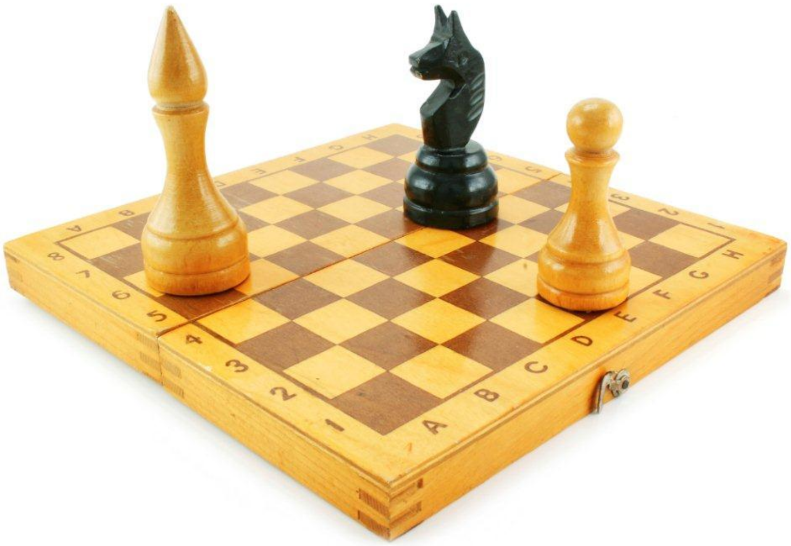
RBI Guidelines for New Private Banks

Opportunities and Challenges



Deloitte Point of View

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Introduction

- RBI has released the Guidelines for "Licensing of New Banks in the Private Sector" on February 22, 2013
- As a part of the guidelines, RBI has provided several parameters related to minimum capital requirement, corporate structure, ownership and governance, foreign shareholding, eligible promoters, specific provisions for NBFCs, business model considerations, etc.
- The objective of these guidelines is to frame an explicit policy on structure of new private sector banks as well as to outline application and selection process to guide the applicants
- Opening of the banking sector by RBI to new private and public sector players, by way of issue of new licenses for them provides a tremendous opportunity to participate in the banking sector which has been growing at a high rate of around 20% since the last decade

About this document

- This document summarizes the key tenets proposed in the guidelines and provides Deloitte view on implications and observations of these guidelines for banking sector aspirants

Executive Summary

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

Highlights of the Guidelines

- Eligible promoters are defined as entities/groups in the private sector owned and controlled by residents as well as public sector with sound credentials and integrity and with a successful track record of 10 years.
- To improve governance and enable ring fencing of financial services business, new banks are intended to be set-up only through a wholly-owned Non-Operative Financial Holding Company (NOFHC).
- The minimum capital has been pegged at INR 500 crores, with the promoter NOFHC holding not less than 40% of capital, along with a 5 year lock-in period.
- Progressive reduction of shareholding of promoter NOFHC is envisaged to restrict it to 40% for the initial 5 year period, to eventually 15% within 12 years.
- Initial foreign shareholding has been restricted to 49% for the first 5 years.
- To improve corporate governance, the Board is envisaged to have minimum of 50% independent directors.
- Existing NBFCs can promote a new bank or convert themselves in to a bank

Critical Considerations

- Setting up NOFHC with the appropriate shareholding and governance structure that will meet RBI requirements. Strong pedigree of the top management and independent directors
- Tax implications (direct, indirect, stamp duty) and other considerations (existing JVs etc.) on transferring of financial services business under NOFHC.
- Relatively stringent capital adequacy requirement of 13% for 3 years as well as compulsory opening of 25% branches in unbanked rural centers may strain the viability and render them uncompetitive against established players who do not have such restrictions.
- Establishing a successful track record and profitability within 3 years, in order to get appropriate valuation at the time of compulsory public listing
- Prohibition of opening a new financial services entity by NOFHC for the first 3 years can result into a disadvantage in the near term for players who wish to have a wider financial services footprint.
- Existing NBFCs may wish clarification on the conversion of its existing Tier 1 center branches, as the guidelines have proposed RBI approval for such branch conversion.

While the number of licenses that RBI is likely to grant has not been specified in the guidelines, considering the capital requirement of the sector, it is estimated that around 6-8 licenses may be issued over the next 24 months. RBI has invited applications from the aspirants by July 01, 2013.

Players who are aspiring for bank licenses have been provided clear indication of the strategic intent of the RBI on the eligibility criteria as well as selection criteria for evaluation of their banking license application. The next steps for such players will include preparing themselves for the test of responsiveness in terms of governance, structure, capital readiness and a well articulated sustainable, economic value additive business model that are both economically feasible and also entail financial inclusion.

Evaluation of Guidelines on New Bank Licences

The guidelines for New private Banks have to be assessed in the context of Applicant’s background and proposed business plan (1/3)

Eligible Promoters	• Private groups that are owned and controlled by residents and entities in public sector • Promoters / Promoter Groups with an existing non-banking financial company (NBFC) • Groups with sound credentials and integrity that have a successful track record for at least 10 years • Groups’ existing business model and culture should not be misaligned with the banking model and their business should not potentially put the bank/banking system at risk
Foreign Shareholding	• Aggregate non-resident shareholding from FDI, NRIs and FIIs in the new banks in the private sector shall not exceed 49% for the first five years from the date of licensing of the bank • No non-resident shareholder, directly or indirectly, individually or in groups, or through subsidiary, associate or joint venture will be permitted to hold 5% or more of the paid-up capital of the bank for 5 years from date of commencement of business of the bank • After the expiry of 5 years from the date of commencement of business of the bank, the aggregate foreign shareholding could be increased to existing limit of 74 % of the paid-up voting equity capital
Corporate Structure	• Promoters will be permitted to set up a new bank only through a wholly owned NOFHC, which will hold the bank, as well as all other financial services companies regulated by the RBI or other financial sector regulators • Only non-financial services companies/entities, other non –operative financial holding company in the group and individuals belonging to the promoter group will be allowed to hold shares in the NOFHC. Financial services entities whose shares are held by NOFHC cannot hold shares of the NOFHC • Only those regulated financial sector entities in which a Promoter Group has significant influence or control will be held under the NOFHC. • NOFHC should continue to hold 40% of the enhanced capital of the bank for a period of five years from the date of commencement of business of the bank. Capital, other than the holding by NOFHC, could be raised through public issue or private placements • NOFHC will be registered as an NBFC and will be governed by a separate set of guidelines • Capital structure of the wholly-owned NOFHC set up by Promoter / Promoter Groups in Private Sector shall consist of : a) voting equity shares not exceeding 10% to held by any individual belonging to the Promoter Group, along with his relatives (as defined in Section 6 of the Companies Act 1956) and along with entities in which he and / or his relatives hold not less than 50 % of the voting equity shares, and b) companies forming part of the Promoter Group whereof companies in which the public hold not less than 51% of the voting equity shares shall hold not less than 51 % of the total voting equity shares of the NOFHC. • NOFHC shall not be permitted to set up any new financial services entity for at least three years from the date of commencement of business of the NOFHC. They can have a subsidiary or joint venture or associate, where it is legally required or specifically permitted by RBI • Shares of the NOFHC shall not be transferred to any entity outside the Promoter Group. Any change in shareholding by the Promoter Group within the NOFHC as a result of which a shareholder acquires 5 % or more of the voting equity capital of the NOFHC shall be with the prior approval of RBI

The guidelines for New private Banks have to be assessed in the context of Applicant’s background and proposed business plan (2/3)

Minimum Capital Requirement & Holding By NOFHC	• Initial minimum paid-up capital for a new bank shall be INR 500 Crores and the NOFHC shall hold at least a 40% stake of the bank, which shall be locked in for a period of five years from the date of commencement of the business of the bank • Any shareholding by NOFHC beyond 40% shall be brought down to 40% within three years from the date of commencement of business of the bank • The shareholding by NOFHC shall be brought down to 20% of the paid-up capital of the bank within a period of 10 years and to 15% within 12 years from the date of commencement of business of the bank and retained at that level thereafter • Capital, other than the holding by NOFHC, could be raised through public issue or private placements
Corporate Governance	• No NOFHC shall have as a Director in its Board of Directors, who is a Director in any other NOFHC or a bank other than a banking company under it. • No NOFHC shall be managed by any person- a) who is a Director in any other company not being a subsidiary of the NOFHC or a company registered under Section 25 of the Companies Act, 1956 or b) who is engaged in any other business or vocation. • At least 50% of the directors of the NOFHC should be totally independent of the promoter/promoter group entities, their major customers and major suppliers • Ownership and management should be separate and distinct in the NOFHC, the bank and entities regulated by RBI and the source of promoters’ / promoter groups’ equity in the NOFHC should be transparent and verifiable • NOFHC shall obtain a Deed of Covenant and a declaration and undertaking in its favor, an annual declaration from its Directors as may be specified by RBI. • NOFHC shall have a Nomination Committee to perform due diligence in respect of its Directors. • NOFHC shall have a Remuneration Committee of the Board to decide on the compensation payable to the key management executives of NOFHC • NOFHC shall comply with such soundness standards in terms of corporate governance including ‘fit and proper’ criteria, as applicable to banks to the extent they are appropriate
Business Model	• Applicants for new bank licenses will be required to forward their business plan for a new bank along with their applications addressing how the bank proposes to achieve financial inclusion. • The RBI may consider restricting the bank’s expansion, effecting change in management and imposing other penal measures in case of deviation from the stated business plan after issue of license.
Exposure Norms	• NOFHC shall not have any credit and investment exposure to any entity belonging to the promoter group except those held under it • Consolidated NOFHC shall adhere to all exposure norms on the consolidated such as single and group borrower exposure limits, capital markets exposure limits etc. as applicable to bank groups • The bank cannot take any credit and investments exposure on the promoters/promoter group entities or individuals associated with promoter group • The financial entities (other than banks) held by NOFHC shall not have any credit and investment exposure to the promoters/ promoter group entities or individuals associated with the promoter group of the NOFHC

The guidelines for New private Banks have to be assessed in the context of Applicant's background and proposed business plan (3/3)

Other Conditions	
Other Conditions	• Shareholding of 5% or more of the paid-up capital of the bank by individuals/entities/groups will be subject to prior approval of the RBI and no single entity or group, other than the NOFHC, shall have shareholding or control, directly or indirectly, in excess of 10% of the paid-up capital of the bank. • In taking a view on whether an entity belongs to a particular promoter group or not or whether the entities are linked / related to the promoter group, the decision of the RBI shall be final. • The bank shall get its shares listed on the stock exchanges within three years of the commencement of business by the bank. • The bank should operate on Core Banking Solution (CBS) from the beginning. • The bank shall be required to maintain a minimum capital adequacy ratio of 13% for a minimum period of three years after the commencement of its operations subject to such higher percentage, as may be prescribed by the RBI from time to time. • The bank shall comply with the priority sector lending targets and sub-targets as applicable to the existing domestic banks • The bank will open at least 25% of its branches in unbanked rural centers (population up to 9,999 as per latest census) • The promoters, their group entities, NOFHC and the proposed bank shall be subject to the system of consolidated supervision by the RBI in terms of prudential norms exposure norms • The NOFHC shall not be permitted to set up any new financial services entity for at least three years from the date of licensing. • The promoter/promoter group with an existing NBFC, if considered eligible for a bank license, will have three options: – They can promote a new bank, if some or all the activities undertaken by it are not permitted to be undertaken by banks departmentally and in such cases, the activities will have to be transferred to the new bank – Convert the NBFC into bank, if all the activities undertaken by it are allowed to be undertaken by a bank departmentally. In this case NBFC shall have minimum networth of Rs. 500 Crores – Convert the NBFC into a bank and divest the activities which banks are not allowed to undertake departmentally. In this case, the bank shall have minimum networth of Rs. 500 crores • In all the cases, the promoters will have to first set up an NOFHC. The RBI will consider allowing the new bank to take over and convert the existing NBFC branches into bank branches only in Tier 2 to 6 centres. Existing branches of the NBFC in Tier 1 centres may be allowed to convert into bank branches only with the prior approval of the RBI and also subject to maintaining 25% of the bank branches in unbanked rural centers • Any non-compliance of terms and conditions will attract penal measures including cancellation of license of the bank

Eligible promoters – Implications and Observations

Guideline	Implications	Deloitte Observations
"Entities in the private sector that are owned and controlled by residents and entities in the public sector shall be eligible to promote banks"	• The competition for obtaining banking license would intensify with public sector companies also coming in to fray along with private sector players	• The guidelines are applicable to companies in the private sector, owned and controlled by residents as well as public sector institutions • Many public sector entities shall be able to apply for banking license under these guidelines
"Promoters / promoter groups with sound credentials, and integrity that have a successful track record for at least 10 years in running their businesses shall be eligible to promote banks" "RBI may seek feedback on applicant group on these or any other relevant aspects from other regulators, enforcement and investigative agencies"	• Ownership structure (concentrated /diversified) does not bear any significance as provided in guidelines • New companies keen to foray in Banking but with a track record of less than 10 years may not be able to apply • Companies with impeccable market standing would be preferred by the RBI	• By ensuring licenses to the business houses with high degree of integrity and market reputation the RBI would ensure higher corporate governance for the new banks • This implies that the RBI shall conduct detailed 'Qualitative Assessment' of the applicants
"Promoter/Promoter groups' business model and business culture should not be misaligned with the banking model and their business should not potentially put the bank and banking system at risk on account of group activities which are speculative in nature and subject to high asset price volatility"	• While no sector has been explicitly ruled out, companies with significant dependence on broking and real estate business may find it difficult to obtain license to promote a bank. They can potentially take a minority stake along with the promoting company	• While RBI has not drawn a negative list, promoters in sectors such as real estate and broking that have shown volatility in the past may find it difficult to obtain a banking license

Corporate structure (1/2) – Implications and Observations

Guideline	Implications	Deloitte Observations
"Promoter shall be permitted to set up a new bank only through a wholly-owned Non-Operative Financial Holding Company (NOFHC)" "The NOFHC shall hold the bank as well as all the other financial services companies regulated by RBI or other financial sector regulators"	• RBI wants to ensure ring fencing of regulated financial services activities including Bank under the holding company from other activities of the group i.e., commercial, industrial and financial activities that are not regulated by financial sector regulators • Any loss of promoter / group companies as well as subsidiaries of NOFHC should not impact the balance sheet of the bank and jeopardize the interests of the depositors of banks thus reducing contagion risk	• Banks under this structure would not face burden of corporate management as well as of equity infusion pressures from other subsidiaries of the Holding Company which may lead to freeing up of Bank's managerial competence and financial capacity • Banks still face certain degree of reputational risks, notwithstanding this structure • Players currently operating financial services businesses under JV structure may face a challenge to bring them under NOFHC • Players may need to consider competition law implications arising out of restructuring of financial services businesses under NOFHC
"Only non-financial services companies / entities, other non-operative financial holding company in the group and individuals belonging to the promoter group will be allowed to hold shares in the NOFHC. Financial services entities whose shares are held by NOFHC cannot be shareholders of NOFHC"	• This will require restructuring of the existing financial services businesses under NOFHC and may have tax implications	• Any new financial services company / entity within the promoter group has to be a subsidiary of this NOFHC and existing financial services companies have to restructured as subsidiaries of NOFHC • RBI has released its discussion paper on "Financial Holding Company" structure, which details the strategic intent of the regulator to create differentiated capital and asset pool for all group financial services businesses.
"No financial services entity under the NOFHC would be allowed to engage in any activity that a bank is permitted to undertake departmentally. "Accordingly, the activities which are to be carried outside the bank will have to be carried out through separate financial services entity"	• Promoters with existing NBFCs would have to realign their existing business for any overlapping business activities as there are many overlapping activities between banks and NBFCs	• Existing business activities of NBFCs which could also be undertaken by banks shall be required to be brought under the banking entity • This may involve significant restructuring in terms of business alignment and tax implications. This may create additional cost burden on NBFCs having overlapping businesses. Tax implications have been covered subsequently

Corporate structure (2/2) – Implications and Observations

Guideline	Implications	Deloitte Observations
"RBI will have to be satisfied that the corporate structure does not impede the financial services under the NOFHC from being ring fenced, that it would be able to supervise the bank and the NOFHC on a consolidated basis"	• Existing businesses which have a complex structure will need to restructure to adapt to the Financial Holding Company model	• -
"RBI would be able to supervise the bank, the NOFHC,, and its subsidiaries/JVs/Associates on a consolidated basis and that, it will be able to obtain all required information relevant for this purpose"	• This structure will bring all financial businesses under one corporate umbrella and ensure effective supervision by the regulator	• As part of systemic risk management, Financial Holding Company Model is better than the Banking Subsidiary Model in terms of fulfilling the requirements of Basel III • Players may face challenge to comply with these requirements due to tax and regulatory issues
"Any acquisition of shares which will take the aggregate holding of an individual / entity / group to the equivalent of 5 per cent or more of the paid-up voting equity capital of the bank, will require prior approval of RBI" "No single entity or group of related entities, other than the NOFHC, shall have shareholding or control, directly or indirectly, in excess of 10 per cent of the paid-up voting equity capital of the bank"	• The RBI wants the NOFHC to be the only controlling party in the new banking entity	• The RBI wants to ensure that the NOFHC functions in the best possible way as per the business plan submitted without any restrictions or interference from any other party by restricting them from holding a significant stake in the new banking entity

Corporate Governance of NOFHC – Implications and Observations

Guideline	Implications	Deloitte Observations
“No NOFHC shall have as a Director in its Board of Directors, any person who is a Director in any other NOFHC or a bank other than a banking company under it”	• The NOFHC needs to ensure that no person should be a Director in the Board of Directors for any other NOFHC or bank	• The RBI wants to avoid any conflict of interest as well as ensue independence and objectivity of the Board
“No NOFHC shall be managed by any person- a) who is a Director in any other company not being i. a subsidiary of the NOFHC or ii. a company registered under Section 25 of the Companies Act, 1956 (1 of 1956) or b) who is engaged in any other business or vocation”	• The NOFHC needs to ensure that the persons managing the NOFHC should focus on the new banking entity and do not have any engagements in any other business or vocation	• The RBI wants the NOFHC management to fully focus on its new banking entity • In case the person involved in management is also a Director in a Section 25 company, the RBI has shown flexibility in allowing that person to manage the NOFHC
“At least 50% of the Directors of the NOFHC should be totally independent of the promoter / promoter group entities, their major customers and major suppliers” “Independent Directors shall have special knowledge or practical experience in respect of one or more following matters…”	• The NOFHC would have to ensure adequate representation of Independent Directors in the board of Directors and may have to appoint Directors with Banking/financial sector/economics/rural finance well in advance to avoid any potential conflicts with other applicants	• A majority of independent directors (i.e. independent of promoter / promoter group companies / related entities) will ensure good corporate governance
“Ownership and management should be separate and distinct in the NOFHC, the bank and entities regulated by RBI”	• Separation of ownership and management will ensure that the management of the banks is in the hand of the professionals with necessary expertise and experience	• In case of family owned and managed business, professional management may have to brought in to manage the bank

Exposure Norms – Implications and Observations

Guideline	Implications	Deloitte Observations
<u>For standalone NOFHC</u> “NOFHC shall not have any credit and investment exposure to any entity belonging to the promoter group except those under it” “NOFHC shall not have any equity, debt capital and credit exposure to any outside the group including other NOFHCs, other banks, financial and non-financial entities” “NOFHC’s exposure for the purpose of its liquidity management to non-Group entities will be within the extant exposure limits”	• NOFHC will only have limited avenues available to make its investments (as per guidelines, allowed investments for liquidity management are bank deposits, money market instruments, government securities and actively traded bonds/debentures)	• RBI has ensured that NOFHC is non-operative as well as adequately ring fenced company to ensure systemic risk mitigation • On a standalone basis, NOFHC would not have any credit and investment (equity and debt capital) exposure to any company except for those held under it
“The bank cannot take any credit and investments (including investments in the equity/debt capital instruments) exposure on the Promoters / Promoter Group entities or individuals associated with the Promoter Group or the NOFHC.” “The bank shall not invest in the equity / debt capital instruments of any financial entities under the NOFHC” “The bank’s credit and investment (other than equity / debt capital instruments) exposure to financial entities under the NOFHC will be subject to Intra-Group Transactions & Exposures (ITEs) norms”	• RBI has ensured that lending operations of the banking are ring fenced from the promoter group companies (other than those held under NOFHC) and individuals associated with promoter group	• The RBI’s apprehension in allowing corporates to promote bank was about self-dealing - that corporates might use the bank as a private pool of readily available funds • Bank’s credit and investment exposure to other entities under NOFHC shall be restricted by single and group exposure limits

Minimum voting equity capital requirements for banks and shareholding by NOFHC (1/2) – Implications and Observations

Guideline	Implications	Deloitte Observations
"The initial minimum paid-up voting equity capital for a bank shall be INR 500 crores. Any additional voting equity capital to be brought in will depend on the business plan of the Promoters"	• The minimum paid- up capital requirement would ensure that applicants with strong financial position and long term capital commitment are permitted to promote banks	• A relatively low capital requirement (as compared to the earlier consideration of INR1000 crores in discussion paper) indicates RBI's commitment to permit broader participation in the licensing process. It also furthers the agenda of financial inclusion and a need to create smaller, flexible and adaptable business models
"The NOFHC shall hold a minimum of 40 per cent of the paid-up voting equity capital of the bank which shall be locked in for a period of 5 years from the date of commencement of business of the bank"	• The promoters have to bring in start-up capital of atleast Rs. 200 crores and continuously maintain that level by recapitalizing the balance sheet	• Provides incentive to the promoter when the bank size is comparatively smaller • Lock in would ensure serious commitment towards the development of bank and the promoter would play an active role in forming vision and strategy for the bank as well as executing the same
"Shareholding by NOFHC in the bank in excess of 40 per cent of the total paid-up voting equity capital shall be brought down to 40 per cent within three years from the date of commencement of business of the bank"	• This will ensure diversified ownership but at the same time holding promoter accountable for the bank	• Involuntary ownership dilution might force the promoters to expand the balance sheet of the bank to unlock the value creation before diluting excessive stake
"In the event of the bank raising further voting equity capital during the first 5 years from the date of commencement of business, the NOFHC should continue to hold 40 per cent of the enhanced voting equity capital of the bank for a period of 5 years from the date of commencement of business of the bank. Voting equity capital, other than the holding by NOFHC, could be raised through public issue or private placements"	• There may be demand on capital from promoters in the context of compulsory listing and maintaining 40% stake. The promoters need to provide evidence of their ability to inject capital in such cases	• It is expected that the new bank would need more capital as it grows and may look at raising capital through public issue or private placements. However, the NOFHC (effectively, promoters) needs to maintain its shareholding at not less than 40% over the first 5 years in order to exhibit its commitment and control of the to the banking entity to be able to realize the envisaged business plan
"The shareholding by NOFHC shall be brought down to 20 per cent of the paid-up voting equity capital of the bank within a period of 10 years, and to 15 per cent within 12 years from the date of commencement of business of the bank"	• Ensures that in the long run, banks are managed by independent management and on its own strength	• Promoter holding will go down to 15% ensuring diversified ownership • Promoters have to commit significant resources in the initial years before diluting their stake in order to unlock the value of their investments

Minimum voting equity capital requirements for banks and shareholding by NOFHC (2/2) – Implications and Observations

Guideline	Implications	Deloitte Observations
"The capital requirements for the regulated financial services entities held by the NOFHC shall be as prescribed by the respective sectoral regulators" "The financial entities held by the NOFHC will be governed by the applicable Statutes and regulations prescribed by the respective financial sector regulators"	• Other financial entities would be governed by the relevant regulators and the NOFHC structure would not in any case impede or complicate the governance	• Other financial entities continue to operate without any hindrances in their non-banking activities
"The bank shall be required to maintain a minimum capital adequacy ratio of 13 per cent of its risk weighted assets (RWA) for a minimum period of 3 years after the commencement of its operations subject to any higher percentage as may be prescribed by RBI from time to time"	• Promoters may have to continuously recapitalize the balance sheet in the early years or go slow on growth • RBI has tightened the CRAR norms in order to compensate for not putting any restriction on the promoters' current businesses	• The RBI has proposed higher capital adequacy norms for the new banks by providing a higher capital buffer. However, capital adequacy norms should match the industry norms of the time when the new banks start their operations
On a consolidated basis, the NOFHC and the entities held by it shall maintain a minimum capital adequacy of 13 per cent of its consolidated RWA for a minimum period of 3 years"	• Other financial entities may have to set aside larger capital to maintain 13% capital adequacy on an overall level • Promoters may have to recapitalize other financial entities in the NOFHC as well	• The promoters need to provide evidence of their ability to inject capital in such cases
"The bank shall get its shares listed on the stock exchanges within 3 years of the commencement of business by the bank"	• RBI has provided 3 years in order to provide time for the new banking entity to find its feet in the business and build a credible record to protect public interests • Aspirants will need to evaluate their ability to list the bank within three years	• Listing on the stock exchanges within a three year time frame may seem difficult • Valuation related issues may crop up as banks may take time to turn profitable as financial inclusion and priority sector targets and sub targets will increase costs • Involuntary ownership dilution might force the promoters to expand the balance sheet of the bank to maximize the value creation before diluting excessive stake

Foreign shareholding in the bank – Implications and Observations

Guideline	Implications	Deloitte Observations
"Notwithstanding the current FDI policy, where foreign shareholding in private sector banks is allowed up to a ceiling of 74 per cent of the paid-up voting equity capital, the aggregate non-resident shareholding from FDI, NRIs and FIIs in the new private sector banks shall not exceed 49 per cent of the paid-up voting equity capital for the first 5 years from the date of licensing of the bank"	• The limit for FDI in banks will be applicable for up to 5 years from receiving the license	• The RBI wants the control of the bank to be with Indian residents for the initial 5 years • Considering that as part of 'Foreign Bank Licensing Discussion Paper' the RBI has proposed listing of the foreign bank's Indian subsidiary, the foreign holding norms are likely to converge for Indian banks as well as foreign banks
"No non-resident shareholder, directly or indirectly, individually or in groups, or through subsidiary, associate or joint venture will be permitted to hold 5 per cent or more of the paid-up voting equity capital of the bank for a period of 5 years from the date of commencement of 6 business of the bank. After the expiry of 5 years from the date of commencement of business of the bank, the aggregate foreign shareholding would be as per the extant FDI policy"	• -	• The RBI wants to discourage any external influence or interference in the new banking entity and hence wants to restrict non-resident's from having a significant shareholding in the banking entity for the first few years

Regulatory framework – Implications and Observations

Guideline	Implications	Deloitte Observations
"The bank will be governed by the provisions of the Banking Regulation Act, 1949, Reserve Bank of India Act, 1934, Foreign Exchange Management Act, 1999, Payment and Settlement Systems Act, 2007, other relevant Statutes and the Directives, Prudential regulations and other Guidelines/Instructions issued by RBI and other regulators from time to time, including the regulations of SEBI regarding public issues and other guidelines applicable to listed banking companies"	• The new banking entity will be governed in the same way as the existing banks are governed	• The RBI wants to govern the new banking entity under the same rules and regulations that are applicable for existing banks without constraining the normal operations or business of the bank
"The NOFHC will be registered as a non-banking financial company (NBFC) with the RBI and will be governed by a separate set of directions issued by RBI"		• RBI is likely to come out with separate sets of directions for the bank holding NBFC and these will need to be reviewed

Prudential Norms for NOFHC on a 'Standalone' Basis – Implications and Observations

Guideline	Implications	Deloitte Observations
"The NOFHC shall create a reserve fund and shall, out of the balance of profit each year as disclosed in the profit and loss account and before any dividend is declared, transfer to the reserve fund a sum equivalent to not less than 25 per cent of such profit" "Any dividend proposed to be paid by the NOFHC to its shareholders shall be payable only out of the profits and further subject to meeting certain conditions"	• The NOFHC should not look for early rewards (dividends) for the promoters/ promoter groups and create a reserve fund for future	• The RBI wants to ensure that the promoters/ promoter groups are investing in the banking entity for long term sustainable success and not looking for any short term gains from the new venture

Business Plan and other conditions for the Bank (1/2) – Implications and Observations

Guideline	Implications	Deloitte Observations
"Applicants for new bank licenses will be required to furnish their business plans for the banks along with their applications. The business plan will have to address how the bank proposes to achieve financial inclusion" "The bank shall open at least 25 per cent of its branches in unbanked rural centres (population up to 9,999 as per the latest census) to avoid over concentration of their branches in metropolitan areas and cities which are already having adequate banking presence"	• The financial inclusion plan must be integrated with the business plan and financial inclusion congruent with their business models • The Applicants will have to show their due commitment to promote rural banking and financial inclusion as against more profitable commercial and urban retail banking	• The RBI wants the new banks to move forward to achieve financial inclusion and may be a crucial evaluation criteria • However, the requirement will put pressure on new players to compete with existing players who have established their network in more lucrative urban markets
"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 will have to submit a conservative business plan with sufficient logical backing	• This is to ensure that the plans submitted are implementable and that banks would adhere to the conditions agreed to at the time of receiving the license. There should be no implicit difference between a Business Plan and a Regulatory Business Plan • The RBI has been issuing only single bank licenses, that are permitted to undertake all permissible banking activities. Based on the business model, players may see some limited / conditional licenses being issued
"In taking a view on whether an entity belongs to a particular Promoter Group or not or whether the entities are linked / related to the Promoter Group, RBI will be guided by the provisions of the Banking Regulation Act, 1949, Accounting Standards and other related factors. The decision of the RBI in the matter will be final"	• The applicants will have to form the promoter group which will apply for the license based on sound principles and logic so as to the satisfaction of the Committee	• As this term is subjective, the committee may need to analyze and take decisions on a case to case basis

Business Plan and other conditions for the Bank (2/2) – Implications and Observations

Guideline	Implications	Deloitte Observations
"The bank shall comply with the priority sector lending targets and sub-targets as applicable to the existing domestic banks. For this purpose, the bank should build its priority sector lending portfolio from the commencement of its operations"	• The Banks will need to quickly build capabilities to lend to these sectors	• 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 should operate on Core Banking Solutions (CBS) from the beginning with all modern infrastructural facilities"	• 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 this service oriented architecture to improve banking operations, reduce costs and provide scalability • As compared to the last decade, core banking vendors now provide innovative and cost efficient products to suit the needs of the banks

Non Banking Financial Companies (NBFCs) – Implications and Observations

Guideline	Implications	Deloitte Observations
"The Promoters / Promoter Groups with an existing NBFC, if considered eligible for a bank license, will have three options: a) Promote a bank, if some or all the activities undertaken by the NBFC are not permitted to be undertaken by banks departmentally. In such cases, the activities undertaken by the NBFC which banks are allowed to undertake departmentally, will have to be transferred to the new bank, or b) Convert the NBFC into a bank, if all the activities undertaken by it are allowed to be undertaken by a bank departmentally. In such a case, the NBFC shall have a minimum net worth of Rs. 500 crores, or c) Convert the NBFC into a bank and divest the activities which banks are not allowed to undertake departmentally. In such a case, the bank shall have a minimum net worth of Rs. 500 crores"	• NBFCs shall need to assess their businesses to categorize it into two types: – Business activities which can be undertaken by banks – Business activities which cannot be undertaken by banks • Accordingly, NBFCs shall be required to realign their business structure to suit the RBI requirements	• Existing business activities of NBFCs which could also be undertaken by banks shall be required to be brought under the banking entity • This may involve significant restructuring in terms of business alignment and tax implications. Tax implications have been discussed separately
"Under the above options, the Promoters will have to set up a NOFHC. The NOFHC and the bank set up under it should comply with all the requirements laid down in the guidelines. RBI will consider allowing the bank to take over and convert the existing NBFC branches into bank branches only in the Tier 2 to 6 centres"	• The Banks set up by NBFCs would be able to convert NBFC's rural/ semi-urban branches into bank branches • However, for business activities of NBFCs which are not undertaken by bank may require separate set up in case the NBFC converts its branches into bank branches	• The NBFCs with significant rural/ semi-urban branches shall be able to quickly ramp up their presence by converting their branches into bank branches • The RBI wants to encourage NBFCs with significant rural presence to promote banks as it would help in financial inclusion
"Existing branches of the NBFC in Tier 1 centres may be allowed to convert into bank branches only with the prior approval of RBI and subject to the existing rules / methodology applicable to domestic banks regarding opening of branches in these centres and also subject to maintaining 25 per cent of the bank branches in unbanked rural centres (population up to 9,999 as per the latest census) required of all banks"	• The Branches of NBFCs in Tier 1 centers shall need separate RBI approval • In case, the RBI does not give approval to convert Tier 1 branches into bank branches, NBFCs with strong urban presence may incur significant costs in terms of ramping their presence in urban as well as rural areas	• The RBI wants to ensure that NBFCs converting into banks are subjected to same restrictions as existing banks in terms of opening of rural bank branches • However, conversion of existing urban branches to bank branches is not automatic and subject to the RBI's approval

Differences between the Draft and the Final Guidelines

Guideline on…	Draft Guidelines (August 29, 2011)	Final Guidelines (February 22, 2011)
Eligible promoters	Only private sector companies allowed	Private as well as public sector companies allowed
Diversified ownership as one of the 'fit and proper' criteria	Included as the criteria	Not included as the criteria
Negative List	Brokerages, Real estate companies	None. But business model and business culture fitment as one of the 'fit and proper' criteria
Capital structure of the wholly owned NOFHC	Not included	Included in detail
Capital adequacy ratio	12%	13%
Timelines for the banking entity listing	2 years after commencement of business	3 years after commencement of business
Allowing conversion of NBFC branches into bank branches	In the Tier 3 to 6 centres	In the Tier 2 to 6 centres
Prudential norms and Exposure norms	Not included	Included in detail

Banking License Evaluation Process

Banking License Evaluation Process

The RBI final guidelines suggest that RBI shall evaluate the application for the banking license on three categories of filters. The applicants who pass all the three filters viz. Eligibility, Credentials and Governance and Business Plan suitability shall be considered by the RBI for issuing banking license.

Banking License Evaluation

Banking Application → Filter #1: Eligibility → Filter #2: Credentials and Governance → Filter #3: Business Plan → Banking License

Filter #1: Eligibility

Promoter Eligibility

- Entities/groups in private sector, owned and control by residents
- Promoters should have an impeccable track record of successfully managing their business for at least 10 years
- Conform to “fit and proper” and any other criteria prescribed by RBI

Minimum Capital and Shareholding

- Minimum capital contribution of promoter of Rs. 200 Crores (40% of Rs. 500 Crores)
- Restriction on aggregate shareholding of FDI, NRIs and FIIs

Filter #2: Credentials and Governance

Credentials

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

Governance

- Promoter to set up NOFHC as NBFC to hold Banking entity
- Separation of ownership and management of the bank
- Top management of the Bank should have expertise in financial services sector
- Appointment of independent directors

Filter #3: Business Plan

Corporate Structure

- Restrictions on other entities under NOFHC to engage in financial services business which can be undertaken by bank departmentally
- Corporate structure should enable easy monitoring of bank and NOFHC by the RBI

Business Model

- Realistic and financially viable business model
- Demonstrate focus to address financial inclusion
- Adoption of CBS and other modern technologies

Post License Requirements

- Diversification of shareholding of NOFHC in the bank
- Capital Adequacy ratio to be maintained at 13% for a period of 3 years from date of commencing operations
- Compliance with priority sector lending targets and sub targets
- Compliance with rural branches target
- Listing requirement on the stock exchange within 3 years from date of licensing
- Restrictions on shareholding of single entity or group of related entities other than NOFHC
- Restrictions on exposure to promoter group entities
- Restriction on NOFHC to set up any new financial services entity for next 3 years from date of licensing

Procedure for granting new banking licenses (1/2)

Procedure for application

1. In terms of Rule 11 of the Banking Regulation (Companies) Rules, 1949 applications shall be submitted in the prescribed form (Form III). In addition, the applicants should furnish the requisite information including project report (business plan, product lines, technology), pattern of shareholding/ management and financial statements/credit information
2. Applications for setting up banks in the private sector, along with other details as mentioned above, should reach the following address **on or before July 1, 2013:**

   The Chief General Manager-in-Charge, Department of Banking Operations and Development, Reserve Bank of India, Central Office, 12th Floor, Central Office Building, Shahid Bhagat Singh Road, Mumbai-400001

Procedure for RBI decision on the application

1. In view of the increasing emphasis on stringent prudential norms, transparency, disclosure requirements and modern technology, banks would need to have strength and efficiency to work profitably in a highly competitive environment.
2. Banking being a highly leveraged business, licenses shall be issued on a very selective basis to those who conform to the above requirements, who have an impeccable track record and who are likely to conform to the best international and domestic standards of customer service and efficiency. Therefore, it may not be possible for RBI to issue licenses to all the applicants meeting the eligibility criteria prescribed above.
3. At the first stage, the applications will be screened by RBI to ensure prima facie eligibility of the applicants. RBI may apply additional criteria to determine the suitability of applications, in addition to the ’fit and proper’ criteria prescribed. Thereafter, the applications will be referred to a High Level Advisory Committee to be set up by RBI.

Procedure for granting new banking licenses (2/2)

4. The High Level Advisory Committee will comprise eminent persons with experience in banking, financial sector and other relevant areas. The constitution of the committee will be announced shortly.
5. The High Level Advisory Committee will set up its own procedures for screening the applications. The Committee will reserve the right to call for more information as well as have discussions with any applicant/s and seek clarification on any issue as may be required by it. The Committee will submit its recommendations to RBI for consideration. The decision to issue an in-principle approval for setting up of a bank will be taken by RBI. RBI's decision in this regard will be final.
6. The validity of the in-principle approval issued by RBI will be one year from the date of granting in-principle approval and would thereafter lapse automatically. Therefore, the bank will have to be set up within one year of granting the in-principle approval.
7. After issue of the in-principle approval for setting up of a bank, if any adverse features are noticed subsequently regarding the Promoters or the companies/entities with which the Promoters are associated and the group in which they have interest, the RBI may impose additional conditions and if warranted, it may withdraw the in-principle approval.
8. In order to ensure transparency, the names of the applicants for bank licenses will be placed on the RBI website after the last date of receipt of the applications.

Additional information to be furnished by the Promoters

1. Project Report

A project report covering business potential and viability of the proposed bank, the business plan, the product lines, proposed regional spread, level of information technology capability, and any other information that they consider relevant. The project report should give as much concrete details as feasible, based on adequate ground level information and avoid unrealistic or unduly ambitious projections. The business plan should address how the bank proposes to achieve financial inclusion.

2. Pattern of shareholdings and management

As the Promoters/ Promoter Groups are required to set up a bank through a wholly-owned Non-Operative Financial Holding Company (NOFHC), the applicants should furnish detailed information about the persons/entities, who would subscribe to the voting equity capital (shareholding pattern) of the proposed NOFHC and the bank, including foreign equity participation in the proposed bank.

Where the applicant belongs to an existing group, the details of ownership, management and corporate structure of all the entities in the group should be furnished, including an organogram showing shareholding and management.

3. Financial statements and credit information

Applications should also be supported by detailed information on the background of Promoters, their expertise, track record of business and financial worth, Memorandum and Articles of Association and latest financial statements of the Promoter entities for the past ten years, income tax returns for last three years, details of Promoters' direct and indirect interests in various entities/companies/industries, details of credit/other facilities availed by the Promoters/ Promoter entity(ies)/ other group entity(ies) along with details of the bank's/ financial institution's branches where such facilities were / are availed.

4. Any other information

The Promoters may furnish any other relevant information and documents supporting the applications. Further, the RBI may call for any other additional information, as may be required, in due course.

Conclusion

Conclusion

- Private Sector Banks, particularly New Private Sector Banks have played an important role in the Indian banking sector by increasing the efficiency of the domestic banking system and bringing in more sophisticated financial services
- The final Guidelines on New Banking Licenses issued by RBI has provided a framework for applicants to ensure their eligibility and check for the test of responsiveness to the guidelines. Considering the current stage of banking reforms in India as well as a need for capital, it is expected that the RBI may consider issuing 8-12 licenses over the next 2 years
- With the deadline for application submission being on or before July 1, 2013, the interested corporate players as well as NBFCs need to start their preparatory work at the earliest in terms of aligning their corporate structures, finalizing strategic intent, tailoring business model and developing a viable as well as sustainable business plan for the new banking entity
- **The next steps for applicant will include preparing themselves for the test of responsiveness in terms of governance, structure, capital readiness and a well articulated sustainable business model which is economically feasible and financial inclusive**

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