

# *Analytical Speaking*

## **New banking licenses : Confusions galore in RBI “clarifications”**

---



**Vinod Kothari**  
[vinod@vinodkothari.com](mailto:vinod@vinodkothari.com)  
Vinod Kothari & Company  
June 05, 2013

Check at:  
<http://india-financing.com/staff-publications.html>  
for more write ups.

### **Copyright:**

This write up is the property of Vinod Kothari & Company and no part of it can be copied, reproduced or distributed in any manner.

### **Disclaimer:**

This write up is intended to initiate academic debate on a pertinent question. It is not intended to be a professional advice and should not be relied upon for real life facts.



## *Analytical Speaking*

With all humility being harnessed, one cannot call it “clarifications”. In fact, the whole scenario surrounding the new banking licenses has become a lot more confused, with the 165 page document euphemistically called “clarifications”.

For the starter, one does not have to be impressed the massive amount of writing that the RBI might have had to do to produce the 165-pager, since the document contains questions too – questions that users may have posed to the RBI. And there are 422 questions! And in addition, there are several answers which are repetitive.

### **Existing NBFCs converting into banks:**

One of the most vexed questions is what would be the mode of conversion of existing NBFCs into banks. From what appears from newspaper stories, the most significant interest in the new banking licenses has come from existing leading NBFCs. How would these companies convert themselves into NBFCs?

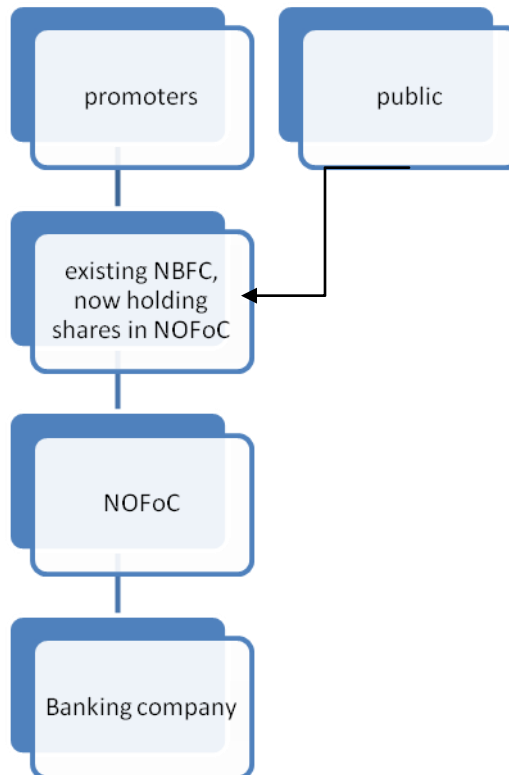
It is notable that the ownership structure of banks in India would envisage substantial holding in the banking company being with another entity, a holding company, called NOFHoC. The NOFHoC, in turn, must also have at least 51% of its shares held by companies, in which the “public” (read this non-promoter) holding is not less than 51%.

Most of the NBFCs proposing to convert themselves into banks are listed companies. If these companies were to convert themselves into banks, the issue is – what do the shareholders of these companies get? It is evident that the banking company itself cannot be held by the public, since a banking company has to be mandatorily held by the NOFHoC. Therefore, the most plausible solution seemed to be to transfer the business of the NBFC to a banking company, and hold the shares of the banking company into the erstwhile NBFC.

However, the RBI’s suggested structure, coming from Q 71 of the Clarifications, seems to be that the listed NBFC will hold shares of the NOFHoC, which, in turn, will hold the bank. This multi-tier structure creates a huge tax drain, thereby causing a loss of shareholder value. Let us not forget that India has double tax on corporate dividends, in form of distribution tax. Therefore, as we proliferate entities, we keep increasing the tax drain.

The structure envisaged by the RBI comes in the diagram.

## *Analytical Speaking*



One must realize that this leads to 2 layers of dividend distribution tax, besides one layer of corporate tax. One would argue that it is possible to eliminate one layer of dividend distribution tax taking advantage of the provisions of sec. 115-O (1A); however, one needs to then structure NOFHoC as the subsidiary of the NBFC.

Ideally, it would be better for the NBFC to opt for a court-approved scheme of restructuring and offer the shares of NOFHoC to the shareholders of the NBFC by way of a swap. However, the insistence of the RBI that the shares of NOFHoC should be owned by the promoter group creates a problem. In answer to Q 78 etc., the RBI seems to be permitting a listed company being a shareholder of NOFHoC. The RBI also is clearly opposed to the idea of the listed company itself being the NOFHoC (see Q 79 (b) ).Further, Q 96 clearly rejects the swap of shares model. Thereby, there has necessarily to be a layer of shareholding between the NOFHoC and the shareholders of the NBFC, which will create the tax drain referred to above.

### **Loss of regulatory arbitrage:**

One possible limitation that anyone nurturing a banking dream needs to consider is that the banking group (meaning all financial entities under the NOFHoC group) will not be eligible to carry any unregulated activities. Currently, NBFCs have absolute liberty to carry financial activities, as well as non-financial activities. For example, an NBFC may even carry trading



## *Analytical Speaking*

in properties, or trading in commodities, or any other activity for that matter. The only thing that NBFCs need to ensure is that their income from such non-financial activities stays limited to 50%, thereby ensuring that the principal business is financial activity.

However, once the financial group (that is, the banking company and other financial activities which necessarily have to come under the NOFHoC umbrella) has a banking company in terms of the RBI guidelines, surely enough, the banking company can only carry such activities which are regarded as para-banking activities by the RBI. The examples of these are given in Q 86. For other regulated financial activities, the group has the liberty of carrying them under other entities within the NOFHoC umbrella. But then, can any of the entities under the NOFHoC umbrella carry non-financial activities? For example, trading, or consulting? Surely, there is a restriction against a bank carrying non-banking activity under the Banking Regulation Act, but surely, there is should not be any such restriction in case of other financial entities under the NOFHoC umbrella.

However, the mood of the RBI seems to be that entities under the NOFHoC umbrella cannot engage in any non-financial activities. Answer to Q 47 seems to be putting a complete bar on “unregulated financial activities” being carried by any entity under the NOFHoC. There is, therefore, an obvious bar on any unregulated activity, clearly ruling out any non-financial activity.

Operating leasing is regarded as a non-financial activity. Hence, the RBI’s clarification may rule out operating lease business being carried out by any entity under the NOFHoC umbrella.

Not only unregulated financial activities and non-financial activities, there will also be restriction on carrying activities such as housing finance, as a separate entity. The Guidelines require that all lending activities must come under the banking company. Several NBFCs currently also have housing finance companies. There is, arguably, a regulatory arbitrage that exists in keeping housing finance under a housing finance company umbrella, rather than under the bank. In Q 102, the RBI has clearly ruled out any housing finance company under the NOFHoC umbrella. This is repeated in questions 109-113 as well. So, once a financial group decides to set up a bank, it has to merge the housing finance company with the bank.

There are considerable restrictions on lending by banks – for examples, banks are generally not allowed to lend against promoter shareholdings. Most NBFCs do so. Once a banking group comes into existence, all lending transactions necessarily come under the bank, and hence, the restriction applies.

In essence, several avenues for regulatory arbitrage that exist currently will go away once a group decides to set up a bank.



## *Analytical Speaking*

### **Ekla chalo re..**

Very strangely, the RBI seems to have taken a view that more than promoter cannot come together to form an NOFHoC. Q 116 (also Q 142-3) blanketly discards the idea of more than one promoter coming together to have control over an NOFHoC. This, by itself, seems quite self-contradicting, as there is a limit of 10% on the holding of an individual along with his relatives. There is also a minimum 51% holding required by companies which have majority “public” interest. If that is so, the answer to Q 116, saying only one promoter must hold the NOFHoC, is completely non-reconciling. In answers to several questions, the RBI has stated that even a listed company can hold the NOFHoC. Is it not strange that a listed company, purportedly having wide-spread ownership interest, can own an NOFHoC, but when it comes a promoter, not more than one promoter can own an NOFHoC? In fact, the whole idea of a single promoter for an NOFHoC is completely self-contradicting and unreasonable.

In several bank-promoter groups, there will be strategic investors, joint-venturers, groups of promoters or associates joining together to put up equity in the NOFHoC. The stipulation of a single promoter will only lead to creation of one more layer at the shareholding level of the NOFHoC. That is, if 2 or more promoters of strategic investors want to come together to own an NOFHoC, they will together have to form a shareholding company (a CIC), which in turn will own the NOFHoC. The entire ownership structure arising as a result of the RBI Guidelines will lead to proliferation of entities, thereby making the ownership structure of banking companies highly opaque.

### **Conclusion:**

In the 400+ list of questions, most questions came on the holding structure of the NOFHoC. The holding structure as envisaged by the RBI is either not clear, or, if it is clear, it is not practical, at least in the Indian context.