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RBI Guidelines for Licensing of Small Finance Banks
Opportunities and Challenges

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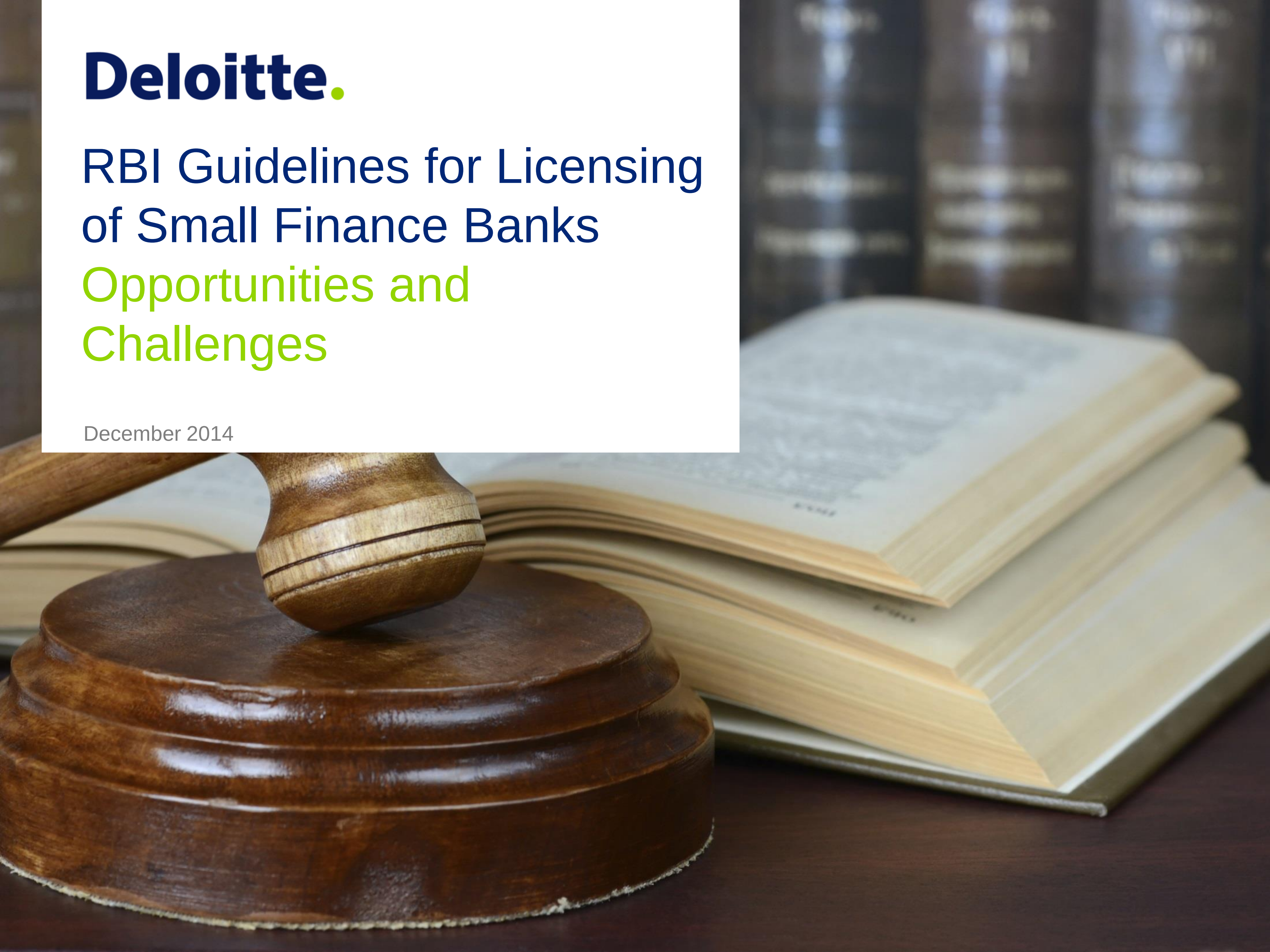

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Introduction

Overview of Small Finance Bank License

- In August 2013, RBI published a policy discussion paper on ‘Banking Structure in India – The way forward’. One of the observations in the discussion paper was that there is merit in considering access to bank credit and services through expansion of Small Banks in unbanked and under-banked regions of India
- Subsequently in July 2014, RBI published draft guidelines for setting up Small Bank in the private sector and invited comments and suggestions from various participants by August 2014.
- Post reviewing the comments RBI has published the guidelines for Small Finance Bank and has invited applications by January 16, 2015

Likely considerations of RBI for issuing Small Finance Bank license

Financially Inclusive and Sound Business Model	• Through the issue of Small Finance Bank license, RBI wishes to further its goal of broader financial inclusion • Applicants for Small Finance Bank licenses will be required to forward their business plan along with their applications addressing how the Small Finance Bank proposes to achieve financial inclusion
Adequate Capital Structure	• The nature of business for Small Finance Bank involves offering basic banking products, non-risk sharing distribution of financial products and forex business, leading to the regulator setting the minimum capital requirement at Rs. 100 crore (lower than that for Universal Bank license which was pegged at Rs. 500 crore) • The RBI is likely to prefer applicants with strong capital base since ‘financially sound’ applicant may be better positioned to sustain the ‘financial inclusion’ agenda
Strong management track record and governance	• The RBI may evaluate credentials, integrity and track record of the promoter/ promoter groups for awarding the Small Finance Bank license • The RBI will evaluate the ‘fit and proper’ status of the promoter (professional experience of minimum 10 years in banking and finance)/ promoter groups as well as the board of directors and look for a sound track record of running businesses for at least a period of 5 years in order to be eligible to promote a Small Finance Bank • The regulator will also evaluate the corporate governance practices followed, the board composition, and the level of ring fencing of the Small Finance Bank from other promoter group companies

Executive Summary (1/2)

The guidelines aim at creating a banking entity which is adequately capitalized, financially inclusive and has a competitive business model

The **objectives of setting up of Small Finance Bank** will be for furthering financial inclusion by (i) provision of savings vehicles primarily to unserved and underserved sections of the population, and (ii) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganized sector entities, through high technology-low cost operations

The **entities eligible to set up a Small Finance Bank** include resident individuals/professionals with 10 years of experience in banking and finance, Companies and Societies, Existing Non-Banking Finance Companies (NBFCs), Micro Finance Institutions (MFIs), Local Area Banks (LABs). **Not allowed** - JVs by different promoter groups for setting up a Small Finance Bank, large public sector entities and industrial and business houses including NBFCs promoted by them

A Small Finance Bank can offer **basic banking services** (acceptance of deposits and lending to unserved and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganized sector entities), **non-risk sharing simple financial services activities** not requiring any fund commitment, such as distribution of MFs, insurance products, pension products, etc. and the Small Finance Bank can also become a **Category II Authorized Dealer in foreign exchange business**

The **minimum paid up voting equity capital has been fixed at Rs 100 crores** with a **minimum CAR of 15%** on risk weighted assets . Once the net worth reaches Rs. 500 Crore, listing will be mandatory within 3 years of reaching the net worth. For others listing is voluntary. The **promoter's minimum initial contribution to at least 40% locked in for 5 years –** need to be brought down to 30% of the paid-up voting equity capital within a period of 10 years, and to 26% within 12 years. Proposals having diversified shareholding and a time frame for listing to be preferred by the RBI for a license

Foreign shareholding allowed up to 74% (49% under automatic route and 25% under approval). **Individual FII/ FPI is restricted to below 10%.** Aggregate limit for FII/FPI and QFI cannot exceed 24%, which can be raised to 49%. **Individual NRI holding restricted to 5% and aggregate limit of 10%**, which can be allowed up 24% through a special resolution of general body

Executive Summary (2/2)

The guidelines aim at creating a banking entity which is adequately capitalized, financially inclusive and has a competitive business model

At least 25% of its branches in unbanked rural centers with **no restriction in areas of operation**; however, **preference** will be given to applicants who in the initial phase set up the Small Finance Bank in a cluster of under-banked states/ districts such as **North East, East and Central Regions**. These applicants will not have hindrance to expand to other regions in due course

Priority Sector Lending (PSL) requirement for Small Finance Bank to be 75% of ANBC compared to 40% for domestic SCBs. 40% of ANBC should be allocated to different sub-sectors as per existing PSL prescriptions; allocate the balance 35% to any one or more sub-sectors under the PSL. **At least 50% of its loan portfolio should constitute loans and advances of size up to Rs. 25 lakh** in order to extend loans primarily to small borrowers. The maximum loan size and investment limit **exposure to single and group borrowers** would be restricted to 10% and 15% respectively of its capital funds.

If a promoter setting up a Small Finance Bank desires to set up a Payments Bank, both the entities should be set up under NOFHC structure. The Small Finance Bank **cannot be a Business Correspondent (BC) for another bank**. However, it can have its own BC network

The operations of the Small Finance Bank should be **technology driven from the beginning**, conforming to generally accepted standards and norms; while new approaches (such as for data storage, security and real time data update) are encouraged, a detailed technology plan for the same should be furnished to RBI

An existing NBFC / MFI would be allowed to convert to a Small Finance Bank. that on conversion into a Small Finance Bank, the NBFC / MFI will cease to exist and all its business which a bank can undertake should fold into the bank and the activities which a bank cannot statutorily undertake be divested / disposed of. Further, the branches of the NBFC / MFI should either be converted into bank branches or be merged / closed as per the business plan

Evaluation of Guidelines on Small Finance Bank Licenses

The guidelines for Small Finance Bank (1/3)

Eligible Promoters	• Eligible promoters as defined in the final guidelines include: Resident individuals/professionals with 10 years of experience in banking and finance, Companies and Societies, Existing Non-Banking Finance Companies (NBFCs), Micro Finance Institutions (MFIs), Local Area Bank (LABs) owned and controlled by residents • **Not allowed** - Joint Ventures by different promoter groups for setting up Small Finance Bank, Large public sector entities and industrial and business houses including NBFCs promoted by them
Foreign Shareholding	• Foreign shareholding in the Small Finance Bank to be as per existing FDI policy for private sector banks i.e. up to 74% (49% under automatic route and 25% under approval) • Individual NRI holding (both on repatriation and non-repatriation basis) restricted to 5% and aggregate limit of 10%, which can be allowed upto 24% through a Special resolution of General body • Mandatory 26% resident shareholding
Promoter's Contribution	• The promoter's minimum initial contribution to the paid up equity capital shall be at least 40% which shall be locked in for a period of **five** years from the date of commencement of business of the Small Finance Bank • The promoter's stake should be brought down to 30% of the paid-up voting equity capital of the Small Finance Bank within a period of 10 years, and to 26% within 12 years from the date of commencement of business of the Small Finance Bank • Proposals having diversified shareholding and a time frame for listing will be preferred by the RBI for a license • Once the net worth reaches Rs 500 Crore, listing will be mandatory within 3 years of reaching the net worth, subject to fulfilment of the requirements of the capital market regulator. For others listing is voluntary
Minimum Capital Requirement	• The minimum paid up equity capital has been fixed at Rs 100 crores, • Small Finance Bank, is required to maintain a minimum capital adequacy ratio of 15% of its RWA as per BASEL Committee's standardized approaches (Tier I capital at least 7.5% of RWA and Tier II capital a maximum of 100% of Tier I)
Corporate Structure & Governance	• The Small Finance Bank will be required to use the word "Small Finance Bank" in its name in order to differentiate it from other banks. • Corporate Governance : (i) The Board of the Small Finance Bank should have a majority of independent directors, and (ii) The Small Finance Bank should comply with the corporate governance guidelines including 'fit and proper' criteria for Directors as issued by RBI from time to time • The voting rights in private sector banks are capped at 10%, which can be raised to 26% in a phased manner by the RBI. Further, any acquisition of 5% or more of equity shares in a private sector bank will require prior approval of RBI. This will also apply to the Small Finance Bank • It cannot set up subsidiaries to undertake non-banking financial services activities

The guidelines for Small Finance Bank (2/3)

Scope of activities	• **Basic banking Services**: Acceptance of deposits and lending to unserved and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganized sector entities. • **Other Services** I. Non-risk sharing simple financial services activities not requiring any commitment of own fund, such as distribution of mutual fund units, insurance products, pension products, etc. with the prior approval of the RBI and after complying with the requirements of the sectoral regulator for such products II. The Small Finance Bank can also become a Category II Authorized Dealer in foreign exchange business for its clients' requirements • The other financial and non-financial services activities of the promoters, if any, should be kept distinctly ring-fenced and not comingled with the banking business
Branch / Geography Expansion	• Branch expansion plan for initial five years would need prior approval of RBI. At least 25% of its branches in unbanked rural centers (population upto 9999 as per last census) • No restriction in the areas of operation of Small Finance Bank; however preference will be given to applicants who in the initial phase set up the bank in a cluster of under-banked States/districts such as North East, East and Central Regions. These applicants will not have hindrance to expand to other regions in due course • It is expected that the Small Finance Bank should primarily be responsive to local needs. • After the initial stabilization period of five years, and after a review, RBI may liberalize the requirement of prior approval for annual branch expansion plans and scope of activities of the Small Finance Bank.
Prudential norms	• The Small Finance Bank will be subject to all prudential norms and regulations of RBI as applicable to existing commercial banks including requirement of maintenance of CRR and SLR. • The Small Finance Bank will be expected to put in robust risk management framework • PSL requirement for Small Finance Bank will be 75% of Adjusted Net Bank Credit (ANBC) compared to 40% for Domestic Scheduled Commercial banks. While 40% of ANBC should be allocated to different sub-sectors as per existing PSL prescriptions, balance 35% can be allocated to any one or more sub-sectors under the PSL where Small Finance Bank finds it has competitive advantage • The maximum loan size and investment limit exposure to single and group borrowers would be restricted to 10% and 15% respectively of its capital funds • At least 50% of its loan portfolio should constitute loans and advances of size up to Rs. 25 lakh in order to extend loans primarily to small borrowers • RBI may relax the above provisions after an initial stabilization period of 5 years • Small Finance Bank are restricted on giving loans and advances to Directors and companies in which its Directors have interest. Additionally the Small Finance Bank are precluded from having any exposure to its promoters, major shareholders (>10%), relatives of promoters, entities promoters have significant influence or control

The guidelines for Small Finance Bank (3/3)

Business Plan	• The applicants will be required to furnish their business plans and project reports with their applications. • The business plan will have to address how the bank proposes to achieve the objectives behind setting up of Small Finance Bank and in the case of an NBFC / MFI applicant, how the existing business of NBFC / MFI will fold into the bank or divested / disposed of. • The business plan submitted by the applicant should be realistic and viable. • In case of deviation from the stated business plan after issue of license, RBI may consider restricting the bank’s expansion, effecting change in management and imposing other penal measures as may be necessary
Other conditions	• If a promoter setting up a Small Finance Bank desires to set up a Payments Bank, both the entities should be set up under NOFHC structure • Individuals and entities other than the promoters will not be permitted to have shareholding in excess of 10% of the paid-up equity capital of the bank. For existing NBFCs / MFIs / LABs converting into Small Finance Bank, where non-promoters hold more than 10%, RBI may give 3 years to bring down holding to 10% • The Small Finance Bank cannot be a Business Correspondent (BC) for another bank. However, it can have its own BC network. • The operations of the Small Finance Bank should be technology driven from the beginning, conforming to generally accepted standards and norms; while new approaches (such as for data storage, security and real time data updates) are encouraged, a detailed technology plan for the same should be furnished to RBI • The Small Finance Bank should have a high powered Customer Grievances Cell to handle customer complaints. The Small Finance Bank will come under the purview of RBI’s Banking Ombudsman Scheme, 2006.
Additional Conditions for NBFC/MFI/LAB	• The entity shall have a minimum net worth of Rs. 100 cr or infuse additional paid-up equity capital to achieve net worth of Rs. 100 crore. • On conversion into a Small Finance Bank, the NBFC / MFI will cease to exist and all its business which a bank can undertake should fold into the bank and the activities which a bank cannot statutorily undertake be divested / disposed of. Further, the branches of the NBFC / MFI should either be converted into bank branches or be merged / closed as per the business plan. The Small Finance Bank and the NBFC / MFI cannot co-exist. • Small Finance Bank are precluded from creating floating charge on their assets. For such NBFCs / MFIs, which succeed in obtaining licenses to convert into Small Finance Bank, For existing floating charges, RBI will permit grandfathering of such borrowings till their maturity, subject to imposition of additional capital charge in order to protect the interest of the depositors. • If the existing Promoter holding is already diluted to below 40% (but above 26%) then they need not raise their holding level to 40%

Eligible promoters & Capital Requirement (1/2)

Broad Analysis and Remarks

Guideline	Broad Analysis	Remarks
(a) Resident individuals/ professionals with 10 years of experience in banking and finance; and (b) Companies and Societies owned and controlled by residents will be eligible as promoters to set up Small Finance Bank	• The guidelines do not limit the pool of applicants to just companies and societies. Even individuals/ professionals with significant experience in banking and finance are eligible as promoters	• The RBI is looking for strong promoter/ promoter groups that have significant experience and proven track record
Existing NBFCs, MFIs, and LABs that are owned and controlled by residents can also opt for conversion into Small Finance Bank provided these entities comply with all relevant regulations	• The guidelines allow existing financial institutions such as NBFCs, MFIs, and LABs to convert to a Small Finance Bank	• There are entities (NBFCs, MFIs, and LABs) that are looking to expand their businesses on the liability side and this would be a welcome step for such players
JVs by different promoter groups for the purpose of setting up Small Finance Bank would not be permitted	• The RBI doesn't envisage a Small Finance Bank with multiple promoter groups	• -
As local focus and the ability to serve smaller customers will be the key criteria in licensing, this may be a more appropriate vehicle for local players or players who are focused on lending to unserved/ underserved sections Accordingly, proposals from large public sector entities, and industrial and business houses, including from NBFCs promoted by them, will not be entertained	• The RBI would prefer entities with local area presence/ focus on lending to unserved/ underserved sections • Therefore, the RBI has discouraged large public sector entities and industrial and business houses, including from NBFCs promoted by them in applying for a Small Finance Bank license	• In line with the target customer segments and associated greater priority sector lending criteria, the regulator believes that 'local' players would be more suitable for a Small Finance Bank license

Eligible promoters & Capital Requirement (2/2)
Broad Analysis and Remarks

Guideline	Analysis	Remarks
Promoter/ promoter groups should be 'fit and proper' in order to be eligible - RBI would assess the 'fit and proper' status of the applicants based on their past record of sound credentials and integrity; financial soundness and successful track record of professional experience or of running their businesses, etc. for at least a period of 5 years	• New companies keen to foray in Banking but with a track record of less than 5 years may not be able to apply • The RBI would focus on the 'fit and proper' status of the applicants very closely	• The RBI used similar criteria for Universal Bank license applications; however, for Small Finance Bank, the track record has been curtailed to 5 years from 10 years
The minimum paid-up equity capital shall be Rs. 100 crore	• The minimum paid- up capital requirement would ensure that applicants with strong financial position and long term capital commitment are permitted to promote a Small Finance Bank	• The minimum capital has been kept lower compared to that of the Universal Bank license guidelines considering the size of operations and limited scope of activities of the Small Finance Bank compared to a Universal Bank
In view of the inherent risk of a Small Finance Bank, it shall be required to maintain a minimum capital adequacy ratio (CAR) of 15% of its risk weighted assets (RWA) on a continuous basis (as prescribed by RBI from time to time) • Tier I capital should be at least 7.5% of RWAs • Tier II capital limited to a maximum of 100% of total Tier I capital • As Small Finance Bank are not expected to deal with sophisticated products, the CAR will be computed under Basel Committee's standardized approaches	• Given the higher CAR of 15%, the promoter/ promoter groups may have to continuously recapitalize the balance sheet in the early years or go slow on growth	• The guidelines have proposed higher CAR compared to both the current norms for scheduled commercial banks (9%) as well as for the new Universal Bank licensees (13%) • This indicates that the RBI perceives that a Small Finance Bank would be exposed to higher risks compared to the Universal Bank due to the local nature of business

Promoter's Contribution
Broad Analysis and Remarks

Guideline	Analysis	Remarks
The promoter's minimum initial contribution to the paid-up equity capital of such Small Finance Bank shall at least be 40%. If the initial shareholding by promoter in the bank is in excess of 40%, it should be brought down to 40% within a period of 5 years. The promoter's minimum contribution of 40% of paid-up equity capital shall be locked in for a period of 5 years from the date of commencement of business	• The promoters have to bring in start-up capital of atleast Rs. 40 crores and continuously maintain that level by recapitalizing the balance sheet • Ownership in excess of 40% shall be brought down to 40% within a period of 5 years in order to ensure diversified ownership but at the same time holding promoter accountable for the bank	• The guidelines have provided for a longer period of 5 years for bringing down the promoter's minimum contribution compared to the same under Universal Bank license application (3 years) • This shall provide a longer term incentive to the promoter when the bank size is comparatively smaller • Lock-in would ensure serious commitment towards the development of bank with the promoter playing an active role in forming and executing the vision and strategy for the bank • Involuntary ownership dilution might force the promoters to expand the balance sheet of the bank in the initial years to unlock the value creation before diluting excessive stake
Further, the promoter's stake should be brought down to 30% of the paid-up equity capital of the bank within a period of 10 years, and to 26% within 12 years from the date of commencement of business of the bank Proposals having diversified shareholding subject to the initial minimum shareholding of promoters and a time frame for listing of the bank will be preferred	• Ensures that in the long run, a bank is managed by independent management and on its own strength • Promoters have to commit significant resources in the initial years before diluting their stake in order to unlock the value of their investments	• Promoter holding will go down to 26% ensuring diversified ownership and it's clear that RBI would give preference to such aspirants that have diversified shareholding and a time frame for listing • Compared to the Universal Bank license applications, the shareholding for promoters is considerably higher as the RBI believes that a Small Finance Bank would need greater handholding and it is important to have the promoter on board for a longer time to preserve the 'local' nature of the Small Finance Bank
After the Small Finance Bank reaches the net worth of Rs. 500 crore, listing will be mandatory within 3 years of reaching that net worth. However, Small Finance Bank having net worth of below Rs.500 crore could also get their shares listed voluntarily, subject to fulfillment of the requirements of the capital markets regulator	• After the Small Finance Bank has attained a significant size, the guidelines mandate a compulsory listing within 3 years • For the others which are still to reach this milestone, the listing is voluntary	• The RBI perceives that once a Small Finance Bank breaches the Rs. 500 crore barrier (the minimum capital required to start a Universal Bank as per February 22, 2013 guidelines), the Small Finance Bank would have attained a significant size and scale • As a result, the RBI would push for a public listing to diversify the shareholding as well as bring the Small Finance Bank under the SEBI scanner with additional requirements for reporting, corporate governance, etc.

Foreign Shareholding & Voting rights and transfer/acquisition of shares

Broad Analysis and Remarks

Guideline	Analysis	Remarks
The foreign shareholding would be as per FDI policy for private sector banks: • Aggregate foreign investment in a private sector bank will be allowed up to a maximum of 74% of the paid-up capital of the bank (automatic up to 49% and approval route beyond 49% to 74%) • At all times, at least 26% will have to be held by residents • In the case of FIIs/ FPIs, individual FII/ FPI holding is restricted to below 10%, aggregate limit for all FIIs /FPIs / QFIs cannot exceed 24%, which can be raised to 49% by the bank concerned through a resolution by its Board followed by a special resolution by its General Body • In the case of NRIs, the individual holding is restricted to 5% both on repatriation and non-repatriation basis and aggregate limit cannot exceed 10%. However, NRI holding can be allowed up to 24% provided the bank passes a special resolution in the General Body	• A Small Finance Bank may initially be owned and controlled by residents; however, the guidelines do not put restrictions on foreign shareholding as stringent as that for the Universal Bank licensees	• With the restrictions on foreign shareholding not very stringent, going forward, this space may witness significant M&A activity for Small Finance Bank
• As per Section 12 (2) of the Banking Regulation Act, 1949, any shareholder's voting rights in private sector banks are capped at 10% (can be raised to 26% by the RBI) • As per Section 12B of the Act, any acquisition of 5% or more in a private sector bank will require prior approval of RBI	• This is in line with the current norms for the private banks and new Universal Bank	• -

Scope of activities (1/2)
Broad Analysis and Remarks

Guideline	Analysis	Remarks
A Small Finance Bank can: • Primarily undertake basic banking activities of acceptance of deposits and lending to unserved and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganized sector entities • Undertake other non-risk sharing simple financial services activities, not requiring any commitment of own fund, such as distribution of mutual fund units, insurance products, pension products, etc. with prior RBI approval and in compliance with relevant norms • Become a Category II Authorized Dealer in foreign exchange business for its clients' requirements	• A Small Finance Bank can deal in basic banking offerings, distribution (MFs, insurance products, pension products, etc.) and forex business • The guidelines do not allow Small Finance Bank to delve in complex sophisticated products as the target clientele is expected to be a first-timer or relatively new user of financial services	• This bouquet of services covers all the basic needs for a customer in the unserved/ under-served areas
A Small Finance Bank cannot set up subsidiaries to undertake non-banking financial services activities	• A Small Finance Bank would not be able to diversify into non-banking financial services activities	• The RBI mandates the Small Finance Bank to focus their efforts on basic banking activities and not take undue risks of expanding to other activities
At least 25% of its branches in unbanked rural centres (population up to 9,999 as per the latest census) with RBI approval required for first 5 years – RBI may liberalize this and scope of activities post this period	• The applicants have to show their due commitment to promote rural banking and financial inclusion as against more profitable commercial and urban retail banking	• Continuing the mandate of financial inclusion, the RBI wants to ensure that the Small Finance Bank cater to the unbanked rural regions. However, it will put pressure on these players to compete with existing players (e.g. national banks, co-operative banks, NBFCs, MFIs, LABs, etc.) as well as upcoming players (e.g. Payments Bank) in these areas

Scope of activities (2/2)

Broad Analysis and Remarks

Guideline	Analysis	Remarks
There will not be any restriction in the area of operations of Small Finance Bank; however, preference will be given to those applicants who in the initial phase set up the bank in a cluster of under-banked States/ districts, such as in the North-East, East and Central regions of the country. These applicants will not have any hindrance to expand to other regions in due course. It is expected that the Small Finance Bank should primarily be responsive to local needs	• An applicant with its business plan focused on setting up a Small Finance Bank in a cluster of under-banked States/ districts such as in the North-East, East and Central regions of the country would be preferred • While the initial nature of business would be 'local', the Small Finance Bank would not be restricted in expanding to new regions	• A player with initial local focus operating in the regions earmarked by the guidelines would stand a higher chance of getting a Small Finance Bank license
The other financial and non-financial services activities of the promoters, if any, should be kept distinctly ring-fenced and not comingled with the banking business. The Small Finance Bank will be required to use the words "Small Finance Bank" in its name in order to differentiate it from other banks.	• The guidelines suggest a complete ring fencing of the Small Finance Bank business	• With the RBI discouraging proposals from large public sector entities, and industrial and business houses, including from NBFCs promoted by them, this would not be a big challenge for the applicants

Corporate Governance & Other Conditions (1/2)
Broad Analysis and Remarks

Guideline	Analysis	Remarks
The Board of the bank should have a majority of independent Directors. The bank should comply with the corporate governance guidelines including 'fit and proper' criteria for Directors as issued by RBI	• The regulator intends to follow the same guidelines that have been issued for the private banks in India	• This will help the Small Finance Bank to adopt the best corporate governance practices right from the commencement of business
Other conditions: • If a promoter setting up a Small Finance Bank desires to set up a Payments Bank, it should set up both types of banks under an NOFHC structure. However, a promoter will not be granted licenses for both Universal Bank and Small Finance Bank even if the proposal is to set them up under the NOFHC structure • Individuals (including relatives) and entities other than the promoters will not be permitted to have shareholding in excess of 10% of the paid-up equity capital. In case of existing. NBFCs / MFIs / LABs converting into Small Finance Bank, where there is shareholding in excess of 10% of the paid-up equity capital by entities other than the promoters, RBI may consider providing time up to 3 years to comply with this guideline	• While the RBI allows for a promoter/ promoter group to run both a Small Finance Bank as well as a Payments Bank under a holding company (NOFHC), the guidelines do not allow a promoter/ promoter group to hold a Small Finance Bank as well as a Universal Bank license at the same time • The guidelines intend to discourage creation of any other influential power centres apart from the promoter/ promoter group that may derail the development of the Small Finance Bank	• The RBI perceives a Small Finance Bank and Payments Bank have different value propositions and has hence, allowed the two to be held under a single promoter/ promoter group. However, in case of a Universal Bank and Small Finance Bank under a similar structure, the RBI's perception is different. Therefore, a player looking for a Universal Bank in future may need to clearly articulate if it should look for a Small Finance Bank license in the short term • The problem of differing vision and strategy going forward has been seen in a few private banks. Therefore, the RBI intends to discourage such events right from the inception of a Small Finance Bank

Corporate Governance & Other Conditions (2/2)
Broad Analysis and Remarks

Guideline	Analysis	Remarks
Other conditions (continued):		
• The Small Finance Bank cannot be a BC for another bank. However, it can have its own BC network	• The guidelines restrict a Small Finance Bank to become a BC. However, it may employ a BC network of its own	• This supports the view of RBI where a promoter/ promoter group may have both a Small Finance Bank as well as a Payments Bank under an NOFHC structure where a Small Finance Bank can leverage a Payments Bank network.
• The operations of the bank should be technology driven from the beginning, conforming to generally accepted standards and norms; while new approaches (such as for data storage, security and real time data updates) are encouraged, a detailed technology plan for the same should be furnished to RBI	• Technology will need to be an integral part of the planning stage • This will have an impact on the cost allocation towards technology	• The RBI wants banks to adopt a high technology-low cost operations model to keep the servicing costs low
• The bank should have a high powered Customer Grievances Cell to handle customer complaints	• The bank should have a strong customer grievance cell to start with	• With majority of the customers expected to be relatively first time users of financial services, such a facility would be crucial as this segment would look for trust and safety of their capital in addition to the convenience offered by the Small Finance Bank
• The compliance of terms and conditions laid down by RBI is an essential condition of grant of license. Any non-compliance will attract penal measures including cancellation of license of the bank		

Prudential norms

Broad Analysis and Remarks

Guideline	Analysis	Remarks
The Small Finance Bank should ensure that they put in place a robust risk management framework	• The Small Finance Bank would need to have a robust risk management framework	• This is in line with the RBI's expectations from any banking entity operating in India
The bank will be subject to all prudential norms and regulations of RBI as applicable to existing commercial banks including CRR and SLR requirements. No forbearance would be provided	• A Small Finance Bank needs to be prepared to meet all prudential norms and regulations right from the commencement of business	• The RBI wants to create a level playing field for the new players as well as the existing players who are subject to these guidelines
The bank will be required to extend 75% of its Adjusted Net Bank Credit (ANBC) as PSL. While 40% of its ANBC should be allocated to different sub-sectors under PSL, the bank can allocate the balance 35% to any one or more sub-sectors under the PSL where it has competitive advantage	• Given the target segments and scope of activities, the guidelines envisage the operations of these banks to be in line with the PSL criteria	• The PSL targets are significantly higher compared to the scheduled commercial banks i.e., 40% of ANBC • Therefore, a Small Finance Bank would need to quickly build capabilities to lend to these sectors in a cost-effective sustainable way
The maximum loan size and investment limit exposure to a single and group obligor would be restricted to 10% and 15% of its capital funds, respectively. Further, in order to ensure that the bank extends loans primarily to small borrowers, at least 50% of its loan portfolio should constitute loans and advances of up to Rs.25 lakh	• The guidelines prevent any undue concentration risks and encourage wider customer base of small borrowers	• This issue has cropped up in cases where the financing entity (e.g. LABs, Co-operative Banks) has a local nature
In addition to the restrictions placed on banks' loans and advances to its directors and the companies in which its directors are interested, the bank is precluded from having any exposure to its promoters, major shareholders (10% of paid-up equity shares), the relatives of the promoters as also the entities in which they have significant influence or control	• The guidelines intend to ring fence the bank from any promoter or promoter group's misconduct or negligence	• This issue has cropped up in cases where the financing entity (e.g. LABs, co-operative banks) has a local nature

Additional conditions for NBFCs/MFIs/LABs converting into a Small Finance Bank

Broad Analysis and Remarks

Guideline	Analysis	Remarks
An existing NBFC/MFI/LAB, if it meets the conditions under these guidelines. The entity shall have a minimum net worth of Rs. 100 crore or it shall infuse additional paid-up equity capital to achieve net worth of Rs. 100 crore.	• The guidelines encourage only the financially healthier/ stronger entities to apply for a Small Finance Bank license	• -
It may be noted that on conversion into a Small Finance Bank, the NBFC / MFI will cease to exist and all its business which a bank can undertake should fold into the bank and the activities which a bank cannot statutorily undertake be divested / disposed of. Further, the branches of the NBFC / MFI should either be converted into bank branches or be merged / closed as per the business plan. The bank and the NBFC / MFI cannot co-exist.	• The guidelines strictly restrict any co-existence on the two entities	• Any entity looking to convert to a Small Finance Bank would need to articulate the businesses it can keep within the new bank structure
Banks are precluded from creating floating charge on their assets. For such NBFCs / MFIs, which succeed in obtaining licenses, if they have created floating charges on their assets for secured borrowings which stand in their balance sheets on the day of conversion, RBI will permit grandfathering of such borrowings till their maturity, subject to imposition of additional capital charge	• The RBI intends to make the conversion as seamless as possible for specific items on the books of the entity seeking conversion	• -
If the existing NBFCs / MFIs / LABs have diluted the promoters' shareholding to below 40%, but above 26%, due to regulatory requirements or otherwise, RBI may not insist on the promoters' minimum initial contribution as indicated in the guidelines	• The RBI intends to make the conversion as seamless as possible	• -

Business Plan & Transition path
Broad Analysis and Remarks

Guideline	Analysis	Remarks
The applicants will be required to furnish their business plans along with project reports with their applications The business plan submitted by the applicant should be realistic and viable. In case of deviation from the stated business plan after issue of license, RBI may consider restricting the bank's expansion, effecting change in management and imposing other penal measures as may be necessary	• Applicants need to submit a business plan with sufficient logical backing and actionable strategies	• The RBI wants to ensure that the plans submitted are implementable and there are no implicit differences between a Business Plan and a Regulatory Business Plan
The business plan will have to address how the bank proposes to achieve the objectives behind setting up of Small Finance Bank and in the case of an NBFC / MFI applicant, how the existing business of NBFC / MFI will fold into the bank or divested / disposed of	• Applicants need to clearly outline their strategy as well as implementation roadmap in order to fulfill the objectives outlined in the guidelines	• The RBI wants to ensure that the plans submitted are in line with the expectations • The regulator would look for a clear transition plan for an NBFC / MFI applicant seeking conversion to a Small Finance Bank
The Small Finance Bank may choose to continue as a differentiated bank. If it aspires to transit into a Universal Bank, such transition will not be automatic, but would be subject to it applying to RBI for such conversion and fulfilling minimum paid-up capital/ net worth requirement as applicable to Universal Banks; its satisfactory track record of performance as a Small Finance Bank for a minimum period of 5 years and the outcome of RBI's due diligence exercise. On transition into a Universal Bank, it will be subjected to all the norms including NOFHC structure as applicable to Universal Bank	• The guidelines provide a long term road map in terms of scope of business for a Small Finance Bank	• The RBI wants Small Finance Bank to become the Universal Bank of tomorrow. In this way, the RBI would have an excellent opportunity to witness and assess the growth of a Small Finance Bank and if that bank is capable of making the transition to the next level

Small Finance Bank License Evaluation Process

Evaluation Process

The Evaluation process would involve critical questions on Who is the promoter and What is the value proposition?

The RBI guidelines suggest that RBI shall evaluate the application for the license on three categories of filters- Eligibility, Credentials & Governance and Business Plan suitability

Small Finance Bank License Evaluation

Banking Application

Filter #1: Eligibility

Promoter Eligibility
- Promoters should have 10 years of experience in banking and finance
- Successful track record of running their business for 5 years
- Existing NBFCs, MFIs, LABs are permitted
- Conform to “fit and proper” and any other criteria prescribed by RBI

Minimum Capital and Shareholding
- Minimum capital contribution of promoter of Rs. 40 Crores (40% of Rs. 100 Crores)
- Restriction on aggregate shareholding of FDI, NRIs and FIIs

Filter #2: Credentials and Governance

Credentials
- Promoter groups should have sound credentials and integrity
- Source of promoters' equity should be transparent and verifiable

Governance
- The Board of the Small Finance Bank should have a majority of independent Directors.
- The bank should comply with the corporate governance guidelines including ‘fit and proper’ criteria for Directors as issued by RBI from time to time

Filter #3: Business Plan

Business Model
- Realistic and financially viable business model
- Demonstrate focus to address financial inclusion.
- Adoption of technology and other modern technologies to lower the operational costs and extend reach

Small Finance Bank License

Post License Requirements

- Need to have at least 25% of branches in unbanked rural areas
- 75% of adjusted net bank credit to priority sector
- 50% of loan portfolio should constitute loans and advances of upto Rs. 25 lakh ticket size
- Capital Adequacy ratio to be maintained at 15% on a continuous basis
- Bank should be fully networked and technology driven from the beginning
- Shareholding by promoters in excess of 40% shall be brought down to 40% within 5 years of commencement
- Promoter’s stake should be brought down to 30% within a period of 10 years, and to 26% within 12 years from the date of commencement
- If net worth reaches Rs. 500 crores, listing is mandatory within 3 years of reaching that net worth

Procedure for granting Small Finance Bank license as suggested by the RBI

Procedure for application:

- In terms of Rule 11 of the Banking Regulation (Companies) Rules, 1949, applications shall be submitted in the prescribed form (Form III) to the RBI
- In addition, the applicants should furnish the business plan and other requisite information as indicated. Applications will be accepted till the close of business as on January 16, 2015. After experience gained in dealing with Small Finance Bank, applications will be received on a continuous basis. However, these guidelines are subject to periodic review and revision

Procedure for RBI decisions:

- RBI will conduct a preliminary review of the applications
- An External Advisory Committee (EAC) comprising eminent professionals like bankers, chartered accountants, finance professionals, etc., will evaluate the applications
- The decision to issue an in-principle approval for setting up of a Small Finance Bank will be taken by the Reserve Bank. The Reserve Bank's decision in this regard will be final.
- The validity of the in-principle approval issued by the Reserve Bank will be 18 months
- The names of applicants for Small Finance Bank licenses will be placed on the Reserve Bank website

Approach

A structured and proven approach will help an applicant secure the Small Finance Bank license and effectively launch the bank

<table>
<tr><th>Prepare</th><th>Plan/Structure</th><th>Apply</th><th>Build</th><th>Launch</th></tr>
<tr><td>Analyze internal & external environment & develop business case</td><td>Develop overall business structure & business plan</td><td>Apply for license as per RBI guidelines</td><td>Develop detailed design of the bank’s operating model</td><td>Launch operations of the bank/ implement the operating model</td></tr>
<tr><td>• Have I ensured Management and key Stakeholder Buy-in?
• What are my internal capabilities that can be leveraged?
• Do I have a solid Business Case?
• How much capital do I need to raise?
• Am I eligible to apply for a Small Finance Bank license?
• Does new venture require corporate restructuring?
• What are tax and regulatory structuring implications?
• What should be the mix of debt-equity?
• Exit strategy post 5 years of licensing?</td><td>• What is my Business and financial plan in terms of key markets, products, channels, risks, etc.?
• What are the key elements of strategy, business and financial plan that need to be reviewed?
• How best to implement the corporate, legal and tax structure?
• What is the financial structure required for the venture?</td><td>• What are the key criteria for a Small Finance Bank license?
• How to ensure the test of responsiveness set by RBI?
• What are the other necessary documents to be submitted along with the application?
• What are the Liasioning requirements with RBI?
• What are the timelines to send the documentation to RBI?
• Liaison / response to RBI queries?</td><td>• What is the proposed operating model for the bank?
• How should I establish PMO, implementation and communication plans?
• What are product features?
• How to get the bank structuring in place in terms of AOA/MOA/SHA
• What will be the risk, compliance and treasury function of the bank
• What should be the IT architecture?
• Which vendor should be selected for IT?
• How to develop org structure & staffing profile?</td><td>• What are the key policies for business processes?
• What are my branch/channel expansion plans?
• What is the branding spend I want to do?
• How to recruit and train staff?
• How to manage the change?
• How to build/ test systems?
• How to prepare for regulator review and regulatory reporting?
• What all alliances need to be in place?
• How to implement the risk requirements of the bank</td></tr>
</table>

Considerations for applicants

Desirable outcomes for each stage of the process need to be individually and collectively managed

Defining the right strategy	• What customer segments (e.g. retail, merchants) and what geographies to focus on initially? How fast should the Bank grow? • What products and services should the firm offer? What channels should the firm focus on? • What capabilities does the firm have? What additional capabilities should be developed to succeed in the banking sector?
Implementing the strategy	• What initiatives should the firm launch to implement the strategy? How much will these initiatives cost? What should be the sequence of implementing? • What is the impact of these initiatives on the existing businesses? What is the risk associated with these initiatives? What can the firm do to minimize these risks? • Who are the key people for implementing these strategies?
Understanding the Small Finance Bank license application process	• What are the key gaps/opportunities in the market? • What preparation should the firm do before applying for the Small Finance Bank license? • Who are the key stakeholders in the banking license application process? What are their needs?
Addressing complex regulatory and compliance requirements	• What key regulations might impact the firm? • What can we learn from companies that have received banking licenses in the past? • What steps can be taken to improve the chances of securing a banking license?

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Disclaimer

Annexures

Abbreviations

ANBC	Adjusted Net Bank Credit
BC	Business Correspondent
CAR	Capital Adequacy Ratio
EAC	External Advisory Committee
FDI	Foreign Direct Investment
FII	Foreign Institutional Investors
FPI	Foreign Portfolio Investors
JV	Joint Venture
LAB	Local Area Banks
MFI	Micro Finance Institution
NBFC	Non Banking Finance Institution
NOFHC	Non-Operating Financial Holding Company
NRI	Non-Resident Indians
PSL	Priority Sector Lending
QFI	Qualified Foreign Investors
RBI	Reserve Bank of India
RWA	Risk Weighted Assets

Differences between the Draft and the Final Guidelines

Guideline on…	Draft Guidelines (July 2014)	Final Guidelines (November 2014)
Eligible Promoters	No restriction on • different promoters coming together to set up the bank • large public sector entities and industrial and business houses	• Joint ventures by different promoter groups for the purpose of setting up Small Finance Bank would not be permitted • Large public sector entities and industrial and business houses, including NBFCs promoted by them, will not be entertained.
Scope of activities	Areas will normally be restricted to contiguous districts in a homogenous cluster of States/Union Territories so that the bank has the "local feel" and culture	• No restriction on the area of operation; however preference will be given to those applications who in the initial phase set up the bank in a cluster of under-banked States/districts such as North East, East and Central regions • Small Finance Bank also permitted to become a Category II Authorized dealer
Promoter's Contribution	Minimum contribution of 40% locked in for five years	• If existing NBFC/MFI/LAB is converting in to a bank and has already diluted promoter's shareholding to below 40%, but above 26% due to regulatory requirements or otherwise, will be permitted • Compulsory listing within 3 years of reaching a net worth of Rs 500 cr
Foreign shareholding	As per extant FDI policy	• Detailed out the policy on individual and aggregate shareholding limits for FII/FPI, QFI, NRI
Prudential Norms	To comply with PSL targets as applicable to domestic banks	• PSL target at 75% of ANBC, which is higher than the target for domestic scheduled commercial banks (40%)
NBFCs/MFIs/LABs converting into a Small Finance Bank	No additional conditions were laid down on branch conversion / charge on assets	• Additional conditions with respect to divestment/disposal of non-banking activities, conversion of existing branches and existing charges on assets
Other conditions	-	• Promoter allowed to simultaneously set up Small Finance Bank and Payments Bank under NOFHC structure • Non-promoter Individuals and entities not allowed to hold more than 10% in the bank • Small Finance Bank cannot be a BC to other bank
Transition path to Universal Bank	No transition path defined	• Transition to Universal Bank subject to a separate application and satisfactory performance for a minimum 5 years