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469A Bukit Timah Road
#07-01, Tower Block
Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

The RBI Discussion Paper on Entry of New Banks in the Private Sector: A Comment

S. Narayan[1]

Abstract

The Reserve Bank of India (RBI) does not have an articulated policy for the expansion of private sector banking in India. There have been two guidelines, issued in 1993 and 2001, under which the RBI granted some licenses for private sector banking. For the first time now, the RBI has put out a discussion paper on a new strategy – of permitting corporate houses to enter the banking industry in India. As an effort to bring transparency to policy making in this important sphere, it is a very welcome move. However, there are some concerns and this paper highlights some of the issues posed by the discussion paper.

The Reserve Bank of India, on 11 August 2010, put out a discussion paper[2] on 'Entry of New Banks in the Private Sector' for public debate and discussion, and promised that the final policy would take note of the comments that it received. This in itself is a new approach to transparency

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[1] Dr S. Narayan is Head of Research and Visiting Senior Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He is the former Economic Adviser to the Prime Minister of India. He can be reached at snarayan43@gmail.com. The views reflected in this paper are those of the author and not of the institute.

[2] 'Entry of New Banks in the Private Sector - Discussion Paper'; Reserve Bank of India http://rbidocs.rbi.org.in/rdocs/content/PDFs/FIDIS110810.pdf. Accessed on 16 August 2010.

in policy making and is perhaps the first time that the RBI has opened itself up to public comments before framing a policy.[3]

The Indian Banking system has two public sector banks, 22 private sector banks, 86 regional rural banks (RRBs), four local area banks (LABs), 1,721 urban cooperative banks, 31 state cooperative banks and 371 district central cooperative banks. In addition, 31 foreign banks operate in the country. The average population coverage by commercial banks has been improving steadily over the years and stands at 9,400 in urban areas and 15,900 in rural areas.

Until 1993, almost five decades after independence, no new licenses for private banking were issued. There was some old private sector banks, most of them established before independence, which continued to function. But these were mostly small, community managed banks with only regional footprints. Guidelines for licensing of new banks were first issued by the RBI in 1993 and subsequently revised in 2001. Even the latter guidelines for licensing were quite conservative in nature. Large industrial houses were not permitted to promote banks. Individual companies were permitted to own 10 per cent of the equity of the banks, without any controlling interest. There were other conditions as well. The capital requirement was prescribed at Rs 300 crore (S$ 100 million, approximately). Promoters could not contribute more than 40 per cent of the equity and their voting rights were restricted to 10 per cent with the shares to be listed on the stock exchange.

Ten new banks were licensed after the 1993 guidelines and two more after the 2001 revised guidelines. Out of these, four were promoted by financial institutions, one each by the conversion of a cooperative institution and a Non-Banking Financial Institution (NBFC), and the remaining six by individual banking professionals. The two banks licensed after 2001 have been functioning fairly smoothly. Of the earlier lot, the success rate has been quite poor with almost all the individual sponsored banks having to compulsorily merge with nationalised banks due to poor governance and lack of financial strength. The banks promoted by financial institutions have merged with their parent institutions and have rebranded themselves and achieved some growth.

The experience with the small banks has not been encouraging. Only four out of the original six LABs remain. Out of these, only two are functioning satisfactorily. Lack of professional expertise, poor credit management and diversion of funds has affected the performance of the urban cooperative banks as well.

[3] *Financial Express*, editorial, 12 August 2010.

The RBI's experience in opening up the banking sector has been somewhat patchy. It must be said to the credit of the regulator that it has consistently intervened to prevent any shocks in the banking sector. It has also tried to ensure that the weak and poorly managed banks merge with stronger banks and that there is adequate safeguard for consumer deposits. It is interesting that wherever larger entities have taken over these ailing banks, they have been able to turn them around and make the merger successful. In short, capital, professional management, capital adequacy and transparent functioning have been the key to success in the banking sector. All the failures can be attributed to the lack of one or other of these attributes.

Even in respect of foreign banks, the RBI's view has been that these banks have not achieved adequate coverage of rural and semi-urban areas, and have focused more on providing banking solutions to urban population and relatively wealthier sections of the people. The RBI and the government have always felt that the rural areas are not adequately covered by banks.

The new guidelines have to be viewed against this experience. There is an attempt to address some of these concerns in the discussion paper.

For the first time, there is a discussion on whether industrial and business houses can be allowed to promote banks. The argument perhaps stems from the poor experience in allowing individuals to promote banks and the need to enlarge the number of banks that are functioning outside the private sector. The paper draws upon other countries' experiences: corporate houses are not allowed to set up banks in the United States; the European Union, the United Kingdom, Australia and Canada. While there is no regulatory bar on the establishment of banks by industrial houses, there are restrictions on the percentage of voting rights and controlling positions that any shareholder can obtain.

The RBI paper argues that industrial houses in India have demonstrated managerial and technical capabilities, adequate capital and experience. They therefore offer a suitable source of capital and expertise for the establishment and management of new banks. The RBI still appears cautious suggesting a slew of safeguards. It is suggested that the credentials of the promoters should be carefully verified, including through the taxation and criminal investigation agencies. The new entity should be ring fenced from financial and industrial entities of the rest of the group. Industrial houses engaged in real estate activities either directly or indirectly should not be allowed to promote banks and there should be stringent limits on transactions between the banks and other entities in the group. The board should have a majority of independent directors and the chairman should be a part-time chairman. The RBI has asked for legislation to allow it to supersede the board where, in the regulators view, the functioning is not in the interest of the depositors or financial stability.

There is also a suggestion that NBFCs, those engaged in leasing and other forms of financing, could also be allowed to convert into banks subject to the regulatory restrictions of the RBI.

There is also a suggestion that the business model should emphasise financial inclusion by clearly articulating a strategy and business plan to reach the clientele in the tier three to six centres (with population density of less than 50,000), and in the unbanked regions of the country either through branches or through branchless models.

On minimum capital requirements, there are two options in the paper – either to go for a higher number of Rs 1,000 crore, or have an intermediate figure of between Rs 500 to Rs 1,000 crore (S$15-30 million). There are various suggestions for promoters' equity, ranging from a maximum of 40 per cent to be held for a minimum period of five years, down to a limit of 5 per cent shareholding requirement while permitting promoters to take it up to 20 per cent, based on stringent regulatory criteria. A number of alternatives in between are also discussed. On foreign banks, the suggestion is that aggregate non-resident holding including NRI, FDI and FII[4] in these banks could be capped to below 50 per cent and be locked at that level for an initial period of 10 years.

The paper must be commended as it has put out into the public domain a range of issues that need to be considered before opening up the banking sector. Given its past negative experience, the RBI is understandably cautious, prescribing several fairly stringent criteria for selecting potential licensees. At the same time, the paper gives rise to several questions, some of which are examined here.

First and most importantly, the need for new licenses is not adequately argued. Clearly, the RBI paper points out that past experience with private banking, particularly after 1993 has been poor and that it has not been able to improve the performance of cooperative banks and RRBs, both of which should have been appropriate vehicles for ensuring that rural and semi-urban areas are well banked. If the failures are managerial, then it is perhaps just a wish that the new entities would be better managed. If the failures are due to inadequate regulatory supervision, then there is little in the paper in the nature of regulatory introspection and how things can be different in the future. Even in case of foreign banks, the RBI has not been able to ensure the financial inclusion criteria – it is difficult to see how 'business as usual' in the RBI would enable better banking facilities to be available in the less-banked areas. Further, and perhaps for the first time, there is an implicit statement here that public sector banks can do no more and that they cannot do much better than what they are doing, and therefore it is necessary to bring in private banking

[4] NRI, FDI and FII refer to Non-Resident Indian, Foreign Direct Investment and Foreign Institutional Investor respectively.

to serve the rural and semi-urban population. This in itself is a major policy statement, a change from three decades of reliance on the strengths of public banking.

One would have liked a clearer articulation of why this approach is necessary and why it is a better approach than strengthening existing institutions. For example, the so called ‘old’ private banks have been in existence since before 1947, and by and large, have held on to their regional character, while performing quite satisfactorily. There would perhaps be an opportunity to enlarge the capital bases of these banks and also enlarge regulatory support to ensure that these banks grow into serious players in unbanked areas. Their managerial capabilities as well as ability to manage in the smaller towns are by and large proven – yet there is little analysis about their experience. Thus the shadow of doubt that the paper has been prepared with specific corporates in mind that have applied for licenses, could have been dispelled more clearly.

Second, the capital adequacy that has been prescribed appears to be on the lower side. The highest figure in the paper is Rs. 1,000 crore (S$ 30 million), and the highest promoter contribution that is suggested is 40 per cent. Thus a large industrial house can become eligible with a promoter contribution of S$ 12 million, which is surely not an onerous requirement, given the size of some of the industrial houses in India. The RBI had prescribed Rs 300 crore (S$ 8 million) as early as in 1993. Given the increase in incomes and taking into account inflation, the current requirements could have been at least twice as much as proposed. A S$ 30 million capital base is still a very small base for a bank, since given access to Tier II capital and the prescribed capital adequacy ratio, its commercial operations would be only of the order of Rs. 20,000 crore (S$ 650 million), a fairly small figure by the standards of the banking industry. It is not clear why the RBI has been so timid, for it could result in the new licensees becoming under-capitalised with little room to grow. This size is smaller than the book size of several of the ‘old’ private banks, which are already looking for ways to augment capital.

The third issue relates to the regulatory capability of the RBI. The conditions of integrity, transparency, independent directors and public shareholding appear to be very laudable: but the past record of the RBI in preventing misdemeanors in private banks and RRBs has been quite poor. In all the recent cases, where the RBI has intervened to close down or merge banks, there has been public shareholding: the intervention has happened after the sins have been committed, never at a preventive stage. Finally, none of the erring promoters have ever been brought to book or punished; in most cases, they have got away with some of their assets quite intact. Therefore, the conditions prescribed in the discussion paper may well be viewed by applicants against the backdrop of past regulatory oversight by the RBI, and indeed, may not be taken very seriously. There is little in the paper to encourage confidence that the regulatory oversight will be better or more stringent.

Fourth is the issue of existing banks. There are the public sector banks where the government is unlikely to give up majority ownership, and where the government, in spite of an articulated policy, has been unable to bring in economies of scale through mergers and capital enhancement. The old private banks, as pointed out earlier, suffer from poor capital base, which leads to lack of access to deployment of new technology and products. The private sector banks, fewer in number, appear to be doing well. But even here, the regulatory requirements appear to have been compromised. The government has already stated that the majority shareholding of the ownerships of the ICICI bank and the HDFC bank are with foreign investors and that they may be Indian banks that are 'foreign owned'. The discussion paper suggests a maximum of 50 per cent ownership for foreign entities. Equity demands that these rules should apply to existing entities as well, in which case the character of ownership of these banks need to change significantly. The RBI paper does not address these issues.

Finally, it is important that the RBI as regulator and a central banker must be seen to be entirely impartial and transparent.[5] In two cases in the last three years, the reasons for the closing down and merger of private banks were never made public, nor were any accountability fixed. Depositors and shareholders were protected through a merger with a nationalised bank, but the exact extant of the failings of the earlier management were not made public.

This shadow of doubt on the impartiality of the regulator is not entirely without basis. On 9 August 1960, fifty years ago[6], almost to the date that the RBI put out this new paper, it ordered the liquidation of the Palai Central Bank, a small bank in Kerala that had been functioning for several decades. The poor functioning of the bank was well known to the regulators, as evidenced from the prior correspondence with the RBI. Yet the RBI held its hand for several months. At that time Kerala was under a Marxist government, the first democratically elected communist government in India. Mid-term elections were due in early 1960 and the Congress was eager to regain power. The main promoter of the Palai Central Bank was George Thomas Kodakapally, a staunch Congress supporter and member of the legislature. At that time, the banking sector had not been nationalised and the failure of the Palai Bank would certainly have caused the ruin of thousands of depositors. The Congress government – in Delhi held its hand until the Kerala elections were over, fearing that the electorate would turn against them. Mid-term election was held in February 1960. Pattom Thanu Pillai formed his Congress-led government on 22 February 1960 after the landslide victory of the anti-communist coalition. The Palai Central Bank scandal became public in August 1960, with the liquidation of the entity. Nothing happened to Mr Kodakapally, but a large number of small depositors were ruined. At

5 Today, this is perhaps a comment that can be made for several central banks.
6 I am grateful to Professor Robin Jeffrey, Visiting Research Professor, ISAS for bringing this historical fact to my attention.

least in this case, the RBI did not act as an independent regulator. These memories linger, as there is a renewal of the question of the autonomy of the regulator in India, with the Finance Minister assuming arbitration powers to settle differences between regulators.

This is not to say that the RBI effort is without merit.

It is perhaps possible to take advantage of the opportunities offered by the RBI discussion paper to examine the sate of Indian banking in greater depth. There is no doubt at all that financial inclusion requires greater access to credit and deposit linked products to the citizens of smaller towns in India. Given the rising savings rates and the improvement in incomes, the smaller towns are leading the savings and the consumption boom, and it is important that the banking sector penetration improves substantially. Kerala received inward remittances of S$10 billion during 2009, from overseas Kerala workers. Bihar receives close to S$ 3 billion from the Bihari labour working in several states in India, and most of these remittances go to small towns. There is an opportunity to increase the reach of financial products, encourage savings and create capital for the deployment in developing infrastructure. Of all the aspects of the RBI paper, this is perhaps the most important: that the new licensees should unequivocally commit to a strategy of reaching to towns with population below 50,000.

This is also perhaps the single most important feature that the RBI should enforce, while regulating the new entities.

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