New Licensing Guidelines for Private Sector Banks

Vinod Kothari Consultants P Ltd

1012 Krishna
224 AJC Bose Road
Kolkata – 700017
Phone 033-22811276/ 22813742/ 22817715

222, Ashoka Shopping Center
2nd floor
L T Road
Mumbai 400 001
phone – 022 22675600

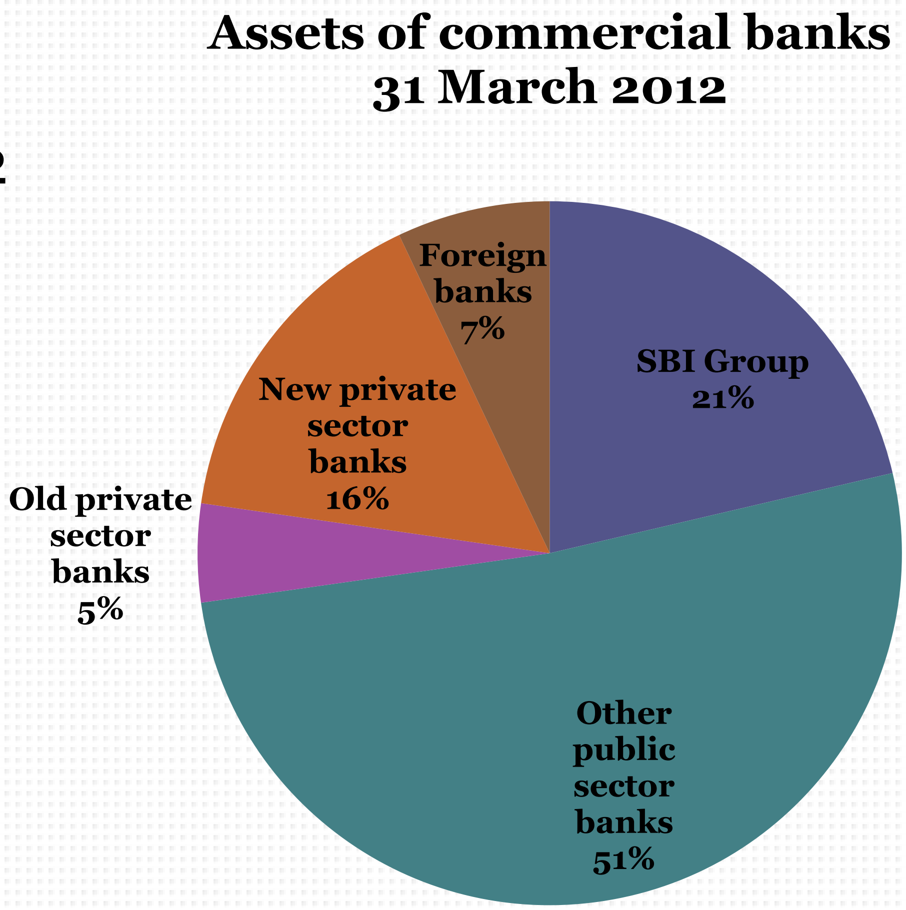
www.vinodkothari.com
Email: vinod@vinodkothari.com

Copyright and disclaimer

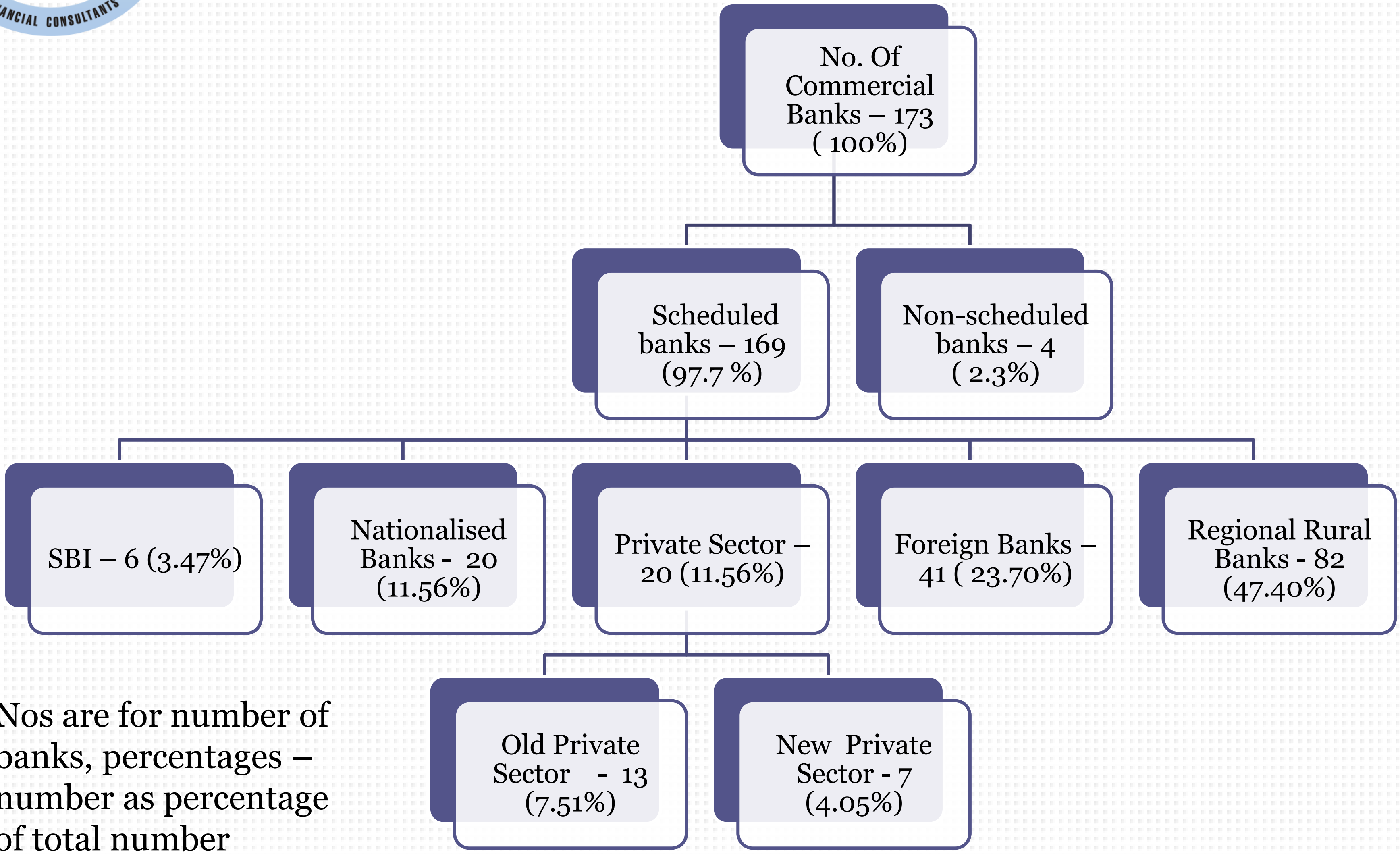
- The contents of the presentation are intended solely for the use of the client to whom the same is marked by us.
- No circulation, publication, or unauthorised use of the presentation in any form is allowed, except with our prior written permission
- No part of this presentation is intended to be professional advice, or solicitation of professional assignment.

State of banking in India

- Currently, there are 169 banks in India, including 82 regional rural banks
- About 76% of the total banking assets are in the PSU banks, though private sector banks are making a significant headway



Banking sector (2011-12)



Nos are for number of banks, percentages – number as percentage of total number

Banks vs NBFCs 1/3

	Banks	NBFCs
Sources of funding		
Leverage	Capital requirements in case of banks is 9%. Basel III imposes an additional 2.5% capital conservation buffer (retention of profits)	Capital requirements for NBFCs 15%
Tier 1 capital	7% as per Basel III	10% as per Usha Thorat draft
Risk weights	Basel II risk weights based on rating of corporate borrowers, and lower risk weights for retail pools applicable	No such rating-based or lower risk weights in case of NBFCs
Access to deposits	Permissible	Not permissible
Regulation of bond issuances	No regulations applicable to private issue of bonds	RBI regulates short-term bonds. In general, bonds may also come under Deposit Regulations

Banks vs NBFCs 2/3

	Banks	NBFCs
Business		
Checking accounts	Permissible	Not permissible
Remittance business	Permissible	Not permissible
Credit cards, smart cards, etc	Permissible	Not permissible
Non-funded exposures (guarantees, LCs, etc)	Permissible	Not permissible
Non-banking business (trading, investments, operating leasing)	Not permissible	Permissible

Banks vs NBFCs 3/3

	Banks	NBFCs
Tax benefits		
Ability to write off provisions against income	Allowed in case of banks	Not allowed
Deduction of tax at source on payments received	Borrowers making payments to banks are not required to deduct tax at source	Borrowers are required to deduct tax at source
Rate of corporate tax	Same rate (30% +surcharge+edu cess)	Same rate (30% +surcharge+edu cess)
Legal privileges		
Access to Sarfaesi Act	Allowed	Not allowed
Access to DRT law	Allowed	Not allowed
Applicability of regulatory controls		
SLR and CRR requirements	Applicable to banks based on depository balances	Not applicable to non-depository NBFCs
Priority sector lending requirements	Applicable	Not applicable

CRR and SLR requirements in case of banks

- SLR:
  - Currently 23% of DTL
- CRR:
  - Currently 4% of DTL
- Demand and time liabilities (DTL)
  - Means aggregate of liabilities as defined in sec 42 (1) (c) of the RBI Act
  - Liabilities to other banks are excluded
    - We are of the view that even where there are bonds/debentures offered to other banks, the same will be excluded
- SLR is maintained in form of cash balance and balance of specified securities

RBI Guidelines for new banking licenses

Background

- Union Finance Minister's budget speech for 2010-11 gave indication some additional banking licenses to private sector players
- Discussion Paper was placed on its site by RBI in 2010
- Draft Guidelines were placed on RBI's site on August 29, 2011 inviting public comments
- Final Guidelines issued on February 22, 2012
  - Keeping in view the recommendations of the Narasimham Committee, Raghuram Rajan Committee and feedback from market players
- As on date, 22 private sector banks registered with RBI
- Previously, RBI issued guidelines in 1993
  - 10 private sector banks registered
- Under guidelines in 2001
  - 2 private sector banks registered

Highlights of Guidelines

- Eligibility Criteria
- 'Fit and Proper' criteria
- Corporate structure of the NOFHC
- Minimum voting equity capital requirements for banks
- shareholding by NOFHC
- Regulatory framework for banks and NOFHC
- Foreign shareholding in the bank
- Corporate governance of NOFHC
- Prudential norms for the NOFHC
- Exposure norms for banks and NOFHC
- Additional conditions for NBFCs promoting / converting into a bank

Who can apply?

Following can promote a bank through a wholly-owned Non-Operative Financial Holding Company (NOFHC)

- Entities / groups in the private sector that are 'owned and controlled by residents'
- Entities in public sector

Promoters / Promoter Groups with an existing NBFC

- In name of their NBFCs

Meaning of Promoter/Promoter Group

- Promoter to mean person having control of NOFHC by virtue of his ownership of voting equity shares and includes
  - His relatives
  - All entities which form part of the Promoter Group
- Promoter Group have same definition as provided in SEBI SAST Regulations
  - All entities disclosed as a part of promoter group to stock exchanges are a part of the promoter group
  - All entities bearing the flagship name of a promoter group entity are also part of promoter group

How to make the application?

Applications to be submitted to Department of Banking Operations and Development of RBI on or before July 1, 2013 in Form III

Applications to first screened by RBI

After review, referred to High Level Advisory Committee to be set up by RBI

Based on the recommendations of the said Committee, RBI to its decision on the application

In-principle approval issued by RBI to be valid for one year from the date of granting approval

Regulatory Framework

Banks

- Banking Regulation Act
- RBI Act
- FEMA
- Payment and Settlement Systems Act

NOFHC

- Companies Act
- RBI's Directions issued to NBFCs
- New set of directions to be issued by RBI

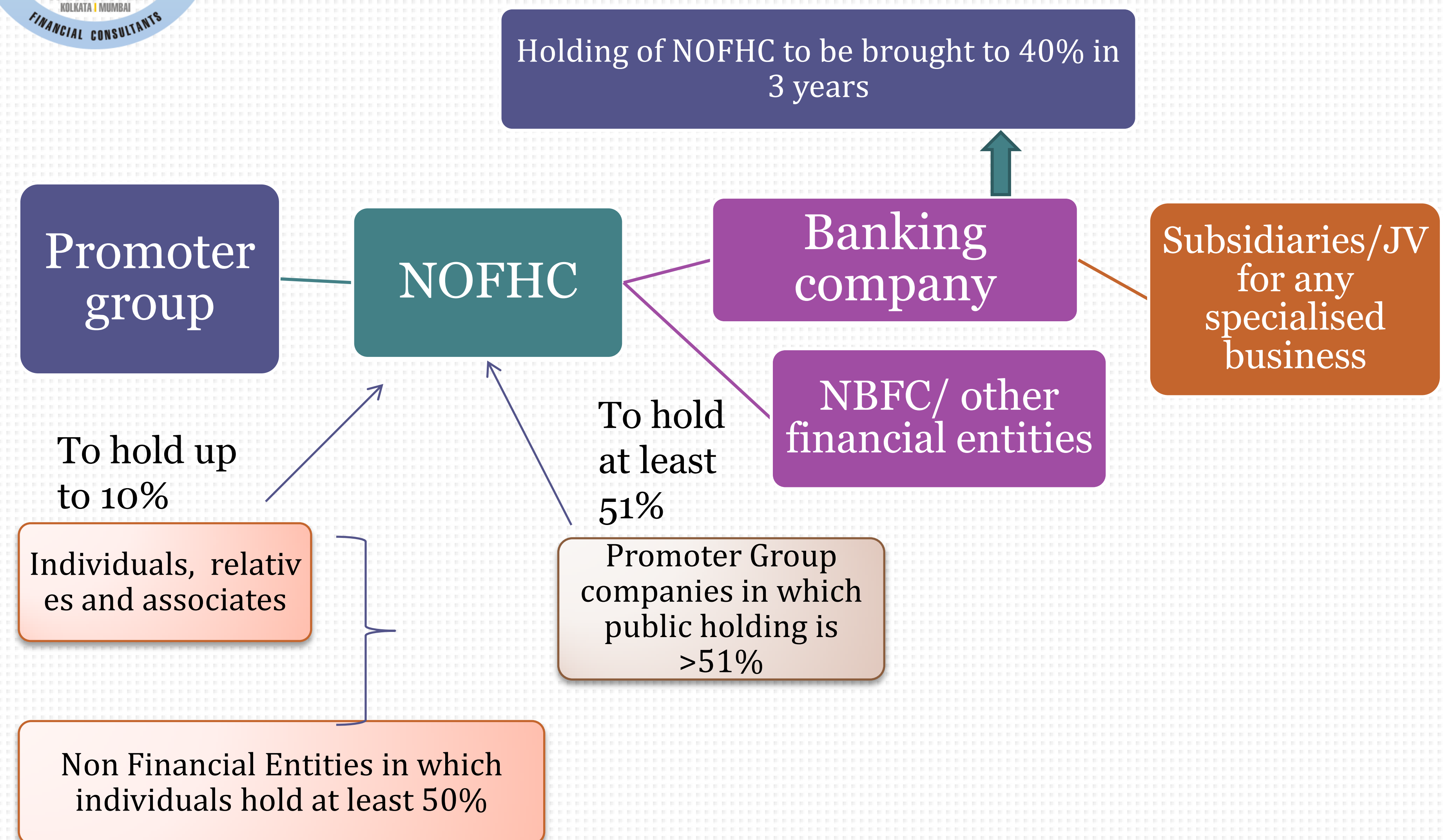
Incorporation rules for NOFHC

- New banks would require NOFHC as their holding company
- In our view, incorporation of NOFHC is not required at the time of making application
  - As application to be made in name of banking company, not holding company
  - May also be incorporated before application
- Incorporation documents
  - MOA to limit the business only to hold shares in financial companies
  - AOA may contain restrictions on directorship and change in control as provided in the guidelines
- Can existing CICs be used as NOFHCs?
  - We are of the view, yes

‘Fit and Proper Person’ criteria for promoters

- Promoters/ Promoter Groups to have
  - past record of sound credentials and integrity
  - successful track record of running their business for at least 10 years
- Promoter / Promoter Groups’ business model and business culture not to be misaligned with the banking model

Structure of Bank and NOFHC



Clarity on the 2 percentages for shareholding in the NOFHC

- Individual promoter holding
  - Maximum 10% for each individual promoter
    - This includes the companies where promoter holding is 50% or above
- Corporate holding in the promoter group
  - Minimum 51% for corporate holdings within the promoter group
  - These are the companies where the promoter holding is 49.99% or less
- Individual promoter holding is a cap
  - This may go from 0% to 9.99% per individual
- Company holding is a minimum
  - This may go from 51% to 100%

Corporate Structure of NOFHC

- NOFHC to hold shares of:
  - Banks
  - All other regulated financial entities of group
    - All shareholding of promoters will be transferred
    - Entities having significant influence to be included only
      - Entities with minor interest of promoters may be kept outside
- NOFHC, including all its consolidated entities, may make investments in other financial entities (which are not consolidated), to a limit of 10% of aggregate capital funds of the group
  - Cross holding to be eliminated

Meaning of 'regulated financial service entities'

- Includes:
  - All banking companies,
  - NBFCs,
  - housing finance companies,
  - SEBI-regulated entities
    - CICs which do not require registration are not covered

Shareholding in NOFHC

- 100% owned by Promoters
- Following can hold shares in NOFHC within specified limit
  - Non-financial services companies / entities
  - Non-operative financial holding company
    - Meaning CICs; hence, CICs not requiring registration can also hold shares
  - Individuals
- Shares of NOFHC cannot be held by any entity outside the Promoter Group
- No mention about foreign shareholding, hence extant FDI Policy becomes applicable
  - Since the NOFHC is an investment company, foreign shareholding will not be allowed

Transfer of promoters shareholding- Implications

- Stamp Duty
  - Exempted in terms of Banking Laws (Amendment) Act, 2012
    - However, exemption on transfer of shares of banking company only
  - No issue if shares are demat
    - Significant cost might have to be incurred in case of physical shares
- Capital Gain Tax
  - Presently tax is applicable
  - Exemption may be announced in the forthcoming Union Budget
- SEBI SAST Regulations
  - Presently no exemption
  - Eventually exemption may be granted

Shareholding in Bank

- NOFHC to hold a minimum of 40 per cent of the paid-up voting equity capital of the bank
  - This will be locked in for a period of five years from the date of commencement of business of the bank
  - Holding beyond 40% shall be brought down to 40% within three years
  - Holding to be brought down to 20% of the paid-up voting equity capital of the bank within a period of 10 years, and to 15% within 12 years
- Foreign Shareholding allowed up to 49% for first 5 years
  - After 5 years, extant FDI policy to apply
    - As per extant FDI Policy, FDI up to 49% is allowed under automatic route and beyond 49% but up to 74% is allowed under approval route

Capital Requirements

- For Banks
  - Initially Rs. 500 crores (as per the Guidelines)
    - However, to maintain Basel II/ Basel III capital requirements which are effective from April 1, 2013
      - Basel III guidelines require a minimum Tier 1 capital requirement of 5.5%
  - Hence, Rs 500 crores, or 5.5% of risk weighted assets, whichever is higher
- For NOFHCs
  - To be laid by directions yet to be issued by RBI
  - Assuming that the NOFHC holds 100% capital of the bank, the NOFHC will need resources of Rs 500 crores
    - This can be a combination of equity and debt

Capital Adequacy Requirements under Basel II/III

- For Banks
  - Guidelines put a minimum capital requirement of 13% for a period of 3 years
    - Not clear how much of the 13% will be in form of Tier 1
    - Going by the commonly-followed 50% norm, logical to hold that the minimum common equity requirement for new banks, for first 3 years, will be 6.5% of the risk weighted assets
- For NOFHCs
  - Minimum capital adequacy of 13% of its consolidated risk weighted assets
  - As it has no substantial business other than investments in regulated financial businesses, consolidated RWA to be seen

How can resources be raised

- By NOFHCs
  - Equity
  - Interest bearing debt instruments
    - Up to a limit of 1.25 times of paid up capital and free reserves

Provisions on distribution of Dividend

Bank	NOFHC
Can pay dividend only after writing off of all its capitalized expenditures	No bar. Can pay
Transfer of at least 20% of its net profits every year to "reserve fund" before declaration of any dividend	Transfer of at least 25% of its net profits every year to "reserve fund" before declaration of any dividend

Exposure Norms for Bank

- To be governed by RBI's Master Circular on 'Exposure Norms'
- Limits in place for investments in
  - shares and debentures of companies,
  - PSU bonds,
  - Commercial Papers (CPs)
- Guidelines provides that
  - Cannot make investment in same group companies
    - However, allowed to invest in entities which are under NOFHC subject to guidelines of the RBI on intra-group exposures
      - There are draft guidelines on intra group exposure putting limit as:
        - 10% on a single regulated financial entity, and
        - 20% on all regulated financial entities

Exposure Norms for NOFHCs

- To avoid round tripping of funds and to avoid circular movement of funds in the banking group, restrictions imposed
  - Financial entities held by NOFHC to not have exposure to Promoter Group or NOFHC
  - Inter-se investment among financial entities prohibited
  - Cannot make investment in equity of other NOFHC
    - Investment in debt securities can be made

Corporate Governance Norms

Directors of any CIC holding the NOFHC

- Generally speaking, directors of all registered NBFCs have to be "fit and proper" persons
- Usha Thorat recommendations lay down Clause 49 to be applicable to all NBFCs.
- so if the shareholding CICs in the NOFHC are regulated CICs, they need to abide by the applicable guidelines

Directors of the NOFHC

- Cannot hold directorship of other companies except subsidiary or a sec 25 company
- ‘Fit and proper’ person criteria applicable as prescribed for banks by Dr Ganguly Group Report
- At least 50% of the Board should comprise of IDs with special knowledge and practical experience
- Undertaking and declarations required from directors

Corporate Governance Norms (contd..)

Directors of Bank

- At least 51% directors to be IDs with special knowledge or practical experience in specified fields
- Directors other than chairman and WTD are restricted to hold office for more than 8 years at a stretch
- Chairman, MD and director appointed by RBI not required to hold qualification shares
- Whole time chairman to manage the bank
  - Appointment of part time chairman to be approved by RBI and MD shall be managing the bank
- Director cannot hold directorship of other banking companies
- Board to not to have more than 3 directors who shall be directors of companies exercising 20% or more voting rights in bank
- Nomination Committee to undertake process of due diligence to determine the suitability based on qualifications, technical expertise, track record, integrity, etc.
- Undertaking and declarations required from directors
- Not more than one member of family or close relative or should to be on board

Additional conditions for Banks

Bank to open at least 25 per cent of its branches in unbanked rural centres

Bank to comply with the priority sector lending targets and sub-targets as applicable to the existing domestic banks.

Banks promoted by groups having 40 per cent or more assets/income from non-financial business will require RBI's prior approval for raising paid-up voting equity capital beyond Rs. 10 billion for every block of Rs. 5 billion.

Any non-compliance of terms and conditions will attract penal measures including cancellation of license of the bank.

Banks to get its shares listed on the stock exchanges within three years of the commencement of business

Prudential Norms for NOFHCs

To comply on stand alone as well as on consolidated basis

Prudential norms guidelines for banks are applicable; to adhere to norms for

- Classification, valuation and operation of investment portfolio
- Income Recognition,
- Asset Classification and
- Provisioning pertaining to Advances

Conditions for existing NBFCs applying for license

- Options available:
  - Start a bank as a separate entity afresh
    - In this case, all existing banking business being carried by the NBFC will be transferred to the bank
  - Convert the NBFC itself into a bank
    - If NBFC carrying on business which is not permitted for banks, such business will be divested into the NBFC
- Lots of factors be evaluated, primarily the reorganisation of shareholdings
  - SEBI SAST compliances required
  - Most transformation of existing companies into banks may need schemes u/s 391, 393 of the Companies Act