

Regulatory Tax Alert

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Reserve Bank of India releases panel report on ownership, governance norms for Indian private sector banks

On November 20, 2020, the Reserve Bank of India released the report of Internal Working Group¹ constituted to review the existing Ownership Guidelines and Corporate Structure for Indian private sector banks

With a view to comprehensively review the existing licensing and regulatory guidelines on ownership, governance, corporate structure and other related issues in private sector banks, on June 12, 2020, the Reserve Bank of India ('RBI') had set up an Internal Working Group led by Dr. P.K. Mohanty ('IWG').

After detailed deliberations with serving and retired officials of RBI, bankers and other professionals and experts in the field of banking, the IWG submitted its recommendations to the RBI. The key recommendations of the IWG have been summarized in the ensuing paragraphs.

Eligibility of Promoters

Individuals

- Currently, 'Resident Individuals' having 10 years of experience in banking and finance at senior level would be eligible to promote banks singly or jointly.

IWG recommends that instead of the words 'Resident Individuals' the eligibility criterion should be defined as 'Individual/professionals who are residents [as defined in Foreign Exchange and Management Act, 1999 ('FEMA'), as amended from time to time] and Indian citizens (as defined in Citizenship Act, 1955) having 10 years of experience in banking and finance at senior level would be eligible to promote banks singly or jointly.'

Entities, Groups

- Currently, the eligibility criteria for Entities/Groups state that they should be 'owned and controlled by residents as defined in FEMA regulations'.

¹ The report is placed on the RBI website for comments of stakeholders and members of the public. Comments on the report may be submitted by January 15, 2021 through email.



In line of the changes recommended in case of individual promoters, the IWG recommends that the criterion may be modified as, 'Entities/ groups in the private sector that are owned and controlled by resident Indian citizens (as defined in FEMA regulations as amended from time to time) should be eligible to be a promoter of a bank.'

Entry of Large Corporates into Banking Space

- Over the years, RBI has been hesitant on large corporate/ industrial houses promoting banks. Broadly, the main concerns of allowing large corporate houses to own banks relate to conflicts of interest, concentration of economic power and safety net concerns. More specifically, it heightens the risks of misallocation of credit, connected lending, extensive anticompetitive practices, and exposure of the government safety net established for banking to a broad range of risks emanating from commercial sectors of the economy.

IWG recommends that large corporate/ industrial houses may be permitted to promote banks only after necessary amendments to the Banking Regulations Act, 1949 to deal with connected lending and exposures between the banks and other financial and non-financial group entities akin to the US Federal Reserve Act in this regard; and strengthening of the supervisory mechanism for large conglomerates, including consolidated supervision.

Conversion of Non-Banking Financial Companies ('NBFCs') [owned by large corporate houses] into banks

- Currently, NBFCs are permitted to convert into a universal bank subject to certain conditions such as the promoters should meet the fit and proper criteria including a 10 year track record of successful operations, part of a group with total assets of over INR 5,000 crores and non-financial business must not exceed 40% of the group's total assets/ total income. However, these NBFCs were not being considered for the conversion if they were owned by large corporate houses.

IWG recommends that well-run NBFCs with an asset size of INR 50,000 crores or more including those which are owned by a large corporate house, maybe permitted to convert into a bank provided they have completed 10 years of operation, meet certain due diligence

criteria and satisfy additional conditions as may be specified.

Shareholding Limits and Requirements

- The existing guidelines require the promoters' shareholding to be locked-in at not less than 40% during the first 5 years of operations of a new bank.

IWG recommends that no change may be required in the existing guidelines related to initial lock-in requirements since it ensures that the promoters remain committed to the business in the formative years, providing necessary strategic direction.

- Currently, the promoter's shareholding is capped at 15% of the paid-up voting equity share capital of the bank.

IWG felt that if India's private sector banks are to grow, it appears desirable that they be permitted to access the pool of capital without imposing excessively narrow investment limits. Accordingly, the IWG recommends that cap on promoter's stake in the long run (i.e. 15 years) may be raised from current level of 15% to 26% of the paid-up voting equity share capital of the bank.

- As regards non-promoters, the existing guidelines provide for a three-tier long run shareholding limits (10%, 15% and 40% for specified categories of investors).

IWG was of the view that higher threshold beyond 26% creates concerns relating to influence over the affairs of the banks and threshold at 10% is not in line with international norms. Accordingly, IWG recommends replacement of current three-tier long run shareholding limits for non-promoter shareholder by a simple cap of 15% of paid-up voting equity capital of the bank.

Initial Capital

- Currently, the minimum initial paid-up voting equity share capital requirement for universal banks is INR 500 crores and for Small Finance Banks ('SFB') is INR 200 crores.

IWG is of the view that minimum initial capital requirement should be in alignment with the investment requirements for setting up a new banking business, which varies with time and recommends that the minimum initial paid-up voting equity share capital requirement for universal banks should be INR 1,000 crores and INR 300 crores for SFBs.



- IWG also recommends that RBI may put a system to review the initial paid up voting equity share capital/ net-worth requirement for each category of banks, once in 5 years.

Corporate Structure - Non-operative Financial Holding Company ('NOFHC')

- Currently, the NOFHC structure is not mandatory in various cases.

The IWG noted that NOHFC structure is desirable in long run for a level playing field and efficiency in regulation and supervision. The IWG recommended that NOHFC structure should be mandatory in cases where individual promoters/ promoting entities/ converting entities have other group entities.

The IWG recommends that once NOFHC structure attains a tax-neutral status, all banks licensed before 2013 shall move to the NOFHC structure within 5 years from announcement of tax neutrality. RBI should engage with the Government to treat NOHFC as a pass-through structure

- It is also recommended that banks currently under NOFHC structure be allowed to exit from such a structure if they do not have other group entities in their fold.
- The IWG has highlighted that the concerns with regard to banks undertaking different activities through subsidiaries/ Joint Ventures/ associates need to be addressed through suitable regulations till the NOFHC structure is made feasible and operational.

Pledging of shares by promoters

- The existing guidelines do not prescribe any restrictions on the pledge of shares held by promoters, either during or after end of lock-in period.

IWG recommends that during the lock-in period, the promoters should not be permitted to pledge their shares to the extent of the prescribed minimum shareholding. The reason for this is that if the lender invokes the pledge and acquires/ transfers the shares, it may lead to reduction in shareholding thereby breaching the minimum shareholding requirement during lock-in period.

- In case of default, if the lender invokes the pledge, it is possible that he may acquire more than 5% shares of the bank. Currently, the regulations mandate prior permission

from RBI for acquisition of 5% or more of paid-up share capital or voting rights of a banking company.

IWG took a view that since under share pledges, the collateral agreement is not for the express purpose of acquisition of shares but as a collateral for an underlying lending transaction, it may not be desirable to be too restrictive in this regard. Accordingly, IWG recommends that where pledgee ends up with more than 5%, he may immediately apply for post-facto approval of the RBI and till the approval is obtained, the voting rights of pledgee must be restricted to 5%.

- IWG recommends that RBI may introduce a reporting mechanism for pledging of shares by promoters of private sector banks.

ADR/ GDR issued by banks

- As per the existing guidelines, the depository shall not exercise voting rights in respect of the shares held by them or shall exercise voting rights as directed by the Board of Directors of the bank.

The IWG acknowledged that the current provision has the unintended impact of diluting the shareholder rights by giving the Board of Directors significant indirect influence. IWG recommends that banks should be advised by RBI to seek its prior approval before entering into agreements with depositories and wherever promoters hold more than 15% holding, the depository agreement may be modified to assign no voting rights to depositories.

Listing requirements

- Currently, the existing guidelines require universal banks to be listed within 6 years of commencement of operations, SFBs and payments bank to be listed within 3 years from the date of reaching net-worth of INR 500 crores.

IWG noted that a newly set up bank may need initial 2-3 years to focus on building its business and expansion of customer base and another 2-3 years to gain investor's confidence in the market before listing.

Accordingly, IWG felt that universal banks shall continue to be listed within 6 years of commencement of operations, however, SFBs to be set-up in future should be listed within 6 years from date of reaching prescribed net worth or 10 years from date of



commencement of operations, whichever is earlier.

- Further, IWG recommends that existing SFBs and Payment Banks should be listed within 6 years from date of reaching net-worth of INR 500 crores or more or 10 years from the date of commencement of operations, whichever is earlier.

Licensing guidelines

- There are various guidelines issued by the RBI for universal banks and other differentiated banks over the years.

IWG noted that differences in prescription in licensing of universal banks which have been issued at different points of time, have sometime led to difficulties in applying uniform/harmonized approach to achieve the objective of level playing field.

Accordingly, IWG recommends that whenever a new licensing guideline is issued, if new rules are more relaxed, benefit should be given to existing banks, immediately. If new rules are tougher, legacy banks should also confirm to new tighter regulations, but transition path may be finalised in consultation with affected banks to ensure compliance with new norms in a non-disruptive manner.

- IWC also recommends that RBI may prepare a comprehensive document encompassing all

licensing and ownership guidelines at one place, with as much harmonisation and uniformity as possible, providing clear definition of all major terms.

Dhruva Comments

The recommendations come against the backdrop of putting the Indian economy on fast track which would not be possible without strong credit institutions. However, experts caution that these liberal norms are accompanied with changes that ensure stricter supervision and oversight of the banking system.

If the suggestions of IWG are accepted, large corporates and conglomerates could own banks. Allowing NBFCs owned by large corporate houses to get banking licences would increase healthy competition, making the banking system more efficient and ultimately increasing credit penetration in the system.

NBFCs with diversified operations may be required to adopt the NOFHC structure. Therefore, for NBFC entities which also have insurance and asset management operations, rejigging the corporate structure would be a pre-condition for conversion.

While there may be salient advantages of conversion, corporates may also have to look into the cost aspect of the process.



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