

## Case

### License to Bank

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#### Abstract

*This case study has been modelled upon the recent working paper released by the RBI<sup>2</sup>. As the Indian economy surges ahead, the requirements of the consumers, the profile of the stakeholders and the complexity of the operations is undergoing a huge change. The interlocking of the financial community worldwide and at the same time the uniqueness of the Indian situation make it a tough balancing act for the regulator(RBI). The need to encourage sound operations, robust regulations keeping in mind the public interest and watching the growth options are some of the issues discussed herein. The case aims at highlighting international practices along with those followed in Indian so as to invite a discussion on topics listed in this important document released by the Indian regulator (RBI) which is bound to impact the future course of the banking industry.*

**Keywords:** Reserve Bank of India, License, Non-Banking Financial Company

It is a muggy Monday afternoon in Mumbai. The senior officials of the Reserve Bank of India (RBI)<sup>2</sup> along with the banking industry representatives have congregated in the board room to decide upon some crucial issues one among which was the granting of new bank licenses to prospective candidates(see Illustration # 1). The list of the applicants is impressive and has a good sprinkling of leading names of NBFC's, leading real estate players, banking professionals with impeccable qualifications etc. If the weather outside the room is humid, the temperature inside the board room fluctuates rapidly, sometimes soaring very quickly, the atmosphere

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charged by the discussions between the board members. Excerpts of the conversation are given below

**Illustration #1:**

**List of Board Members of the RBOB present for the meeting:**

Name		Designation	Abbreviation (used in the case)
1.	Mrs. Disha Gupta	Deputy Governor-RBI	DG
2.	Mr. A.C Chakraborty	Deputy Governor-RBI	ACC
3.	Mr. Rana Talwar	Director : Indian Bank’s Association <sup>1</sup>	RT
4.	Mrs. Subhalaxmi Pendse	Deputy Director : Indian Bank’s Association	SP
5.	Mr. Mahesh Rao	Officer on Special Duty : RBI	MR

1 Indian Bank’s Association is a service organization which has representation from the entire banking fraternity. All the scheduled banks operating in India are its members. Its primary objective is to develop a progressive and robust banking structure in India.

Given below is an account of the discussion between the Board Members:

**DG:** “As all of you are aware, we have received applications from many interested parties”. However we are expecting some more since the time deadline for application of new bank licenses is not yet over”.

**RT:** “Madam Gupta, I have circulated the names. Please refer to the details.

**ST:** “Yes, I see the sheet here. It’s called “List of applicants” (see Illustration #2).

**Illustration # 2:**

**List of Applicants<sup>A</sup>**

Name	Brief Description of Applicants Business
<b>Tata Capital</b>	NBFC engaged in: Consumer Loans/Wealth Advisory/Commercial Finance/Treasury/Investment Banking/PE etc
<b>Reliance Industries</b>	Business Conglomerate .One of the largest business houses in India
<b>Future Capital Holdings</b>	NBFC: Backed by trail blazing success in the retail business. The group is engaged in catering to the retail, commercial sector and real estate sector. It has also expanded into Investment Banking activities
<b>PFC</b>	Govt of India undertaking dedicated to Power Sector Financing with an aim to develop the power sector in the country
<b>LIC Housing Finance</b>	One of the largest NBFC's in India backed by the Government. Has the largest market share in the life insurance business
<b>Bajaj Capital</b>	NBFC associated with one of the leading companies operating in the two/three wheeler auto segment.

A: RBI discussion paper dated Aug 20 2010 has stipulated that industrial/business houses engaged in real estate activity directly or indirectly will not be permitted to apply for a banking license.

**ACC:** “I would like to make a point here that the it would be prudent to be cautious in analyzing the need for granting a bank license in view of the RBI’s past experience of 17 years(refer Annexure # 1 for details).

**SP:** “Sir, the banking fraternity has requested that in view of the changing complexion of commerce and the need to keep up with the growing complexities involved in handling banking operations, a consideration needs to be given to the need for granting further bank licenses”.

**RT:** “We need to see if there is any need to change anything or even grant new bank licenses at this stage given the huge turmoil that the industry has witnessed over the past couple of years”. The exemplary leadership of the RBI has helped us deal with a lot of turbulence and has steered the country’s banking ship very well through the troubled financial seas”. “Our cautious approach has worked well for us”.

**MR:** “CASA<sup>3</sup> which is the main raw material of the business has become a prized possession of many banks. The differentiation among products is not much however banks are finding it very challenging to find new ways to attract and retain fresh business. As it is the competition is very fierce. Consolidations are the buzz words hence do we want to consider fresh licenses before we see what happens with the existing players?”

**ACC:** “MR is right. Now with the introduction of the new base rate system<sup>4</sup>, banks will have to work really hard at keeping their cost of deposits low else the pricing of their loans will get hampered. The aspect of financial inclusion needs to be kept in mind, so that the masses are also benefitted”.

**ACC:** “In any case prospective promoters engaged in real estate activity will not be eligible to apply.

**RT:** “Lets also consider the fact that financial inclusion is important and needs more commitment than is being shown at present by the foreign banks and private sector banks. Normally it’s the Public sector banks which get shouldered with the responsibility of catering to the masses while the private players are focused on fee based incomes which they prefer to earn through investment banking, advisory services etc rather than indulging in core banking. Do we really want more such “cream skimming” entities<sup>5</sup> when we already have enough?”If we introduce more players then when will take the time to shore up the RRB’s and the Cooperative banks which are already around for a long time? The recent crisis in the West has also shown that what a sound and robust set-up is more important that a high tech-high stakes game”.

**SP:** “Sir your point is valid .However we also need to have a system that is able to cater to the needs of the industry which has spread its footprint internationally. Plus we have a huge Indian diaspora<sup>6</sup> all over the world which wants to invest in India but are looking for good service, which sometimes is lacking in a PSU setup.

**DG:** “Let’s take a look at some of the documents placed in front of us”. Do you all have a copy of the document titled “Options & the Pros and Cons of Bank Licensing”? (See Illustration #3.1).That same document binder also has other related documents as well (refer Annexure 1).

**Everybody:** “Yes”.

### Illustration # 3.1

#### Options & the Pros and Cons of Bank Licensing

Option	Pros	Cons
<b>Allow Industrial Houses to promote banks</b>	Have necessary capital, managerial talent etc. Already present in financial services(life, general insurance, wealth advisory etc)	Linking banking with commercial activities may undermine the neutrality of banks and may hamper allocation of credit to the real sectors thereby hampering overall productivity of the economy.
Allow Industrial Houses to takeover RRB's <sup>A</sup> before granting bank license	Allow corporate to prove their mettle in running a bank. Help revitalize RRB's	Require legislative changes plus the shaky state of RRB's may pose a problem
Permit standalone NBFC's <sup>B</sup> to promote banks	Contribution to the financial sector	Robustness of NBFC's to be ascertained since some may encounter risks of asset liability mismatch
Enhance entry level capital <sup>C</sup>	Ensure that banks operate on a sound capital base	Promoters may focus on large ticket size commercial banking and maynot be seriously committed to financial inclusion
Allow foreign share holding capped at 50% <sup>D</sup> with a	Help with capital and foreign technical collaboration	Foreign investors maybe constrained. Raising capital from local sources may be

10 year lock-in		difficult
Retain current approach on stake dilution <sup>E</sup>	Helps in getting capital in the initial stage while dilution leads to diversified holding	The bank may lack vision in the absence of a serious promoter. Accountability and responsibility may be an issue.
Allowing industrial houses with a predominant presence in the financial sector	Professional management and resources available so is the track record. Can add value to the bank	Possible concentration of power

A: RRB's: Regional Rural Banks cater mainly to the rural areas. Promoted by 3 parties viz: Central Government, State Government jointly with a sponsor bank.

B: NBFC's : required to be registered with the RBI. Hence their track record is known. Details provided in Annexure 1.

C: Present requirement Rs 300 Crores. Various options have been placed before the committee such as a) Increasing from existing requirement of Rs 300 Crores but < Rs 500 Crores b) Rs 500 Crores with a condition to raise the amount to Rs 1000 Crores within 5 years c)>Rs 1000 Crores. Details provided in Annexure 1.

D: RBI's guidelines of 2001 permitted NRI's to participate in the primary equity of a new bank to maximum extent of 40%. Details provided in Annexure 1.

E: As per the current approach promoters bring in minimum 40% of capital with a lock-in clause of 5 years. Dilution of capital by the promoters to a level of below 10% of the bank's share capital within a specified time is required. Details provided in Annexure 1.

### **Issues for Discussion:**

- A. Should the entry of new banks in the private sector be considered?
- B. What should be the business model for the new banks?

- C. Whether industrial houses should be allowed to promote banks?
- D. Should NBFC's be allowed conversion into banks?
- E. Should the prospective entrants be required to fulfill any caveats or pre-requisites?

## **Annexure # 1**

### **Provided as part of the meetings Proceedings**

For several years now, the issue of corporate houses promoting banks has generated much debate. In 2006, the SS Tarapore committee had first recommended this option. Noted economist Raghuram Rajan had suggested that RBI could grant licenses to corporate that have financial services as their sole business.

According to the RBI, the country's experience in the past has not been very positive (see illustration #3.2) below. Although banks were started by Indian promoters under the *Swadeshi* spirit of the twenties, the economic power was concentrated in the hands of a few people which led to the bulk of finances being diverted to favored groups. Diversion of advances to industry meant that vital sectors like agriculture, exports remained neglected. The Government of India introduced a system of "social control" over banks in 1967 with the main objective of achieving a wider spread of bank credit, preventing misuse and directing the flow of funds to priority sectors. Subsequently in July 1969, 14 major banks were nationalized. This marked a paradigm shift in banking as it aimed at shifting the focus from class banking to mass banking. Additional statutory powers were conferred upon the RBI, not only with the objective of protecting the depositors but also to ensure that particular group of clients / industry are not favored in the distribution of credit and that various levels of bank management are involved in the credit disbursal process. However the huge losses suffered by the industry and the public in 1992 and thereafter in early 2000 ( Harshad

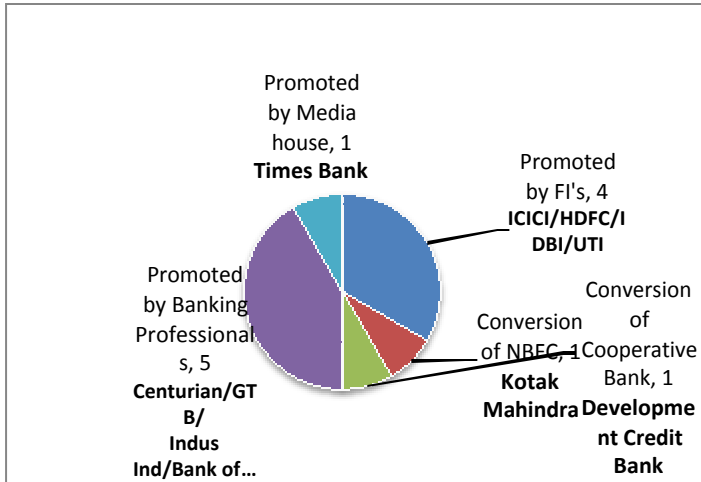
Mehta & CRB Scam)moulded the guidelines issued by the RBI as it sought to reduce the control of the promoters over various the functions of banks. The timeline given below capitulates the events over a decade.

### **The Journey So Far: A Timeline of Events from the early 1990's to 2010**

- I. A robust financial system which is sound in procedures contributes to economic growth. The Harshad Mehta scam of the early 1990's exposed many chinks in the Indian banking system. The financial sector reforms had guidelines for the licensing of private sector banks .These were revised in January 2001. These revised guidelines were cautious in nature. Large industrial houses were not allowed to promote new banks.
- II. An NBFC was considered eligible to convert into a bank provided it was not promoted by a large industrial house, satisfied the minimum capital requirements, had a A (AAA) or its equivalent credit rating in the previous year, Capital adequacy greater than 12% and net NPA ratio <5%
- III. The initial minimum paid up capital requirement was set at Rs 200 crore to be raised to Rs 300 crore within 3 years of commencement of business
- IV. Promoters were required to contribute a minimum of 40% of the paid up with a lock-in period of 5 years. However if the promoter's contribution to the initial capital was more than the minimum 40%, they were required to dilute the excess stake after 1 year of the bank's operation
- V. NRI's were allowed to participate in the primary equity of a new bank to the maximum extent of 40%.
- VI. Banks were required to maintain an arm's length relationship with the promoters/investee companies.
- VII. The shares of the bank had to be listed on a stock exchange
- VIII. Banks were obliged to maintain 40% of their net bank credit as loans to the priority sector
- IX. Capital adequacy ratio of banks had to be 10% on a continuous basis
- X. Banks were obliged to open atleast 25% of their total branches in the rural areas.

### Illustration # 3.2

10 new banks were set-up in 1993 and 2 new banks after the 2001 revised guidelines. Details per the illustration.



### Explanation of Illustration # 3.2

- 1) Times Bank merged with HDFC in February 2000.
- 2) IDBI Bank merged into IDBI Ltd in January 2005.
- 3) UTI was rebranded as Axis Bank in May 2007
- 4) Bank of Punjab merged with Centurian Bank , which then merged with HDFC Bank
- 5) GTB merged with Oriental Bank of Commerce in August 2004 after it suffered huge losses due to high exposure to capital markets.

Hence the RBI has found that only banks with adequate experience in the financial sector backed by strong managerial talent, resources and operating systems could withstand the rigueur. The disappointing experience was similar with small local area banks, NBFC's and in some cases with urban co-operative banks.

The global financial crisis also highlighted the need for correlating macroeconomic stability with financial stability. The former was only focused on controlling inflation while the latter dealt with dealing with firm level supervision of the banking system. In the process the unusually large bubble of the subprime mortgages was ignored but even the interconnectedness between banks across continents overlooked. The crisis impacted entities which were considered landmarks and too-big-to-fail such as Bear Sterns, and Lehman Brothers.

## **Issues for Consideration**

### **A. Minimum Capital Requirements for new banks & promoters contribution**

#### *International Experience*

- Internationally bank regulators either insist on certain initial minimum capital to be brought by the applicant/applicants in order to obtain a banking license based upon the scale, nature, complexity and inherent risks of operations as proposed in the business plan
- Examples are :
  - Argentina - USD 1.6 million ( INR 8 crore)
  - Singapore – USD 1077.8 million ( INR 5389 crore)
  - Malaysia- USD 618.8 million (INR 3094 crore)
  - Kuwait – USD 257.3 million (INR 1286 crore)
  - Indonesia – USD 331 million ( INR 1655 crore)
  - Singapore – USD 1077.8 million (INR 5389 crore)
  - USA/Australia – Capital is prescribed on a case to case basis depending upon the business plan, scale of operation, complexity etc. In Hong Kong and Argentina, minimum capital is determined depending upon the type of institution being set-up.

### *Indian Approach*

- 1993 guidelines prescribed Rs 100 crore as minimum capital
- In 2001 new guidelines were released which raised this to Rs 200 crore
- This was to be increased to Rs 300 crore over three years from commencement of business
- In India there are only full fledged banking licenses given
- No revisions have been made since January 2001.

### **B. Minimum and maximum caps on promoter shareholding and other stake holders**

#### *International Experience*

- Most banking jurisdictions require banks to be widely held.
- In Hong Kong no restriction on maximum percentage of shares that an individual can hold in an authorized institution. However >50% holding must be by a well established institution.
- In Canada, Ministerial approvals are required for acquiring 10%, 20% , 30% shareholding. Differential treatment with respect to shareholding depends upon the size of the bank: (small, medium or large. Small is defined as equity < \$2billion, medium has an equity of >\$2billion but < \$8 billion and large banks having equity of \$ 8 billion +).However in Canada the rules are tighter for ownership & control with respect to large banks as compared to smaller banks

#### *Indian Approach*

- Modern banking in India was started during the British rule and catered mainly for financing trade in raw materials needed by British business houses
- The early twenties saw the entry of Indian enterprises into the banking sector. This endeavor was strengthened by the growth of the Swadeshi movement .However the economic power in the Indian joint stock companies was concentrated in the hands of a few families who managed

to make the resources available to themselves and their favored groups. Hence the needs of the vital sectors such as small scale industry ,agriculture & exports tended to be neglected

- Keeping in view the country's social and economic objective, the Government of India nationalized banks in 1967.the main objective was to encourage wider spread of bank credit, preventing its misuse, directing the flow of credit into the priority sectors and making them an effective channel of economic development. In July 1969, 14 major commercial banks were nationalized as a step in this direction. Additionally statutory powers were conferred upon the RBI so as to protect the interest of small depositors and prevent favoritism in credit disbursal
- In India promoters have been allowed to bring in a minimum of 40% of the paid-up capital of the bank at the time of licensing with a lock in period of 5 years. The main idea is to have a stable financial base and strong professional management without any interference or control. The promoters and other shareholders of the bank have to divest their share capital to a level below 10% within a specified time. Exceptional circumstances where the entity is well managed, publicly listed, widely held and well regulated and additional shareholding is permitted upto 30 % ( Eg: Yes Bank where Rana Kapoor holds 14.48% of the shares as on March 31 2010. Madhu Kapoor has a holding of 12.68%.Total family holding 27.16%).A shareholding of > 30% is subject to higher due diligence standards.
- Banks and FI's are not permitted to acquire any fresh stake in a banks equity shares rendering the holding to exceed 5% of the investee bank's equity capital. This is to limit interlocking of capital in the banking system.

### *Foreign Shareholding in Indian Banks*

- As per guidelines issued by the Government of India, that at all times atleast 26% of the paid up capital of a private sector bank will have to be held by Indians,except for a wholly owned subsidiary of a foreign bank.

- Transfer of shares under Foreign Direct Investment from residents to non residents requires approval of the Foreign Investment Promotion Board (FIPB) under Foreign Exchange Management Act (FEMA). This approval is also required in case the acquisition results in any person owning/controlling 5% or more of the paid-up capital of the private bank.
- The sub caps for individual FII and NRI holding is restricted to 10%. The aggregate limit for FII and NRI's is capped at 24% and 10% respectively. This cap can be raised with the approval of the Board to 49% and 24% respectively.
- Vide Press Notes 2,3 &4 issued by the Government of India in February 2009, banks with foreign shareholding of more than 50 % would be treated as non resident owned banks

### **Industrial and Business Houses be permitted to promote banks.**

#### *International Experience*

- In Canada, small banks can be owned by single owners and commercial enterprises
- UK has allowed industrial groups to participate in banking operations ( Eg : Tesco Bank)
- In South Africa, the regulator is more focused on the quality and reputation of shareholders
- Taiwan and Hong Kong do not have any restrictions on ownership of banks by industrial houses/families. However there are standard restrictions on related party transactions and intra group lending has to be at arms length.
- In Japan the regulator has strict standards for granting a banking license. While there are no specific restrictions on granting of banking licenses to conglomerates/industrial houses, strict regulations are in place a shareholder crosses 5% ownership and any such breach requires regulatory approval.
- In Korea subsequent to the Asian crisis, industrial houses (chaebol) are barred from promoting new banks so as to separate banking and commerce functions.

- Brazil allows industrial houses to set up banks. However ownership limits beyond certain percentage require regulatory approval
- In the USA, industrial houses are not allowed to own banks. The GLB Act of 1999 ensures the separation of banking and commerce. However certain exceptions were allowed in certain states in 1987. Several large international companies like GM, GE, BMW etc own industrial loan companies under this exception

### *Indian Experience*

- Prior to nationalization in 1969, several large business houses diverted bank credit to “favored companies”.
- 2001 licensing guidelines by the RBI prohibited promotion of new banks by industrial houses. However individual companies directly or indirectly connected to large industrial houses were permitted to acquire shares not exceeding 10% of the paid-up capital of a bank subject to RBI approval.

### **NBFC’s be allowed to convert into banks or promote banks.**

### *International Experience*

- In Hong Kong the entry level criterion for an applicant is that it should already be a Deposit Taking Company (DTC) or a Restricted License Bank (RLB) for more than three continuous years.
- IN USA certain types of depository institutions are allowed to convert into national banks provided they demonstrate the ability to operate safely and soundly and are in compliance with the applicable laws of the National Bank Act and OCC regulations.

### *Indian Experience*

- The Non Banking Financial Sector in India comprises various types of financial institutions. The All-India financial institutions and development finance institutions, are largely an off shoot of development planning in India an NBFC is a main stream private sector institution

- Unlike the banking system, NBFC's are heterogeneous in nature functionally and in terms of size, nature of business etc. NBFC's include entities of large multinational groups or Indian groups but also "small" players with net owned funds (NOF) hovering at the statutory minimum of Rs 200 lakh.
- Close attention was paid to NBFC's accepting public deposits (NBFCs-D) with a view to protect the interest of depositors. Over the years the framework has been widened since the number of NBFC's and the quantum of business has increased. Deposit taking NBFC's (NBFCs-D) have decreased both in size as well as in quantum of funds held. NBFC – ND have increased in terms of number and asset size. NBFC's-ND with an asset size of Rs 100 crore and above is subject to CRAR norms prescribed by the RBI.
- So far only one NBFC has been converted into a bank (Kotak Mahindra Bank) and the transition has been smooth

## Endnote

2 The Reserve Bank of India (RBI) is the apex banking institution in the country .All characters, names and situations listed above are fictional

3 CASA: Abbreviation for Current & Savings Accounts-common parlance in the banking industry.

4 Base Rate: Effective July 1 2010, the Indian Banking system transitioned to a Base Rate system. This is the minimum rate below which banks are not permitted to lend. Banks have the freedom to decide upon the base rate which is revised periodically. For details visit [www.rbi.org](http://www.rbi.org)

5 Currently, India has 27 public sector banks(PSU), 7 new private sector banks, 15 old private sector banks, 31 foreign banks, 86 regional rural banks, 4 local area banks, 1721 urban cooperative banks, 31 state cooperative banks, and 371 district central co-operative banks. (Source: RBI)

6 Estimated 20 million Indians live abroad (Source: Wikipedia)