligibility criteria which restricts public sector and the condition of transfer of assets to the bank. REC and PFC do not wish to convert to a bank. But these companies are sector-specific lenders and might not serve the objective of financial inclusion. The case of India Post, may, however, be different due to their outreach. The Basel III norms (beginning January 2013) has forced the government to earmark Rs6,000crores in this fiscal for infusion in PSBs for bank capitalisation and to raise government holding to 58 percent. It must also be remembered that if PSUs were debarred from setting up private banks under the 1993

	guidelines, there would have been no Axis Bank today.
ii) Must have diversified ownership, sound credentials/integrity and a successful track record of at least 10 years. RBI can seek feedback from other agencies such as the Income Tax, CBI, etc.	a) 'Diversified ownership and sound credentials/integrity' not having been detailed/quantified leaves scope for discretion. Would firms with huge promoter shareholding be left out? Or will those with diversified kinds of businesses qualify? Further, RBIs experience with the condition of 'integrity of promoters' has not been particularly sharp in some cases. b) While the condition of obtaining a clean chit from other enforcement agencies is welcome, but in the wake of recent scandals in the telecom sector where big businesses have come under the scanner, RBI needs to spell out how it would address the governance issues.
iii) Any entity/group undertaking real estate and capital market (in particular, broking) activities with 10 percent or more of their income and assets or both in the two areas taken together in the last three years shall not be eligible.	It is not clear as to how a firm's exposure to real estate and broking business would be calculated. In case a company has over 10 percent income generated from such activities and a promoter group that applies for a licence through this company shows such income as below 10 percent, how would the case be dealt with?
iv) Applicants will be required to list group companies undertaking key business activities.	Needed to address the fears of self dealing and regulatory supervision.
B) Corporate structure: i) Such new banks can be set up only through a wholly-owned Non-Operative Holding Company (NOHC) which will hold the bank and fence it from other activities of the group – commercial, industrial	a) Many in the industry feel that the creation of a NOHC would be an impediment. Since all existing businesses would have to be transferred to NOHC, there are possible tax implications. But in the

and financial that are not regulated by financial sector regulators. Only non-financial service companies/entities and individuals of the promoter group will be allowed to hold shares in the NOHC.	overall to ensure action against self-dealing, such a body is needed. Reference to the recommendations of the working group report on introduction of financial holding companies (FHCs) has not been given in the guidelines, even though the report had stated that RBI would draw regulatory framework for FHCs. b) RBI rightly wants the ownership and management functions to be separate and distinct in the promoter group entities that own and control the NOHC.
ii) The NOHC shall be registered as a NBFC with RBI and will be governed by a separate set of prudential guidelines.	Needed. The separate prudential guidelines are awaited.
iii) The NOHC will not be permitted to borrow funds for investing in companies held by it.	Regulatory necessity.
C) Minimum capital requirements: i) Initial minimum paid up capital for a new bank shall be Rs500crore and the actual capital to be brought in will depend on the business plan of the promoters.	This is being considered by many as a lenient provision when compared with the overall tough stance of RBI. Industry hopefuls were prepared for a minimum cap of Rs1000crore. However, RBI has also laid down that the actual capital to be brought in will depend upon the business plan of the promoters.
ii) The NOHC shall hold a minimum of 40 percent of the paid up capital of the bank which shall be locked in for five years and such shareholding in excess of 40 percent shall be brought down to 40 percent within two years; to 20 percent within 10 years and to 15 percent within 12 years (to be retained at this level thereafter).	

iii) If the bank raises further capital during the first five years, the NOHC shall continue to hold 40 percent of the enhanced capital for a period of five years. Capital, other than the holding of NOHC could be raised through public issue or private placements.	
D) Foreign shareholding: i) The aggregate non-resident shareholding from FDI, NRIs and FIIs shall not exceed 49 percent for the first five years and no non-resident shareholder will be permitted to hold 5 percent or more of the paid up capital of the bank. After five years, the foreign shareholding would be as per extant policy – currently 74 percent of the paid up capital for private banks.	Pegging it at 49 percent for the first five years makes sense to prevent profit repatriation.
E) Corporate governance: i) At least 50 percent of the Directors of the NOHC should be independent of the promoter group, its entities, its business associates, customers and suppliers. ii) No financial services entity under the NOHC would be allowed to engage in any activity that a bank is permitted to undertake departmentally. iii) RBI will have to be satisfied that the corporate structure does not impede the financial services under the NOHC from being ring-fenced and that it has smooth and prompt supervision. iv) Ownership and management should be separate and distinct in the promoter/promoter group entities that own or control the NOHC and the management should be professional. v) The sources of promoters'/promoter groups' equity in the NOHC should be transparent and verifiable.	a) Provision of 'Independent Directors' (ID) is in line with the requirement under the Companies Bill 2009. Lessons from recent corporate fiascos like the Satyam Scam have also taught us how IDs can play an effective role in evolving good corporate conduct, which is enumerated here. IDs should not be provided any 'commission of profits' as has often been the trend, and their remuneration should be restricted to reasonable 'sitting fees'. They should be protected from any liabilities and adequately empowered. b) A section on Role/Function of Auditors needs to be included. c) It has been recommended by the Planning Commission Task Force on Business Responsibilities (September, 2011) that measures should be introduced by the

	Government (Ministry of Finance, as is applicable here) for business entities that consistently conducts itself in a responsible manner[1] to be able to better access lending. Financial institutions need to develop ways in which they support such entities in India. This recommendation needs to be integrated here.
F) Business model: i) Applications for new bank licences should be accompanied by business plans which should address how financial inclusion would be achieved. ii) In case of deviations from the plans, RBI may consider restricting the bank's expansion, effecting changes in management and imposing other penal measures.	A key assessing and monitoring tool but with the checks and balances proposed, most applications and business plans would be within the narrow confines thereof making it difficult to choose one over the other.
G) Other conditions: i) Shareholding of 5 percent or more of the paid up capital by individuals/entities/groups will be subject to prior approval of the RBI and further subject to the stipulation that none of the above (other than NOHC) can have a shareholding in excess of 10 percent. ii) The bank shall maintain an arm's length relationship with promoter group entities, their business associates, suppliers and customers of these entities. The exposure of the bank to any entity in the promoter group shall not exceed 10 percent and the aggregate exposure to all entities in the group shall not exceed 20	

[1] Responsible Business in India is henceforth assessed in terms of their alignment with the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business adopted by the Govt. of India (July 2011), and can be referred at: http://www.nfcgindia.org/pdf/National_Voluntary_Guidelines.pdf

percent of the paid up capital. All exposures would be governed by the Banking Regulation Act and would need approval of the Board. iii) The decision of the RBI shall be final in determining whether an entity belongs to a particular promoter group or whether the entities are linked.	
iv) The top management of the bank shall have expertise in the financial sector, preferably banking; the bank should operate on Core Banking Solutions (CBS); should make full use of modern infrastructural facilities; should have a high powered Customer Grievances Cell; list its shares on the stock exchange within two years and maintain capital adequacy ratio of 12 percent for 3 years.	a) The prescribed norm for listing within two years requires clarifications on the promoter's group businesses that are unlisted and whether those are to be listed before applying for banking licence. b) Will it be possible for a new bank to earn profits within two years given the need for opening 25 percent of the branches in unbanked areas? In the face of losses, can a bank be listed? c) Credit rating agency, ICRA, also feels that listing of a new bank within two years may be challenging in view of the fact that it would take time after receiving the licence for the bank to commence banking operations while managing teething problems and, therefore, some of such banks may not be mature for listing within the prescribed time. d) Since the new banks would need to start with CBS, connectivity in rural branches would be an issue.
v) The bank shall comply with priority sector lending targets/sub-targets as applicable to other domestic banks and open at least 25 percent of its branches in unbanked rural centres (2001 census).	a) Should a couple of large industrial groups bag licences, increased M&A activity could be on the cards as several small family-owned small banks fulfill priority sector lending norms and could be eyed by

	newcomers. b) Opening at least 25 percent of new branches in unbanked areas is a modest obligation and given the fact that a selective few might eventually bag such licences, the FMs stress on ‘inclusive growth’ in his budget speech appears ornamental. It is not clear how financial inclusion would be served by some rural branches of the kind that already exist. What prevents the new bank to open ‘rural’ branches in close proximity to urban/metro areas that technically fall in ‘rural’ classification? c) Existing banks have to adhere to this norm only in respect of their new branches. New banks have to adhere to it from the beginning, which would raise their operating expenses. d) What could be considered is creation of a Universal Services Obligation (USO) Fund which operates in a non-discriminatory fashion. The USO funds in the telecom and aviation sectors in the country are good examples. For banks, a possible source could be the existing inoperative funds over 10 years lying with the banks. e) Gaurav Chorey of ILS, Law College, Pune had suggested that struggling RRBs, particularly in underbanked areas, be allowed to be taken over by the proposed banks. While the guidelines are silent on this, maybe taking over a RRB could be pegged with every licence. This would enable the RRBs to take benefit of envisaged justifications for new private banks, namely, injection of capital, better management and

vi) The promoters, their group entities, NOHC and the bank shall be subject to consolidated supervision by the RBI; the NOHC shall not be permitted to set up any new financial entity for three years and the bank shall be governed by the relevant Acts, guidelines including that of SEBI. vii) A group within an existing NBFC, if eligible, will have to promote a new bank if some or all of its activities are not permitted to be undertaken. Setting up of a NOHC would be mandatory. RBI would consider the new bank to take over and convert the existing NBFC branches into bank branches only in Tier 3 to 6 centres and also subject to maintaining 25 percent of the bank branches in unbanked rural centres.	improved technology. f) Given the fact that the very reason why these licences were thought of was financial inclusion, it was incumbent upon the RBI to lay down this condition. g) The condition also supports and prevents over-concentration of banks in cities.
H) Additional considerations: i) Where promoter groups have 40 percent or more assets/income from non-financial business, the Board of the bank should have a majority of independent Directors. Further stringent exposure norms to entities in the promoter group have been laid down. ii) A quarterly return to RBI on such exposures would be submitted. iii) The bank would be required to seek prior approval of RBI for raising paid	

up capital beyond Rs1000crore for every block of Rs500crore.	

The RBI has also clarified that it may not be possible to issue licences to all eligible applicants. However, the guidelines are not specific on the number of licences to be given out. The applications would first be screened by RBI to ensure *prima facie* eligibility before referring the applications to a High Level Advisery Committee to be set up, which in turn would submit its recommendations to RBI. In order to ensure transparency, the names of applicants and all details submitted will be placed on the website of the RBI. An in-principle approval would be issued by RBI would be valid for one year.

The last time when RBI issued final guidelines for new banks in 2001, it took the regulator another two-three years for granting approvals for commencement of business. This time around, amendments have been sought in the Banking Regulation Act and fructification of the final guidelines might take longer. Reportedly, the Standing Committee on Finance will not submit its report on the Banking Regulation Amendment Bill, 2011 during the current session of the Parliament which can be expected only in the winter session.

The amendment proposes:

- to raise voting rights of the shareholders of nationalised banks from one to 10 percent;
- to remove the existing restriction on voting rights limited to 10 percent in the case of private banks;
- to confer powers upon the RBI to call for information and returns from the associate enterprises of banking companies and to inspect the same, if necessary; and
- to confer powers upon the RBI to supersede the Board of Directors of a banking company for a total period not exceeding one month and to appoint an administrator to manage the banking company during the said period.

The RBI has already clarified that it would wait for the amendment of the bill before granting new bank licences.

Conclusion

It has been widely reported in the media that the draft guidelines have been generally welcomed. While such a response from depositors and public could well be appreciated but similar sentiments from prospective licence seekers is baffling in view of the following:

1. As remarked by Shobhana Subramanian in the FE following the announcement of the draft guidelines “ if the discussion paper on new bank licences, put out in August last year, showed how diffident the central bank was about allowing large industrial houses into the banking space, the draft guidelines reaffirms that it remains so.”

2. When the Banking Regulation Act is finally amended to accommodate the proposed guidelines, it would empower RBI to supersede banks boards in case of any serious irregularities. At the moment, such a provision is conspicuous by its absence. Since the draft guidelines contain a strong focus on financial inclusion, efficient corporate governance, adequate controls on exposure to group companies, and time-bound milestones for listing, these have already precluded a number of aspirants. Even those left in the fray now probably are still struggling to come to terms with the implication of each of the rather stringent set of conditions.

3. Reportedly, aspirants are busy justifying their claims to be eligible even as analysts are not too optimistic about the chances of most of them. Add to this the rider imposed in the guidelines that RBI will give licences on a very selective basis and that it may not be possible to issue licences to all the eligible applicants, the situation underlines the fact that the apex bank's discretionary powers shall play a major role.

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