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RBI Releases Gist of Comments on the Discussion Paper on Entry of New Banks in the Private Sector

The Reserve Bank of India released on its website today, the gist of the comments on the Discussion Paper on "Entry of New Banks in the Private Sector". The range of comments received has been very wide and does not indicate consensus on any of the issues. The comments received are reflective of sectoral positions, i.e. of banks, NBFCs and industrial houses. Comments from others also spanned a wide range.

It may be recalled that pursuant to the announcement made by the Union Finance Minister in his budget speech for the year 2010-11 that the Reserve Bank was considering giving some additional banking licences to private sector players, the Governor, Reserve Bank of India indicated in the Annual Policy Statement for the year 2010-11 that the Reserve Bank would prepare a discussion paper marshalling the international practices, the Indian experience as well as the extant ownership and governance (O&G) guidelines and place it on the Reserve Bank's website by end-July 2010 for wider comments and feedback. Accordingly, the Reserve Bank released on its website on August 11, 2010, the Discussion Paper on "Entry of New Banks in the Private Sector" seeking the views/comments from banks, non-banking financial institutions, industrial houses, other institutions and the public at large.

The Discussion Paper reviewed the international and Indian experience on issues listed below together with possible approaches with the pros and cons of each of the approaches.

i) Minimum capital requirements for new banks and promoters contribution

ii) Minimum and maximum caps on promoter shareholding and other shareholders

iii) Foreign shareholding in the new banks

iv) Whether industrial and business houses could be allowed to promote banks

v) Should Non-Banking Financial Companies be allowed conversion into banks or to promote a bank

vi) Business model for the new banks

Detailed discussions on the above issues were held on October 7 and 8, 2010 with associations of stakeholders from the industry, banks, NBFCs and MFIs and some consultants, viz, CII, ASSOCHAM, FICCI, IBA, RRBs Officers' Federation, FIDC, MFIN, Ernst & Young, and Pricewaterhouse Coopers. In addition, comments on the discussion paper were received from a large number of respondents which include parties interested in setting up new banks, industry associations, banks, academicians, eminent personalities associated with banking and finance and members of general public.

Gist of Comments

The gist of comments on various issues received from important stakeholders and eminent people through mail and discussions is summarised below:

(A) Minimum capital requirement for new banks

There were diverse views on the minimum initial capital requirement of new banks to be set up in the private sector. Generally, the federations/associations of industry/banks favoured a high start-up capital of ₹ 1000 crore, which could be raised up to ₹ 1500-2000 crore over a period of time, as new banks would require high investments in technology for financial inclusion and to scale up operations to be viable. Further, higher level of minimum capital would ensure that only serious players with long term vision could enter banking sector.

NBFC/MFI sector preferred a lower start-up capital ranging from ₹ 300 to ₹500 crore. With this capital requirement, it has been argued that 30- 40 banks could be licensed within a period of next 5-10 years with dedicated focus on financial inclusion. One view was that a large bank with capital of ₹ 1000 crore was unlikely to be effective at local lending or at financial inclusion and therefore, RBI may also consider giving restricted (traditional) banking licences to about 20 new banks with minimum capital of ₹ 50 crore and a capital to asset ratio of not less than 15 percent.

(B) Promoters' shareholdings in new banks

The suggestions on initial promoters' contribution ranged from 30 percent to 100 percent. The federations/associations of industry suggested a range of 40-51 percent, while NBFC/MFI sector suggested a lower range of 30-40 percent. The minimum promoters' contribution to be retained after dilution of stake over a period of 5-10 years ranged from 5-26 percent. The industry representatives were of the view that strong companies are promoter driven and therefore, advocated a higher range of final stake holding of 20-26 percent as it would ensure long term interest and commitment of the promoters. There was a suggestion that on the lines of Canadian Model, depending upon the size of the bank, promoters should be permitted to hold to the extent of 40 percent in case of banks with ₹ 1000 crore initial capital, 30 percent in case of banks with ₹ 1000-2000 crore capital and 10 -20 percent in case of banks with capital of more than ₹ 2000 crore. Another suggestion was that promoters' contribution could continue at 40-50 percent with restrictions on voting rights to ensure that promoters' economic interest is retained while addressing the concerns relating to control. The suggestion from the Micro Finance sector was a lower cap of 10 percent on promoters' holding in the long run to ensure that the banks are agenda driven rather than individual driven.

(C) Foreign shareholdings in new banks

A number of suggestions were received in regard to foreign share holdings ranging from capping the shareholdings at 50 percent to have no restrictions at all. Even amongst the industry/associations/ banks, while some of them advocated putting a cap at 50 percent, others have suggested continuing with the existing norm of 74 percent or not having any restriction for the initial period of 10 years. The NBFC/MFI sector was of the view that prescribing a cap of 50 percent for banking industry will be contradictory since foreign investments in NBFC sector is permitted upto 100 percent. They were in favour of retaining the existing norm of 74 percent or not putting any restrictions at all.

Another suggestion received from public was to put restriction on the voting rights, which should not exceed 5 percent individually and 26 percent in aggregate or such other limits as may be prescribed.

(D) Industrial/business houses promoting new banks

A wide range of views have been expressed as to whether industrial/business houses should be allowed to promote new banks. These include, why they should not be given, why they should be given and if so, who should be permitted and with what conditions. The federations/associations of industry as well as NBFC/MFI sector were generally in favour of permitting industrial/business houses to promote new banks. On the other hand, RBI has been advised by others to exercise caution about the entry of industrial houses into banking and not to allow industrial houses an unrestricted banking licence. Banks were also not in favour of the proposal due to the unsavory past experience in India and abroad and that large capital buffer that would be available to the banks sponsored by industrial/business houses would create an uneven playing field with the existing banks.

The main arguments put forward were :

i) Arguments against giving licence to industrial/business houses:

- Experience of other counties show that combining banking and commerce, that is, having a financial licence and having industrial activity, implies there would be a lot of connected lending. India does not have enough experience in supervising in a scenario when banks are owned by diversified corporates, and allowing such ownership could have serious potential disasters.
- The ownership structure of large industrial / business groups may open opportunities for regulatory arbitrage. In cases where the apex entity of a financial conglomerate is an unregulated entity, there could be gaps in risk assessment and supervision, and associated contagion risk within the financial conglomerate concerned and the wider system.
- India already has a concentrated wealth structure, which influences political decisions. Allowing industrial houses to own banks will exacerbate the concentration of economic power and political influence. However, as an experiment, a couple of industrial houses could be allowed to own restricted small banks and the future moves should be based on this experience.
- As there is no dearth of capital, existing players also could raise the required capital and, as such, no additional benefit accrues by granting bank licences to industrial houses.

ii) Arguments in favour of giving licence to industrial/business houses:

- Financial inclusion requires higher scale of operations which the industries would be able to bring by deploying large capital.
- Industrial / business houses have the entrepreneurial and managerial talent in running asset management companies, mutual funds and insurance companies and have successfully penetrated into rural India, as such, their talent could be gainfully harnessed in the banking sector. Moreover, industrial houses could bring to banking strong governance practices, management

expertise, talent, innovation and global best practices especially in customer service, as they have had a long history in nurturing and developing businesses.

iii) Eligibility criteria for granting licence to the industrial/business houses:

- Industrial / business houses with diversified shareholding and transparent shareholding structure should be permitted to set up banks.
- Industrial / business houses having predominant presence & experience in the financial sector (for certain minimum years, say 10 years) could be considered granting banking licence after examining their track record of dealing with public deposits and considering their existing retail customer base.
- Real estate groups should not be barred from entering into the banking sector as other businesses such as steel, textiles, petrochemicals, oil and gas, etc. are much more vulnerable to deep and prolonged cyclical downturns than real estate.

iv) Safeguards for allowing industrial/business houses to promote new banks:

- If industrial / business houses are permitted to promote banks, they should not be allowed to have their own banking operations through the bank they have promoted.
- Banks promoted by industrial houses should be issued only a retail banking license for first 5 years. Subsequently, commercial banking should be allowed with restrictions on annual credit lines, extensive reporting requirements relating to large credits, etc.
- Inherent conflict of interest with the industrial houses setting up banks could be addressed through strong regulation relating to connected lending, mutual lending to each other’s sponsor groups, ring fencing of the activities, governance standards and exposures which could be clearly addressed through licensing conditions. Violation of these regulations should attract severe penal action, including withdrawal of the bank license. No Board member or employee of an industrial house should be allowed to be on the Board of the bank or be an employee of the bank. Further, independence of the Board of the bank could be ensured by defining independent directors and restricting their compensation to only a professional fee.
- There may be value in experimenting with the industrial / business houses and the dual license structure offers some scope for it. A couple of industrial houses with substantial integrity could be given restricted small bank licenses. Whether the industrial / business houses’ license is upgraded will depend on their performance and supervisory comfort with them. Establishing many small and mid size banks will help the banks to be innovative in delivering local need based services to the low income & poor households.

(E) Permitting conversion of NBFC into banks or promoting new banks

There were diverse views on the issue of permitting conversion of NBFCs into banks or to promote new banks. A leading industry association was of the view that conversion of NBFC should not be permitted due to difficulty in aligning its business model to banking. However, if NBFCs are allowed to promote new banks, they should be asked to wind up the activities which banks can do, in a phased manner in order to eliminate the arbitrage opportunities due to the lighter regulations in the NBFC sector. Other industry associations were generally in favour of conversion or promotion of new banks by NBFCs. The NBFC/MFI sector was in favour of both the options. Banks were in favour of allowing only stand alone NBFCs to promote banks and at the same time, debarring NBFCs sponsored by industrial/business houses.

(F) Business Model

The dominant view of the industry associations and banks was that general banking licences should be given to new players for ensuring level playing field. Concentration in any geographical area or business line, such as, financial inclusion would be an unviable proposition. Financial inclusion should be market driven, but not prescribed. Since the banks need to cope with the objective of financial inclusion and also compliance with CRR, SLR, Priority Sector Advances stipulations, etc., certain time period needs to be given to the new banks for achieving the objectives.

As the objective of granting licence for new banks is financial inclusion, a different type of licence could be given to new banks. An eminent economist has suggested that their activities in the initial period may be restricted to more traditional banking, which could be relaxed as supervisors gained confidence in the banks. Full-fledged banking licences could be given after three years of operations subject to compliance with certain criteria. There are also suggestions that new banks should cater to small ticket financial products with clear definition regarding the size of loans. However, there is no need for specifying the areas in which the new banks should function as there are financially excluded people even in metros and big cities.

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