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Regulatory Alert

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Guidelines for ‘on tap’ Licensing of Small Finance Banks in the Private Sector

Background

The Reserve Bank of India (‘RBI’) had issued the Guidelines for licensing of Small Finance Banks (‘SFB’) in the private sector on November 27, 2014 (‘2014 Guidelines’). Till date, the RBI has granted in-principle approval to 10 applicants for setting up a SFB.

The RBI had earlier mentioned that after gaining experience in dealing with these SFBs, it may consider ‘on tap’ licensing of SFBs. After a review of the performance of the existing SFBs and to encourage competition, it was announced in the second bi-monthly Monetary Policy Statement, 2019-20 dated June 6, 2019 that the RBI would issue draft guidelines for ‘on tap’ licensing of SFBs. Accordingly, the draft guidelines were published on the RBI website on September 13, 2019 inviting comments from the stakeholders and members of the public. After taking into consideration the responses received, the RBI has issued the Final Guidelines on December 5, 2019 (‘2019 Guidelines’). With the ‘On Tap’ facility, the RBI will now grant licenses for SFBs throughout the year.

Major changes (other than being an ‘On Tap facility’) from the 2014 Guidelines on SFBs are that the minimum paid-up voting equity capital/ net worth requirement shall be INR 200 crores (instead of INR 100 crores) and SFBs will be given scheduled bank status immediately upon commencement of operations.

Certain other liberalizations made in the 2019 Guidelines are that large industrial house/ business groups[1], who are not permitted to apply for SFB license, has been redefined to mean a group with assets of INR 5,000 crores (as against INR 1,000 crores) and Primary (Urban) Co-operative Banks (UCBs) desirous of voluntarily transiting into SFBs, initial requirement of net worth shall be at INR 100 crores, which will have to be increased to INR 200 crores within

[1] Large industrial house/ business groups are not permitted to apply for SFB license.

5 years from the date of commencement of business. Also, Payments Banks can apply for conversion into SFB after five years of operations, if they are otherwise eligible as per the 2019 Guidelines.

Key features – 2019 Guidelines

Some of the key features of the 2019 Guidelines is summarised below:

Particulars	Guidelines
Eligible applicants	• Resident individuals/ professionals (Indian citizens), singly or jointly, each having at least 10 years of experience in banking and finance at a senior level • Companies and Societies in the private sector [owned and controlled by residents - as defined in Foreign Exchange Management Act, 1999 ('FEMA')] and having successful track record of running their businesses for at least a period of 5 years, will be eligible as Promoters[2][3] to set up SFBs • Existing Non-Banking Finance Companies (NBFCs), Micro Finance Institutions (MFIs) and Local Area Banks (LABs) in the private sector (controlled by residents - as defined in FEMA Regulations), and having successful track record of running their businesses for at least a period of 5 years • Existing Payments Banks which are controlled by residents and have completed 5 years of operations are also eligible for conversion into SFB • Primary (Urban) Co-operative Banks (UCBs) can voluntarily transition into SFB as per Scheme[4] on voluntary transition of Urban Co-operative Bank into a SFB. Such UCBs will be required to ensure compliance with these 2019 Guidelines.
Non-eligible applicants	• Government owned/ public sector entities and large industrial house/ business groups[5], including from NBFCs and Payment Banks promoted by them, autonomous boards/ bodies set up under enactment of a state legislature, state financial corporations, subsidiaries of development financial institutions. • Joint ventures by different Promoter groups • Alternative Investment Funds
Registration/ licensing	• SFB shall be registered as a public limited company under the Companies Act, 2013

[2] Promoters/ Promoter Groups should be 'fit and proper' in order to be eligible to promote small finance banks. RBI would assess the 'fit and proper' status of the applicants on the basis of 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 five years.
[3] The definition of Promoter and Promoter Group has also been defined in the Final Guidelines.
[4] Circular reference no. DCBR.CO.LS.PCB. Cir.No.5/07.01.000/2018-19 dated September 27, 2018.
[5] A group with assets of INR 5,000 crore or more with the non-financial business of the group accounting for 40% or more in terms of total assets/ gross income.

Particulars	Guidelines
	• SFB will be given 'scheduled bank' status once they commence their operations
Scope of SFB	• SFB can 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 unorganised sector entities • SFB can 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 approval of the RBI and after complying with the requirements of the sectoral regulator for such products • SFB can become a Category II Authorised Dealer in foreign exchange business for its clients' requirements • SFB can open banking outlets subject to atleast 25% of the banking outlets in unbanked rural centres (population upto 9,999 as per the latest census)
Corporate structure	• The Promoters/ Promoter group may choose to set up the SFB either as a standalone entity or under a holding company ('Promoting Entity'). The Promoting Entity is required to be registered as a NBFC – CIC with the RBI • If there is an intermediate company between the SFB and its promoting entity, it should be a Non-Operative Financial Holding Company (NOFHC)[6] • SFB is not permitted to set up any subsidiaries • Prior approval is required where the Promoters desire to continue existing specialized activities from a separate entity proposed to be held under the NOFHC. Also, it should be ensured that such specialized activities are not conducted through the SFB • Activities not permitted to the SFB would also not be permitted to the group i.e. entities under the NOFHC would not be permitted to engage in activities that the SFB is not permitted to engage in
Capital requirements	• The minimum paid-up voting equity capital for SFBs is INR 200 crores, except for such SFBs which are: – Transited from UCBs - the minimum net worth of such SFBs shall be INR 100 crores from the date of commencement of business. However, the minimum net worth will have to be increased to INR 200 crores within 5 years from the date of commencement of business – Converted from NBFC/MFI/LAB/PB - shall have a minimum net worth of INR 200 crores or it shall infuse additional paid-up

[6] NOFHC would be required to conform to all requirements relating to NOFHC stipulated under paragraph 2 (C) II of the Guidelines for 'On Tap' Licensing of Universal Banks in the Private Sector dated August 1, 2016.

Particulars	Guidelines
	voting equity capital to achieve net worth of INR 200 crores within 18 months from the date of in-principle approval or as on the date of commencement of operations, whichever is earlier • The minimum capital adequacy ratio shall be 15% of the risk weighted assets ('RWA'); Tier I capital should be at least 7.5% of RWAs and Tier II capital shall not exceed Tier I capital
Promoter's contribution and listing	• The Promoter should hold a minimum of 40% of the paid-up voting equity capital for 5 years from the date of commencement of SFB business. If the initial promoter shareholding is above 40%, it should be brought down to 40% within a period of 5 years from the date of commencement of SFB business, 30% within 10 years and 15% in 15 years • In case of SFBs which have transited from UCBs, the Promoters shall hold a minimum of 26% of paid-up voting equity capital at all times during the first 5 years from commencement of business of the SFB. Promoters' holding may be brought down to 15% over a period of 15 years from the date of reaching net worth of INR 200 crores by such UCBs • Where 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 mentioned above. In such cases, the Promoters' have to ensure that their holding does not fall below 26% of paid-up voting equity capital during the first 5 years from commencement of business of the bank, even if fresh equity is infused • Whether a Promoter ceases to be a Promoter or could exit from the bank, after completing the lock-in period of 5 years, would depend on the regulatory and supervisory comfort/ discomfort of RBI/ Securities Exchange Board of India
Listing of SFB	• Listing will be mandatory within 3 years after the SFB reaches the net worth of INR 500 crores for the first time • SFBs having net worth of below INR 500 crores could also get their shares listed voluntarily, subject to fulfilment of the requirements of the capital markets regulator
Voting rights and acquisition of shares	• Any acquisition of 5% or more of paid-up share capital in SFB or voting rights therein will require prior approval of RBI. However, shareholding limits of Promoters / Promoter group will be subject to the minimum Promoter's contribution (as mentioned in the table above).
Prudential norms	• SFBs will be subject to all prudential norms and regulations of RBI as applicable to existing commercial banks

Particulars	Guidelines
	• SFB will be required to extend 75% of its Adjusted Net Bank Credit to the sectors eligible for classification as priority sector lending by RBI • 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 • At least 50% of the loan portfolio should constitute loans and advances of up to INR 25 lakhs[7] on an ongoing basis • The SFB is precluded from having any exposure to its Promoters, major shareholders (who have shareholding of 10% or more of paid-up voting equity shares in the bank), the relatives (as defined in the Companies Act, 2013) of the Promoters as also the entities in which they have significant influence or control
Other conditions	• The Board of directors of the SFB should have a majority of independent directors • A Promoter will not be granted licenses for both universal bank and SFB even if the proposal is to set them up under the NOFHC structure • If a Promoter of a payments bank desires to set up a SFB, both the banks should be under 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 voting equity capital of the SFB • In case of existing NBFCs/ MFIs/ LABs converting into SFB, where there is shareholding in excess of 10% of the paid-up voting equity capital by entities other than the Promoters (including private equity funds), RBI may consider providing time up to 3 years from the date of the 'in principle' approval for the shareholding to be brought down to a maximum of 10% • SFB cannot be a Business Correspondent (BC) for another bank. However, it can have its own BC network • The operations of the SFB 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 updation) are encouraged, a detailed technology plan for the same should be furnished to RBI • The SFB should have a high-powered Customer Grievances Cell to handle customer complaints. The SFBs will come under the purview of RBI's Banking Ombudsman Scheme, 2006, as amended from time-to-time

[7] The criteria of upper limit of INR 25 lakhs shall be borrower wise.

Particulars	Guidelines
Foreign investment	• The foreign shareholding (ie. 49% under the automatic route and government route beyond 49% and upto 79%) would be as per the existing Foreign Direct Investment policy for private sector banks, subject to the minimum Promoter's contribution (as mentioned in the table above)
Application procedure	• Applications shall be submitted in the prescribed form (Form III). In addition, the applicants should furnish a business plan • The applications will be referred to a Standing External Advisory Committee to be set up by RBI • The Internal Screening Committee (ISC), consisting of the Governor and the Deputy Governors will examine all the applications. The ISC will also deliberate on the rationale of the recommendations made by the SEAC and then submit its recommendations to the Committee of the Central Board of RBI for the final decision to issue 'in-principle approval' • The validity of the 'in-principle approval' issued by RBI will be 18 months from the date of granting 'in-principle approval' and would thereafter lapse automatically • Preference will be given to those applicants who, in the initial phase, set up the SFB in a cluster of under-banked states/ districts, such as in the North-East, East and Central regions of the country

Dhruva comments

The 'On Tap facility' will allow applicants to approach RBI on an ongoing basis.

Existing rules do not allow Payments Banks to lend, and deposits are capped at INR 1 lakh per customer. If these entities get the SFB license, it will give them access to more deposits and boost their profitability, which is at present under stress. However, the stipulation that the entity should have been in operation for 5 years will come in the way of the Payments Banks for seeking SFB license immediately.

Also, one would need to examine its corporate structure to see whether it fits into the description of a large industrial house.

The liquidity crunch over the last one year and risk aversion to NBFCs/ MFIs may induce many NBFCs/ MFIs to explore the SFB model to address the liabilities issue.

Being a scheduled bank, a SFB may have certain additional advantages such as the SFB shall become eligible for debts or loans at the bank rate from the RBI, and shall automatically acquire the membership of clearing house, which is a financial institution formed to facilitate the exchange of payments, securities, or derivatives transactions.

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