

Reserve Bank of India

Draft Guidelines for Licensing of New Banks in the Private Sector

August 29, 2011

Over the last two decades, the Reserve Bank licensed twelve banks in the private sector. This happened in two phases. Ten banks were licensed on the basis of guidelines issued in January 1993. The guidelines were revised in January 2001 based on the experience gained from the functioning of these banks, and fresh applications were invited. The applications received in response to this invitation were vetted by a High Level Advisory Committee constituted by the Reserve Bank, and two more licences were issued.

The January 2001 guidelines indicated that the Reserve Bank will consider licensing more banks after three years following a review of the working of the private sector banks. However, this was deferred owing to a variety of factors including our experience with the new banks and the fact that the banking sector was going through a phase of consolidation.

Finance Minister's Budget Announcement

The Finance Minister made the following announcement in his budget speech for 2010-11 with regard to licensing of new banks:

“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 the geographic 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 licences to private sector players. Non Banking Financial Companies could also be considered, if they meet the RBI's eligibility criteria.”

In pursuance of the budget announcement, the Reserve Bank put out a Discussion Paper on its website in August 2010 inviting feedback and comments. The Discussion Paper marshalled international practices, Indian experience, as well as the extant ownership and governance (O&G) guidelines.

The Discussion Paper covered a swathe of issues. Important among them are the following:

- (i) Eligibility criteria for applicants including importantly whether corporates be made eligible, and if so under what safeguards?
- (ii) Should Non-Banking Financial Companies be allowed to convert themselves into banks or promote new banks?
- (iii) What should be the appropriate entry level capital to attract serious players committed to financial inclusion?
- (iv) What should be the level of promoters' shareholdings at the initial formative stage of the bank and what should be the level of promoters' holding in the long run to ensure diversified ownership? What should be the time frame for dilution?
- (v) With the objective of creating strong domestic banks, what should be the level of foreign shareholding in the initial stages and within what time frame the extant FDI rules should become applicable?

The Discussion Paper elicited wide response from the general public, consultants, existing banks, industrial and business houses, Non-Banking Financial Companies, Micro Finance Institutions, etc. through emails and letters. There was also extensive discussion in the media through analytical pieces as well as editorial opinion. The Reserve Bank also held discussions with important stakeholders viz. Confederation of Indian Industry (CII), Finance Industry Development Council (FIDC), Indian Banks' Association (IBA), The Associated Chambers of Commerce and Industry of India (ASSOCHAM), Federation of Indian Chambers of Commerce & Industry (FICCI), Indian Merchant Chambers (IMC), Micro Finance Institutions Network (MFIN), Consultants, All India RRB Officers' Federation, etc. on October 7 and 8, 2010. The gist of these comments and discussions was placed on the Reserve Bank's website on December 23, 2010.

The present draft guidelines on 'Licensing of New Banks in the Private Sector' have been framed taking into account the experience gained from the functioning of the banks licensed under the guidelines of 1993 and 2001 and the feedback and suggestions received in response to the Discussion Paper.

It may be pertinent to mention that certain amendments to the Banking Regulation Act, 1949 are under consideration of the Government of India including a few which are vital for finalization and implementation of the policy for licensing of new banks in the private sector. These vital amendments are: removal of restriction of voting rights 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'; empowering RBI to supersede the Board of Directors of a bank so as to protect depositors' interest; and facilitating consolidated supervision. The final guidelines will be issued and the process of inviting applications for setting up of new banks in the private sector will be initiated only after the Banking Regulation Act is amended as above.

2. Guidelines

(A) Eligible promoters

- (i) Only entities / groups in the private sector that are owned and controlled by residents shall be eligible to promote banks.
- (ii) Promoters / promoter groups with diversified ownership, sound credentials and integrity that have a successful track record for at least 10 years in running their businesses shall be eligible to promote banks. RBI may seek feedback on applicants on these aspects from other regulators and enforcement and investigative agencies like Income Tax, CBI, Enforcement Directorate, etc. as appropriate.
- (iii) Banking is essentially based on fiduciary principles as depositors' money is involved. It therefore becomes imperative that the fit and proper assessment framework for bank promoters is much more comprehensive in scope as compared to other sectors. Any such framework also needs to look into the nature of activities the promoter group of the bank is predominantly engaged in. There are certain activities, such as real estate and capital market activities, in particular broking activities which, apart from being inherently riskier, represent a business model and business culture which are quite misaligned with a banking model. Post-crisis, there are concerted moves even internationally to separate banking from proprietary trading. More importantly, in India, past experience with brokers on the boards of banks has not been satisfactory. It will therefore be necessary to ensure that any entity/ group undertaking such activities on a significant scale is not considered for a bank licence. Otherwise there will be real risks

of the same business approach getting transmitted to the banks as well and it will be difficult to address this only through regulations. Accordingly, entities/groups that have significant (10% or more) income or assets or both from/ in such activities, including real estate construction and broking activities taken together in the last three years, shall not be eligible to promote banks.

- (iv) Applicants will be required to list group companies undertaking key business activities.

(B) Corporate structure

- (i) Promoter / promoter groups will be permitted to set up a new bank only through a wholly-owned Non-Operative Holding Company (NOHC) which will hold the bank as well as all the other financial services companies regulated by RBI or other financial sector regulators. The objective is that the Holding Company should ring fence the regulated financial services activities of the group including the new bank from other activities of the group i.e., commercial, industrial and financial activities not regulated by financial sector regulators. Thus, only non-financial services companies / entities and individuals belonging to the promoter group will be allowed to hold shares in the NOHC. Financial services companies belonging to the promoter group would be held by the NOHC and would not have shareholding in it.
- (ii) The NOHC will be registered as a non-banking finance company (NBFC) with the Reserve Bank and will be governed by a separate set of prudential guidelines.
- (iii) The NOHC will not be permitted to borrow funds for investing in companies held by it. It will just be a vehicle to hold the investments in all regulated financial sector entities on behalf of the promoter/promoter group for regulatory and prudential comfort.

(C) Minimum capital requirements and holding by NOHC

- (i) The initial minimum paid-up capital for a new bank shall be ₹500 crore. The actual capital to be brought in will depend on the business plan of the promoters.
- (ii) 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.

- (iii) Shareholding by NOHC in the bank 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.
- (iv) In the event of the bank raising further capital during the first five years from the date of licensing, the 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. Capital, other than the holding by NOHC, could be raised through public issue or private placements.
- (v) 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.

(D) Foreign shareholding in the bank

The aggregate non-resident shareholding from FDI, NRIs and FIIs 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.

(E) Corporate governance

- (i) 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.
- (ii) No financial services entity under the NOHC would be allowed to engage in any activity that a bank is permitted to undertake departmentally. All such activities, if any, will have to be moved to the new bank subject to such conditions as RBI may specify.
- (iii) RBI will have to be satisfied that the corporate structure does not impede the financial services under the NOHC from being ring fenced, that it would be able to supervise the bank and the NOHC on a consolidated basis, and that it will be able to obtain all required information from the group relevant for this purpose smoothly and promptly.

- (iv) 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.
- (v) The source of promoters' / promoter groups' equity in the NOHC should be transparent and verifiable.

(F) Business model

- (a) Applicants for new bank licences will be required to forward their business plan for the new banks along with their applications. The business models will have to address how the bank proposes to achieve financial inclusion.
- (b) The business model submitted by the applicant should be realistic and viable. In case of deviation from the stated business plan after issue of licence, RBI may consider restricting the bank's expansion, effecting change in management and imposing other penal measures as may be necessary.

(G) Other conditions

- (i) Shareholding of 5% or more of the paid up capital of the bank by individuals / entities / groups will be subject to prior approval of RBI.
- (ii) No single entity or group of related entities, other than the NOHC, shall have shareholding or control, directly or indirectly, in excess of 10% of the paid up capital of the bank.
- (iii) The bank shall maintain arm's length relationship with promoter group entities, their business associates, and the suppliers and customers of these entities. The exposure of the bank to any entity in the promoter group shall not exceed 10% and the aggregate exposure to all the entities in the group 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 Regulation Act, 1949. All exposures to promoter group entities will have to be approved by the Board.

- (iv) In taking a view on whether an entity belongs to a particular promoter group or not or whether the entities are linked / related to the promoter group, the decision of RBI shall be final.
- (v) The top management of the bank shall have expertise in the financial sector, preferably, banking.
- (vi) The bank should operate on Core Banking Solution (CBS) from the beginning.
- (vii) The bank shall make full use of modern infrastructural facilities in office equipments, computer, telecommunications etc. in order to provide cost-effective customer service. It should have a high powered Customer Grievances Cell to handle customer complaints.
- (viii) The bank shall get its shares listed on the stock exchanges within two years of licensing of the bank.
- (ix) 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.
- (x)
 - (a) The bank shall comply with the priority sector lending targets and sub-targets as applicable to other domestic banks, and
 - (b) The bank shall open at least 25 per cent of its branches in unbanked rural centres (population up to 9,999 as per 2001 census) to avoid over concentration of their branches in metropolitan areas and cities which are already having adequate banking presence.
- (xi) The promoters, their group entities, NOHC and the proposed bank shall be subject to the system of consolidated supervision by the Reserve Bank of India.
- (xii) The NOHC shall not be permitted to set up any new financial services entity for at least three years from the date of licensing.
- (xiii) The bank will be governed by the provisions of the Banking Regulation Act, 1949, Reserve Bank of India Act, 1934, other relevant Statutes and the Directives, Prudential regulations and other Guidelines/Instructions issued by RBI and other regulators, including the regulations of SEBI regarding public issues and other guidelines applicable to listed banking companies.

(xiv) The promoter / promoter group with an existing NBFC, if considered eligible for a bank licence, will have two options:

(a) Promote a new bank, if some or all the activities undertaken by it are not permitted to be undertaken by banks departmentally. In such cases, 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. Reserve Bank will consider allowing the new bank to take over and convert the existing NBFC branches into bank branches only in the Tier 3 to 6 centres. Existing branches of the NBFC in Tier 1 and 2 centres may be allowed to convert into bank branches only with the prior approval of RBI and subject to the existing rules / methodology applicable to domestic banks regarding opening of branches in these centres and also subject to maintaining 25% of the bank branches in unbanked rural centres (population up to 9,999 as per 2001 census) required of all new banks as specified in G(x) (b) above.

(H) Additional considerations in respect of promoter groups having 40% or more assets / income from non financial business

(a) In respect of promoter groups having 40% or more assets / income from non financial business, the following additional requirements will be applicable:

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

(ii) 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 Regulation Act, 1949. All exposures will have to be approved by the

Board and all credit facilities to these entities should have a minimum tangible security cover of 150%.

- (iii) 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 ₹1 crore.
 - (iv) Banks would be required to seek prior approval of RBI for raising paid-up capital beyond ₹1000 crore for every block of ₹500 crore. While examining such proposals, the RBI shall primarily look into whether the bank has indulged in connected lending and self dealing, 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'.
- (b) If RBI is not satisfied about compliance with the above provisions, it would take severe deterrent action as per law and licensing conditions.

3. Procedure for RBI decisions

- (i) In view of the increasing emphasis on stringent prudential norms, transparency, disclosure requirements and modern technology, the new banks need to have strength and efficiency to work profitably in a highly competitive environment.
- (ii) Banking being a highly leveraged business, licences shall be issued on a very selective basis to those who conform to the above requirements, who have an impeccable track record and who are likely to conform to the best international and domestic standards of customer service and efficiency. Therefore, it may not be possible for Reserve Bank to issue licences to all the applicants meeting the eligibility criteria prescribed above.
- (iii) At the first stage, the applications will be screened by RBI to ensure *prima facie* eligibility of the applicants. RBI may apply additional criteria to determine the suitability of applications, in addition to the minimum criteria prescribed at 2(A). Thereafter, the applications will be referred to a High Level Advisory Committee to be set up by RBI.

- (iv) The High Level Advisory Committee will comprise eminent personalities with experience in banking, financial sector and other relevant areas.
- (v) The High Level Advisory Committee will set up its own procedures for screening the applications. The Committee will reserve the right to call for more information as well as have discussions with any applicant/s and seek clarification on any issue as required by it. The Committee will submit its recommendations to RBI for consideration. The decision to issue an in-principle approval for setting up of a bank will be taken by RBI. RBI's decision will be final.
- (vi) In order to ensure transparency, the names of the applicants and all details submitted along with the application for new bank licences will be placed on the RBI website.
- (vii) The validity of the in-principle approval issued by RBI will be one year from the date of granting in-principle approval and would thereafter lapse automatically. Therefore, the bank will have to be set up within one year of granting the in-principle approval.
- (viii) After issue of the in-principle approval for setting up of a bank, if any adverse features are noticed subsequently regarding the promoters or the companies/firms with which the promoters are associated and the group in which they have interest, the Reserve Bank of India may impose additional conditions and if warranted, it may withdraw the in-principle approval.
